"Compliance with the Stability and Growth Pact: An Economic Analysis of Emerging Pressures Relating to Pension Provision "

by

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Abstract

The Treaty of Rome assigns overriding importance to price stability in the firm belief that maintaining stable prices on a sustained basis is a crucial pre-condition for increasing economic welfare and the growth potential of an economy. Price stability is given formal expression in the Stability and Growth Pact, which confines the budgetary freedom of Member States within precisely defined parameters. The European Union takes the view that by helping to create a favourable economic environment, sound monetary policy should secure the broad objectives of the Community laid down in Article 3. One of these objectives is the promotion of social justice and protection. The thesis focuses on an aspect of social protection: the provision of old age security. The realisation that current pension schemes in many Member States will not be fiscally sustainable has forced their governments to start the process of legislative reform. The challenge is to design pension systems that do not place too heavy a burden on members of working age, while still offering an adequate level of benefit to retired members. Pension system reform has often proved a particularly difficult and awkward political undertaking. The thesis argues that Member States with ageing populations will find it increasingly difficult to maintain high standards of social provision and still comply with the obligations of the Pact. It is contended that continuing demographic imbalance will be a constant impediment to the required maintenance of budgetary balance. Countries have implemented changes, such as increases in statutory retirement age, and reductions in replacement rate, so as to avoid further increasing the contribution burden borne by the diminishing proportion of workers. The thesis concludes that public pension design modifications, whether parametric, such as raising the retirement age, or systemic, such as the introduction of a funded component, will only alleviate and not solve the problem. The only answer is an increased number of younger workers, and that requires birth-rates to move towards replacement level.

Introduction

The purpose of this thesis is to explore the difficulties faced by European governments who seek to provide high levels of social protection whilst still maintaining fiscal sustainability in their ageing societies. The investigation focuses on one aspect of social protection: the provision of security in old age, and assesses fiscal sustainability in terms of compliance with the Stability and Growth Pact. Among the various diverse topics explored are declining fertility, increased longevity, migration patterns, welfare provision, rates of labour market participation and economic growth. Interconnections are exposed. In particular, it is discovered that demographic shift will impede the efficient functioning of the European socioeconomic model. In the conviction that future demographic imbalance will be the root cause of fiscal pressures, it concludes that fiscal sustainability looking forward will require the rectification of that imbalance, and that calls for government policy initiatives aimed at increasing European fertility rates.

Article 3 of the Treaty of Lisbon states that the aim of the European Union "is to promote peace, its values, and the well-being of its peoples". [1] The Union is required "to work for the sustainable development of Europe based on balanced economic growth and price stability". The Union should also aim to secure "full employment and social progress", and to "promote social justice and protection". These worthy objectives cannot be achieved unless each Member State "can finance, now and in the

[1]The Treaty of Lisbon amended the Treaty on European Union (TEU; also known as the Treaty of Maastricht) and the Treaty establishing the European Community (also known as the Treaty of Rome). The Rome Treaty was renamed the Treaty on the Functioning of the European Union (TFEU). The TEU and the TFEU have equal legal value and are to read in conjunction. The Treaty of Lisbon was signed in the Portuguese capital on 13 December 2007 by the representatives of the twenty-seven Member States. It entered into force on 1 December 2009, after being ratified by all the Member States.

future, the public expenditure programmes required... in an efficient and sustainable manner, that is, with the least amount of damage to a nation's capacity to create material wealth, now and in the future.[2] Without fiscal sustainability, no economic development strategy can succeed".[3] Fiscal policy decisions remain under the control of the individual Member States. Excessive budgetary deficits and large public debts in one Member State could pose a serious threat to the stability of the whole Union. Co-ordination at European level of national economic policies, based on fiscal discipline and enforced by a system of multilateral surveillance becomes necessary.

The crucial importance of fiscal sustainability is emphasized in Article 126 of the Treaty on the Functioning of the European Union (TFEU). The Article stipulates that "Member States shall avoid excessive government deficits", and confers responsibility on the Commission for monitoring the budgetary situation and level of government debt in the Member States. The Commission's task was thought best accomplished by a rule-based mechanism, designed to avoid the flaws of discretionary national fiscal policy, and which, if applied fully, would avert any form of debt crisis.[4] The Stability and Growth Pact (SGP) was first proposed by Germany, which had long maintained a low-inflation policy. Germany sought to ensure the continuation of that policy through the SGP: budgetary discipline would limit the ability of governments to exert inflationary pressures on the European economy. The SGP, introduced in 1998, consists of two regulations that provide detailed guidance on its implementation. First, the preventive arm of the Pact deals with maintaining a sound fiscal policy. Compliance is

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[2] Buiter, W. H. (2003) *Fiscal Sustainability,* p.1. Paper presented at the Egyptian Center for Economic Studies in Cairo. 19 October.
http://www.nber.org/~wbuiter/egypt.pdf. Accessed 10.11.10.

[3] ibid. p.24

[4] Larch, M., P. van den Noord, and L. Jonung (2010) *The Stability and Growth Pact: Lessons from the Great Recession*, p.5. European Economy. Economic Papers, 429. December. Brussels.

to be determined on the basis of two criteria: first, whether the ratio of the budgetary deficit to gross domestic product (GDP) exceeds a reference value; second, whether the ratio of government debt to GDP exceeds a reference value. The reference values are specified in the Stability and Growth Pact (SGP). Article 126 offers a degree of flexibility, where there are exceptional circumstances, and where deficit and debt levels are declining and are likely to approach the required level within a reasonable time.

The SGP defines sustainable debt levels as 60 per cent of GDP. The corresponding budget deficit consistent with this target debt ratio is set at 3 per cent. In a steady state relationship between deficit and debt ratios a 3 per cent deficit will ensure that the 60 per cent debt ratio can be keep constant, provided nominal growth of GDP is 5 per cent. While this assumption is not unreasonable in normal circumstances, the chosen parameters are arbitrary. Nonetheless, the selection of numerical targets allows the rules of the SGP to be simple and transparent. Compliance with the SGP calls for Member States to set realistic and appropriate policies which are clearly defined and against which performance can be judged.

Second, the dissuasive arm of the Pact is charged with ensuring that countries respect these debt and deficit ratios. Article 104 of the Treaty, or the Excessive Deficit Procedure (EDP), describes the procedures to be adopted when Member States breach the reference limits. Member States not in compliance are subject to increasingly stringent surveillance under the EDP, which can culminate in the imposition of financial penalties. If an excessive deficit is deemed to exist, these countries are obliged to undertake corrective policies within a defined timeframe (Article 104.7). After the allotted time, if the ECOFIN Council considers that the Member State is not implementing corrective measures, or that they are inadequate, or that data indicate that the excessive deficit will not be corrected within the time limit, the next step of the procedure is applied: enhanced fiscal surveillance under Article 104.9.[5] A second recommendation will be issued, and ECOFIN may request the Member State to submit regular reports to monitor adjustment efforts. If the country is not in compliance with the second recommendation, then it could face sanctions (Article 104.11). The Treaty prescribes a range of options for sanctions: requiring the Member State to publish additional information before issuing bonds; inviting the European Investment Bank to reconsider its lending policy; requiring the Member State to make a non-interest bearing deposit; and imposing fines.[6]

Yet despite clearly defined enforcement procedures, the Council of Ministers failed to apply sanctions against France and Germany for breaches of the Pact. Punitive proceedings were started against Portugal (2002) and Greece (2005), though fines were never applied. Indeed, it is questionable whether the imposition of a fine on an already over-indebted country is ever likely to be a feasible policy option. Since Member States retain their fiscal sovereignty, in practice the Pact relies on the good faith of each Member State. There is an assumption that each will act in accordance with the "pacta sunt servanda" principle of international law, and at all times display a sense of fiscal responsibility.

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[5] The Economic and Financial Affairs Council is, together with the Agriculture Council and the General Affairs Council, one of the oldest configurations of the Council. It is commonly known as the Ecofin Council, or simply "Ecofin" and is composed of the Economics and Finance Ministers of the Member States, as well as Budget Ministers when budgetary issues are discussed. It meets once a month.

[6] Annett, A. (2005) *Enforcement and the Stability and Growth Pact: How Fiscal Policy Did and Didn't Change under Europe's Fiscal Framework*, pp.8-9. Paper prepared for Conference on "New Perspectives on Fiscal Sustainability", Frankfurt, October 13-13, 2005. International Monetary Fund.

The President of the European Central Bank draws attention to the wide application of the Pact:

> "Let us not forget that the Stability and Growth Pact applies to the 27: the only difference with the euro area is that in the euro area there are sanctions that can be decided upon by the peers, the members of the euro area, but the principles, the rules of the Stability and Growth Pact are valid for the 27." [7]

Under the provisions of the Pact euro-area Member States are to prepare annual stability programmes and other EU Member States are to prepare convergence programmes for submission to the Commission and the Council each year. The aim is to ensure more rigorous budgetary discipline through surveillance and coordination of budgetary policies within the euro area and EU. This is in accordance with Article 121 TFEU (ex Article 99 TEC): "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council". Although Sweden and the United Kingdom, two of the Member States whose pension reforms are later described, have not adopted the Euro, they remain subject to these Treaty requirements. *A fortiori,* the deficit and debt ratios are set out in Protocol (No 12) on the Excessive Deficit Procedure, and Protocols form an integral part of the Treaty (Article 51(TEU)).

The Commission clarifies the position of the United Kingdom. Under Article 5 of the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, the obligation under Article 104(1) of the Treaty to avoid excessive general government deficits does not apply to the United Kingdom unless it moves to the third stage of EMU. Instead, as long as it is in the second stage of EMU, the UK is

[7] European Union (2010a) Committee on Economic and Monetary Affairs. Monetary dialogue with Jean-Claude Trichet, President of the ECB (pursuant to Article 284(3) TFEU), p.8. Brussels, Monday, 22 March 2010.

still committed under Article 116(4) of the Treaty to "*endeavour* to avoid excessive deficits".[8]

According to Article 104(2), the Commission has to monitor compliance with budgetary discipline on the basis of the Pact's deficit and debt criteria. Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. According to the EDP data notified by the UK authorities in March 2008 the general government deficit in the United Kingdom was planned to reach 3.2% of GDP in 2008/09. The Commission considered that the figure for the 2008/09 deficit in the notification provided prima facie evidence of a planned excessive deficit in the United Kingdom in the sense of the Treaty and the Stability and Growth Pact. The planned deficit was close to the 3% of GDP reference value but the planned excess over the reference value was neither exceptional nor temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggested that the deficit criterion in the Treaty was not fulfilled. The Commission decided to initiate the excessive deficit procedure for the United Kingdom.[9]

The deadline for compliance by the United Kingdom has been extended to the 2014/15 fiscal year, which would represent an average annual structural budgetary adjustment of 1¾ percentage points of GDP between 2010/11 and 2014/15 . The UK authorities have confirmed the planned reversal in 2010/11 of several fiscal stimulus measures. The 2009 budget also included plans for more ambitious fiscal consolidation from 2011/12 onwards driven by tighter spending plans. The Commission considered that all this is

[8] European Union (2008a) Report from the Commission. United Kingdom. Report prepared in accordance with Article 104(3) of the Treaty. SEC(2008) 2014.Brussels, 11.06.2008.
http://ec.europa.eu/economy_finance/sgp/pdf/30_edps/104-03/2008-06-11_uk_104-3_en.pdf. Accessed 22.09.11.

[9] ibid.

needed in view of the expected increase in the public debt to almost 90% of GDP by the end of 2011/12, from 52% in 2008.[10]

At Lisbon a series of declarations concerning the provisions of the Treaty were annexed. While not legally binding, these declarations are important as statements of the intentions of the drafters. Declaration No.30 on Article 126 (TFEU) shows the strength of commitment to the SGP. The Declaration confirms that raising growth potential and securing sound budgetary positions are the two pillars of the economic and fiscal policy of the Union and the Member States. The SGP should be regarded as an important tool to achieve these goals, serving as the framework for the coordination of budgetary policies in the Member States. Moreover, a rule-based system is the best guarantee for commitments to be enforced. It is further asserted that the Union's aims of achieving balanced economic growth and price stability should be reflected in the orientations of budgetary decisions at the national and Union level. The Declaration considers that the present economic downturn underlines the importance of sound budgetary policy throughout the economic cycle. Member States should aim to gradually achieve a budgetary surplus in good times which would create the necessary room to accommodate economic downturns.

Even before the present economic downturn both the debt and deficit levels set by the Pact have been breached by numerous Member States. France and Germany, who were the biggest promoters of the Pact when it was created, have run excessive deficits under the Pact definition for some years. In March 2005, the

[10] European Union (2009a) Press Release: Excessive Deficit Procedure steps: the Stability and Growth Pact as the anchor for fiscal exit strategies IP/09/1694.Brussels, 11 November. http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1694. Accessed 22.09.11.

EU Council, under pressure from France and Germany, relaxed the rules.[11] The ceilings of 3 per cent for budget deficit and 60 per cent for public debt were maintained, but before deciding to declare a country in excessive deficit certain factors must be now be taken into account: the behaviour of the cyclically adjusted budget, the level of debt, the duration of the slow growth period and the possibility that the deficit is related to productivity-enhancing procedures.[12] In 2009 twenty of EU-27's Member States were in breach of the 3 per cent deficit ceiling.[13] On 22 April, 2010 Eurostat noted that government debt to GDP ratio in the eurozone increased from 69.4 per cent at the end of 2008 to 78.7 per cent at the end of 2009, and in the EU from 61.6 to 73.6 per cent.[14]

Should these breaches of the Pact be seen largely as temporary lapses, the consequence of fiscal pressures suffered by governments during the present economic downturn? The past budgetary performance of France and Germany implies that there is a fundamental impediment to compliance and that the downturn has merely exacerbated pre-existing budgetary imbalances. The difficulty of compliance with the Pact arises from the demographic shift in the peoples of Europe. As the EU has acknowledged,

[11] On 20 March 2005 the European Council adopted a report from the (ECOFIN) Council entitled "Improving the implementation of the Stability and Growth Pact". The report was endorsed by the European Council in its conclusions of 22 March 2005. Presidency conclusions of the Brussels European Council (22 and 23 March 2005). 7619/1/05 REV 1, Brussels, 23.03.05.

[12] On 27 June 2005 the Pact was completed by two additional Regulations: COUNCIL REGULATION (EC) No 1055/2005 of 2 June 2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; COUNCIL REGULATION (EC) No 1056/2005 of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

[13] Moussis, N. (2009) *Budgetary discipline and the single currency*. Europedia. http://europedia.moussis.eu. Accessed 22.09.10.

[14] Eurostat (2010a) News release: Euro indicators: Provision of deficit and debt data for 2009 - first notification 55/2010 - 22 April 2010. http://epp.eurostat.ec.europa.eu. Accessed 23.06.10.

"demographic change is transforming the EU."[15] Many Member States experience some of the lowest fertility rates in the world; other Member States enjoy the highest life expectancies. The ageing process increases the ratio of pensioners to those of working age. There is increasing recognition that ageing populations will have profound economic, budgetary and social consequences. The European Commission considers that "the rise in the old age dependency ratio will be the dominant factor contributing to increases in public spending in the coming decades".[16] The SGP requires Member States to continue running balanced budgets without resort to excessive borrowing.[17] As ageing populations make demands on governments to allocate a growing share of public spending to transfer programmes benefiting the elderly, compliance will necessitate constant monitoring and modification of public pension schemes in order to maintain the requisite budgetary balance.

Member States will find that compliance with the Pact is further complicated by the variety of aims expressed in Article 3. While each one of these aims may be individually desirable, in the multiplicity of aspirations lurks the potential for conflict. Reconciliation of different objectives will present governments with a task that is not easy to manage. In particular, the decision to make price stability a defining characteristic of the European economic model, while simultaneously promoting social protection could be problematic, and made more so by the aim to promote the well-being of its peoples implying that the provision of social protection should be to a high

[15] European Union (2009a*) The 2009 Ageing Report: Economic and budgetary projections for the EU-27Member States (2008-2060)*. Joint Report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee, p.19.
http://europa.eu/epc/pdf/2009_ageing_report.pdf. Accessed 05.09.09.
[16] European Union (2006a) *European Economy: the impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long term care, education and unemployment transfers (2004-2050)*. Special Report n° 1/2006*,* p.13. Directorate-General for Economic and Financial Affairs.
http://europa.eu.int/comm/economy_finance/epc/epc_publications_en.htm. Accessed 09.10.10.
[17] Declaration 30 on Article 126 of the Treaty on the Functioning of the European Union.

standard. Recent events in Greece have shown that a government required to restore fiscal sustainability may need to reduce the level of social protection offered to its people. The unfilled expectations of those with a powerful sense of entitlement to welfare provision can lead to political turmoil.

The thesis investigates the relationship of price stability, demographic change and welfare provision. It seeks to show how each is closely related to the others, and that together they form interdependent elements of an economic order. The theme of this study is to reveal the interconnections of these elements, and to show that an imbalance in one element, namely, the age structure of a society, will adversely impact on the overall functioning of the system. Since all Member States are experiencing similar demographic developments, the study attempts to discover what common factors exist in the individual pension reform strategies, and to ask whether there are any general lessons to be learnt. Implicit in this study is a consideration of the future nature of the European social model.

Chapter one discusses the interplay of ideas and events that led to the maintenance of price stability being established as the foundation stone of European monetary policy. The economic theories of four major economists of the 20th century – Keynes, Mises, Hayek and Friedman – are examined to illustrate how in changing economic circumstances different panaceas for prosperity found favour with policymakers. In the 1930's depression Keynes argued that unregulated capitalism was incompatible with full employment and economic stability. After World War II the Keynesian welfare state offered a degree of success in generating prosperity, employment and social provision. Governments when confronted with the oil price shocks of the 1970s found

Keynesian techniques of demand management ineffective. The problems had become those of supply. The theories of Mises and Hayek, the advocates of the free market, appeared more relevant.[18] Both rejected central planning, and accorded the price mechanism a central role as market regulator. The 1970s also brought stagflation – simultaneous sharply rising prices and unemployment. Milton Friedman insisted that inflation was a monetary phenomenon. Low and steady rates of growth of the money stock should result in stable economic growth without inflation. Though it proved difficult to define money stock, Friedman's enduring insight is that monetary policy does matter. The legal implementation of price stability into the Treaty is considered, as are the penalties that can be imposed on Member States for fiscal laxity. By helping to create a favourable economic environment, sound monetary policy secures the broad objectives of the Community laid down in Article 3.

Chapter two focuses on one of these objectives – the promotion of social justice and protection. An account is offered of the two contrasting systems of welfare provision devised by Bismarck and Beveridge, the main designers of the modern welfare state. Whereas the Bismarckian system provides benefits closely linked to occupation and income, the Beveridgean system ensures all individuals are entitled to a basic level of income at a flat rate independent of income. "Since no country follows either of the two systems in its pure form, a clear system allocation is not always possible."[19] The choice of combination is essentially political. Among the Member States a variety of methods of welfare delivery have evolved. Esping-Anderson provides a typology to explain

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[18] Mises, L. von (1949) *Human Action: A Treatise on Economics.*4th revised edition (1996). Hayek, F.A. (1960) *The Constitution of Liberty.*
[19] Munich Society for the Promotion of Economic Research - CESifo (2008) *Bismarck versus Beveridge: A Comparison of Social Insurance Systems in Europe,* DICE Report 4/2008. Database, p.70. http://www.cesifo-group.de Accessed 23.09.10.

these differences in welfare state development.[20] In his classification welfare state regimes fall into three distinct clusters: the Social Democratic, the Conservative-Corporatist, and the Liberal. In order to explore this diversity, the welfare arrangements of three Member States are examined, each seen as typifying a particular welfare regime: first, Sweden as representing the Social Democratic; then Germany as a Conservative-Corporative regime; and finally, and possibly more controversially, the United Kingdom is presented as a Liberal regime. Each country faces the onslaught of globalisation, limiting national policy options. The Chapter aims to show the ways in which these countries are adapting their systems of welfare provision in a rapidly changing socio-economic environment. In all Member States the financing and operation of extensive welfare schemes is a major component of the budget. Since the required funding must not compromise the macroeconomic stability of the individual state, the increasing cost of provision caused by the rapid ageing of European populations may well pose the most serious threat to the long-term sustainability of these welfare systems.

Chapter three opens with an overview of world demographic developments, and considers their impact on the European Union. The chapter then investigates whether migration from third countries can counteract the ageing process occurring in European societies. A recent estimation of the net migration necessary to keep the ratio of working-age population-to-total population constant at the 2008 level over the period 2008 to 2020 indicates that EU 27 would require immigration inflows of nearly 44 million.[21] Finding that inwards migration cannot solve, but only alleviate the

[20] Esping -Andersen, G. (1990) *The Three Worlds of Welfare Capitalism,* p.29.
[21] European Union (2009a*) The 2009 Ageing Report***:** *Economic and budgetary projections.* op.cit. p.46.

demographic deficit, the current policy of the European Union towards future migration is explained.

The timing and scale of the budgetary changes that could result from an ageing population are considered. The Economic Policy Committee established the Working Group on Ageing Populations (AWG) with the mandate to produce age-related expenditure projections that assess the sustainability of public finances over the long term. The 2006 AWG Report offers a degree of relief to governments by taking the view that changes in factors such as the employment rate, the eligibility rate and the relative benefit level, will partly offset demographic pressures.[22] The realisation that current pension schemes in many cases will not be fiscally sustainable has forced governments to start the process of legislative reform.

Chapter four examines the difficulties of public pension design faced by governments that need to reform their systems of old age provision. With rising longevity, six decades may pass between an individual member's first contribution to a scheme and the receipt of the final benefit payment. It becomes the task of government to design pension systems that do not place too heavy a burden on members of working age, while still offering an adequate level of benefit to retired members. As population ageing occurs gradually, countries have time to rectify their systems.

The chapter first examines the nature and purpose of pensions, with reference to the classic analysis of Samuelson. Pay As You Go schemes form the basis of old age

[22] European Union (2006a) *European Economy: the impact of ageing on public expenditure*. op.cit.p.10.

provision in Europe.[23] The increasing numbers of the elderly have made the schemes increasingly expensive to operate, forcing governments to reduce the scale of their pension commitments. While numerous parametric modifications to schemes are possible, each change has particular consequences, limiting the range of reform options available to policymakers.

Since societal ageing is a global phenomenon, countries share common concerns, and their policy makers wish to be informed of different pension reform measures being implemented, wherever they occur. In response to these demands the World Bank disseminates a constant stream of information on pension reforms in all parts of the world. The OECD monitors and evaluates the pension schemes of its 34 constituent members, alerting countries to future difficulties and increasing general awareness of reform strategies.

As Thomas Jefferson memorably wrote:

> "That ideas should freely spread from one to another over the globe, for the moral and mutual instruction of man, and improvement of his condition, seems to have been peculiarly and benevolently designed by nature." [24]

The global interchange of information regarding pension reforms and ideas gives policy makers the opportunity to consider whether there are any features of another country's pension reform that are of relevance to their country's problems, and, should this be the case, then decide how such reform strategies could be adapted to meet their country's particular needs.

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[23] Samuelson, P. A. (1958) An Exact Consumption-Loan Model Of Interest With Or Without The Social Contrivance Of Money. *Journal of Political Economy,* 66(6), pp.467-482.
[24] Jefferson, Thomas (1813) Letter to Isaac McPherson, 13 August. The Founders' Constitution, Volume 3, Article 1, Section 8, Clause 8, Document 12. http://press-pubs.uchicago.edu/founders/documents/a1_8_8s12.html.The University of Chicago Press Online. Quoted by Jean-Claude Trichet, President of the ECB at the Jackson Hole Economic Symposium Panel: Setting priorities for long-term growth Jackson Hole, U.S.A., 27 August 2011.

The proposed reform of the United Kingdom public pension scheme (discussed in Chapter 5) provides an excellent example of the benefits of learning from other countries' experiences. The Pensions Commission was impressed by the insights of US behavioural economists into ways of encouraging employee participation in US company savings schemes, and recommended that the device of automatic enrolment be employed in the British scheme. The Commission also gave careful attention to the nature and operation of the funded component of the Swedish scheme, which in turn had been influenced by the success of Chilean pension privatisation. An examination of relevant events in Chile and Sweden would seem appropriate.

Accordingly, the chapter offers short accounts of the Chilean and Swedish pension reforms. The Chilean privatisation of the public pension system and the Swedish introduction of a notional defined contribution scheme were radical innovations that attracted international interest. A comparative evaluation is made of the relative merits and drawbacks of the Chilean and Swedish reforms in order to show the lessons that these two systemic reforms offer to policy makers in other countries, whose governments seek to reduce the financial burden of pensions caused by population ageing.

The main features of a well-designed public pension system are now known, as are the hazards to avoid. Knowing the correct formulae does not make reform any easier to implement. Public pension provision enjoys wide support. Governments tend to proceed cautiously, realising that legislative reform might lead to electoral defeat. The political vision can be myopic, since the costs of reform often fall in the short term, whereas the benefits to society as a whole may only be evident many years after the life of the administration responsible for the reform. Governments often employ two strategies in order to prevent electoral retribution. First, they attempt to evade full responsibility for any retrenchment in pension generosity by gaining the support of other political parties and organized labour for pension policy changes. Second, reforms are typically modest for current retirees and those approaching retirement, but often substantial for future generations as reforms are gradually phased in. Examples of both strategies are shown in the two case studies presented in the following chapter.

Chapter five offers a discussion and critical evaluation of the public pension systems of Germany and the United Kingdom. In each country from the 1990s onwards the long term sustainability of the pension system in the face of demographic change has been high on the policy agenda. Pension system reform has often proved a particularly difficult and awkward political undertaking. The following case studies also reveal that the process of pension reform is often protracted. The two countries have similar demographics, but different systems of pension provision, and different problems. Germany has been forced to accept that its previous level of provision was over generous and could not continue. In contrast, the United Kingdom maintains a public pension system that is fiscally balanced. Its government now admits this desirable situation is only possible by offering increasingly inadequate pensions for many people. Despite the differences that exist between these countries, since the reform options available to policymakers are limited, the solutions arrived at are very similar. Examples are found of the tightening of eligibility criteria for a full state pension, the raising of the minimum retirement age and the introduction of a funded component. In each country reform measures indicate that the need for cost containment will result in state provision of old age support being offered at a less generous level in the future.

Chapter six concludes with observations and questions that arise from the preceding study:

i. It is of crucial importance to maintain public confidence in long-term sustainability of a State-operated pension scheme. Will Member States succeed in preserving widespread electoral support for their systems of old age provision?
ii. Many countries have introduced a funded component into their existing pension systems, hoping that funded provision will lessen budgetary pressures caused by demographic shift. Can funded schemes help countries avoid the adverse consequences of demographic shift?
iii. What will be the impact of the present economic downturn on pension provision, both public and private?
iv. The European Union has at last acknowledged that low fertility rates are a matter of public concern. The fear is that one of the other aims of Article 3, "solidarity between generations", could be jeopardised if the burden of ageing has to be carried by a younger population decreasing in numbers and economic strength.

In relation to the third question, it must be admitted that the present exceptional uncertainty over medium-term economic prospects prevents a straightforward response. In terms of overall budgetary impact, and the sustainability of all types of old age provision in particular, the answer lies in whether the shock is temporary or permanent. The Commission puts forward a "rebound" scenario, where recovery is assumed to have materialized completely by 2020. At worse there may be a "lost decade".[25] In contrast, a permanent shock would have a strong negative impact on future GDP, per capita income levels and budgetary conditions. In such adverse economic conditions current levels of both public and private pension provision would difficult to maintain. The Commission considers it imperative to put in place all necessary policies to avoid the current financial crisis turning into a permanent shock. "Europe's ability to get out of the slump fast and restore sound public finances will depend crucially on its ability to deploy targeted and well co-ordinated policy responses, as stressed by the European Economic Recovery Plan." [26] And "The Recovery Plan reiterates the importance of staying within the Stability and Growth Pact, which is part of the solution, not part of the problem."[27]

Summary of the Argument

The thesis aims to explore the conflict between the needs of economic efficiency and the desire for social protection. It contends that the ageing of society will exacerbate tensions. It seeks to support its contention by focusing on a major component of social protection: public pension provision. The purpose of the thesis is to discover whether there is a means of resolving the conflict over the longer term.

The argument is advanced as follows:

First, the European Union is an open market economy, in which price acts as the market regulator. Price stability is fundamental to the efficient operation of the economy. The wealth-creating capacity of the economy determines the level of resources available to

[25] European Union (2009a*) The 2009 Ageing Report: Economic and budgetary projections* op.cit.p.31.
[26] ibid.p.32.
[27] European Union (2008a) Press Release: FAQs on the European Economic Recovery Plan. Memo/08/735. Brussels, 26 November.
http://europa.eu/rapid/pressReleasesAction.Accessed 16.11.09.

governments, who seek to offer social protection to their peoples. It becomes essential that governments exercise firm control of their expenditure lest they damage their country's capacity to create wealth. The avoidance of excessive budgetary deficits and large public debts is crucial to the continuance of high levels of social protection over the longer term.

Second, welfare provision in Europe is not monolithic in type. The forms of welfare delivery are varied, each with particular strengths and weaknesses, but all aiming to provide high levels of social protection.

Third, demographic shift in Europe challenges economic growth and social provision. With increased longevity the number of pensioners grows, while the fall in birth rates reduces the number of workers. When fewer workers are required to support more pensioners, stress on all systems of old age provision is inevitable.

Four, faced with the costs of pension provision escalating, governments who attempt to contain that expenditure will find reform options are limited.

Five, two major economies are chosen to demonstrate the difficulties of public pension reform. Aware that public pension schemes enjoy wide support among their electorates, often only fiscal necessity causes governments to adopt reform strategies. The process of reform can be prolonged as governments try to avoid electoral retribution.

Six, maintaining the proposition that demographic imbalance will be a major cause of fiscal pressures, the remedy must lie in the correction of that imbalance. It falls to governments to safeguard their fiscal sustainability over the longer term by implementing policies aimed at increasing birth rates in Europe.

Methodology

The research project does not set out to discover new economic facts but to draw together existing facts and relevant analysis from a wide variety of sources. The intention is to analyse the implications of the totality of collected information for the topic selected. It becomes imperative that the sources of information are reliable.

The methodological approach adopted in the thesis is to rely on primary sources wherever possible. Since the subject matter concerns issues of public pension policy in the European Union, the main authoritative sources in this area are reports issued by the European Commission and the national governments of the Member States. On issues of demographic change the authoritative sources are the U.S. Census Bureau with its global remit, the United Nations, Eurostat, and the U.K. Office for National Statistics. Reference is also made to relevant published reports of international bodies, such as the Organisation for Economic Cooperation and Development, the World Bank, and the International Monetary Fund. The thesis makes extensive use of the writings of academic commentators, with preference accorded to those who can be regarded as policy-makers by their acting in an advisory capacity in the government decision-making process. In order that the thesis presented is fully informed of the latest developments in pension policy, press reports, in particular from the Economist and the Financial Times, are utilised, as are reliable web-based resources, such as the BBC and Bloomberg.

Chapter One

This introductory chapter is based on the work of Keynes, Mises, Hayek and Friedman. It makes extensive use of references to and quotations from their selected works. The chapter then explains the implementation of the aim of price stability into European Law by reference to the relevant Treaty provisions and statements issued by the European Central Bank for the purpose of clarifying its stance on monetary policy.

Chapter Two

The typology devised by Esping-Anderson in "*The Three Worlds of Welfare Capitalism*" is employed to explain differences in welfare state development. The writings of leading academics and government publications in Sweden, Germany and the United Kingdom are utilised. There is reference to press reports and web-based resources to ensure the information presented is up to date.

Chapter Three

The overview of world demographic developments relies mainly on "*Global Population Profile: 2002",* issued by the U.S. Census Bureau. Additional information is provided by a United Nations report, "*Report of the Expert Group Meeting on Completing the Fertility Transition*". The demographic impact of the HIV/AIDS epidemic is assessed using the facilities of Avert, a web-based source. The discussion of the changing demographics of the European Union relies largely on the European Union publication, "*The 2009 Ageing Report",* with additional input from a World Bank paper by R. Muenz, "*Aging and Demographic Change in European Societies".* Further data is provided by the U.K. Office for National Statistics. The investigation of the role of international migration in countering population decline uses data provided by a United

Nations report, "*Replacement Migration: Is It a Solution to Declining and Ageing Population?"* European Union policy on immigration and integration is explained by reference to two Commission reports: "*The Third Annual Report on Migration and Integration* (2007) and *"A Common Agenda for Integration- Framework for the Integration of Third Country Nationals in the European Union".*

With regard to the wide variety of EU policy responses to population ageing, an examination is conducted into a series of communications from the Commission, Council Decisions and Directives. In particular, the discussion of employment policy is based largely on the annual report "*Employment in Europe".*

<u>Entrepreneurship in an Ageing Society</u> relies largely on *Executive Reports* issued by the Global Entrepreneurial Monitor. <u>Towards a Sustainable Society:</u> the main source of information is the United Nations report, "*World Population in 2300",* with additional input from Population Council working papers by J. Bongaarts and J. Demeny. <u>Intergenerational Equity</u> refers to the IMF report, *"World Economic Outlook: The Global Demographic Transition*". Further insight is provided by Sinn and Uebelmesser in "*When Will the Germans Get Trapped in Their Pension System?"*

Chapter Four

Theoretical analysis is founded on the overlapping generations model as expounded by Paul Samuelson in *"An Exact Consumption-Loan Model Of Interest With Or Without The Social Contrivance Of Money".* The diverse types of public pension provision are explained by reference to Nicholas Barr's *The Economics of the Welfare State* and two reports from the OECD: *Ageing and Pension System Reform; Implications for Financial*

Markets and Economic Policies and *Old Age Income Support in the 21st Century -An International Perspective on Pension Systems and Reform.* The investigation of reform options relies heavily on R.Disney, *"Crises in Public Pension Programmes in OECD; What are the Reform Options?"* Further information is provided by the OECD in "*Pensions at a Glance 2011"* and a report from the Bank of International Settlements, *"The Macroeconomic and Financial Implication of Ageing Population".* Extra insight is given by Esping-Andersen in a paper on his personal website.

The discussion of the various government responses to the need for pension system reform is informed by a paper based on a World Bank core course on pensions: D.A. Robalino, *"Reform Option 1: Parametric Changes. Implementation issues with parametric reforms*".

The case study of Chilean pension system reform draws mainly from papers made available by Estelle James on her website. Current information is provided by A. Iglesias-Palau: "*Pension reform in Chile revisited: What has been learned?*

The case study of Swedish pension system reform relies on an account of NDC schemes by Edward Palmer: *'Conversion to NDCs – Issues and Models'*, in *Pension Reform: Issues and Prospects for Non-Financial Defined Contribution* (*NDC) Schemes*. Two articles by A. Sunden: "*The Swedish Experience with Pension Reform"* and *"The Future of Retirement in Sweden"* offer additional information. Data is also provided by the Swedish Government report: *"The Swedish National Strategy Report on Adequate and Sustainable Pensions".*

The final section - a comparative evaluation- is compiled in the main from web-based resources.

Chapter Five

Germany

This relies heavily on A.H Börsch-Supan and C.B. Wilke: "*The German Public Pension System; How it Was, How it Will Be*". Additional information comes from econometric analysis presented by C.B. Wilke in "*Rates of Return of the German PAYG System – How they can be measured and how they will develop*".

The critical appraisal of the future direction of pension policy in Germany refers to W. Schmähl, "*Dismantling an Earnings-Related Social Pension Scheme: Germany's New Pension Policies*".

United Kingdom

The account is based on the reports of the Pensions Commission. Reliance is also placed on two reports from the Department for Work and Pensions: "*Personal Accounts: a new way to save",* and *"Security in retirement: towards a new pensions system".* The short section on behavioural economics relies on the findings of leading US economists working in this area. The final section on recent developments is largely based on information from dirct.gov.uk and the NEST Trust. Reference is also made to two reports from the Department for Work and Pensions: "*Making automatic enrolment work – a review for the Department for Work and Pensions"* and "*A state pension for the 21st century"*.

Chapter Six

Concluding Observations

Maintaining Public Confidence

Reference is made to the Department for Work and Pensions report, "*A state pension for the 21st century*", and to A.Börsch-Supan, "*Rational Pension Reform*".

Funding

The Federal Reserve Bank of Kansas City hosts an annual economic policy symposium at Jackson Hole. The subject of the 2004 meeting was "Global Demographic Change: Economic Impacts and Policy Challenges". This discussion on funding makes extensive reference to papers presented at that meeting.

The Economic Downturn

This uses mainly press reports and web-based sources to ensure that the account is up to date.

The Only Long-Term Solution

This final section relies largely on the European Union Green Paper *'Confronting Demographic Change; a new solidarity between the generations'* and the report, *"The demographic future of Europe – from challenge to opportunity"*. Additional data is provided by the Flash Eurobarometer: "*Intergenerational solidarity*".

CHAPTER ONE: THE PHILOSOPHICAL FOUNDATIONS OF THE POST – WAR OPEN MARKET IN EUROPE

This chapter outlines and evaluates the theories of four significant economists of the 20th century – Keynes, Mises, Hayek and Friedman – in order to show their role in shaping the present European economic order. It considers how in a changing economic environment their different panaceas for prosperity found favour with policymakers. The chapter has three primary objectives:

First, it puts forward theoretical reasons why an open market economy is seen as more efficient at wealth generation than a centrally-directed one.

Second, it demonstrates the interplay of ideas and events that led to the maintenance of price stability being established as the foundation stone of European monetary policy.

Third, it explains the European legal framework designed to facilitate optimal economic output, and so allow member states to continue providing high levels of social protection to their peoples.

The chapter is arranged as follows:

First, it examines the demand management theories of Keynes, who argued that unregulated capitalism was incompatible with full employment and economic stability, and called for governments to run deliberate deficits in times of recession to increase effective demand. It considers the relative success of the Keynesian welfare settlement prevailing in the post-war period.

Second, it notes that steep oil price increases halted economic growth in the first half of the 1970s. It reveals that, when confronted with rising inflation and unemployment, governments found Keynesian techniques of demand management ineffective. Free market policies appeared to be a solution. It examines the theories of Mises and Hayek, both of whom rejected central planning, and accorded the price mechanism a central role as market regulator.

Third, it examines the theories of Milton Friedman, whose dominant concern was monetary policy. There it discovers an insistence that inflation was a monetary phenomenon; a conviction that control of the money stock should result in stable economic growth without inflation. While, for reasons explained in the short account, money stock proved difficult to define, it contends that Friedman's enduring insight was that monetary policy does matter.

Four, it recognizes that the advocates of the free market have succeeded in their overall objective: the European Union has embraced the principle of a free market economy, in which monetary stability has a crucial role. It describes the European System of Central Banks established to maintain price stability. It discusses the European Central Bank's definition of price stability. It explains the role of the Stability and Growth Pact in seeking to ensure sound government finances throughout the Member States. It examines the Pact's definition of fiscal sustainability. It then gives details of other provisions in the Treaty that apply to the monetary and fiscal policies of the United Kingdom, and explains the responsibilities of the Bank of England in relation to monetary policy.

1.1. The Age of Keynes

By the middle of the 1930s most countries were engulfed in depression. Severe declines in economic activity occurred throughout Europe. Wholesale prices and share values fell by about 50 per cent, while the value of European trade declined from $58bn in

1928 to $20.8bn in 1935. Socially perhaps, the worst aspect of the depression was the high level of unemployment. In Germany unemployment reached 6m by the end of 1932. Britain's worst figure was just over 3m.[1]

Since orthodox economic analysis at the time seemed incapable of explaining these problems, a challenging onslaught against received economic wisdom found a receptive audience. The "Keynesian revolution" brought a new political and economic order in many Western countries.

1.1.1. John Maynard Keynes (1883-1946)

Some of the greatest advances in economic thinking in the 20th century have been associated with the name and work of John Maynard Keynes. Keynes regarded government response in the 1930s to mass unemployment and its attendant social problems as unsatisfactory. His most notable work, *The General Theory of Employment, Interest and Money* offered an analysis of the economic problems of the time and proposed radical solutions.

The General Theory focussed on one central issue: the determination of levels of national income and employment in industrial economies and the cause of economic fluctuations. Keynes considered that a "laissez-faire" attitude to the increasingly complex problems of industrialised societies was unsatisfactory. He believed that the essential features of capitalism could be preserved if reforms were made. An unregulated capitalism was incompatible with the maintenance of full employment and economic stability.[2] Accepting the immediacy of the employment problem of the 1930s, Keynes did not discuss the factors that determine the level of employment over a

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[1] Aldcroft, D. H. (2001) *The European Economy 1914-2000*, p.63.
[2] Keynes, J. M. (1936) *The General Theory of Employment, Interest and Money*, pp.380-381. Collected Writings of John Maynard Keynes.Vol. VII (1973).

long term of twenty or fifty years. His theory was in essence short term, and sought to provide answers to unemployment in a brief period of time – about one or two years. Full employment, he insisted, was not the normal state of affairs. There was no self-adjusting mechanism that could be relied upon to maintain full employment. Rather, the level of employment was a variable determined by certain causal factors. The task was to discover these factors, and to enquire whether it was possible that they might be influenced to operate in a way to reduce unemployment.[3]

He argued that in the short term the level of employment is determined by the level of output and argued that output itself depends on effective demand – that is, actual expenditure.[4] Effective demand had two components, consumption and investment. An individual's consumption is determined mainly by his income; and his consumption will usually be less than his income.[5] "The richer the community, the wider will tend to be the gap between its actual and its potential production."[6] If the distribution of income is highly unequal, the rich will be able to save a great deal; whereas in a more equitable system, few may be sufficiently affluent to save, leading to a high level of consumption. In the short run, the amount of income spent on consumption changes rather slowly.[7] During the up-swing of the business cycle, it takes individuals time to adjust their expenditures to higher levels of income. Conversely, during a down-swing individuals often find it difficult to reduce their expenditure immediately in response to income reduction.[8]

[3] ibid. p.13.
[4] ibid. p.31.
[5] ibid. p.27.
[6] ibid. p.31.
[7] ibid. p.96.
[8] ibid. p.97.

As incomes rose, expenditures on consumption would claim a decreasing proportion of total income. A high and rising volume of investment expenditure would be required to bring saving and investment into equilibrium with one another at a full-employment level of activity. A wealthy community, therefore, would need to discover increasing opportunities for investment if the saving propensities of its wealthier members were to be compatible with the employment of its poorer members. This "paradox of savings" was a startling insight. The virtues of thrift had previously been regarded as axiomatic, yet the analysis led to the inescapable conclusion that the attempts of individuals to improve their financial position through saving for the future might in aggregate leave the community worse off. A private virtue could be a social vice.[9]

Keynes stated that the amount of money spent on investment was decided by two considerations: first, the yield of a particular investment; and second, the cost of borrowing to finance that investment. One should look not only at the immediate rate of return on an investment, but rather assess the probable returns over its life-cycle. Future yield depended on the future volume of sales, and on the price at which these future sales would be effected. A deciding factor was the expectations of investors as to future economic performance. [10]

Keynes considered that the rate of interest was governed – not by the supply and demand for loanable funds – but by the supply and demand for money in the form of currency and coin issued by governments and in bank accounts. Supply could be regulated by government and the Central Bank. Though a certain stock of money was required for transactions and precautionary purposes, money might also be demanded

[9] ibid. p.211.
[10] ibid. p.148.

for speculative reasons, and this amounted to hoarding.[11] The rate of interest should be seen as primarily a monetary phenomenon - "the reward for parting with liquidity".[12] It was detached from the real factors of thrift and the productivity of capital. Should the situation of the liquidity trap occur, the rate of interest could no longer been seen as a delicate mechanism for equilibrating intended saving and intended investment.[13]

The concept of liquidity preference casts serious doubt on the ability of monetary authorities to influence interest rates in periods of depression. The Central Bank could continue to expand the money supply, but if that extra supply merely swelled idle balances, no reduction in interest rates would follow. In a deep depression, banks would find that their ability to lend was curtailed because of the shortage of eligible borrowers. Moreover, financial institutions might choose to protect themselves against capital losses by hoarding for speculative reasons.

Keynes concluded that the conventional techniques of economic policy were insufficient to remedy the lack of effective demand: a more active role for government as a spender was required if prosperity was to return; fiscal policy must be assigned a more active role.[14] Rejecting the orthodox view that governments should run balanced budgets at all times, Keynes called for deliberate deficits in times of recession to increase effective demand. He recognised that public expenditure financed by borrowing would have favourable effects on total demand only to the extent that a net increase in total spending was achieved. The intended growth in total spending would not occur if government projects merely displaced those that would otherwise have been undertaken by the private sector. Always a Liberal, he believed that once full

[11] ibid. p.170.
[12] ibid. p.167.
[13] ibid. p.172.
[14] ibid. p.373.

employment had been achieved by fiscal policy measures, the market mechanism could then operate freely. "Thus," Keynes stated, "apart from the necessity of central controls to bring about an adjustment between the propensity to consume and the inducement to invest, there is no more reason to socialise economic life than there was before."[15]

Keynes also attacked the view that unemployment could be cured through measures aimed at the inflexibility of wages. Trade unions were legitimate bargaining agents, and their role in wage settlement was established. Furthermore, wage-cutting would not solve the problem of unemployment; such tactics were more likely to worsen the problem by reducing effective demand even more, and would meet with union resistance. A better course for government was to increase the quantity of money, allowing price inflation to erode nominal wages in real terms.[16]

1.1.2. The post-war consensus

Throughout most of Western Europe, the Keynesian welfare state seemed to offer a degree of success in generating prosperity, employment and social provision. A kind of "historical compromise" was reached between labour and business management. Private enterprise and the freedom of the market were accepted by labour, in return for collective bargaining, social security, income redistribution, full employment policies, and demand management. For business management this arrangement gave harmonious labour relations, political stability, assured demand and motivated workers. In 1967, Michael Stewart's, *Keynes and After* accurately reflected this world view. The book ends with a statement of confidence and optimism:

> "With the acceptance of The General Theory the days of uncontrollable mass unemployment in advanced industrial countries are over. Other economic problems may threaten; this one, at least, has passed into history."[17]

[15] ibid. p.379.
[16] ibid. p.267.
[17] Stewart, M. (1967) *Keynes and After,* p. 254.

1.2. The Advocates of the Free Market

1.2.1. The turbulent 70s

Governments soon discovered that they faced a dilemma. They were committed, to a greater or lesser extent, to reconcile what proved to be basically incompatible objectives: growth, full employment, price stability, and possibly greater social equality.[18] In practice, full employment could only be achieved at the cost of creeping inflation, while price stability necessitated a level of unemployment that was politically unacceptable. Some countries attempted to avoid these difficulties by ordering their priorities in terms of both objectives and methods of control. Germany gave first priority to price stability and balance of payments equilibrium, believing that full employment and growth would be achieved as a result. In the event, this approach proved to be correct for Germany.[19] France placed emphasis on long-term growth. At regular intervals, a series of major investment plans were instituted, setting targets for private and public investment and for housing. Planning became a dominant feature of French life. The economy recovered from the years of stagnation. France experienced rapid growth and a high investment ratio overall, and in particular, in manufacturing, but at the cost of price and monetary instability.[20]

In contrast to Germany and France, Britain appeared unable to decide on any scale of priorities, and tried to add the achievement of social progress and equality to its list of objectives. This proved unwise for a country whose economy was fundamentally weaker than those of its main European competitors. Fiscal policy played a major part in the management of the economy. Whilst there was a noticeable reluctance to use external regulators, Britain was still forced to devalue in 1967. The failure of Britain to

[18] Aldcroft, D. H. (2001) op. cit. p.158.
[19] ibid. p.205
[20] ibid. pp.119-120.

recognise the incompatibility of its economic objectives and the inadequacy of its means of control resulted in slower growth, inflationary pressures and a weak balance of payments. But high levels of employment were enjoyed; though even here government policy can claim little credit. The labour force had grown very slowly, and output per worker remained low.

The high growth of the post-war period ended in the first half of the 1970s. The convergence of favourable factors which had characterised the boom years were replaced with a strong convergence of disincentives to growth. Serious difficulties were experienced after the first oil shock in 1973, followed by a second oil price rise in 1979. Both steep price rises resulted in rapidly increasing input prices for industry, putting strong upward pressure on inflation. The average rate of growth of gross domestic product for the European countries (EU 15) fell from 4.8 to 3 per cent. The decline in the growth rate of industrial production was greater, falling from 5.4 to 2.6 per cent.[21]

This shortfall was reflected in rising unemployment levels and under-utilised capacity. In the later 1970s unemployment in the EU 15 was on average about twice that of the 1960s. Total annual unemployment rates for Western Europe increased from 2.5 per cent in 1970 to 5.1 per cent in 1979.[22] During the course of the 1970s wage claims were increasingly based on past price changes and expected inflation rises, putting a built-in rigidity into the cost system. With increasing union power, high claims were more readily settled than previously. This tendency was most apparent in Britain, where increasing wage demands became a major obstacle to regaining price stability. Wage settlements were for the most part accommodated by monetary expansion. In consequence, wage gains exceeded those warranted by changes in productivity, leading

[21] ibid. p.189.
[22] ibid. p.190.

to a real wage gap. Wage negotiation was also adversely affected by the increasing inflexibility of labour markets caused by protective labour legislation and structural problems. It could be argued that one of the causes of the slowdown in investment in manufacturing in the later 1970s was caused by the cumulative effects of the long-term decline in profit share and rate of return on capital; a decline accompanied by a rise in wage-income share. For instance, there was a decline in net rates of return in manufacturing from 31 to 11 per cent in Germany, and from 20 to 3 per cent in Britain.[23]

The reliance of governments on demand management policies, involving a combination of fiscal and monetary policies, was brought into question. Priority had to be increasingly given to controlling inflation and dealing with external imbalance in preference to encouraging growth and maintaining employment. Most major countries in the late 1970s adopted some form of control of monetary aggregates, together with fiscal policies designed to stabilise or lower public sector deficits. Only partial success was achieved. To have secured a quick and complete check on inflation would have required a degree of drastic monetary and fiscal action with very real impact on output and unemployment. The constraints of political consensus demanded caution.

Thus the 1970s saw increasing government expenditure, deficits and rising taxes adding an increased tax burden on already depressed business profitability. The reduction in profits caused lower investment and closure of enterprises. Keynesian demand policies that had seemed so effective in the 1950s and 1960s were less attractive now. The problems were those of supply: rising costs of input of energy and labour.

[23] Hill, T.P. (1979) *Profits and Rates of Return*. Quoted in Aldcroft, D. H. (2001) op. cit. p.204.

In addition, the internationalisation of the economy had resulted in a more intense competitive environment. The rapidly growing economies of Asia and of Japan especially, forced Western companies to lower costs to compete in the world market. These competitive pressures demanded improvement in efficiency and exerted downward pressure on wages. In order to support industry governments felt the need to decrease taxes, to reduce social security contributions, and to relax labour protection. This evolving world economy reduced the ability of national governments to implement their own individual stabilisation policies.

In the economic climate of the 1970s voices both of economists and politicians were heard calling for radical changes in economic theory and practice. Indeed the involvement of governments in the economy was seen by many as the cause of the problems. The view was put forward that the welfare state imposed too heavy a burden on business, and resulted in market rigidities, particularly in the labour market. Furthermore, prices were distorted by taxes and subsidies, and governments were only too willing to cover their deficits by monetary financing, leading to inflation. A rise in unemployment was inevitable. It became the task of government to aim to achieve low inflation rates, reduce budgetary deficits and maintain external equilibrium. With the reversal of economic good fortune, Keynesian orthodoxy was challenged; the voices of other prophets found a receptive audience.

1.2.2. Ludwig von Mises (1881-1973)

Mises was one of the last members of the original Austrian School of Economics. In 1912 he published *The Theory of Money and Credit*, arguing that a continued attempt by the state to manipulate the supply of money and credit would distort basic money prices, resulting in major dislocations in economic life. He also stated that business cycles are caused by the uncontrollable expansion of bank credit. Mises reasoned that when government inflates, it lowers the interest rate below the proper market level, which depends on saving. The artificially low interest rate misleads business into making uneconomic investments and creates an inflationary boom. When credit expansion slows or stops, investment errors are revealed, and bankruptcies and unemployment result. Mises considered that since money originated as a market commodity, and not by government fiat, it should be returned to the market. Banks should be subject to competition, and not singled out for special treatment.[24] In 1926 he founded the Austrian Institute for Business Cycle Research, and placed his student, Hayek, in charge.

In 1920 Mises in another article attempted to demonstrate the impossibility of the rational allocation of productive resources in the absence of private ownership.[25] This thesis was then elaborated into a large systematic work, *Die Gemeinwirtschaft (Socialism),* in which he subjected socialism as a form of social and economic organisation to an exhaustive and critical analysis.[26] This book contained the outline later expanded into his treatise, *Human Action*.[27]

Mises argued that in a socialist community there will be hundreds and thousands of establishments in which work is going on. The economic administration will have no real sense of direction. It will have no means of ascertaining whether a given piece of work is really necessary, or whether labour and material are not wasted in completing it. The socialist community would know – or it would imagine it knew – what it wanted to

[24] Mises, L. von (1912) *Theorie des geldes und der Umlaufsmittel*. English translation [*The Theory of Money and Credit*] (1981).
[25] Mises, L. von (1920) Die Wirtschaftsrechnung im Sozialistischen Gemeinwesen. *Archiv für Sozialwissenschaft und Sozialpolitik*. 47, pp.86-121. English translation [Economic Calculation in the Socialist Commonwealth*]* (1935) Reprinted (1990).
[26] Mises, L. von (1922) *Die Gemeinwirtschaft; Untersuchungen über den Sozialismus*. English translation [*Socialism: An Economic and Sociological Analysis*] (1951).
[27] Mises, L .von (1949) *Human Action*: *A Treatise on Economics*. op. cit.

produce. It ought to set out obtaining the desired results with the smallest possible expenditure. To achieve this, it would have to be able to make calculations, economic calculations. Systematic plans can only be made when all the commodities which we have to take into account can be assimilated into money. Otherwise, "economic calculation becomes absolutely impossible".[28]

He argued that it was impossible to ignore the market and its functions. "For the motive force of the whole process which gives rise to market prices for the factors of production, is the ceaseless search on the part of the capitalist and the entrepreneurs to maximise their profits by serving the consumers' wishes." "It is only the prospect of profit which directs production into those channels in which the demands on the consumer are best satisfied at least cost." "The market is thus the focus point of the capitalist order of society." "It cannot be 'artificially' imitated under socialism".[29]

The other pre-requisite for rational calculation is money. Since consumption goods provide us with immediate benefits we can value them directly without monetary calculation. The means of production grows increasingly complex, and it becomes no longer possible to ascertain intuitively their contribution to our well being. Money, an auxiliary method of calculation, is required. Money reduces everything to a common unit allowing exact calculations. Only then can we determine the appropriate methods of production: whether, for instance, to use or to save more steel, and/or to employ more or less manpower. Without the ability given to us by money to calculate and compare relative costs, there would be no rational way to choose from among the plethora of

[28] ibid. p.122.
[29] ibid. p.138.

possible alternatives. "The higgling of the market establishes substitution relations between commodities."[30]

> "The sphere of the 'economic' is plainly the same as the sphere of the rational: and the sphere of the 'purely economic' is nothing but the sphere in which money calculation is possible." [31]

Even if some form of 'money' were used in a socialist society, it could never perform this essential function, for the utility of money implies the ability of the individual to act on his own valuation. It is this rationally acting individual who forms the core of Mises' philosophy. And this presupposes the existence of private property throughout the economy. In this way, the existence of money and the market imply each other, and together they enable us to calculate. Economic calculation "provides a guide amongst the bewildering throng of economic possibilities. It enables us to extend judgments of value which apply directly only to consumption goods…to all goods of higher orders. Without it, all production by lengthy and roundabout processes would be so many steps in the dark."[32]

Because socialism seeks to eliminate exchange, money and private ownership of the means of production, economic calculation is impossible under socialism. The resulting inefficiencies and distortions, Mises insisted, would result in progressive impoverishment. He concluded: "the paradox of 'planning' is that it cannot plan".[33]

In *Socialism* Mises revealed a clear ideological stance. In *Liberalism* he rejected other parts of the socialist agenda, such as the abolition of marriage and the family and the establishment of social egalitarianism. "All human power would be insufficient to

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[30] ibid. p.115.
[31] ibid. p.125.
[32] ibid. p.117.
[33] Mises, L .von (1949) *Human Action*: *A Treatise on Economics*, op. cit. p.700.

make men really equal. Men are and will always remain unequal."[34] He defended the mediating structures of society – in particular, the law and the market, which stand between the individual and the State. Social cooperation, he insisted, rests on human inequalities and institutional hierarchies. In *Liberalism* he put forward his alternative to socialism. He linked liberalism with the capitalist economic order. "The program of liberalism", if "condensed into a single word, would have to read: *property*."[35] Property and its control should be kept in private hands in order to restrict government. There were to be no exceptions to limits on government action, even in times of natural disasters or economic depressions. The second pillar of the liberal society was freedom. This meant that the people, the property owners, were free to pursue their own interests, as long they do not impinge on the property rights of others. The third pillar was peace. War, he believed, was always tragic. Even the victors tended to suffer economic loss. The ideal foreign policy was no foreign policy at all, except one based solely on commerce with all nations.

The criticisms of socialism made by Mises drew on a long tradition of critical analysis of modernity. The intellectual roots of Mises' thought can be seen in the Scottish Enlightenment philosopher and historian, Adam Ferguson (1723-1815). The 'active man' is Ferguson's main protagonist. As a result, he did not have patience for analysing institutions and constitutions in terms of natural rights and law. Human institutions, he argued, emerge spontaneously from human activity, and evolve in a variety of ways.

> "Every step and every movement of the multitude, even in what are termed enlightened ages, are made with equal blindness to the future; and nations stumble upon establishments, which are indeed the result of human action, but not the execution of any human design."[36]

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[34] Mises, L. von (1927) *Liberalismus*. English translation [*Liberalism: A Socio-Economic Exposition*], p.28. 2nd Edition (1978)
[35] ibid. p.19.
[36] Ferguson, A. (1767) *An Essay on the History of Civil Society*, p. 119. Ed. F. Oz-Salzberger (1995).

Mises also regarded these gradually evolving institutions as representing the accumulated wisdom of human social experience and considered them essential for the coordination of modern societies and the creation and maintenance of a social order. His championship of the market and his attack on all impediments to the market had a strong appeal when the regulation of the market was being questioned. The growing problems of Western economies in the 1970s and 1980s were a spur to rediscover and redeploy his arguments.

1.2.3. Friedrich A. Hayek (1899-1992)

Hayek, the protégé and colleague of Mises, spread Austrian ideas throughout the English-speaking world. An avowed liberal, he held that the "aim of liberalism is to persuade the majority to observe certain principles"[37] Fundamental to his philosophical beliefs was the desire to strive towards "that condition of men in which coercion of some by others is reduced as much as is possible in society".[38] The award of the Nobel Prize in Economic Science to Hayek in 1974 brought greater public awareness of his ideas

The view of the supremacy of market forces put forward by Mises is developed by Hayek in a well reasoned and sophisticated attack on central planning: "The Use of Knowledge in Society" (1945).[39] Hayek begins by reflecting on the problems society faces in attempting to construct a rational economic order. Such a task, he feels, would be purely one of logic if all participants in the market were in full possession of all necessary information and enjoyed complete knowledge of available means. This is never the case, because "the 'data' from which the economic calculus starts are never

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[37] Hayek, F. A. (1960) *The Constitution of Liberty*, op.cit. pp.103-104.
[38] ibid. p.11.
[39] Hayek, F. A. (1945) The Use of Knowledge in Society. *American Economic Review*, 35(4), September. pp.519 – 530.

for the whole society 'given' to a single mind which could work out the implications, and can never be so given".[40] Knowledge does not exist in a concentrated or integrated form, but "solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess".[41] The problem of a rational economic order is "of the utilization of knowledge not given to anyone in its totality".[42]

Hayek believes that the use of mathematics in recent refinements of economic theory has further obscured the nature of the fundamental problem. He offers an analysis of the nature of 'planning': "the complex of inter-related decisions about the allocation of our available resources".[43] All economic activity is, in this sense, planning, but this planning will to some extent have to be based on knowledge which, in the first instance, is not given to the planner. The crucial problem for any theory of the economic process is to explain "the various ways in which knowledge on which people base their plans is communicated to them".[44] The necessity for planning is not doubted, but the question arises as to whom is to do the planning? Is the whole economic system to be directed according to one unified planning – central planning, or should it be divided among many individuals? Hayek defines market competition, as decentralised planning by many separate persons. The answer lies in which system will allow the fuller use to be made of existing knowledge.

There are different kinds of knowledge. Scientific knowledge should be the province of a body of suitably chosen experts. There exists also a body of very important but unorganised knowledge: "the knowledge of particular circumstances of time and

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[40] ibid. p.519.
[41] ibid.
[42] ibid. p.520.
[43] ibid.
[44] ibid.

place".[45] Practically every individual has some advantage over all others, because he possesses unique information of which beneficial use might be made, but of which use can be made only if the decisions depending on it are left to him or are made with his active cooperation. In fact, these individuals possess "special knowledge of circumstances of the fleeting moment not known to others".[46] Hayek regards the discovery of the methods by which such knowledge can be made as widely available as possible to be the pressing task.

The advocates of central planning, Hayek argues, tend to minimise this knowledge of particular circumstances. A detailed economic plan set out in advance for a fairly long period and then closely adhered to must assume that no further economic decisions of importance will be required. The growing importance of technological knowledge is thought to lessen the impact of economic considerations. This is to ignore the ever-changing circumstances of the moment. It is a consequence of change that economic problems do arise. Practical experience indicates that cost control requires constant attention.

Hayek places some of the blame for the disregard of these constant small changes in economic activity on economists. He is concerned by their growing preoccupation with statistical aggregates which show a very much greater stability than the movements of the details. As Hayek had previously stated, "neither aggregates nor averages do act upon one another".[47] This is a clear rejection of the Keynesian system which was expressed wholly in terms of aggregates. The mutual compensation of random changes can mislead. The special knowledge of the circumstances of time and place cannot

[45] ibid. p.522.
[46] ibid.
[47] Hayek, F. A. (1931) *Prices and Production*, p.5.

enter into statistics. In consequence, central planning based on statistical information must always lack this knowledge.

A central planning board cannot be expected to solve the economic problem of a rapidly changing environment. Some form of decentralisation is essential. An individual may have an intimate knowledge of the facts of his immediate surroundings, but that knowledge will be limited. The problem remains "of communicating to him such further information as he needs to fit his decisions into the whole pattern of changes of the larger economic system".[48] The solution is the price system. Prices coordinate the separate actions of individuals. The effect of a change in the price of a commodity will rapidly spread throughout the system, influencing not only the uses of that particular commodity, but also those of its substitutes.

Hayek feels that the theoretical habit of assuming more or less perfect knowledge to be possessed by market participants had obscured the true function of the price mechanism: "to make individuals do the desirable things without anyone having to tell them what do to".[49]

Hayek then considers the price mechanism as part of much wider social and cultural phenomena. The voice of Adam Ferguson is heard when Hayek states that the price mechanism is not the product of human design. The mechanism has grown spontaneously; "man has been able to develop that division of labour on which our civilisation is based because he happened to stumble on a method which made it possible".[50] Economic advances and their resultant social advantages will largely

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[48] Hayek, F. A. (1945) The Use of Knowledge in Society. op.cit. p.525.
[49] ibid. p.527.
[50] ibid. p.528.

depend on "the extent to which the individual can choose his pursuits and consequently freely use his own knowledge and skill".[51]

Hayek explores the political and philosophical aspects of this line of thought in his later work, *The Constitution of Liberty* (1960). Arguing the case for a free society, he holds that "liberty is essential in order to leave room for the unforeseeable and unpredictable".[52] He admits that freedom will allow many things to be done of which many will not approve, but faith in freedom does not rest on foreseeable results, "but on the belief that it will, on balance, release more forces for the good".[53]

The case for liberty is not an argument against organisation itself, but one against all exclusive, privileged, monopolistic organisations. "To turn the whole of society into a single organisation, built and directed according to a single plan would be to extinguish the very forces that shaped the individual human minds that planned it".[54] It is the spontaneous forces of growth that has made possible the advance of civilisation. Hayek cites Oliver Cromwell: "Man never mounts higher than when he knows not where he is going".[55]

In his earlier work, *The Road to Serfdom* (1944), Hayek describes his vision of a political order that will foster spontaneous growth. Competition is the only method by which our activities can be adjusted to each other without coercive or arbitrary intervention of authority. "The parties in the market should be free to sell and buy at any price at which they can find a partner to the transaction."[56] "Entry into the different

[51] ibid.
[52] Hayek, F. A. (1960) *The Constitution of Liberty*. op. cit. p.29.
[53] ibid. p.31.
[54] ibid. p.37.
[55] ibid. p.39.
[56] Hayek, F. A. (1944) *The Road to Serfdom*, p.29.

trades should be open to all on equal terms."[57] Governments must strenuously oppose any attempts to control the prices or quantities of particular commodities, because price changes register all the relevant changes in circumstances, and "provide a reliable guide for the individuals' actions".[58]

Hayek regards the provision of social services as being compatible with the preservation of competition provided the organisation of these services is not designed to make competition ineffective over wide fields. He would also allow measures to prohibit certain poisonous substances, to limit working hours, and to require minimum standards of health and safety. "There are common needs that can be satisfied only by collective action and which can be thus provided for without restricting individual liberty."[59] There are two caveats. All restrictions must affect all potential producers equally, and must not be used as an indirect way of price control. Secondly, the question should always be asked as to whether in a particular instance of restriction, the advantages gained are greater than the social cost imposed.

The effective functioning of a successful competitive system places other demands on government. The private sector can never adequately provide the necessary level of organisation of certain institutions, such as money, markets and channels of information. Government must ensure the existence of an appropriate legal system, a legal system designed to preserve competition and to make it operate as beneficially as possible. Hayek acknowledges that there are areas of economic activity where a competitive system will be ineffective. It would be impracticable to make the construction of roads and the control of industrial pollution dependent on the payment of a price. In these areas we have to resort to direct regulation by authority. In modern

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[57] ibid.
[58] ibid.
[59] Hayek, F. A. (1960) *The Constitution of Liberty.* op. cit. p. 257.

times, all governments have made provision for the poor, the victims of misfortune, and the disabled, and have concerned themselves with healthcare and education. These common needs of society can be satisfied only by collective action financed by taxation. Hayek warns that many of the welfare activities of government could present a threat to individual freedom, since, though they are often regarded as mere service activities, "they really constitute an exercise of the coercive powers of government and rest on its claiming exclusive rights in certain fields".[60]

He regards as especially dangerous the use of coercive powers by government to ensure a more even distribution of goods. This aim "requires a kind of discrimination between, and an unequal treatment of, different people which is irreconcilable with a free society".[61] In his view the kind of welfare state that aims at 'social justice' becomes primarily a redistributor of income, and will inevitably lead back to socialism and its coercive methods.

He attacks labour union power. By establishing effective monopolies in the supply of different kinds of labour, the unions prevent competition from acting as an effective regulator of the allocation of resources. Often labour unions use coercion to force unwilling workers into membership and to keep non-members out of employment. Hayek believes that most of the coercive tactics of the unions can be practiced only because legislation has exempted groups of workers from the ordinary responsibility of joint action. Such privileges should not be bestowed in a free society, whose preservation requires the strict prevention of all coercion except in the enforcement of general abstract rules equally applicable.[62]

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[60] ibid. p.258.
[61] ibid. pp.259-260.
[62] ibid. pp.283-284.

Hayek differs from Mises in offering a more nuanced prescription for the monetary framework of the economy. He believes that it is no longer possible to rely on the spontaneous forces of the market to supply whatever is needed for a satisfactory medium of exchange. The use of credit instruments as money or money substitutes has prevented reliance on some self-regulating mechanisms. A degree of deliberate control of the interacting money and credit systems is necessary.[63] This control function has generally been entrusted to central banks. Although it is desirable that these institutions should be largely independent of government and its financial policy, government expenditure now constitutes a large part of the national income, and it is inevitable that governments will dictate monetary policy.[64]

With government in control of monetary policy, the chief threat is inflation. Monetary stability becomes of paramount concern. Keynes is quoted with approval:

> "There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency." [65]

Hayek states that there can be little doubt that current union policies must lead to continuous and progressive inflation. "'Full-employment' doctrines explicitly relieve the unions of the responsibility for any unemployment and place the duty for preserving full employment on the monetary and fiscal authorities"[66] – that is, government.

The only way in which government can prevent union policy from producing unemployment is to counter through inflation whatever excessive rises in real wages unions tend to create. Hayek agrees with Keynes that the regular cause of extensive unemployment is that real wages are too high. But because Keynes considered that a direct lowering of money wages was politically unacceptable, he had advocated that real

[63] ibid. pp.324-325.
[64] ibid. p.327.
[65] ibid. p.324.Quotation taken from Keynes, J.M. (1919) *The Economic Consequences of the Peace*, p. 149. The Collected Writings of John Maynard Keynes, Vol. II (1973).
[66] Hayek, F. A. (1960) *The Constitution of Liberty,* op cit. p.280.

wages must be reduced by the process of lowering the value of money. The Keynesian remedy is that "the supply of money must be so increased as to raise prices to a level where the real value of the prevailing money wages is no longer greater than the productivity of the workers seeking employment".[67]

In practice this results in each separate union, in its attempt to overtake the value of money, never ceasing to insist on further increases in money wages. The aggregate efforts of the unions will thus bring about progressive inflation. Hayek places the blame for the wage-price spiral on 'Keynesian policy'. He forecasts that "the present position of the unions cannot last, for they can function only in a market economy, which they are doing their best to destroy".[68] The solution, Hayek insists, is to deprive unions of their legal privileges, and so curb their power at source.

Inflation at first produces conditions in which more people make profits. People start to expect prices to continue to rise at the same rate, and will bid up the prices of the factors of production to a level corresponding to the future prices they expect.[69] The techniques of capital and cost accounting, on which all business decisions rest, make sense only so long as the value of money is tolerably stable. Real costs, profits, or income will soon cease to be ascertainable by any generally acceptable method.[70]

Unfortunately, inflation can have an almost irresistible attraction for government. Progressive rates of tax will produce a more than proportionate increase in revenue. The greater proportion of national income taken in taxes as nominal profits increase should be reinvested to maintain the real value of capital. Eventually, attempts to

[67] ibid. p.280.
[68] ibid. p.283.
[69] ibid. p.331.
[70] ibid. p.332.

prevent further acceleration of inflation will create a situation in which it will be very difficult to avoid a spontaneous deflation.[71] Hayek holds Keynes responsible for encouraging governments to ignore the long-term consequences of inflationary policies – citing what he regards as the "fundamentally anti-liberal aphorism, 'in the long run we are all dead' ".[72]

Hayek suggests that probably some mechanical rule which aims at what is desirable in the long run, and limits short-term decisions, is to be preferred. A central bank fully protected against political pressure and free to decide the means of achieving previously decided ends, might be the best arrangement.[73] It should be possible to keep both the level of employment and the level of prices stable. The two aims do not necessarily conflict, provided monetary stability is the first consideration and the rest of economic policy is adapted to these aims. There must be definite known limits which the monetary authorities will not exceed.[74]

1.3. Monetarism

For Friedman and his fellow monetarists the early 1970s were what the Great Depression of the 1930s had been to Keynes and his followers. The nightmare of stagflation – simultaneous sharply rising prices and unemployment – had arrived. Policymakers seeking a solution were open to new ideas.

1.3.1. Milton Friedman (1912 – 2006)

Friedman is the best known and influential advocate of the movement that has come to be known as monetarism. Despite Friedman's focus on monetary policy as key to

[71] ibid.
[72] ibid. p.333.
[73] ibid. p.334.
[74] ibid. p.337.

economic prosperity in contrast to Hayek's dominant concern with the market process that governs relative prices, Friedman shared Hayek's firm adherence to the principles of classical liberalism.[75] There existed a common vision of a renewed liberal order founded on free markets and free ideas in a free society. Hayek remarked: "Milton and I agree on almost everything except monetary policy".[76]

Friedman and the Chicago School led the monetarists' assaults on the post-war conventional wisdom of Keynesianism. Although the descriptive term 'monetarism' is a modern one, the long tradition of monetarist ideas can be traced to the philosopher economists, such as John Locke and David Hume. Monetarism rests on two fundamental assertions: first, there is something called money, which can be defined and measured; second, since a close relationship exists between changes in the stock of money and changes in national income, increases in money lead to increases in national income.[77]

As David Hume wrote in 1750:

> "At first, no alteration is perceived; by degrees the price rises, first of one commodity, then of another; till the whole at last reaches a just proportion with the new quantity of specie which is in the kingdom." [78]

Friedman in 1970 offered the same insight:

> "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." [79]

The monetarists' prescription is that governments should control changes in the stock of money – the supply of money – in order to prevent inflation.[80] Monetarists believe that

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[75] Garrison, R. W.(2007) *Hayek and Friedman: Head to Head*, pp.1-2. November. Sea Meetings, New Orleans. www.auburn.edu/~garriro/hayekper cent20andper cent20friedman.pdf. Accessed 16.10.09.
[76] Hayek, F. A. (1994) *Hayek on Hayek: An Autobiographical Dialogue*, p.144. Ed. S. Kresge and L. Wenar.
[77] Smith, D. (1987) *The Rise and Fall of Monetarism,* p.5.
[78] Hume, D. (1777) *Essays Moral, Political and Literary,* II.III.7. Reprinted (1987).
[79] Friedman, M. (1970) *The Counter –Revolution in Monetary Theory*, p.24.

money is the driving force in the economy. They assert that there are clear relationships between changes in the stock of money and other economic variables. These relationships are not just theoretical claims; historical evidence provides undeniable support. Friedman and Anna Schwartz in *A Monetary History of the United States, 1867-1960* argued that the Depression of the 1930s was caused by a massive contraction of the money supply, and not by the lack of investment as argued by Keynes. They also maintained that post-war inflation was caused by an over-expansion of the money supply. [81]

The central concept of monetarism is the quantity theory of money, which postulates a stable and predictable relationship between changes in the stock of money and changes in national output and prices. If low and steady rates of growth of the money stock can be achieved, stable economic growth without inflation should result.

Friedman does not reject the Keynesian concept of liquidity preference, but instead offers a refined approach to money income. Friedman holds that the income received by individuals consists of two parts – permanent and transitory. A sudden and unexpected change in income would not be regarded as effecting permanent income on which spending decisions are based. A three-year time horizon is required for transitory elements to be incorporated into permanent income.[82]

The quantity theory, he holds, is in the first instance a theory of the demand for money. But what determines the demand for money? Friedman argues that Keynes' formulation of money as including only financial assets is too restrictive. Money should be regarded as one of a sequence of assets, on a par with bonds, equities, houses,

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[80] Smith, D. (1987) op. cit. p.5.
[81] Friedman, M. and A. J. Schwartz. (1963) *A Monetary History of the United States, 1867-1960.* 1971 Edition.
[82] Smith, D. (1987) op. cit. p.171.

and consumer durables.[83] And should not wealth include the earning potential of the individual? He states that the demand for money will also depend upon the rates of return on different assets. By taking this wide approach to the concept of money and the demand for it, the rate of interest on financial holdings becomes only one of a number of elements in the restated quantity theory. An increase in the money supply leads to individuals having more money in their portfolio of assets than they wish to hold. The response is to transfer this money into bonds, equities and consumer assets. The shifts will cease when the rates of return to the individual on the different assets are equalised. Money is then restored to its equilibrium share of total assets. The sum of these purchasing decisions is a higher level of money income than previously. Changes in the money stock produce changes in money national income.[84]

Friedman challenges the Keynesian assertion that 'money does not matter' – to Friedman money is of paramount importance. Many modern monetarists take a more measured view of the General Theory, and hold that Keynes did not abandon the quantity theory and was always convinced that money did indeed matter.

Friedman made a second major challenge to the economic orthodoxy of the time. In his presidential address to the American Economic Association he attacked the belief that there was a trade-off between employment and inflation.[85] This notion received theoretical support in the form of the Phillips curve.

A. W. Phillips had examined the statistical relationship between wage inflation and unemployment in the United Kingdom from 1861 to 1957. The findings are illustrated in a graph, showing an inverse relationship between inflation and unemployment. The

[83] ibid. p.15.
[84] ibid. p.172.
[85] Friedman, M. (1968) The Role of Monetary Policy. *American Economic Review,* p.11. 58(1), March.

Phillips curve seemed to present governments with a simple policy choice. They could trade off inflation against unemployment. Lower unemployment could be bought at the cost of higher inflation, and vice versa.[86] From about 1966 the Phillips curve relationship seemed to break down. The United Kingdom, along with many other western countries, began to experience both growing unemployment and higher rates of inflation, without an obvious explanation in the form of sharply higher import costs.[87]

Friedman believed that there was a natural rate of unemployment for the economy, determined by factors such as the ease of labour mobility. This natural rate was not unchangeable. The natural rate would tend to be lower in economies where the labour market is efficient, and higher in those economies with a generous provision of state unemployment benefits.[88] Friedman claimed that Phillips had missed a crucial distinction – the difference between money wages and real, or inflation-adjusted, wages.[89] Friedman described the consequences of a government decision to push unemployment below its natural rate. This would be achieved by expanding the money supply, and the initial effects are favourable. The extra cash received in wage payments results in higher spending and income in the economy. But, because of rising demand for their products caused by monetary expansion, firms increase their prices. Rising prices reduce real wages. Workers notice the decline in their real wages. Their belief in stable prices turns into an expectation of rising prices. The effect of these higher demands is to increase unemployment.[90]

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[86] Phillips, A .W. (1958) The Relationship between Unemployment and the Rate of Change of Money Wages in the United Kingdom 1861-1957. *Economica*, 25(100), pp.283-299.
[87] Smith, D. (1987) op. cit. p.26.
[88] Friedman, M. (1968) The Role of Monetary Policy. op. cit. p.8.
[89] ibid. pp.8-9.
[90] ibid. p.10.

If government still wishes to keep employment below the natural rate, the next monetary expansion must provide for not just expected inflation, but also allow for a degree of unanticipated inflation. This form of government employment policy involves an accelerating rate of inflation. Friedman admitted that there was always a temporary trade-off between unemployment and inflation, but there was never a permanent one.[91] Friedman concluded that a far better approach for governments was to control the money supply in order to achieve the desired outcome for the price level, using other methods of reducing unemployment.[92]

The Keynesian remedy for dealing with unemployment might cause even higher inflation. Friedman warned that the existing state of affairs could degenerate into hyperinflation. Governments should adopt policies that will produce a low rate of inflation and lessen their intervention in the fixing of prices.[93] Friedman's monetary rule expressed in his 1967 presidential address implied the abandonment of discretion. He argued that governments should be required by law to publish and abide by the monetary rule – a steady and pre-determined rate of growth in a specified monetary total.[94] Whilst acknowledging Keynes as 'one of the greatest economists of all time'[95], Friedman believed that Keynes' faith in a political elite acting in a disinterested way to promote what they regard as the 'general interest', "contributed substantially to the proliferation of over-grown government".[96]

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[91] ibid. p.11.
[92] ibid. p.10.
[93] ibid. p.13.
[94] ibid. p.16.
[95] Friedman, M. (1986) 'Keynes' Political Legacy', in *Keynes's General Theory: Fifty Years On*: *its relevance and irrelevance to modern times*, p.47. Ed. J. Burton.
[96] ibid. p.47.

1.3.2. Implementation

It fell to Margaret Thatcher to turn his economic philosophy into a potent political idea. Two negative aspects were soon apparent. The first was that the monetarist route to the defeat of inflation would involve pain for the economy. The second was that it may be easy to state an intention to control money supply, but the achievement of control may be extremely difficult.

In the June 1979 budget of the Conservative administration, monetary policy was tightened. A target growth rate for Sterling M3 of 7-11 per cent was set.[97] Public expenditure cuts of £1.5bn were made. An additional £1bn was raised from a part disposal of the government's shareholding in British Petroleum. The most controversial aspect was a shift from direct to indirect tax. Basic income tax was reduced to 30 per cent and all higher rates reduced. The Value Added Tax rate almost doubled.[98] During the 1979-81 recession the United Kingdom GDP fell by 2.2 per cent in 1980 and 1.6 per cent in 1981. Between the second quarter of 1979 and the first quarter of 1981, industrial production fell by 12.8 per cent.[99] Unemployment stood at 1.2m in June 1979; by the autumn of 1982 it was over 3m. But the elimination of inflation proved elusive. In the first year of the new administration the inflation rate doubled to nearly 22 per cent.[100] The success in keeping Sterling M3 within its target range had been achieved at considerable cost. Minimum lending rate reached 17 per cent in November 1979.[101]

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[97] M3. In Britain it comprised notes and coins in circulation and sight and interest-bearing deposits at banks, building societies and The National Savings Bank, i.e., money which could be readily obtained to spend.
[98] Smith, D. (1987) op. cit. p.88.
[99] ibid. p.90.
[100] ibid. p.31.
[101] ibid. p.94.

In October 1979 all remaining exchange controls were abolished. In June 1980, prescribed limits on bank lending were removed; and in August 1981, there was a short-lived attempt by the Bank of England to suspend minimum lending rates, and allow market factors to determine short-term interest rates.[102]

1.3.3. A Critique

The monetarists' experiment was not a success. Inflation and unemployment continued to rise. March 1982 marked the official end of simple monetarism in the United Kingdom – the idea that rules could be set for the growth of money stock and, no matter what occurred, those rules should not be tampered with by politicians. Monetarism made a lasting contribution.[103] No longer can politicians claim that money, meaning monetary policy, does not matter. Equally, the simplistic view that if money supply is controlled, then everything else will fall into place is no longer tenable.

In respect of Friedman's monetary rule, politicians will always be inclined to jettison targets when political expediency demands.[104] Another difficulty that arose was that the demand for money, or its reciprocal, the velocity of circulation, was not stable, or at least predictable, as had been forecasted by Friedman.[105] Further academic research into the data presented in Friedman and Schwartz's *Monetary Trends in the United Kingdom* found the empirical bases of their claims untested.[106] It can also be asserted that shifts in the demand for money and velocity of circulation may also be caused by the very deregulation and financial liberalisation generally advocated by monetarists.

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[102] ibid. p.96.
[103] ibid. p.106.
[104] ibid. p.148.
[105] ibid. p.149.
[106] Hendry, D. F. and N. R. Ericsson (1991) Assertion without Empirical Basis: An Econometric Appraisal of "Monetary Trends in ... the United Kingdom" by Milton Friedman and Anna Schwartz, *American Economic Review* 81(1) March. pp.8-38.

The most fundamental presumption of monetarism is that money can be controlled by the monetary authorities. At the outset there are differing opinions as to the composition of the monetary aggregate to be used for policy implementation. It was found to be erroneous that the control of the growth rate of the chosen aggregate would result in similar performance of other aggregates. On the contrary, the relative rates of return on various monetary assets changed constantly.[107] Another area of difficulty was the control of bank lending. The sole reliance on interest rates to exercise curbs on lending proved unsatisfactory. In recessionary conditions, higher interest rates did not deter companies in distress from seeking bank loans.

There was also the monetarists' failure to grasp the significance of the exchange rate. Large flows of short-term capital between the major financial centres are often totally unrelated to underlying fundamentals, such as relative inflation and trade performance. Periods of currency over-valuation or under-valuation can be followed by excessively large corrections, which may exacerbate the effects of policy errors in monetary targeting. And of crucial and lasting importance, the rapid acceleration in the pace of innovation, deregulation and structural changes in the international financial system was not fully appreciated by the monetarists. Money became increasingly stateless and divorced from the banking systems of individual countries. The techniques of monetary targeting, which operate on domestic banking systems, became increasingly ineffective.[108]

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[107] Smith, D. (1987) op. cit. p.182.
[108] Bank for International Settlements (1986) *Recent Innovations in International Banking.* Summary of Study Group Report, p.1, April.
http://www.bis.org/publ/ecsc01a.pdf. Accessed 10.09.09.

1.4. Pragmatism

Friedman proclaimed in his Nobel Memorial Lecture (1976):

> "The drastic change that has occurred in economic theory has not been a result of ideological warfare. It has responded almost entirely to the force of events: brute experience proved far more potent than the strongest of political or ideological preferences." [109]

It is ironic that the same comments could be equally applied to his contribution.

1.4.1. Monetary Stability

The advocates of the free market have succeeded in their overall objective. The European Union has embraced the principle of "a highly competitive social market economy".[110] The experiences of the past – the inflation of the 1970s and the ensuing period of monetary instability - have had a formative influence on European monetary policy. Monetary instability was compounded in Europe by the structural characteristics of the labour markets and the response of monetary and fiscal policies. The desire to avoid past problems, stagflation, currency instability, persistent budget deficits, and high and volatile interest rates, led to the gradual emergence of a European consensus: the crucial importance of a stable money. Yet there is a rejection of the doctrinaire prescriptions of theory; the theoretical is always tempered by the empirical.

The Treaty of Maastricht provided that monetary power would be transferred to the European Union, whilst the Member States retained responsibility for conducting their general economic policies. Article 8 established a European System of Central Banks (ESCB) – (the Eurosystem) - and a European Central Bank (ECB).[111] Whereas all EU member states are part of the ESCB, the euro zone is comprised of the 17 member

[109] Friedman, M.(1977) Nobel Lecture: "Inflation and Unemployment", p.47, *Journal of Political Economy*, 85(3).
[110] Article 3(3) (ex Article 2(2) TEU)
[111] Replaced, in substance, by Article 13 TEU and Article 282, paragraph 1, TFEU.

states that have adopted the euro (€) as their common currency and sole legal tender. Membership of the euro zone implies submission to a rigid fiscal discipline, enforceable under the Stability and Growth Pact. Sound government finances are an essential condition for sustainable and non-inflationary growth and a high level of employment.[112] The sustainable financial position is defined by the government deficit not exceeding 3 per cent of GDP and by the government debt not exceeding 60 per cent of GDP.[113] Ongoing fiscal surveillance thus limits the potential for political rent-seeking by elected national governments.

The Treaty specifies the mandate of the ESCB and the ECB in Article 127(ex Article 105 TEC):

> "The primary objective of the ESCB shall be to maintain price stability. Without prejudice, to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contribution to the achievement of the objectives of the Community as laid down in Article 3."

Article 3 includes a long list of 'desirables', e.g., "full employment and of social progress". The focus of the Treaty on price stability reflects the economic arguments and the awareness of past inflationary instability already discussed. The Treaty does not specify a precise, quantitative definition of price stability or a time frame for the achievement of this objective. Price stability in the euro zone has been defined by the Governing Council as annual price increases of less than 2 per cent, according to the Harmonised Index of Consumer Prices for the euro zone as a whole.[114]

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[112]European Union (1996) Presidency conclusions: Dublin European Council . 13 & 14 December. S.M.401/96 Annex, at 9.
www.europarl.europa.eu/summits/dub1_en.htm. Accessed 10.09.09.

[113] Protocol (No. 12) on the Excessive Deficit Procedure, Article 1.

[114] European Central Bank (1998) Press Release: A Stability Oriented Monetary Policy Strategy for the ESCB, 13 October.
http://www.ecb.int/press/pr/date/1998/html/pr981013_1.en.html. Accessed 10.09.09.

The definition of price stability increases the transparency of the ECB's objective, and also helps to coordinate inflationary expectations in a world in which economic agents are forward-looking. It has also been clarified that the final objective of price stability is to be pursued over the medium term. There are good arguments against specification of an exact time frame. An exhaustive classification of shocks is not feasible; nor are the effects of those shocks on price stability always predictable. In consequence, the ECB needs some room for manoeuvre in the interpretation and the nature of the effects of shocks hitting the economy at a particular point in time. This approach is similar to that of the US Federal Reserve; the objective of "price levels sufficiently stable so that expectations of changes do not become major factors in key economic decisions"[115], which suggests anti-inflationary resolve while avoiding over-precise quantitative indications to the market. There are two further aspects of the ECB's definition of price stability: first, the definition focuses on the euro area as a whole, no special attention being paid to country or sector specific shocks; and second, the definition refers to annual price increases, and not to monthly or quarterly fluctuations.

The Treaty's mandate on price stability is consistent with the accepted body of economic thought that there is an undoubted robust relationship between money and prices in the medium and long terms. The experience of the monetarists revealed the uncertainties of monetary policy as a means to stabilise output fluctuations, and the ECB is less willing to take a specific stance on monetary policy. It should not be inferred that the ECB is not concerned about output. An economic environment of low and stable inflation reduces the general level of uncertainty and promotes an efficient allocation of resources. The maintenance of price stability is the main contribution of a monetary policy that encourages a high rate of growth of output. The feasibility of

[115] Greenspan, A. (1989) Statement before the Committee on Banking, Finance and Urban Affairs, US House of Representatives, 24 January. http://fraser.stlouisfed.org/historicaldocs/781/download/27775/Greenspan_19890124.pdf. Accessed 10.09.09

output stabilisation, as opposed to the encouragement of output growth as a general aim of monetary policy, remains doubtful. Day-to-day policy making is characterised by uncertainties that may only be resolved after many years.

In the press release of 13th October 1998, the governing Council agreed that there was "a prominent role for money with a reference value for the growth of a monetary aggregate". Attributing a special role to money is the logical consequence of the notion that aggregate price level, which is the focus of the statutory objectives of the ECB, is nothing else than the price of money, expressed in terms of generality of goods and services that are available in the market. Since monetary developments are consistent with inflationary developments in the long term, they are also a source of information on developments in the shorter term. The analysis of money can point to future price rises.

The practical application of these concepts requires judgement and caution. Financial innovation, the supply of credit, changes in payments technology, fluctuations in portfolio preferences and the tax system, are all factors whose impact on money demand can be difficult to quantify. Reliance on highly rigid analytic schemes is not appropriate. A press release of October 1998 indicated that assessment will be made "using a wide range of economic and financial variables as indicators for future price developments". The ECB has chosen a broad aggregate, M3.[116] A broad aggregate is less affected than a narrower aggregate by the substitution between various assets with very similar degrees of liquidity. Evidence available for the euro zone speaks clearly in favour of broader aggregates as having more stable, predictable long-term relationship with prices. On 2nd December 1999, the Council decided to confirm the reference

[116] Currency in circulation, overnight deposits, deposits with agreed maturity up to 2 years, deposits redeemable up to three months' notice, repurchase agreements, Money Market Funds, Debt Securities up to two years.

value for monetary growth at a rate of 4.5 per cent for M3. The reference value was based on the assumption of a real GDP growth between 2 and 2.5 per cent per year.[117]

The ECB is regarded as the most independent central bank in the world. There is an explicit Treaty undertaking by the Community institutions and by governments to respect the Bank's independence and not to seek to influence the members of the decision-making bodies of the ECB or of national central banks.[118] By incorporating the specific economic objective of price stability in the Treaty, any change would require unanimous assent of all Member States. As always, there are warning voices:

> "Freezing institutional rules and substantive principles…imply an obvious risk which is inherent in all dictates of economic wisdom; subsequent falsification by new empirical messages or by scenarios which have not been anticipated." [119]

The monetary policy conducted by the Eurosystem has been successful. Five years from the introduction of the euro Jean-Claude Trichet pointed to the success of the ECB's monetary policy "in keeping inflation and inflation expectations under control…in a context of exceptional economic, financial and geopolitical uncertainty." He attributed this success to the Eurosystem's unambiguous responsibility for the maintenance of price stability and the independence of the ECB, "which have been indispensable in ensuring a high degree of credibility for our policy from the outset".[120]

1.4.2. The United Kingdom

Although the United Kingdom is not at present part of the euro area, the principles and rules of the Stability and Growth Pact are applicable to its national budget as a Treaty

[117] European Central Bank (1999) Press Release: Review of the quantitative reference value for monetary growth, 2 December.
http://www.ecb.int/press/pr/date/1999/html/pr991202_2.en.html. Accessed 20.05.09
[118] Article 130 (ex Article 108 TEC).
[119] Herdegen, M. (1998) Price Stability and Budgetary Restraints in the Economic and Monetary Union: The Law as Guardian of Economic Wisdom, p.9, *35 CML.Rev*.
[120] Trichet, J.-C. (2004) President of European Central Bank, Speech, Annual Dinner of Guild of International Bankers, London, February 2.
http://www.ecb.int/press/key/date/2004/html/sp040202.en.html. Accessed 10.09.09.

commitment. Protocol (No.15)[121] allowing the UK to remain outside the euro area charges the UK government to endeavour to avoid excessive government deficits.[122] Other Treaty provisions apply. The Commission has the power to investigate serious balance of payments difficulties and to recommend remedial action; the Council of Ministers is empowered to grant assistance.[123] Any crisis measures taken must cause the least possible disturbance to the Common Market and be proportionate. The Council has the ultimate power to override any such measures taken by the Member States.[124]

In 1997, the incoming Labour administration set a target for inflation of 2.5 per cent, and decided to make the Bank of England independent. It was felt that an independent central bank, free to set interest rates in order to achieve a clear target, is more likely to be consistent in the pursuit of this objective than a government concerned about its popularity. In relation to monetary policy, the Bank of England Act (1998) defines the prime, and overriding, objective of the Bank as the maintenance of price stability.[125] The Treasury is empowered to inform the Bank on what price stability is to be taken to consist of.[126] The decision-making processes of the Bank are highly transparent. Statements are published regarding decisions about action taken for the purpose of meeting the objective of price stability.[127] If inflation is more than 1 per cent outside target, the Bank informs the Chancellor in an open letter stating why the divergence has occurred and the policy action taken to deal with it. Transparency is enhanced by the publication of the minutes of the monthly meetings of the Bank's Monetary Policy Committee at which interest rates are set. One of the main purposes of transparency is

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[121] Protocol (No.15) on Certain Provisions relating to the United Kingdom of Great Britain and Northern Ireland.
[122] ibid. para.5.
[123] Article 143 (ex Article 119 TEC).
[124] Article 144 (ex Article 120 TEC).
[125] Bank of England Act (1998) s.11.
[126] ibid. s.12.
[127] ibid. s.14.

to convince financial markets and the wider economy of the seriousness with which the Bank will adhere to its targets. On the 10th December 2003, the Chancellor changed the inflation target to 2 per cent, since the Bank would in future use HICP figures as the basis for its assessments.[128]

1.5. In Conclusion

This chapter has demonstrated the supremacy of the free market and the pivotal role played by price as the regulatory mechanism of that market. It has revealed the importance of the legal structure established in the European Union to allow the free market to function effectively. Compliance with the law is vital, since

> ''In a complex society, anything approaching a free market could only exist if it enjoyed the protection of laws, and therefore the state''.[129]

The following final observations on the free market, price stability, and regulatory compliance are offered:

First, the free market economic model is now dominant in Europe. Towards the end of the 1980s it became clear that the social regimes of Eastern Europe could not compete with western technology or consumerism. State direction of the economy was failing to provide citizens with a standard of living comparable to that being enjoyed in Western Europe. The lack of consumer goods was a particular cause of frustration. With the collapse of the communist system the European Union received membership applications from the former communist countries. One of the conditions for full membership is the operation of a free market economy. The accession of the twelve states of eastern and central Europe to EU membership meant the acceptance of the free

[128] HICP (Harmonized Index of Consumer Prices) is a consumer price index which is compiled according to a methodology that has been harmonized across EU countries.
[129] K. Popper (1997) 'Tribute to the Life and Work of Friedrich Hayek', in *Hayek: Economist and Social Philosopher*, p.312. Ed. S. F. Frowen.

market economic model throughout Europe. Prior to the present downturn the transition in central and Eastern Europe was delivering significant growth. For example, in Poland before 2009, GDP had grown about 5 per cent annually; in Estonia growth averaged 8 per cent per year from 2003 to 2007; in the Czech Republic the economy grew by over 6 per cent annually from 2005-2007 and by 2.5 per cent in 2008.[130]

Yet the most compelling example of the wealth creating capacity of the free market is no longer found in the West. China's economy during the past 30 years has changed from a centrally planned system that was largely closed to international trade to a more market-oriented economy that has a rapidly growing private sector. The restructuring of the economy and resulting efficiency gains have contributed to a more than tenfold increase in GDP since 1978. In 2009 China's GDP stood at an estimated $8.748 trillion with growth at an estimated 9.1 per cent.[131]

Second, despite a more than three year period of economic and financial instability, the euro has continued to be a force of stability. In a speech of 2010 Jean-Claude Trichet notes that over the twelve years following the introduction of the euro, the average annual inflation rate in the euro area has been 1.97 per cent. The euro has maintained its external value. In 1999, the euro was introduced at an exchange rate of 1.18 vis-à-vis the US dollar.[132] The current euro – dollar rate is 1.35 (17.11.10). From 1 January,

[130] CIA (2010) The World Factbook: Poland, Estonia, Czech Republic.
www.cia.gov. Accessed 24.11.10.
[131] ibid. China.
www.cia.gov. Accessed 17.11.10.
[132] European Central Bank (2010) Reflections on EMU. Speech by Jean-Claude Trichet, President of the ECB, Evangelische Akademie Tutzing, 13 November.
http://www.ecb.int/press/key/date/2010/html/sp101113_1.en.html. Accessed 17.11.10.

2011, the euro area will comprise 17 countries with a total population of over 330 million, helping the further integration of Europe's economies.

Third, the success of monetary policy has been marred by deficiencies in economic policy. In his speech Trichet attributes much of the present difficulties to a lack of sufficient discipline by fiscal policy makers. "Fiscal policies in many countries have not been in line with the letter and the spirit of the Stability and Growth Pact". There has also been an inappropriate setting of macroeconomic policies. He considers that "national price and costs developments significantly higher than the union average entail significant losses over time in competitiveness that are painful to reverse". The solution lies in "greater cohesion through a strengthened framework of economic governance". There is a need for "a new system of mutual surveillance in the euro area".

Trichet held his last press conference as President of the European Central Bank on 6 October, 2011. He defended his time in office in an interview with CNBC on that day:

> "The markets are expecting not only that the euro will be here in the next ten years, but that it will keep its value in the next ten years. The inflation expectations for the next ten years are fully in line with our definition of price stability."[133]

1.5.1. Sine qua non

The economy of the European Union generated an estimated GDP of $16.24 trillion in 2009, making it the largest economy in the world. Total population is 492 million (July 2010 est.). Income per capita stands at $32500 (2009 est.).[134] The challenge is to maintain this position of pre-eminence. It is submitted that failures to comply with

[133] Trichet, J-C. (2011) ECB's Trichet: Euro Will Hold Value Over Next 10 Years. Interview. http://www.cnbc.com//id/44801266. Accessed 07.10.11

[134] CIA (2010) The World Factbook: European Union. www.cia.gov. Accessed 17.11.10.

the legal requirements of the Treaty to avoid excessive budget deficits must inevitably impede the economic performance of the Union. The Treaty assigns overriding importance to price stability in the firm belief that maintaining stable prices on a sustained basis is a crucial pre-condition for increasing economic welfare and the growth potential of an economy. By helping to create a favourable economic environment, sound monetary policy secures the broad objectives of the Community laid down in Article 3. It is now proposed to examine in detail one of these objectives – the promotion of social justice and protection. The following chapter will discuss the development and varied forms of welfare provision in Europe today.

CHAPTER TWO: WELFARE CAPITALISM

Having demonstrated in chapter one that the free market is the optimal environment for wealth generation, and having also established that the European Union has created a legal structure designed to facilitate market efficiency, the discussion turns to state redistribution of national wealth.

Chapter two focuses on state promotion of social justice and protection. The direct provision by the state of essential human requirements, such as pensions, health care, housing and education, on a non-market basis, has come to be commonly known as the 'welfare state'. The term 'welfare capitalism' describes the combination of a capitalist economic system with a welfare state. This chapter has the following primary objectives:

First, it describes the legal provisions in International Law, the Treaty of Rome, and the European Social Chapter that define State responsibilities for the provision of social justice and protection. It considers the welfare systems designed by Bismarck and Beveridge and compares the relative merits and disadvantages of each system.

Second, it explains the differing methods of welfare delivery that have evolved among the Member States of the European Union. The typology of Esping-Andersen is adopted to explain these variations in welfare state development. Welfare arrangements in three Member States are examined, each seen as typifying a particular welfare regime: Sweden as representing the Social Democratic; Germany as a Conservative-Corporative regime; the United Kingdom is presented as a Liberal regime. Given that the onslaught of globalisation restricts national policy options, each section seeks to go beyond

Esping-Andersen by offering a perspective of the current financial circumstances of the individual Member State described. The intention is to show the ways in which these countries are adapting their systems of welfare provision in response to a rapidly changing socio-economic environment.

Third, having revealed some of the tensions that exist between the values of societies that seek to offer high levels of social provision to their citizens and the constraints of the contemporary economic environment, the chapter concludes with an assessment of the particular strengths and weaknesses of each type of welfare regime in dealing with these difficulties.

2.1 Introduction

The change from an agrarian to an industrial society made social policy both necessary and possible. Having left the land, the family ceased to be an economic production unit. The elderly and children became a heavier burden. As the dominance of markets became universal, pre-industrial modes of social reproduction, not only the family but also the church and guild solidarity, proved inadequate. In an industrial society where the welfare of individuals depended entirely on a cash nexus, any interruption of the ability to work or the availability of work brought destitution. In addition, urbanization denied recourse to subsistence agriculture in hard times. Although its accompanying social problems were all too prevalent, industrialization had vastly increased the overall wealth of society. Slowly it became generally accepted that the function of welfare provision should be appropriated by the State, which commanded far greater resources than in the past. In the second half of the nineteenth century, the rapid industrialisation of Germany made the inadequacy of existing forms of welfare provision increasingly apparent, and caused Bismarck to implement the first modern welfare scheme, starting a process of continuing development of state systems of social provision throughout the twentieth century until the present day.

State provision of welfare has become so integral a part of a state's legitimate responsibilities as to be regarded as a norm of international law, enshrined in the Universal Declaration of Human Rights. Article 22 proclaims the general principle that: "Everyone, as a member of society, has the right to social security". In Article 40 the principle is amplified:

> "Everyone has the right to a standard of living adequate for the health and well-being of himself and his family, including food, clothing, housing and medical care and the necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control."

Article 26 states: "Everyone has the right to education".

In Europe the commitment to upholding these principles is explicit as evidenced by Article 3 TEU. In 1961, the Council of Europe promulgated the European Social Charter, in which the member countries forming the Council undertook to establish or maintain a system of social security (Article 12). The Charter declares other rights: the right to vocational training (Article 10), to the protection of health (Article 11), to social and medical assistance (Article 13), and to benefit from social services (Article 14). In 1989, the Community Charter of the Fundamental Social Rights of Workers was adopted. This Charter asserts that every worker has a right to adequate social protection, and that this protection is to be extended to those unable to participate in the labour force (Clause 10). When retired, every worker must be able to enjoy sufficient resources to allow a decent standard of living (Clause 24). Elderly persons, who are not entitled to a pension and lack other means of subsistence, are also entitled to sufficient resources, and to medical and social assistance as required (Clause 25).

Article 151 (ex Article 136 TEC) states that the Community and the Member States shall have “in mind fundamental social rights such as those set out in the” above Charters when promoting policies to improve the economic and social conditions of the labour force. The Article, also refers to “the need to maintain the competitiveness of the Community economy”, implying that the pursuit of social justice is constrained by the demands of economic efficiency. The placing of efficiency as a policy consideration prior to that of equity is not universally welcomed, even if the logic of capitalism permits no other approach. Ideological dispute is inevitable. Many on the Left believe that it is the nature of capitalism itself that is the problem: an economic order based on the rights of private property does not merely perpetuate, it intensifies social and economic inequalities.

Ginsburg summarises the position of the neo-Marxists, who perceive contradictions in the role of social welfare under capitalism.[1] Whilst accepting that the welfare state relieves some of the pressures and risks borne by those who sell their labour as a commodity, the neo-Marxists draw attention to the various ways in which the welfare state strengthens and renews capitalism. First, its very existence allows capitalism to appear benevolent, and thereby acceptable to the masses, “disguising its underlying brutality”.[2] Second, the welfare state aims to provide a supply of adequately educated and healthy workers capable of fulfilling labour market requirements. Third, the welfare state makes a direct contribution to capital accumulation by investing in infrastructure, such as schools, hospitals and social housing.

[1] Ginsburg, N. (2003) ‘The Socialist Perspective’, in *The Students’ Companion to Social Policy*, p.96. Ed. P.Alcock.
[2] ibid.

These analytical insights provided by the neo-Marxists into the mechanism of the welfare state are to some extent valid. It would be surprising if welfare provision, a core activity of the modern state, did not perform a variety of diverse functions. As to their principal objection to the welfare state – that in the very concept lays contradiction – this is rejected. It is submitted that the key elements of the welfare state mechanism interconnect, constantly reinforcing each other. To illustrate, the upholding of the individual right to education is of obvious benefit to the individual; it will probably also be of collective benefit to society: a better-educated work force should result in increased economic productivity, and a richer society can afford to provide individual education at a higher standard. Here is found a virtuous feedback loop, not a contradiction.

Yet, the suspicions of the Left regarding the role of the welfare state as a bulwark of capitalism are not groundless. In a modern state where universal franchise decides who shall govern, the continuance of the prevailing socio-economic arrangements rests on the consent of the majority. Only by redistributing part of the wealth generated by the capitalist system can electoral victory be achieved, or at the very least, political instability avoided. The union between the welfare state and capitalism becomes permanent, a symbiotic relationship often described as "welfare capitalism".

Bismarck and Beveridge, the two main designers of the welfare state, understood the political significance of this relationship. Despite being very different personalities, living in different countries at different times, their designs shared a common aim – the securing and retention of mass approval of an existing order. In the late 19th century Bismarck realised that social unrest in Germany made state provision of welfare a political imperative, leading to the introduction of the world's first public pension scheme. During World War II Beveridge designed a comprehensive system of social protection which laid the foundations of the modern welfare state in the United Kingdom. He regarded his social insurance plan as contributing to a better new world after the war. The influence of these two systems of welfare provision continues. The Bismarckian system provides benefits closely linked to occupation and income. The Beveridgean system ensures all individuals are entitled to a basic level of income at a flat rate independent of income. The division between the two systems has become less clear in recent years.

2.1.1. A Comparative Evaluation

Whether inspired by Bismarck or by Beveridge, all systems of state welfare provision encounter dilemmas. Rimlinger notes some of the less welcome consequences of both types.[3]

If benefit levels are determined by contribution levels, all beneficiaries may be treated equally, but existing socio-economic inequalities will be perpetuated, and those who need protection most will be able to earn it least. If all receive the same flat-rate benefit in return for the same contributions, the system may also fail to provide adequate protection. Again, the impact on existing income inequalities will be slight. To prevent abuse, flat-rate benefits tend to be below average earnings. A low benefit, low tax regime does limit the need for state interference with personal income allocation; whereas differential benefits related to previous earnings or contributions require a deeper intervention by the state into personal income allocation.

[3] Rimlinger, G.V. (1971) *Welfare Policy and Industrialisation in Europe, America, and Russia,* pp.191-192.

If differential income taxes are levied to fund equal universal benefits, income equality is increased, but citizens are treated inequally on the contribution side. Such a system of funding may dissuade citizens from productive activity. The desire of government to avoid economic disincentives may restrict the use of this method of funding. Difficult policy decisions are unavoidable: "in a mature industrial society, social security……. (has) the dual task of eliminating unacceptable manifestations of economic and social inequality and of maintaining inequalities that are legitimate and purposeful".[4]

In the attempt to achieve an appropriate balance between equality and efficiency, no Member State relies entirely on any one method of financing welfare provision. All chose a combination of methods. And since these various methods of financing perform the same economic function: a wealth transfer from the producers to the non-producers, the choice of combination is essentially political.

2.2 Modes of Welfare Delivery

2.2.1 The Typology of Esping-Anderson

Comparative research undertaken by Esping-Anderson provides a typology to explain differences in welfare state development and also to cast light on the effects of these differences. In his classification welfare state regimes fall into three distinct clusters, each cluster having its particular arrangement of state, market and family. Three factors are regarded as salient causes of the diversity of regime type; "the nature of class mobilization (especially the working class); class-political structures; and the historical legacy of regime institutionalisation".[5] Countries strongly influenced by Social Democracy have selected highly redistributive, universal welfare provision. In contrast, Christian Democracy has preferred measures that protect the income and status of the

[4] ibid. p.343.
[5] Esping -Andersen, G. (1990) op.cit. p.29.

male worker in the family. Where neither type of political force dominates, countries have tended to rely on a reduced state involvement, providing only a basic social security net.

It is now proposed to discuss the welfare arrangements of three separate Member States, each seen as typifying a particular welfare regime: first, Sweden as representing the Social Democratic; then Germany as a Conservative-Corporative regime; and finally, and possibly more controversially, the United Kingdom is presented as a Liberal regime. Although the intention is to demonstrate that each of the chosen countries fits broadly into its stylised model, each one retains idiosyncratic features. All face the problems of open market economies operating in a global economic environment. The onslaught of globalisation on national economies continues relentlessly, limiting national policy options. Since economic and social policies are inextricably linked, the task of satisfying public demands for social protection becomes more challenging. Each state is only too aware that only economic growth can offer a painless solution.

2.2.2 The Social Democratic Regime: Sweden

The Swedish Welfare Model, "the middle way", emerged in the mid 1930's. In 1938, a Basic Agreement was concluded at Saltsjöbaden between the Swedish Trade Union Confederation (LO) and the Swedish Employers' Confederation (SAF). The Agreement marked the end of the tumultuous relationship between labour and capital. During the previous forty years of industrial strife, the employers had resorted to frequent use of lockouts. The electoral victories of the Social Democrats (SDP) provided the labour movement with the political power to counter employer actions. In this new political reality, both sides agreed to co-operate in promoting economic prosperity. Business declared its nominal political neutrality with respect to the distributive policies of the welfare state. In exchange the Social Democrats accepted policies that would facilitate capital accumulation and development in the private sector. While market forces would rule in the trade-exposed sector of the economy, a 'nationalization' of the means of consumption would occur.

A solidaristic wages policy was agreed. The LO accepted a 'socially responsible' pay strategy. In return, it was allowed to pursue a policy of minimizing pay differentials across jobs, sectors, and employers. Wage compression was also desired by the SAF. High and rapidly rising pay in the sheltered construction industry often caused difficulties for the manufacturers of internationally-traded metal products. Wage restraint was crucial to the maintenance of market position in conditions of intense international competition. The leaders of the metalworkers' union had realised that the costs of militancy and strikes were lost jobs and pay, resulting from a declining, and possibly unrecoverable, share of world trade. Workers in the less-productive industries and the service sectors benefited from wage levels higher than previously enjoyed.[6]

By the 1960s the Swedish economy began to experience labour shortages. With around 90 per cent of men of working age in employment, business demanded that the government and the LO consider additional sources of labour. Both acceded to these demands. First, the recruitment of immigrant workers was increased. Swedish immigration policy stated that the right to work should not be separated from the right of residence. Accordingly, naturalization was eased. Second, the employment of more women was accepted.[7] These potential female participants in the labour force were

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[6] Swenson, P. (1991) Bringing Capital Back In, or Social Democracy Reconsidered, pp.522-523*, World Politics*, 43(4).

[7] Rosenbluth, F., M. Light and C. Schrag (2002) *The Politics of Low Fertility: Global Markets, Women's Employment, and Birth Rates in Four Industrialized Democracies*, p.18. August. www.allacademic.com//meta/p_mla_apa_research_citation/0/6/5/2/2/pages65223/p65223-1.php.a. Accessed 15.05.09.

inevitably married and mothers with family responsibilities. The only way to induce them into the labour force was to alleviate their domestic burdens. A multitude of national laws were passed to improve the position of women in society, although certain measures could be said to have penalised married women who did not enter the labour force. In 1971 separate taxation of married couples was made mandatory. Even families with average earnings found that high marginal tax rates on a sole earner created the need for a second earner.[8] Then in 1974, flat-rate maternity benefits were changed to benefits based on last salary.[9]

The duration of maternity benefits was continually increased from 180 days in 1970 to 450 days in 1989. Lavish systems of childcare were established. In 1966, 10,000 day care places were available; by 1995 these had risen to 400,000.[10] Expenditure on public day care became 1.9 per cent of GDP in 2004, equivalent to the contribution of agriculture to the economy. Childcare funding reached on average US$ 12097 per child by 2006, becoming the second highest among OECD countries (after Denmark).[11]

While the ruling SDP and the LO both saw women and immigrants as future champions of the welfare state,[12] the Social Democrats also understood that social policies that delivered welfare benefits solely to the working classes would not command the needed broad electoral support. Overall electoral appeal required the extension of social rights to the middle classes. Services and benefits were upgraded to meet middle class expectations. Workers were guaranteed full enjoyment of these new, higher levels of provision. As intended, the role of private provision of care became minimal; the

[8] ibid. p.19.
[9] Lewis, J. and G. Alston (1992) Equality, Difference and State Welfare: Labor Market and Family Policies in Sweden, p.59, *Feminist Studies*, 18(1).
[10] Rosenbluth, F. et al. (2002) op.cit. p.20.
[11] OECD (2006) *Starting Strong II: Early Childhood Education and Care, p.408.* Annex E. Country Profiles: Sweden. http://www.oecd.org/dataoecd/16/16/37423778.pdf. Accessed 24.08.09.
[12] Rosenbluth, F. et al. (2002) op.cit. p.22.

market was crowded out. Although all social strata came under this universal insurance system, benefits were graduated according to individual earnings.[13]

The social-democratic system of high-quality welfare provision was, and of course still is, highly expensive. Middle class support for the required high taxes was essential. Additional middle class support came from another aspect of the system that this class of voters found beneficial. The expanding public sector created many extra employment opportunities for the better educated. By appealing to broad sections of society, the Social Democrats succeeded in establishing a firm and wide-based solidarity in favour of the welfare state:

> "All benefit; all are dependent; and all will presumably feel obliged to pay."[14]

The large numbers of women entering the labour force in the 1960's and 70's were mainly recruited to occupations and sectors that reflected their traditional roles, such as child care, nursing, care of the elderly, routine industrial jobs and office work. Although Swedish women now have close to the same labour participation rate as men, sex segregation in the labour force persists. The public sector has become the employer of first resort for women; the private sector remains predominantly male. The management structure is indicative: in 2008 managers were 62 per cent female in the public sector and 75 per cent male in the private sector.[15] The labour force showed a similar split. Only four occupations had an equal sex distribution, defined as 40–60 per cent of each sex. The most women-dominated occupation was office secretaries with 97 per cent women and 3 per cent men. The most men-dominated occupation was

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[13] Esping – Andersen, G. (1990) op.cit. p.27.
[14] Esping – Andersen, G (1990). op.cit. p.28.
[15] Statistics Sweden (2010) *Women and Men in Sweden, Facts and Figures,* p.95. www.scb.se/statistik/_publikationer/LE0201_2010A01_BR_X10BR1001ENG.pdf. Accessed 25.10.10.

carpenters, joiners etc. with 1 per cent women and 99 per cent men.[16] Sweden is taking extensive action to lessen these divisions.

For many years Sweden had appeared to defy the Iversen-Wren trilemma that maintains that no government can simultaneously achieve income equality, full employment, and fiscal health.[17] The 1990s revealed a different reality. Despite lower productivity strong public sector unions had been able to tie public sector wages to those of the private sector. This undermined the wage restraint essential for macroeconomic stability. The consequences were budget deficits, inflation, and a weakening currency. Between 1990 and 1993 employment declined by over half a million people, equal to 13 per cent of the labour force. GDP growth rate was negative three years in a row. The downturn in employment led to a massive increase in public expenditure as well as drastically eroded revenue.[18] Social expenditure peaked at 40.3 per cent of GDP in 1993.[19] A rapidly accelerating budget deficit resulted:

> "The provision of generous benefits has always depended on keeping the cohorts of recipients small." [20]

The crisis in the economy triggered policy changes in virtually all areas, including social security. Although the basic structure of the welfare system has been preserved – universal social services and benefits still dominate - the overall picture is one of a less generous welfare state. Benefit levels have been reduced in almost all earnings-related schemes. Parental leave and sickness insurance have been reduced from 90 to 80 per

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[16] ibid. p.57.
[17] Iversen, T. and A. Wren (1998) Equality, Employment and Budgetary Restraint; The Trilemma of the Service Economy. *World Politics,* 50(4), pp.507-546.
[18] Palme, J., A. Bergmark, O. Backman, F. Estrada, J. Fritzell, O. Lundberg, O. Sjoberg, and M. Szebehely (2002) Welfare Trends in Sweden; balancing the books for the 1990's, p.329. *Journal of European Social Policy,* 12(4).
[19] Eitrheim, P. and K. Stein (2000) 'Nordic welfare states in the 1990's', in *Survival of the European Welfare State*, p.48. Ed. S. Kuhale.
[20] Pierson, P. (1996) The New Politics of the Welfare State, p.172, *World Politics*, 48(2).

cent of earnings.[21] Benefit periods are shortened and waiting periods prolonged. One waiting day for compensation for sickness insurance was introduced in 1993.[22] The rules on eligibility for benefits have been tightened. Unemployment insurance benefit is now conditional on six months' work during the 12 months immediately preceding unemployment or alternatively 450 hours' work over an uninterrupted six-month period.[23] Much stronger emphasis is placed on rehabilitation, activation, education and training for re-entry into the labour force. Basic requirements for old-age pensions are more stringent. Full basic pension is now only granted to those with at least 40 years of residency in Sweden.[24] Benefit levels of disability and old-age pensions have also been reduced. These are calculated on the basis of the consumer price index. In 1995, it was decided that in the event of the national budget deficit climbing above a certain point, increases were no longer to be fully linked to the consumer price index.[25]

Despite retrenchment, the Swedish welfare system displays persistent stability. There remains widespread political consensus, both among the political elite and the electorate, as to continued public responsibility for welfare provision. Belief in the principle of redistribution through general taxation to produce a relatively egalitarian distribution of income appears to be strong.

In 1993 the *Riksbank* (Central Bank) announced that monetary policy would be run based on an inflation targeting regime. In 1997 the *Riksbank* was charged to maintain price stability, interpreted as inflation at around two per cent.[26] Despite a strong

[21] Palme, J.et al. (2002) op.cit. p.342.
[22] ibid. p.343.
[23] ibid.
[24] ibid.
[25] ibid.
[26] Article 2 of the Sveriges Riksbank Act.

Keynesian tradition, the government recognised that capital market integration severely limited the setting of deficit budgets and the pursuit of inflationary monetary policies.[27]

The massive increase in unemployment experienced in the crisis of the early 1990's forced the government to rescind its commitment to full employment. The goal of wage equality remains, though voices questioning its desirability become more strident. In an advanced, open economy, international competition and technological innovation restrict job creation in the high-productivity, exposed (and mainly manufacturing) sector. In this sector labour costs, though by no means insignificant, are not the major cost factor. Employers may wish to introduce pay flexibility to motivate their labour force. A policy of wage compression is not helpful. Low-skilled labour-intensive manufacturing finds its very survival threatened by increasing competition from the newly industrializing countries with their far lower labour costs. The only possible source of employment growth is the low-productivity service sector. This is the area where solidaristic wage negotiation causes real difficulties for job creation.

The OECD comments:

> "If the social partners concentrate wage increases on raising the lowest pay rates in forthcoming agreements, this will make it harder for the low-skilled, whether immigrants or native Swedes, to find jobs commensurate with their current skills and productivity levels." [28]

The continuing process of economic globalisation increasingly widens the gap between the private exposed high-productivity sector and the home-market low-productivity service sector. Swedish women, who are disproportionately represented in the home-market sector, find themselves on the wrong side of the divide. Often sheltered in

[27] Giavazzi, F. and F. S. Mishkin (2006) *An Evaluation of Swedish Monetary Policy between 1995 and 2005*, p.13. Riksdagstryckeriet, Stockholm. www.riksbank.com/templates/Page.aspx?id=23688. Accessed 10.05.09.

[28] OECD (2004) *Economic Survey of Sweden*, p.4. http://www.oecd.org. Accessed 17.06.09.

hitherto secure public sector service jobs, their future position is becoming less certain. Budget restraint not only impedes expansion of the public sector, it also makes public sector jobs the likely target of expenditure cutbacks. The semi-official report, *The Swedish Economy*, cited examples of curtailment:

> "Hiring of new staff at social-insurance offices, at universities and in the system of justice is expected to decrease this year… Purchases of services, such as temporary engagement of nurses and physicians, are decreasing relatively rapidly." [29]

Since public service provision accounts for over 30 per cent of total employment, and over 30 per cent of the population receive transfer benefits, retrenchment meets with understandable resistance.[30] Public service providers and welfare recipients now comprise entrenched groups, with considerable electoral strength. New political cleavages are emerging, centred on a gender gap between the mostly male private sector workers and the mostly female public sector ones. In public opinion polls, Swedish women are disproportionately hostile to EU membership. Presumably, those in sheltered public sector jobs are more likely to be fearful of economic integration.

A referendum on EMU membership was held on 13 September, 2003. The "no" side won with a majority of 55.9 per cent. Suggested reasons for the rejection of membership include voter resistance to change in a strong domestic climate, traditional views of Swedish independence, and the government's inability to assure voters that EMU membership would not endanger the benefits of Sweden's generous welfare state.

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[29] National Institute of Economic Research (2004) *The Swedish Economy March 2004,* p.42. Stockholm. www.konj.se. Accessed 26.05.09.

[30] Economist (2006) Admire the best, forget the rest. 9 September, Vol.380, Issue 8494, pp.27-29.

The Confederation of Swedish Enterprise takes a very different stance. The Confederation has 48 member associations, which represent almost 55,000 member companies with more than 1.5 million employees, and covers around 70 per cent of the private sector. It strongly supports a free enterprise culture and a well-functioning market economy, and therefore endorses competition in the labour market and lower taxes. The continued self-exclusion from the eurozone is held to have increased the vulnerability of the economy to money market turmoil. The Confederation believes that the solution to the rising cost of health care and old age provision lies in sound economic development. Its long-term goal is to do everything to help Sweden reclaim a top position in the OECD in respect of GDP per capita. Between 1970 and 2009 Sweden fell from 4th to 10th position in the table of the world's richest countries expressed in terms of GNP per capita.[31]

The ideological gulf is wide. The welfare providers should not ignore the concerns of the Confederation. The continuance of the Swedish welfare model rests on respect for the Basic Agreement at Saltsjöbaden. Any action that impedes the productivity of the private sector can only reduce the wealth generation that funds welfare provision.

Though Sweden still enjoys high standards of living, the numbers of those employed continue to cause concern. The official unemployment rate of 6 per cent excludes those in job activation programmes and early retirees. Workers on long–term sick leave are counted as working. Sickness benefits account for 16 per cent of public expenditure. The McKinsey Global Institute concluded that the "true" unemployment rate was around 15-17 per cent.[32]

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[31] Confederation of Swedish Enterprise (2009) How Sweden can raise its prosperity ranking. 2 March. Stockholm. www.svensktnaringsliv.se/English. Accessed 22.05.09.
[32] Economist (2006) Admire the best, forget the rest. op.cit.

In the election of September, 2007, Fredrik Reinfeldt of the New Moderate Party defeated the Social Democrats, who have ruled Sweden alone or with other parties for 65 of the previous 72 years. Reinfeldt convinced voters that he would address their concerns regarding unemployment, whilst at the same time assuring them he intended to fix, rather than dismantle the welfare system. The election manifesto of the New Moderate Party promised to cut payroll taxes for lower earners and to introduce a new working tax credit. This would be paid for by reducing unemployment benefit from 80 per cent of previous income to 65 per cent. Further deregulation, especially of services, and more privatisation were proposed. The Party hoped that labour market reforms would have a significant impact on reducing youth unemployment.[33] The 2010 election result caused Reinfeldt's centre-right coalition to form a minority government. In 2009 over 26 per cent of Swedish young people aged 15 to 24 were unemployed, compared with an EU 27 average of 21 per cent.[34] The overall unemployment rate in Sweden has climbed from 5.9 to 8.3 per cent.[35]

2.2.3 The Conservative-Corporatist Regime: Germany

The total collapse of Germany at the end of World War II presented fundamental problems of economic and social reconstruction. As in Britain, the common sharing of hardships during the war had led to a mood of social egalitarianism. The chaotic conditions of the early post-war years gave rise to feelings of individual helplessness, causing many to look to the state for protection. In this context of economic doldrums and social confusion, the governing Christian Democratic Party embraced the concept of the Social Market Economy in 1949. Chancellor Ludwig Erhard (1897 - 1977) saw

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[33] ibid.

[34] Ekonomifatka (2010) Youth Unemployment. 26.04.10. Stockholm. www.ekonomifakta.se/en/Facts_and_figures/The_Labour_market/Unemployment/Youth_unemployment. Accessed 26.04.10.

[35] National Institute of Economic Research (2009) *The Swedish Economy August 2009,* p.8.Stockholm. www.konj.se. Accessed 30.05.09

the overriding practical problem as defining the proper balance of individual and state responsibility in respect of economic and social policy. The Social Market Economy had on one hand a basic free-trade orientation and on the other, a social programme to modify the outcome of market forces by redistributive and social welfare measures.

The source of intellectual inspiration for this type of political economy came from a merger of two different approaches to economic policy and policy-making. One approach came from the neo-liberal movement, whose main centre was the University of Freiberg. Here the leading economist, Professor Walter Eucken, regarded the preservation of individual freedom as his prime concern; a concern that brought him to reject central planning, and to be wary of social measures. Monetary stability must be given priority over measures to achieve full employment. Another approach offered the Social Market. The Social Market was the realization of the concept of a socially-conditioned market regime. The major proponent of this regime was Professor Alfred Müller-Armack, who held that any policy of reconstruction must be based on a careful re-examination of the alternative merits of market-coordinated and centrally-directed economies. Müller-Armack drew attention to the laissez-faire capitalism of the Weimar Republic that had produced economic instability and social conflict; the Nazi dirigisme that followed had destroyed individual freedom and undermined rational economic calculation. To Müller-Armack the unavoidable conclusion was an economic and social policy in the centre.

Müller-Armack and the neo-liberals shared a common belief that the outcome of dirigisme was an ever-increasing number of controls that would stifle incentive and economic progress. He advised that the degree of social intervention should be limited to measures that could achieve their social objectives without disrupting the market process. He was convinced that the competitive framework of the market would make it highly productive and so capable of supporting substantial income redistribution for social purposes.[36]

The middle way of the Social Market found widespread support from the German public. Many believed that Germany could enjoy the economic benefits brought about by the enhanced productivity of the free market, while at the same time unfettered market forces could be prevented from determining its social order. One possible reason for the popular acceptance of the Social Market may have been the ambiguity inherent in the concept; all could associate the term 'social' with whatever suited their own particular interests. Indeed over time, the term 'social' began to take on a life of its own. Interest groups soon learned to exploit this vague notion in their rent-seeking activities. It proved all too easy to hide the pursuit of self-interest behind accusations of social injustice, and so move the German economy toward an extensive social welfare system that became one of Europe's most expensive.[37]

Müller-Armack described the socially conditioned market regime as the *social irenic* strongly indicating the origins of the concept in the social and political doctrines of the Catholic Church.[38] All corporatist regimes are "typically shaped by the Church"; Germany is no exception.[39] Two important Papal encyclicals, *Rerum Novarum* (1891)[40] and *Quadragesimo Anno* (1931)[41], expound the teaching of the Church on social and political challenges facing modern society. The impact of this teaching on the formation of the German welfare model has been profound. In *Rerum Novarum* Leo

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[36] Rimlinger, G.V. (1971) op.cit. pp.138–143.
[37] Witt, U. (2002) Germany's "Social Market Economy": Between Social Ethos and Rent Seeking, p.366, *The Independent Review.* 6(3), Winter.
[38] Müller-Armack, A. (1950) Soziale Irenik. *Weltwirtschaftliches Archiv(Rev World Econ),* 64, pp. 181–203.
[39] Esping-Andersen, G. (1990). op.cit. p.27.
[40] Leo XIII (1891) *Rerum Novarum*.
[41] Pius XI (1931) *Quadragesimo Anno.*

XIII acknowledges the social conflicts caused by the sweeping changes of industrialization, but believes that industrial society and Catholicism can be reconciled. His rejection of socialism is clear: "The socialists …., are striving to do away with private property."[42] "Every man has by nature the right to possess property as his own."[43] There is a firm commitment to the preservation of the traditional family: "The family, the 'society' of a man's house (is) older than any State. Consequently, it has rights and duties peculiar to itself which are quite independent of the State."[44] In normal circumstances, the civil government should not interfere with family affairs. Only if a family should find itself in great distress, from which it has no prospect of extricating itself, would that extreme necessity permit public aid.

Employers and workers "should dwell in harmony and agreement." "Each needs the other; capital cannot do without labour, nor labour without capital."[45] Accordingly, the State must take the interests of all into account, not neglecting one portion of society while at the same time favouring another. At this point in the encyclical, the doctrine of subsidiarity makes its first appearance in modern times. Aquinas is quoted with approval: "As the part and the whole are in a certain sense identical, so that which belongs to the whole in a sense belongs to the part."[46]

The rights of the working class are defined; wage earners should be cared for and protected by the government. "Daily labour ….should be so regulated as not to be protracted over longer hours than strength admits."[47] Although wages should be freely negotiated between employers and workers, wages must always be sufficient to support

[42] Leo XIII (1891) *Rerum Novarum.* op.cit. 4
[43] ibid.6.
[44] ibid.12.
[45] ibid.19.
[46] ibid.33. Aquinas. *Summa theologiae*, IIa-IIae, q. lxi, are. l, ad 2m.
[47] ibid.42.

a frugal life style. And consistent with the right of private property, the State would be unjust "if under the name of taxation it were to deprive the private owner of more than is fair".[48]

Associations and organisations for mutual help should be encouraged, workingmen's unions being the most important. Funds should be established to help in cases of accident, sickness, old age and distress. Always the aim must be to seek harmony among the divergent interests and various classes of society.

In *Quadragesimo Anno* Pius XI further develops and refines the Church's position. There is a marked distaste for the "teaching of the so-called Manchesterian Liberals"[49], whose free market theories are roundly condemned. " 'Individualism' by denying or minimizing the social and public character of the right to private property is just as harmful as the 'collectivism' of socialism."[50] Only through "the maintenance of a certain and definite order"[51] can Society find a path that avoids the twin perils of Liberalism and Socialism.[52] It is clear that "the right ordering of economic life cannot be left to a free competition of forces".[53] The notion that the market has a principle of self direction which governs it more perfectly than any deliberate invention, and must therefore be allowed to function altogether free of .public authority, is the source, "as from a poisoned spring",[54] of the errors of individualist economic teaching. It is essential that the economic order is directed: the principles of social justice and social charity must dominate, and should be implemented in a juridical and social order which will shape all economic life.

[48] ibid.47.
[49] Pius XI (1931) op.cit.54.
[50] ibid.46.
[51] ibid.45.
[52] ibid.46.
[53] ibid.88.
[54] ibid.88.

Again, the need for the worker to be paid a wage sufficient to support him and his family is stated. Moreover, "it is an intolerable abuse….. for mothers on account of the father's low wage to be forced to engage in gainful occupations outside the home to the neglect of their proper cares and duties, especially the training of children".[55]

An interesting aspect of this encyclical is its elaboration of the principle of subsidiarity. Championing the cause of corporatism, it argues that since it is wrong to take from individuals what they can accomplish by their own initiative and industry and give it to the community, it is equally wrong to assign to a greater and higher association what lesser and subordinate organizations can do. The State ought, therefore, to let subordinate groups handle matters and concerns of lesser importance, so enabling it to act more effectively in matters that belong to it alone. The more perfectly a graduated order is kept among the various associations, in observance of the principle of 'subsidiary function', the stronger will be the social authority and economic prosperity of the State.[56]

These ethical teachings underpin the concept of the Social Market Economy. The model created has proved resilient. The belief that there exists an indissoluble unity of Market and Social Orientation remains largely intact.[57] While a continuous attempt to harmonise conflicting interests has given rise to a specific identifiable mix of social policies, which may mitigate divisions within the society, this policy mix does not aim at a fundamental change of the social order.[58]

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[55] ibid.71.
[56] ibid.79 & 80.
[57] Zweig, K. (1980) *The Origins of the German Social Market Economy: The Leading Ideas and Their Intellectual Roots,* p.9.
[58] Kersbergen, K. van (1995) *Social Capitalism. A study of Christian Democracy and the welfare state,* p.231.

Today Germany operates a. generous system of social security provision. The system comprises four major elements: old-age pensions, care of the elderly, health insurance, and unemployment insurance. Financing of this system is mainly linked to the labour contact. The bulk of expenditure is funded by contributions paid half and half by employers and employees, with tax revenue contributing about one-fifth. Membership of the old-age insurance scheme is compulsory for all dependent employees (all those with a labour contract other than civil servants). Contributions are paid proportional to wages received, and may amount to 19-20 per cent. of gross pay. The pension scheme is a pay-as-you-go type.

Care of the elderly is financed by contributions of 1.7 per cent of gross wages paid by employees. Health costs are financed by mandatory insurance.[59] The German social security system is self-administered by the social partners – the trade unions and the employers' associations.[60] The self-government of the system from a legal prospective reflects the fear of the neoliberals that a national health service or an old-age pension scheme run by the state could become an instrument of vote-maximizing political behaviour.

Old-age pensions and health care are the two major items of social welfare expenditure, which now amounts to almost one third of GDP. The state absorbs nearly half of gross labour income through income taxes and social security contributions. Tax ratio was 37.0 per cent in 2009.[61]

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[59] Siebert, H. (2003) *Germany's Social Security System under Strain*, p.10. Working Paper 1155, March. Kiel Institute for World Economics. www.ifw-kiel.de/das.ifw/organisation/siebert/publikationen. Accessed 26.05.09

[60] ibid. p.14.

[61] OECD (2011a) Revenue Statistics - Comparative tables**.** http://stats.oecd.org/Index.aspx. Accessed 09.05.11.

Today Germans seem to prefer non-market mechanisms to find consensus and solve economic issues. In Germany economic activities in most areas are regulated in minute detail. A measure of the intensity of regulation is illustrated by the index of prices administered and influenced by government: almost a third of the prices of index items are regulated in some way.[62] In an attempt to reconcile the conflict between the claims of social welfare and the pursuit of efficiency, the labour market is the most intensively regulated of all.

The principle of *Tarifautonomie* (autonomy of employers and unions in collective bargaining) rules German industrial relations. The approach is to set wage bargaining for a specific industrial sector in a specific region, and then to apply the negotiated wages to the other regions of the same industrial sector.[63] *Günstigkeitsprinzip* (the principle of the most favourable condition) stipulates that a worker can as a union member deviate from the negotiated wage contract if this is favourable to him. 'Favourable' has been narrowly defined by the labour courts as a wage higher than specified in the union contract or as reduced working hours. The labour courts regard neither the risk of unemployment nor job security as legal grounds for deviation.[64]

A special feature of German company structure is the separation between a supervisory board and a management board. Under the Law of Codetermination of 1976, employees are allocated control rights over all corporate decisions in the form of seats on the

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[62] Siebert, H. (2004a) *Economic and Political Governance in Germany's Social Market Economy*, p.5. Working Paper 1207, April. Kiel Institute for World Economics. www.ifw-kiel.de/das.ifw/organisation/siebert/publikationen. Accessed 26.05.09.
[63] Siebert, H. (2004b) *Why the German Labor Market Fails, p.14*. Kiel Institute for World Economics. October. www.ifw-kiel.de/das.ifw/organisation/siebert/publikationen. Accessed 26.05.09.
[64] ibid.p.23

supervisory board. The objective is that the employees, the suppliers of labour, and the shareholders, the suppliers of capital, will guide the commercial entity co-operatively.[65]

The position of labour is further strengthened by the establishment of workers' councils. The workers' council has a set of decision rights where its consent is mandatory. Wide-ranging rights of codetermination apply to the conditions of work and the work place; these include the arrangement of working hours, vacation plans, company benefits, and the assessment of individual performance. The consent of the workers' council is required for lay-offs.

These mechanisms provide labour market insiders with a high degree of protection, while the outsiders, the unemployed, suffer. A wage cartel is created that gives trade unions and employers' associations the right to decide wage levels, while also permitting them to ignore the effects of their decisions on overall employment levels. German labour market policy became dependent on the compensating capacity of the welfare system. It was increasingly questionable whether the raison d'être of the Social Market Economy, the balance between the various groups in society, was feasible in the actual operation of the economy.

The development pattern of unemployment provides clear evidence of fundamental structural problems. Since the 1970s unemployment in Germany has risen in several distinct steps. After each economic recovery, the unemployment rate has never fallen back to pre-recession levels. In 1980 the unemployment rate was 3.35 per cent, rising to 6.2 per cent in 1990. From 1991 until 2010, it averaged 9.73 per cent. Population

[65] Pontusson, J. (2005) *Inequality and prosperity: social Europe vs. liberal America*, p.115.

shrinkage and improved economic growth have caused a reversal of this trend. The unemployment rate now stands at 7.60 per cent (March 2011).[66]

The expansion of the welfare system occurred in the 1970s. The high real growth rates of labour productivity of 7 per cent in the 1950s and 5 per cent in the 1960s were thought to indicate the pattern of future growth. This was mistaken. By the 1970s the rapid growth resulting from post war reconstruction had ended, with the oil price hikes also slowing growth. While the growth rate continued at about 4 per cent during the 1970s, it further declined to just over 2 per cent during the 1980s and to 1.6 per cent since 1995.[67] Thus, the economic basis of the welfare state displayed a decelerating growth trend at the time when welfare provision was rapidly expanding. With the German economy now on a path to recovery, the OECD predicts Germany would likely see an annual growth rate of 3 per cent in the first half of the 2011.[68]

The unemployment situation is worsened by the strict adherence to the insurance principle. This puts a premium on steady working careers. Workers with relatively high skills and incomes benefit, but an earning-related system can only discriminate against part-time workers and women whose career patterns are often broken. A welfare system that focuses on the male worker who enjoys full-time life-long employment, and holds the 'standard worker family' as the norm, is not conducive to significant job creation in the service sector and more flexible employment patterns.

With the decline of industrial employment that began in earnest in the 1980s, almost all net job creation has occurred in the service sector. Whilst services such as business and

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[66] Trading Economics (2011) Germany's unemployment rate. http://www.tradingeconomics.com/germany/unemployment-rate. Accessed 18.04.11.
[67] Siebert, H. (2003) *Germany's Social Security System under Strain*. op.cit. p.38.
[68] Deutsche Welle (2011) Economy outpacing expectations in Germany**.** 4 May**.** http://www.dw-world.de/dw/article/0,,14967506,00.html. Accessed 18.04.11.

medical care are skill-intensive, many personal services require only a low level of skill. German post-industrialisation has not provided significant employment opportunities for redundant workers, less-qualified young people and women. Employment growth in the low-skilled service sector is hampered by the relatively high price of services, which restricts demand

The vulnerability of the German welfare model is revealed. A high wage–high productivity strategy remains viable only as long as those excluded stay relatively small in number. In consequence, although the German economy is still able to maintain its international competitiveness, it becomes increasingly difficult to defend the welfare state objectives of high employment and social protection.

German unification in 1990 brought added stress to the system. The reunified country found itself unable to solve its labour market crisis though job creation during the 1990s. From 1991 until 2003 GDP grew by only 18 per cent, about half the growth rate of the United Kingdom (35 per cent) or the Netherlands (34 per cent) during the same period.[69] Despite the need in Eastern Germany to first retrain the labour force and restructure the formerly centrally planned economy, it was decided to adjust East German wages to the comparatively high West German levels. In contrast other Central and Eastern European transition countries allowed wages to stay at competitive levels to create sustainable growth. The East German economy experienced rising unemployment and continuing dependence on federal subsidies and transfer payments from West to East. Disparities continue. In January, 2005 the country's overall unemployment rate stood at 12.1 per cent (more than 5 million unemployed); in Eastern

[69] Jacobi, L. and J. Kluve (2006) *Before and After the Hartz Reforms: The Performance of Active Labour Market Policy in Germany,* p.3. DP No. 2100. Forschungsinstitugt zur Zukunft der Arbeit. Institute for the Study of Labor, Bonn. http://hussonet.free.fr. Accessed 25.10.10.

Germany it was 20.5 per cent.[70] Apart from the high fiscal costs of unification, the Maastricht criteria reduced the government's scope for expansive growth policies further. Only a small share of overall German unemployment is thought to be attributable to business cycle factors; rather the underlying cause is structural.

In 2002 the government started a series of radical policy changes. The Hartz reforms, named after the chairman of the commission that recommended the reform programme, constitute a comprehensive modification of active and passive labour market reforms. The Hartz Commission had emphasized unemployment as the overriding problem of German society. As Chancellor Schroder explained to the German parliament in 2003: "In the future no-one will be allowed to rest at the expense of society. Anyone who refuses reasonable work can expect to receive sanctions".[71] Germany implemented the first two Hartz reforms in January, 2003, followed by the third and fourth packages of Hartz reforms in January, 2004 and January, 2005 respectively. The reforms aim to accelerate labour market mobility and reduce unemployment duration, thereby reducing the financial burden imposed by the hitherto generous welfare system. Key points include:

Hartz I-III

- Stricter rules for accepting "reasonable" employment. For example, relocation without family ties now considered reasonable.
- Benefit reduction. Where there are cases of rejected job offers, burden of proof concerning the rejections falls onto the job seeker.

[70] Dingeldey, I. (2005) *Hartz in Context: The German Way to Employability*, p.1. AR1 No. 38/2005. Real Instituto Elcano de Estudios Internacionales y Estrategicos, Madrid. http://www.realinstitutoelcano.org/. Accessed 25.10.10.
[71] Deutsche Welle (2010) The much-hated Hartz IV. 9 February. http://www.dw-world.de/dw/article/0,,5221558,00.html. Accessed 24.10.10

- Programs targeted at the elderly. For example firms who hire workers over the age of 55 do not need to contribute to unemployment insurance; longer temporary contracts allowed.
- The Federal Labour Agency given power to cut benefits by up to 30 per cent if recipients of unemployment benefit refuse a job offer without adequate grounds for doing so.

Hartz IV

- Merging of long-term unemployment assistance with social welfare transfers – inclusion of fit-to-work individuals previously not registered as unemployed. Unemployment benefits and social security are now set at approximately the lower level social security claimants received (up to 345 euro per month) plus the cost of "adequate" housing.
- Further tightening of "reasonableness" clause (sub-union wages and "standard regional wages" must now be accepted); otherwise transfers may be cut; reintegration contracts.
- Introduction of "entry assistance" as a financial incentive to take up employment.
- Full unemployment pay (*Arbeitslosengeld I* - set at 60 to 67 per cent of the previous net salary) is restricted to 12 months in general and 18 months for those over 55-year-old. This may followed by the (usually much lower) *Arbeitslosengeld II* if the claimant is eligible. Eligibility is determined by individual savings, life insurance and the income of the husband or wife: only when these reserves are used up will a claimant receive *Arbeitslosengeld II*. The government forecast that half a million claimants (out of 2.1 million) would no longer be eligible for any benefits at all.

- In order to receive even the diminished payments, unemployed persons can now be forced to accept any legal job, even if the pay does not provide subsistence and no matter how advanced their (previous) professional formation. There is provision of public utility jobs for fit-to-work transfer recipients. These are popularly termed the “One-Euro Jobs”.

The Hartz reforms represent a fundamental shift in post-war social welfare policy. Hartz IV reform has been particularly resented. In February, 2010 the Constitutional Court concluded the reform was in breach of the constitution because it failed to ensure its 6.7 million recipients received a "dignified minimum income". Germany could be forced to make significant increases in welfare payments.[72]

Yet the present administration stands resolute: “The reforms are one of the main reasons why Germany has been more resistant to the recent financial and economic crisis than other countries.”[73] The rejection of the policy of rewarding non-work and the liberalization of temporary work have succeeded in reducing structural employment. During the recent downturn the expansion of short-time work acted as a crisis buffer. Evidence of the close connection of the labour market to government regulation is plain: the labour market participation rate of older people has risen by 15 percentage points to 54 per cent in only five years; the labour market participation of 15-24 year olds has also been increasing since 2003.[74] Prior to the reforms, Germany attempted to reduce unemployment by easing workers into early retirement. Now the problem of the low-skilled has moved to the forefront. Long-term unemployment of the low-skill group forms the core of structurally rigid unemployment. The central problem of the German

[72] Independent (2010) Merkel handed massive bill as court strikes down benefits system, 10 February. http://www.independent.co.uk/news/world/europe. Accessed 30.12.10.
[73] Schneider, H and K.F. Zimmermann (2010) *Agenda 2020: Strategies to Achieve Full Employment in Germany*, p.2. IZA, DIW Berlin and University of Bonn Policy Paper No. 15, March http://www.politiquessociales.net/IMG/pdf/pp15.pdf. Accessed 12.12.10.
[74] ibid.p.8.

welfare state seems intractable: low-wage work does not pay because the wages are often little more than welfare benefits when unemployed. Germany takes the view that benefit claims should generally be coupled with an obligation to perform some form of work defined in the broadest sense. Workfare is perceived as socially just.

Since 2002 public debt has continuously exceeded the SGP reference value for government debt of 60 per cent of GDP. The main political parties and the public at large consider this level of public debt to be unacceptable. It has been decided to introduce a balanced-budget law into the German constitution. A constitutional provision can only be overturned by a two-thirds parliamentary majority. From 2016, it will be illegal for the federal government to run a deficit of more than 0.35 per cent of GDP. From 2020, the länder will not be allowed to run any deficit at all. A less generous welfare regime seems inevitable.

2.2.4 The Liberal Regime: the United Kingdom

In the United Kingdom the long post-war boom of welfare state expansion ended abruptly on Tuesday, 28 March, 1976. The pound valued at $2.30 in March 1974 had fallen to below $1.70. About to depart for a meeting in Hong Kong, the Chancellor, Denis Healey, realised the gravity of the situation and cancelled his journey. Financial markets panicked; the pound went into free-fall. Faced with imminent bankruptcy, the Chancellor applied the next day to the International Monetary Fund for a £2.3 billion loan to save sterling. The IMF demanded a severe programme of cuts in public spending. Healey subsequently slashed £1 billion from a wide range of government expenditures.

The country's economic difficulties were not unexpected. In the three years up to 1976, the economy had grown hardly at all, while public expenditure had risen by 18 per cent.[75] The loan application was humiliating, and forced acknowledgement of a changed world of floating exchange rates, of large financial transactions in the markets, and of accelerating inflation – 26.9 per cent in August 1975.[76] Keynesian economics of full employment and demand management had become inadequate. On the day of the loan application, the Prime Minister, James Callaghan, addressed the Labour Party Conference. The formal break with Keynesianism was announced:

> "We used to think that you could spend your way out of recession and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that option no longer exists, and that insofar as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step… The cosy world we were told would go on forever, where full employment would be guaranteed by a stroke of the Chancellor's pen, cutting taxes, deficit spending – that cosy world is gone." [77]

The speech hints at the deep changes in the world economy that over the next decades were to change the political landscape. It could be argued that 1976 marked the point at which the United Kingdom moved towards the monetarist policies that later came to be identified with Callaghan's successor, Margaret Thatcher.

Recently available documents provide further insights into this period, revealing more of the role played by the Callaghan government in establishing the foundations of 'Thatcherism'. The letter of intent sent by the Chancellor to the IMF in return for the loan has been released by the Treasury after a Freedom of Information request from the Financial Times.[78] The letter reveals a strategy of emergency measures, including tax

[75] Timmins, N. (2001) *The Five Giants: A Biography of the Welfare State*, p.314. 2nd Edition.
[76] ibid.
[77] Labour Party Conference (1976) *Annual Report*, p.188.
[78] Financial Times (2005) IMF Information released.10 December.
www.ft.com. Accessed 14.04.07.

increases, rigid controls on public expenditure, tight money supply targets, a social contract with the trade unions to limit wage increases, elements of protectionism, and investment incentives to improve the performance of industry – plus the anticipation of North Sea oil arriving within a few years. The extent of public expenditure reduction proposed to the IMF by Healey was considerable. Healey committed to reduce borrowing from nine per cent of GDP in 1976/77 to about six per cent in 1977/78; a public expenditure reduction far greater than was known to the public at the time.

Among the documents released is a secret government forecast of the effects on the British economy of the IMF package. The government was aware that the agreed austerity measures would result in higher unemployment. The secret forecast estimated unemployment would rise from 1.3m at the end of 1976 to 1.9m by 1978. As a result of fiscal and monetary restraint, the government expected inflation to fall to 8.5 per cent by 1978, and the current account deficit of £2.3bn to become a £2.9bn surplus within two years.

The measures were painful, and almost certainly contributed to the downfall of the Labour government. The negotiated package did succeed: government borrowing was reduced, and the country's chronic trade difficulties were turned round. The price was persistent high unemployment for almost a decade.

In June 1979 the Conservatives won the election. In her electoral campaign Thatcher had been explicit about her ambition to roll back the state, and so allow more room for individual and private forms of social protection. The welfare state was portrayed as part of the problem, not its solution. Welfare spending was to be restrained by concentrating resources upon those in greatest need. In contrast to the successful privatisation of public utilities, the Conservative administrations found welfare expenditure particularly difficult to control. The State pulled back from its role in only two major areas of social provision: in housing by reducing the public stock (the "Right to Buy") and by a change in the indexation of pensions from wages to prices. Nonetheless, the effects of eighteen years of a series of small cuts in benefit provision were significant, and the Conservative administrations managed to hold welfare expenditure steady at around 25 per cent of GDP.

The Conservative belief that the primary objective of welfare was poverty relief had a lasting impact. The welfare state became leaner as it moved from Beveridgean principles of social insurance. The declining significance of universal and comprehensive National Insurance caused means-tested transfers to rise from 17 per cent of all social spending in the late 1970s to 33 per cent by the end of the 1990s.[79] By insisting on the involvement of the private sector in welfare provision, the accepted modes of delivery changed. These policy re-orientations set the British welfare state on a different path. A new type of welfare regime evolved under which social rights yielded to the demands of labour market integration, backed up by needs-based state assistance for those for whom integration was not possible.

In May 1997, the Labour Party returned to power. On public expenditure Labour inherited a favourable situation. Labour's quest for political hegemony had forced an acceptance of the irreversibility of Thatcher's economic settlement. In its electoral campaign, Labour had given firm assurances that it would observe strict controls on borrowing. Fiscal stability would be the overriding imperative. The Chancellor,

[79] Department of Social Security (1999) *Memorandum Submitted by the Department of Social Security (CP24); to the Select Committee on Social Security, Minutes of Evidence,* House of Commons, 13 December.

Gordon Brown, announced that Conservative spending plans would be followed for the first two years. His desire to calm market fears was clear.

The Labour Party election manifesto had promised that there would be no increase in income tax rates. This rejection of significant redistribution of wealth through progressive taxation was deemed crucial to the Labour Party's strategy of attracting the middle class vote. Labour's pledge closed off a traditional means of raising revenue. Brown was forced to find extra revenue elsewhere, and although the measures he adopted were not overtly redistributive, there was an undoubted redistribution by stealth to move resources towards those in social need. The July 1997 Budget reduced tax relief on mortgages and health insurance. The more affluent were also hit by increasing stamp duties on higher-priced property, changes to tax credits on pensions, and increased council taxes as a result of the easing of local capping limits.

A pattern of fiscal devices emerged. Tax loopholes were gradually closed; capital gains and inheritance tax rules were tightened; even the pledge not to raise income tax rates was honoured more to the letter than in the spirit. Brown refused to raise income tax thresholds in line with increased earnings. The linkage of income tax thresholds to inflation caused significant fiscal drag. In 1996-97 there were just over 2 million higher rate taxpayers; the number had risen to over 3.2 million by 2006-07.[80] The revenue raising potential of these stratagems is limited.

Shortly before his appointment as Minister of Welfare Reform, Frank Field drew attention to the unrealistic expectations of the electorate: "The British electorate want high Continental benefits and low American tax rates. There is no way this dream can

[80] Daily Telegraph (2007) Ten years of growing stealthy taxation. 2 May. www.telegraph.co.uk. Accessed 25.05.09.

be met."[81] The parameters of the politically possible were clearly defined – welfare expenditure must not exceed the share of GDP that it had taken under the proceeding Conservative administration. Labour faced the task of accommodating aspirations for social justice within that fiscal constraint, and accepted that only economic growth could reconcile expanding welfare needs with the desire to control growing public expenditure.

New Labour stated that it would abide by two fiscal rules:

- The golden rule: over the economic cycle, the government will borrow only to invest and not to fund current spending;
- The sustainable investment rule: over the economic cycle, the ratio of net public sector debt to GDP will be set at a 'stable and prudent' level, defined as no more than 40 per cent of GDP.

The government took the view that the burden of public spending should be shared across generations, meaning that all public consumption benefiting the current generation should be funded by that generation. To some extent, the government avoided the rules by the Private Finance Initiative (PFI). Private firms now undertake capital expenditure on behalf of the public sector. In return, the public sector pays a rent for the use of the capital asset provided by the private sector. The consequent reduction in public sector net debt makes compliance with the sustainable investment rule easier. The view taken was that the means of provision should be decided by practical judgements based on empirical evidence of the most effective way to meet social needs, and if neither state nor market alone could meet all welfare needs, then a mix of provision must be sought.

[81] Sunday Times (1997) How Labour will shake the welfare state. 4 May. http://www.thesundaytimes.co.uk. Accessed 26.05.09.

The UK has an ageing population and faces continuing pressure to increase spending on health care. Health care is highly labour-intensive – the NHS employs 1.25 million – and labour costs account for two-thirds of health expenditure. In April 2002 a budget statement announced an increase in annual investment in the NHS of 7.4 per cent in real terms between 2003 and 2008.[82] It was estimated that this increase will raise the proportion of GDP spent on health care to 9.4 per cent, slightly above average EU expenditure levels. With new and increasingly expensive technologies and drugs coming on stream, even this spending boost may prove inadequate. What is more, the NHS must operate today in a consumer society, where the expectations and knowledge of the public have risen. If these reforms fail to satisfy the more affluent, who benefit as much as the poor from a universal and comprehensive service, middle class disenchantment could be politically damaging to any future government.

Middle class support has been crucial to the development of the welfare state. New Labour offered a trade-off - big improvements in schools and the NHS, but a less generous social security system. The chosen objective of rebuilding the welfare state around work was inevitably linked to a more coercive welfare regime. This reorientation of policy might become increasingly difficult to sustain fiscally, since both education and health care display insatiable appetites for cash.

From 1992 the United Kingdom experienced a long period of steady economic expansion. In this benign climate New Labour was able to pursue its aims of economic efficiency and fairness with relative ease. Nevertheless the degree of wealth inequality within the country remains high by European standards. The ratio of income of the richest 10 per cent of the population is estimated to be 13.8 times that of the poorest 10

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[82] H. M. Treasury (2002) *The Budget.* Chapter 1: Overview. www.hmtreasury.gov.uk/bud_bud02_chapter_1.htm. Accessed 08.06.09.

per cent. In comparison, this ratio is 6.5 in Sweden, and 6.9 in Germany. Despite New Labour's redistributive measures, the Gini co-efficient has risen since 2003-4, reaching 0.35 (2008) as against 0.33 when New Labour came into office in 1997– an increase that is statistically significant at the 5 per cent level. [83]

The global economic downturn, restricted access to credit, and decline in property process pushed the country in to recession in the second half of 2008. The Government responded by taking measures to stimulate the economy. The banking system was partially nationalised. Taxes were cut. The rules on public sector borrowing were suspended. Capital projects were brought forward. All welfare regimes are vulnerable in economic downturns. The demand for social expenditure, especially unemployment benefit, is inversely related to the capacity of the economy to fund it. Cuts in expenditure may only intensify problems.

Labour has always claimed the welfare state as its own. In reality the British welfare regime always was, and remains, a cross-party construction. The political debate has been about "the extent of the state welfare, not about the overall need for it".[84] Both Labour and Conservative parties have accepted that "there are not just limits to the maximum role of the state, there are limits to the minimum role too".[85] Half a century of economic and social change has destroyed the social settlement of the Beveridgean welfare state. Now the population is ageing, family structures are changing, and increasing numbers of women participate in the labour force.

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[83] Brewer, M., L. Sibieta and L. Wren-Lewis (2008*) Racing Away? Income inequality and the evolution of high incomes*, p.3. Briefing Note no.72. The Institute for Fiscal Studies. http://www.ifs.org.uk/publications/4108. Accessed 23.09.10.
[84] Alcock, P. (2003) *Social Policy in Britain*, p.145. 2nd Edition.
[85] ibid. p.144

In relation to Esping-Anderson's typology, the classification of the British welfare state as liberal has been accepted with reservations by many commentators. "Britain sits uneasily within its category".[86] These reservations, it is submitted, will gradually disappear. Britain's welfare regime will move ever further from the universalism of Beveridge towards the minimal provision of a safety net for the needy. That is the inescapable consequence of a desired convergence with a prevailing global economic order, which can only be characterised as laissez-faire.

2.2.4.1 The Gathering Storm

The New Labour project was derailed by the global financial crisis. Tax revenue fell because of the recession. Data from the Office of National Statistics reveal a fall in tax receipts in August 2009 of 9 per cent as compared with August 2008, while public expenditure increased by 3 per cent. Spending on benefits rose by £900 million to £135 billion, as higher levels of unemployment were experienced. It became clear that larger borrowing would be required over the next few years. Higher interest charges will result in a greater proportion of GDP being diverted to service the debt.[87] In the immediate term tax increases and spending cuts are unavoidable. The electorate faces the unpleasant prospect of paying higher taxes for a lower level of public benefits.

As a proportion of national output UK government borrowing is not at present excessive when compared with some other advanced economies, but the country's level of debt has been growing at a faster rate. The possibility needs to be considered that capital markets may prove unwilling to continue lending at current rates. A significant rise in long-term interest rates would impede economic recovery. While cuts in public spending will inflict pain on the electorate, a marked reduction in government

[86] Powell, M. (1999) *New Labour, New Welfare State?* Introduction, p.2
[87] Times (2009) The Borrowers.19 September.
www.thetimes.co.uk. Accessed 20.09.09.

expenditure may be necessary to reassure capital markets that the UK government remains in firm control in the present severe downturn.

In the 2009-10 financial year, the budget deficit was £155bn. Total government debt is expected to reach £900bn (70 per cent of GDP) in the next few years. In the Spending Review of October, 2010, the Chancellor, George Osborne, announced major reductions in expenditure on welfare provision, higher education, social housing, policing and local government. £81bn is forecast to be saved in "a measured plan that takes place over four years.” [88] Spending on the National Health Service, schools, some infrastructure schemes and green energy will be sustained. Universal benefits for the elderly, such as free bus travel and winter fuel allowance, will be retained, since the administrative costs of means- testing were considered too great. Carl Emmerson, the acting director of the IFS, warns that “the structural budget deficit could turn out to be larger than the Office for Budget Responsibility's central estimate. Further tax rises or deeper spending cuts might prove necessary”.[89]

The Chancellor told parliament that 490,000 public sector jobs would be cut over the four year period. Pay for most public sector workers will be frozen for two years. Most Whitehall departments face budget reductions of 19 per cent on average, while the defence budget will fall cut by 8 per cent. The retirement age is to rise from 65 to 66 by 2020. Some incapacity benefits will be time-limited, and further savings achieved though changes to tax credits and housing benefit.

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[88] Osborne, G. (2010) Speaking to BBC Radio 4's Today programme. 21 October. http://news.bbc.co.uk/today/hi/today/newsid_9113000/9113434.stm. Accessed 23.10.10.

[89] Financial Times (2010a) Economists’ views on the review. 20 October. www.ft.com. Accessed 08.01.11.

Emmerson comments that the chancellor's plans imply the deepest cuts since the 1976 emergency funding package from the International Monetary Fund.[90] Given the scale of the deficit, and given the implementation lags associated with spending cuts, some taxes will have to rise if the deficit is to be reduced sufficiently quickly. The Chancellor decided that proportion of spending cuts to tax rises should be 80/20. The rate of VAT on most items was increased to 20 per cent. This tax measure aims to demonstrate fairness to the bulk of citizens upon whom cuts will fall. The VAT increase is projected to yield an extra £13 billion a year, though it is likely to intensify inflationary pressures.

Two questions, it is submitted, are especially pertinent. First, will these austerity measures be sufficient to retain the confidence of capital markets, and so allow the country to keep hold of the triple A credit rating accorded to its sovereign debt? Second, is the present coalition administration robust enough to withstand the political turbulence and social unrest that could lie ahead? From Beveridge onwards British welfare provision has never been generous; cutbacks will be painful.

2.3. An Appraisal

All welfare regimes are the products of historical circumstance. Each reflects the values of a particular society, and inherent in each are difficulties, some of which have become more evident over time. This chapter has revealed some of the tensions that exist between the values of societies that seek to offer high levels of social provision to their citizens and the constraints of the contemporary economic environment.

First, social democratic welfare regimes are found in a cluster in Scandinavia. The four countries of Norway, Sweden, Denmark and Finland offer generous welfare

[90] ibid.

entitlements to their citizens, but at high cost. The overall tax-to-GDP ratio in the EU27 was 39.3 per cent in 2008; the tax burden in EU27 was highest at almost 50 per cent in Denmark (48.2 per cent) and Sweden (47.1 per cent).[91] While these welfare regimes command broad public support in their respective countries, cost considerations would argue against such levels of benefit provision being granted in other Member States. It may well be that this particular form of welfare provision can only exist in small countries, whose citizens possess a strong sense of common identity that inclines them towards an egalitarian distribution of economic resources.

Second, the conservative-corporatist regime, the dominant model in continental Europe, aims to achieve social harmony among the various groups in a society, and not to effect change in the social order. Tight labour market regulation ensures employment security for workers with permanent contracts. The cost of lay off makes employers reluctant to hire permanent staff and encourages the use of temporary contracts that have few benefits and rights. In southern Europe this feature of the labour market is especially pronounced. Currently approximately 30 per cent of Spanish workers are employed on temporary contracts.[92] The dual contract system leads to an insider/outsider divide. This is not conducive to the social cohesion, which the system aims to create. High rates of structural unemployment are common. Young people seeking to enter the labour force find opportunities for permanent employment to be scarce. Constant pressure on the welfare budget causes rising social security contributions to be levied on the workers.

[91] Eurostat (2010b) Press Release: Taxation trends in the European Union EU27. Tax ratio fell to 39.3% of GDP in 2008. Steady decline in top corporate income tax rate since 2000. STAT/10/95. 28/06/2010. http://europa.eu/rapid/pressReleases. Accessed 08.12.10.

[92] European Union (2010a) Communication from the Commission. *Fixed-Term Contracts in the European Union.* DG EMPL/A/2 J II 27.
http://www.eu-employment-observatory.net. Accessed 16.12.10.

Third, the liberal welfare regime provides extensive welfare coverage, but delivers benefits and services at a low level. In the United Kingdom successive governments have sought to manage a changing economy and domestic unemployment by restraining social expenditure growth and favouring labour market flexibility. Welfare expenditure including education is 25 per cent of GDP compared with Sweden (38.2 per cent) and Germany (33.2 per cent).[93] The liberal regime rests on the assumption that the private sector will supplement state welfare provision. Yet in order to remain competitive in international markets, employers seek to reduce fixed labour costs by curtailing non-wage welfare compensation. Low wages can necessitate high income maintenance transfers, and may produce poverty traps, since low-paid employment can result in a loss of benefits. While there is wide electoral support for core services of health, pensions, and education, from which all benefit, welfare benefit claimants are a minority and are poorly supported. Some of the most vulnerable become trapped in permanent welfare dependency.

2.4 In Conclusion

With regard to its stated primary objectives, this chapter first sought to demonstrate that social protection systems are highly developed in Europe. Three Member States were chosen as typifying particular forms of welfare regime. All were found to provide pensions, health and long-term care, social protection for the poor and disabled, and policies to support people in the event of unemployment. The strength of European commitment to welfare provision is seen in the average 27% of GDP that the Member States spend on social protection, in strong contrast to the US (15%) and Japan (17%).[94]

[93] Economic and Social Research Council (2010) *Future of Cities*. www.sbs.ox.ac.uk/centres/insis/events/.../futureofcities-keith-16nov2010.pdf. Accessed 15.12.10.

[94] European Union (2011) Eurostat : Social protection statistics. October 2011. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Social_protection_statistics. Accessed 10.11.11.

Second, it has also been demonstrated that while a high level of social protection is a distinguishing feature of the European social model, that model is not monolithic. Within the European Union the competence for organising and financing social protection systems belongs to the Member States. EU Member States are hesitant to relinquish this competence and wish to retain the right to structure their welfare states according to their national traditions and politics. The chapter has revealed a range of distinctive methods of state provision of social protection. Yet despite the diversity between national systems, all Member States were found to share common concerns and challenges, such as early labour market exit, persistent high levels of unemployment, and increasing numbers of elderly persons, challenging the sustainability of public finances. It was observed that the need to maintain a balance between economic efficiency and social progress required the constant readjustment of welfare provision. The three countries discussed have provided examples of systems implementing these necessary adjustments. Each system was found to be subject to further pressure brought by globalisation and the need to adapt to worldwide developments.

Third, the assessment of the particular strengths and weaknesses of each type of welfare regime has shown that no type of welfare regime can offer a perfect solution to the difficulties of providing high levels of social protection to European citizens. Each mode of welfare delivery was found to have negative aspects. In each case fiscal consolidation demanded constant evaluation of welfare benefits in the light of costs imposed on the economy. It is concluded that in order to prove resilient in the 21st century a welfare regime must not only be highly adaptable to a changing socio-economic environment, but also succeed in retaining widespread electoral support.

Finally, advanced economies are confronted with new global challenges. Globalisation continues to gather pace, with emerging economies competing for scarce energy and other primary resources, thus causing oil, food and other commodity prices to escalate. Climate change could have an adverse impact on the distribution of income and wealth given that the least advantaged in society may be disproportionately affected. By themselves globalisation and climate change would have severely tested the adjustment capacity of Member States. Their adverse impact is amplified by the rapid ageing of European populations.

The nature and impact of demographic developments within Europe are profound, and may well pose the most serious threat to the long-term sustainability of all welfare systems, as the next chapter will attempt to explain.

CHAPTER THREE: THE AGEING OF THE EUROPEAN UNION

Having ascertained in chapter two that in all Member States the financing and operation of extensive welfare schemes forms a major component of state budgets, and having also determined that the required funding must not compromise the macroeconomic stability of the individual state, attention now focuses on a change in the structure of European societies that is likely to be a major cause of fiscal pressure in the future.

Chapter three considers the nature and impact of unprecedented demographic shift on the European Union, where very low fertility rates have gradually increased the proportion of the elderly in its population to those of working age. The chapter has the following primary objectives:

First, it outlines world demographic developments, and their implications for the European Union, a major participant in the global market place.

Second, it discusses the present demographic situation in Europe and the probable adverse consequences. It investigates whether migration from third countries offers a solution to the demographic deficit.

Third, it explains the current policy of the European Union towards future immigration. It notes the increasing awareness in Europe of rising health and pension expenditure. It examines the impact of demographic shift on potential growth. It argues that the negative impact of demographic change can be partially offset by the participation of more people of working age in the labour market.

Four, it examines European policy initiatives that seek to mobilise the full potential of people of all ages. These include the outlawing of discrimination on grounds of age, and the Lisbon Strategy that seeks to increase the labour market participation of women, older workers and young adults. It draws attention to the implementation of broad economic guidelines to spread best practice throughout the Member States. It considers the role of the Stability and Growth Pact in ensuring budgetary sustainability. It acknowledges the importance of the budgetary projections of the Ageing Working Group in the assessment of compliance with the Pact, while recognising that all projections rest on assumptions that have a subjective element.

Fifth, it discusses issues that underlie the preceding investigation. The degree of entrepreneurial activity in an ageing society is questioned. The contention that below replacement level fertility presents a threat to continuing viability of countries is examined. The claims of intergenerational equity are acknowledged, and their effects on the future viability of old age provision explored.

3.1 The Global Context

3.1.1 Introduction

At ten yearly intervals the U.S. Census Bureau issues a compendium of demographic statistics for every country of the world. The last survey, *Global Population Profile: 2002,* was issued in March, 2004. According to the U.S. Census Bureau, world population reached 6 billion in June 1999, approximately doubling in size from 1960. Long-term projections suggest a world population of 9.2 billion in 2050,[1] after which it

[1] U.S Census Bureau (2010a) World Vital Events, International Data Base. http://www.census.gov. Accessed 13.01.11.

may peak at under 10 billion.[2] This remarkable rate of growth is equivalent to 2.4 people each second, or 6.3 million each month. Over the period 2002-2010 the world population increased by 525 million people, more than the combined population of EU27. The pace of population growth is on the decline: from a peak of 2.09 per cent in 1964 to 1.1 per cent in 2000, and projected to be 0.45 by 2050.[3]

Behind this global overview lie disparities. In 2002, China was the most populous country in the world (1.3 billion). This situation has existed at least since 1950. India, the second most populous country in the world (1 billion), has been gaining rapidly on China in both absolute and relative terms, and, according to Census Bureau projections, will eclipse China in total population in 2037. Projected populations in 2050 are China (1.4 billion) and India (1.6 billion).[4]

The developing countries in the rest of Asia (excluding Japan, China and India) plus Oceania (excluding Australia and New Zealand) are expected to be more populous than any other region by 2050. The largest percentage increase in population size over the next five decades is projected to occur in sub-Saharan Africa. This area has already experienced a rapid increase in numbers, with a population of 183 million in 1950 increased to 687 million in 2002. Over 800 million people are expected to be added to this region, resulting in a projected population of 1.5 billion in 2050; an area half the size of China is likely to surpass it in population numbers by 2050.[5] China, conversely,

[2] U.S. Census Bureau (2004) *Global Population Profile: 2002,* p.11. International Population Reports, WP/02. http://www.census.gov. Accessed 26.07.07.
[3] U.S. Census Bureau (2010b) Total Midyear Population for the World: 1950-2050, International Data Base. http://www.census.gov. Accessed 13.01.11.
[4] ibid.p.12.
[5] ibid. p.13.

is projected to begin to lose population in larger numbers than any other country or world region; by 2050 reducing by over 5 million each year.[6]

Another area of rapid population growth is the Near East, with a current population of 179 million, projected to rise to 396 million by 2050. Population pressures over the whole African continent are immense - the Egyptian Ambassador to the United Nations draws attention to his country's plight:

> "By 2025 the Egyptian population will between 93 and 100 million persons. In 1913, by comparison, the country had only 13 million persons…. Only four per cent of Egyptian land is arable…. This situation is compounded by the loss of arable land to development. The population of Cairo is now 23 million persons…. We are about 70 million persons today. Adding another 30 million will require creating 600,000 to 800.000 jobs annually…. How are we to stabilize the demographic explosion? " [7]

In contrast, more than half the world's developed countries, including those in Eastern Europe and the former Soviet Union, are expected to experience population decline over the next 50 years.[8] Only the United States is projected to retain its position as one of the top ten largest contributors to global population growth in 2050.[9]

These differentials in population growth will in some cases result in dramatic repositioning of countries and regions according to the size of their relative populations. Current demographic realities and expected future population changes, and their likely far-reaching consequences, will force reassessment of many existing economic, social, and political policies.

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[6] ibid. p.16.
[7] United Nations (2002a) *Report of the Expert Group Meeting on Completing the Fertility Transition*. Part One, p.17. Population Division (ESA/P/WP.171). www.un.org/esa/population/publications/completingfertility/FinalreportPartOne.pdf. Accessed 01.06.09.
[8] U.S. Census Bureau (2004) *Global Population Profile: 2002.* op. cit. Table A-4.
[9] ibid. p.17.

3.1.2. The Mechanics of Population Change

It is necessary to examine the causes of these population changes. Three fundamental factors can be identified: births, deaths, and migrants. Raw numbers are not helpful to understanding the magnitude of these events. A more useful description can be produced by expressing these raw numbers of births, deaths, and migrants as rates in terms of the size of the population that contributes to each event type. Women of childbearing age (say, ages 15 to 49) are used to express births, and the entire population to express deaths and migrants.

The next step is to identify the level at which each component will not affect the size of a population. For fertility this is the Net Reproduction Rate (NRR) the average number of daughters that would be born to a woman if she passed through her lifetime conforming to the age-specific fertility and mortality rates of a given year, taking into account that some women will die before completing their childbearing years. NRR provides an accurate measurement of fertility in populations where the number of male babies is relatively high (due to, for instance, female infanticide and gender selected abortions). A constant level of mortality and number of deaths will contribute to stabilise population size. For migration, when immigration equals emigration (net migration is zero), constant size will be encouraged.

a) <u>Births</u>

One consequence of this manner of description is that a change in size of a population may occur even if fertility is at replacement level, mortality is constant, and migration is prevented. This results from an increase in the number of women of childbearing age relative to the rest of the population, mainly caused by past deviations of fertility from replacement level. This phenomenon is described as population momentum. In 2002, population momentum was the main driving force of world population growth. A lesser role was played by above-replacement level fertility; mortality decline was of little significance. Population momentum was dominant in most of Asia and the Americas, and only in sub-Saharan Africa was above-replacement fertility the main driving force. In Europe below-replacement fertility was the primary cause of change.[10]

Since the United Nations stopped reporting NRR data for member nations after 1998, the commonly used descriptive term is now the Total Fertility Rate (TFR): the mean number of children that would born alive to a woman during her lifetime if she were to pass through her childbearing years conforming to the fertility rates by age of a given year. This rate is therefore the completed fertility of a hypothetical generation, computed by adding the fertility rates by age for women in a given year (the number of women at each year is assumed to be the same). The total fertility rate is also used to indicate the replacement level fertility. In general the higher the level of mortality in a population, the higher the replacement level of fertility will be. Although in the developed world fertility is at replacement level when TFR is 2.1 births per woman, the overall global TFR required to achieve replacement level is 2.3 children per woman, reaching a high of 3.4 children per woman in Mozambique.[11]

If current trends persist, the gap between the actual level of fertility and the replacement level will decrease gradually, with the actual level falling below replacement in 2043. By 2050 TFR is predicted to be 2.09. Nevertheless, despite a general trend towards convergence, country-by-country differences in fertility are expected to persist. Indeed,

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[10] ibid. p.18. Figure 6.
[11] ibid. p.22.

the majority of developing countries will still have above-replacement fertility, though at gradually declining rates.[12]

b) Mortality

One means of describing the level of mortality of a population is the life expectancy at birth. Life expectancy at birth is the mean number of years that a newborn child can expect to live if subjected throughout life to the current mortality conditions (age-specific probabilities of dying). At present, the global pattern is one of gradual declines in mortality. In 2002, the overall life expectancy at birth was 63.8 years (66.12 in 2010)[13], predicted to rise to 76.6 years by 2050. The rate of improvement is expected to be substantially faster in the developing countries than in the developed world. The majority of countries with the current levels of mortality at under 50 years are in sub-Saharan Africa, partly as a result of the HIV/AIDS epidemic.[14]

Recent statistics reveal that nearly 30 million people have died from AIDS-related causes, and that 33 million by the end of 2009 are currently living with HIV/AIDS. Although the overall growth of the epidemic has stabilised in recent years, the disease has now taken hold in the most populous countries. It is believed that the number of infected has reached one million in China and six million in India.[15]

The demographic impact of HIV/AIDS is still predicted to be greatest in Sub-Saharan Africa. About 100 million additional deaths are expected in this region by 2025, resulting in 14 per cent fewer inhabitants than there would have been in the absence of

[12] ibid.
[13] CIA (2011) World Factbook.
www.cia.gov. Accessed 14.01.11.
[14] U.S. Census Bureau (2004) *Global Population Profile: 2002.* op. cit. p.25.Figure 13.
[15] Avert (2011a) Global HIV and AIDS estimates, end of 2009.
http://www.avert.org/worldstats.htm. Accessed 20.04.11.

AIDS. Botswana has the highest HIV prevalence rate in the world. Life expectancy was 65 years in 1990-95 and is at present around 40 years. Population decline is anticipated within a few years. [16] According to most recent information, HIV prevalence in Africa seems to have declined slightly, although it remains at an extremely high level.[17]

European complacency would be unwise. Growth rates in new HIV infections as reported over the last several years in Estonia, Russia and Ukraine are among the highest in the world. Upwards of one out of every one hundred adults in these three countries are infected. There is consensus amongst experts that delays in prevention will prove disastrous. In Russia HIV cases were thought to be zero in 1995, and by 2002 were reported as 225,000. In 2007 the estimated number had reached 1.0 million.[18] The United Nations comments:

> "Just as in some CIS countries today, only twelve years ago, South Africa saw less than 1 per cent of its adult population infected; now the rate is twenty times higher." [19]

c) <u>Migration</u>

Since every person that leaves one country must enter another, net world migration will always be zero. Migration is an important determinant of population change for many countries. In contrast to predictions of fertility and mortality, projections of migration are more problematic. Information on international migration is often unreliable; any projections are likely to be subject to large errors.

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[16] United Nations (2003) *The Impact of Aids*, p.17. 2 September. FSA/P/WP 2003.
http://www.un.org/esa/population/publications/AIDSimpact/AIDSWebAnnounce.htm. Accessed 15.11.09.
[17] Avert (2011b) *HIV and AIDS in Africa*.
http://www.avert.org/hiv-aids-africa.htm. Accessed 20.04.11.
[18] Avert (2009) *HIV and AIDS in Russia, Eastern Europe & Central Asia.*
www.avert.org/aids-russia. Accessed 09.05.09.
[19] United Nations (2004a) News Release: Reversing the Epidemic: Facts and Policy Options, K. Mizsel, UNDP Assistant Administrator and Director for European and CIS. United Nations Development Programme 17 February. Moscow.
www.undp.bg/file_dl.php?url=uploads/images/843_en.pdf. Accessed 01.06.09.

3.1.3. Global Population Composition

Again, there are wide differences. Overall men outnumber women up to the 50–54 age groups, after which women outnumber men. The largest age group for both males and females is aged 10-14 followed closely by ages 0–4 and then 5–9.[20] In 2002, 1.8 billion people were under the age of 15. This represented slightly less than 30 per cent of the total world population. Over the next 50 years the absolute number of children projected to show only a slight increase. Relative numbers are expected to fall to about 25 per cent by 2020 and 20 per cent by 2050.[21] In 2002 children (ages 0–14) as a percentage of total population were 51 per cent in Uganda and 14 per cent in Italy. In fact, sub-Saharan Africa and the Near East show consistently above average percentages of children, whereas below average percentages are found in the developed countries.[22]

In 2002, 1.6 billion women were between the ages of 15 and 49 amounting to about 52 per cent of the total female population. Between 2002 and 2050 this female age group is expected to increase gradually by over 0.4 billion, declining to about 50 per cent of the total female population in 2020 and to 45 per cent by 2050.[23] Regional differences are considerable: between 2002 and 2025 female population will grow substantially faster than the male population in sub-Saharan Africa, the Near East and North Africa, while declining in China, Eastern Europe, Russia and the developed world.[24] For example, the number of women of reproductive age in Germany was 19.5 million in 2002, predicted to decline to 15.4 million by 2025; this female age group numbered 29.8 million in Nigeria and is expected to increase to 52.7 million by 2025.[25]

[20] U.S. Census Bureau (2004) *Global Population Profile: 2002.* op. cit. p.33.
[21] ibid. p.37.
[22] ibid. p.39.
[23] ibid p.43.
[24] ibid. p.44.
[25] ibid. p.114. Table A-6.

In 2002, 4.0 billion people were between 15 and 64, amounting to approximately 64 per cent of the total world population. This age group is projected to increase to 5.7 billion. In relative terms only a slight decline to about 63 per cent is expected by 2050. At present high proportions of this age group are found in the developed world, Eastern Europe, and Russia, and parts of Asia, with low proportions in sub-Saharan Africa. But projections for the period 2002 – 2025 show a reverse situation: sub-Saharan Africa working age group proportion is 53 per cent in 2002 projected to rise to 58 per cent in 2025; Western Europe the current proportion is 66 per cent with a projected decrease to 62 per cent.[26]

The most remarkable change in population composition will be the rapid growth of the elderly. In 2002, 440 million people were aged 65 or over (7 per cent of the total world population). These numbers will almost double by 2020 (9 per cent of total) and more than triple by 2050 (almost 17 per cent of total).[27] Since the relative size of the elderly population is largest in the developed world and Eastern Europe and smallest in Sub-Saharan Africa, the relative size of the elderly will show the most significant increase in the developed world and Eastern Europe.[28]

The United Nation highlights this change. The United Nations notes that at present one in every ten persons in the world is 60 years or over. This ratio is projected to rise to one in every three persons by 2050, at which time the total number of people over the age of 60 will be almost 2 billion, and will outnumber children (0–14 years). And the older population is itself ageing. Currently, those 80 years or older comprise 12 per cent of the over 60 age group. This proportion of the older population is projected to

[26] ibid. p.46.
[27] ibid. p.49.
[28] ibid. p.50.

rise to 21 per cent by 2050. The anticipated number of centenarians will increase eighteen fold from approximately 180,000 in 2000 to 3.2 million by 2050. The majority of older persons are women: the global ratio is 81 men aged 60+ for every 100 women, rising to 53 men for every 100 women in the 80+ age group.[29]

3.2. The Changing Demographics of the European Union

Although to the south and east of the European Union, in Africa and the Near East, populations will increase rapidly, the demographic situation within Europe is very different. The estimated population of the European Union (EU 27) was 491 million in early 2006. Europe has now entered a period of very slow demographic growth. On the basis of present slight rises in the birth rates, life expectancy and migration flows, Eurostat projects that the population of the EU 27 will be roughly the same in 2060 at about 500 million, but will be significantly older. From 2015 deaths will outnumber births.[30] By 2050 the median age in EU27 will have risen to 48 years, meaning that by then, almost half of Europe's population will be above age 50.[31]

From a demographic prospective, the European Union combines some "extremes". Many EU Member States experience the lowest fertility rates in the world. While on average the TFR in EU 25 is 1.52 (2008), there are significant variations. Whereas the TFR in France is 1.98 and in Sweden 1.85, most Member States in Eastern/Central and Southern Europe have very low fertility rates. For example, the Czech Republic

[29] United Nations (2002b) *World Population Ageing 1950-2050*, p.23-25. Population Division, DESA.
[30] European Union (2009b) Press Release: 2009 Ageing Communication: a renewed strategy for tackling Europe's demographic challenge. IP/09/656. 29 April, Brussels. http://ec.europa.eu/social/main. Accessed 24.11.09
[31] Muenz, R. (2007) *Aging and Demographic Change in European Societies: Main Trends and Alternative Policy Options*, p.5. SP Discussion Paper No. 0703. Social Protection. World Bank.

experiences a TFR of 1.33, Slovenia 1.32 and Italy 1.38; for EU25, fertility rates are projected to rise to 1.68 by 2060.[32]

Many Member States enjoy the highest life expectancies in the world. At present Europeans have on average a life expectancy at birth of 70 years (men) and 78 years (women). Life expectancy at birth increased by some 8 years between 1960 and 2000. Eurostat projects these increases to continue, though at a decelerating pace. The largest increases in life expectancy at birth, for both males and females, are projected to take place in the new Member States. For example, the life expectancy of men in Lithuania is projected to increase from 65.9 years (2008) to 78.1 by 2050 and that of women from 77.4 to 85.3.[33]

Low fertility and increasing life expectancy reverse the age pyramid, leading to a shrinking number of younger people, an ageing and eventually shrinking work force, and an increasing and greater proportion of elderly people. In the age group 0 – 14 numbers are projected to decline gradually from 2020 onwards. The size of the working age population (15 - 65) will begin to decline from 2010, and is projected to fall by 15 per cent by 2060. There will be considerable increases in the numbers of age group 65+: 85 million in 2008 rising to 151 million in 2060. One development is of special importance in respect of projected public spending on health and long-term care for the elderly is that within age group 65+ the largest increase is projected to be those over 80 years of age, with numbers projected to almost triple from 22 million in 2008 to 61 million in 2060.[34] The increase in numbers of the old-old will be rapidly apparent. To illustrate, in Britain this age group has increased by over 1.1 million between 1981 and

[32] European Union (2009c) *The 2009 Ageing Report: Underlying Assumptions and Projection Methodologies for the EU-27 Member States (2007-2060)*, p.31. Joint Report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee (AWG). European Economy 7/2008. 29.04.09, Brussels.
[33] ibid. p. 22.
[34] ibid. p.17.

2007 (1,572,160 to 2,749,507), that is, from 2.8 per cent to 4.5 per cent of the total population.[35] Over 28 years the number of centenarians in the UK more than quadrupled from 2,600 in 1981 to 11,600 in 2009.[36]

The improvement in survival at extreme old age has been striking. Writing in 1997, Vaupel noted that in developed countries the number of centenarians was increasing at the exceptionally rapid rate of almost 8 per cent per year on average. He regarded as untenable the belief that mortality at older ages is intractable. "If death rates at older ages were approaching a biological limit, then it might be expected that improvements in countries with the lowest death rates would tend to be slower than in countries with death rates further away from the irreducible minimum."[37] He found "no correlation, either for males or for females, between levels of mortality or rates of mortality improvement".[38] Although males suffer higher mortality than females, the rate of improvement for females is higher. But as to determinants of longevity, knowledge is still sparse, though new findings (especially concerning genetic factors) are emerging at an accelerating rate.[39]

A Glimpse of the Future?

An Obituary:

> *"Miss Guise-Berrows died in March 2004 having celebrated her 110th birthday on 28th February. She was the first female clerk at Worcester branch and she retired from there at the age of 51 and was in receipt of her bank pension for some 59 years. Miss Guise-Berrows spent the last 29 years of her life in a residential home in Malvern and at the time of her death was thought to be the second oldest person in the UK."* [40]

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[35] National Statistics Online (2009)
www.statistics.gov.uk. Accessed 25.06.09.
[34] Office for National Statistics (2011) Centenarians: Number of centenarians grows.
http://www.statstics,gov,uk. Accessed 14.01.11
[37] Vaupel, J.W. (1997) The remarkable improvements in survival at older ages, p.1800. *Phil. Trans. R. Soc.* Lond. B, Vol. 352.
[38] ibid.p.1801.
[39] ibid.p.1802.
[40] Pensioner Today (2004) Obituary, p.11. Issue 168, September. UK Pensioners Association, HSBC Bank.

In 2005 within EU25 the demographically defined old age dependency ratio was 25 people in the age group 65+ per 100 people of working age (15 - 64). In Germany and Italy this ratio was significantly higher at 29 persons in the age group 65+ per 100 persons at working age. By 2050 this ratio will rise to 51 people in the age group 65+ per 100 people at working age. Spain (68) and Italy (66) are projected to have the highest old age dependency ratios. Over the European Union only 60 – 80 per cent of the age group 15 – 65 are currently employed or self-employed. The related support ratio reveals the difficulties of financing future pensions. In 2005 EU25 had 35 people in age group 65+ per 100 people in the labour force. By 2050 this support ratio could reach 72 people in the 65+ age group per 100 people in the labour force.[41] *The 2009 Ageing Report* broadly confirms these projected dependency ratios.[42] *The 2009 Report* notes that fertility rates were slightly higher in 2008 that in 2004, and projects overall TFR in EU27 rising to 1.64 by 2060, though remaining below replacement level in all Member States. Further life expectancy gains are projected. In EU27 life expectancy at birth for males is estimated at 84.5 years in 2060 and for females at 89 years, implying a narrowing gender gap in longevity. Nevertheless the 2009 Report finds that these changes will have little impact on old age dependency ratios in the EU.[43]

3.2.1 Migration

The 2009 Report considers that the expected increase in the employment rates of women and older workers will temporarily cushion the effects of ageing on the labour force. The trend increase in female employment rates is projected to reverse during the period 2020-2060, and since the trend increase in male employment rates also drops, the overall labour force is expected to decrease by as much as 13.6 per cent. Since labour

[41] Muenz, R. (2007) op.cit. pp. 5-6.
[42] European Union (2009a) *2009 Ageing Report: Economic and budgetary projections.* op.cit. p.208.
[43] ibid. p.32.

market participation rates over the period 2020-2060 are projected to continue to increase, albeit more gradually that in the period up to 2020, the projected fall in the labour force over the period 2020-2060 can be ascribed almost exclusively to negative demographic developments.[44]

To some extent these demographic changes in Europe are being offset by migration. In recent years annual net immigration to EU 25 was about 1.2 million people, peaking at 1.88 million in 2007 (EU 27).[45] Spain, Italy, the UK and Germany have been the destination of more than 2/3 of this net inflow.[46] Countries currently experiencing a net outflow (the Baltic States, Poland and Bulgaria and Romania) are projected to see it decline or reverse in the coming decades.[47] Projected net inflows into EU 27 cumulate to close to 59 million people in the period up to 2060.[48]

A degree of caution should be exercised when considering long-term population projections. Demographic projections become increasingly uncertain with an increasing time-scale. Nevertheless, the demographic projections indicate that substantial changes will occur. These projections provide reliable evidence, since the old-age dependency ratio largely depends upon past fertility rate and the age profile (both of which are known), and the life expectancy of the population currently alive (which is likely to alter in a stable manner). Among the demographic variables, only international migration could counter population decline and population ageing in the short to medium term. The United Nations Population Division in its report *'Replacement Migration; Is It a Solution to Declining and Ageing Population?'* examined the viability of this option. "There is a popular belief that a large influx of migrants makes the

[44] ibid. p.18.
[45] ibid. p.39.
[46] Muenz, R. (2007) op.cit. p.9.
[47] European Union (2009a) *2009 Ageing Report: Economic and budgetary projections.* op.cit. p.39.
[48] ibid. p.17.

population of the host country significantly younger" thereby increasing the working age population and so reducing the dependency costs of the elderly.[49]

As part of its regular work programme, the Population Division biennially prepares population estimates for all countries of the world. Four projection variants are prepared: high, medium, low, and constant. The high and low variants provide upper and lower bands for the future path of population growth. The medium variant is a useful central reference point for trends over the longer-term future. The constant variant projects population on the assumption that fertility level will remain constant; this is unlikely, and the results of this variant are intended for illustrative purposes only. Using the medium variant of the 1998 Revision, *Replacement Migration* considers six different scenarios with regard to migration streams needed to achieve particular population objectives. The report computes the size of replacement migration and investigates the possible effects of replacement migration on the population size and age structure for a range of countries that have in common a fertility pattern below replacement level. The time period covered is roughly half a century, i.e. from 1995 to 2050. The Report's projections in relation to the European Union are presented.

The report notes that decreasing fertility and increased life expectancy in EU 15 have reduced the potential support ratio (PSR) from 7.0 (1950) to 4.3 (1995).

Scenario I. The medium variant. This assumes average net intake of just under 300 thousand migrants per year from 1995 to 2050, totalling almost 16.4 million during the period. After a population peak of 376.5 million (2005) decline would accelerate leading to a loss of 40.6 million by 2050. Population age 15–64 peaks at 252 million (2005)

[49] United Nations (2001) *Replacement Migration: Is It a Solution to Declining and Ageing Population?* pp.12-13. Population Division. ST/ESA/SER.A/206.

declining by just under 18.8 million (2050). The population 65+ would grow steadily from 58 million (1995) to 95 million (2050). PSR falls from 4.3 in 1995 to slightly under 2.0 in 2050.

Scenario II. Zero migration assumption. Population would be down to 311 million (2050). Working age population would be cut by 30 per cent rather than by 25 per cent as in Scenario I. Population 65+ would increase to 92 million in 2005. The PSR declines to 1.9 in 2050, 0.1 less than that projected in Scenario I.

Scenario III. Constant population size. This would require 47.4 million migrants, averaging 949,000 per year. By 2050 61.6 million or 16.5 of the population would be post-2000 immigrants or their descendants. PSR in 2050 would show a slight rise to 2.2.

Scenario IV. Working age population constant. This requires 79.6 million migrants, an average of 1.4 million per year. By 2050 out of a total population of 418.5 million, post-1995 immigrants and descendants would be 107.7 million; or 25.7 per cent. PSR would rise to 2.4, though this is modest compared with the 1995 level of 4.3.

Scenario V. PSR not allowed to fall below 3.0. 153.6 million immigrants would be needed between 2015 and 2040. By 2050 out of a total population of 520 million, 40 per cent would be post-1995 immigrants or their descendants.

Scenario VI. Maintenance of PSR level at 1995 value of 4.3. This would require 701 million immigrants over the period at an average of 12.7 million per year. By 2050, out of a total population of 1.2 billion,

> 918 million (about 75 per cent) would be post-1995 immigrants or their descendants. During the period 2040–2050, the net annual number of migrants would be equivalent to half the global annual population growth.

The report predicts that in the absence of migration the upper level of the working age would need to be raised to about 76 years in the European Union in order to obtain in 2050 the same PSR as enjoyed in 1995.

While some of these numbers may appear to be high, those projected in Scenario IV remain within the range of migration experienced in the recent past in some industrialized countries. It is reasonable to regard international migration as a means of alleviating short-to-medium term labour scarcity. Alan Greenspan comments:

> "Demographic pressures will result in the developed economies significantly increasing their immigration rates in order to bring surplus labour to their existing supplies of capital." [50]

Muenz considers the possibility of migratory arbitrage between Europe and its neighbouring region. Given the divergence of demographic trends, Turkey, the Middle East and North Africa could supply labour migrants in larger numbers. Yet "one might come to the conclusion that net immigration in the order of 90-100 million people – even over a period of 45 years – is beyond Europe's integration capacity." He believes that countries in these regions "cannot solve their employment problems by just "exporting" surplus labour". They should also implement internal economic and labour market reforms to cope with rapid increase of working age populations.[51] Whatever

[50] Greenspan, A. (2003) US Senate Select Committee on Aging. 27 February. Quoted by S. J. Schieber (2003) *Creative Destruction in Ageing Societies*, p.28. Watson Wyatt Worldwide. http://ec.europa.eu/economy_finance/events/2003/brussels0303/doc9en.pdf. Accessed 11.10.09.
[51] Muenz, R. (2007) op.cit. p.11.

happens, international migration will not avert the process of population ageing, since previous years' immigrants age alongside the rest of the population.

Some of the United Nation's projections are especially worthy of note. Under Scenario VI, Italy will require an intake of 120 million. The resultant population in 2050 would be 194 million, of which almost four fifths would be post 1995 immigrants or their descendants. In the absence of migration Italy would need to increase retirement age to 77 years to obtain present PSR.[52] It is Korea which reveals the extreme result. Korea presently enjoys a high PSR of 12.6. To maintain this rate the country would require 5.1 billion immigrants. By 2050 over 99 per cent of the population would be post 1995 migrants or their descendants. The report concludes that "it seems extremely unlikely that such plans could happen in these countries in the foreseeable future".[53]

The report also draws attention to the diverging demographic paths of the European Union and its main competitor, the United States. By 2050, it estimates that the working age population of the United States will outnumber that of the EU15 by 26 million, while in 1995 it was outnumbered by 75 million, and that by 2050 the US PSR will stand at 2.8 against the 2.0 PSR in EU15.[54]

3.3. Reactions

In June 2003, the Thessalonika European Council invited the Commission "to present an Annual Report on Migration and Integration, in order to map EU-wide migration

[52] United Nations (2001) *Replacement Migration: Is It a Solution to Declining and Ageing Population?* op. cit. Chapter 4, Italy, p.54.
[53] ibid. Chapter V. Conclusions, p.98.
[54] ibid. Chapter IV. Results A, Overview, p.25.

data, immigration and integration policies and practices".[55] *The Third Annual Report on Migration and Integration* (2007) notes that third country nationals residing in the EU were about 18.5 million in January 2006, i.e. 3.8 per cent of the total population of almost 493 million. Immigration remains the main element in EU demographic growth, and positive net migration is recorded in most Member States. Annual net migration now runs at between 1.5 and 2 million since 2002. The typology of entry differs widely between Member States. Family reunification is considerable in Austria, France and Sweden. More emphasis is given to work-related immigration in Ireland, Spain, Portugal and the United Kingdom. In the recent past important regularisations of migrants have taken place in Spain and Italy.[56]

On 1 September 2005 the Commission adopted the Communication *"A Common Agenda for Integration- Framework for the Integration of Third Country Nationals in the European Union".* The primary aim of the framework is to establish a coherent European policy on integration. The Communication regards the integration of migrants as a dynamic two-way process of mutual accommodation by all immigrants and residents of Member States. Employment policy is seen as a key part of the integration process, and is central to the contributions immigrants make to the host society. A basic knowledge of the host society's language is considered essential to successful integration. Efforts in education are critical. All levels of government need to be involved.[57]

[55] European Union (2003a) Thessalonika European Council. 19 and 20 June. Presidency Conclusions. 01.10.03, Brussels.
http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ec/76279.pdf. Accessed 07.09.09.
[56] European Union (2007a) Communication from the Commission. *Third Annual Report on Migration and Integration,* p.3. COM (2007) 512 final 11.09.07, Brussels.
[57] European Union (2005a) Communication from the Commission. *A Common Agenda for Integration. Framework for the Integration of Third Country Nationals in the European Union,* pp.6-7. COM (2005) 389 final 01.09.05, Brussels.
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52005DC0389:EN:NOT. Accessed 10.09.09.

In October 2008 the European Council adopted the "European Pact on Immigration and Asylum". The Pact is a political document, containing strategic guidelines for the development of European immigration and asylum policies. It starts from the assumption that "the European Union does not have the resources to decently receive all the migrants who hope to find a better life here".[58] Aware that full implementation of the Pact is likely in certain areas to require changes in European Law, the European Council makes five basic commitments, which will continue to be transposed into concrete measures:

- to organise legal immigration to take account of the needs and reception capacities determined by each Member State,
- to control illegal immigration by ensuring illegal immigrants return to their country of origin or to a country of transit,
- to make border controls more effective,
- to construct a Europe of asylum,
- to create a comprehensive partnership with countries of origin and of transit.[59]

Policy makers now accept the inevitability of population ageing. The process is a permanent, irreversible consequence of low average family size and longer life expectancy. At first, demographic transition results in a decline in birth rates, reducing the size of the young age cohorts, and increasing the aged cohorts. And these events can occur relatively without an absolute increase in numbers. In a sense, society ages from the bottom. But when high rates of survival are achieved, those further reductions in death rates also make the population older. The 'old-old' cause ageing from the top.

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[58] European Union (2008b) Note from Presidency to Council, p.3. 13440/08 ASIM 72. 24.08.08, Brussels. http://register.consilium.europa.eu/pdf/en/08/st13/st13440.en08.pdf. Accessed 10.09.09.
[59] European Union (2008c) The European Union Pact on Immigration and Asylum. 15 and 16 October. www.immigration.gouv.fr. Accessed 25.07.09.

An ageing population, with an increasing share of its population aged over 65, and a reducing youth population, will place demands on public expenditure for pension provision and health care. Public pension provision and health care falls within the responsibility of individual Member States. Pension systems in Europe are, for the most part, financed on a pay-as-you-go (PAYG) basis: those in work pay (via a tax on their current wages) for the pensions of those who have retired. Furthermore, all Member States offer universal, or almost universal, rights to health care for persons residing in their territory.

Health and pension expenditures as a percentage of GDP have been rising steadily over the last number of decades. In fact, the Transfer to Household category (i.e. pensions, and social benefits, of which health care is a major component) has accounted for nearly two thirds of the increase in total government expenditure since 1970. Pension and health care expenditures combined represent about one third of all government spending.[60] These increasing expenditures reflect the fact that governments have committed themselves to an unprecedented level of provision. It is these explicit commitments of governments that predetermine the budgetary priorities of the future.
Slowly there has been an appreciation of the underlying economic realities of these demographic changes. The challenges are great, but the problem is not perceived as insoluble. The main objective must be to raise the economic growth potential. It is the only way of assuring that the projected rising claims on future output can be converted into sufficient goods and services.

[60] European Union (2002a) *The Economic Consequences of Ageing Populations. A Comparison of the EU, US And Japan*, p.15, Report prepared by K. McMorrow and W. Roeger for the Directorate-General for Economic and Financial Affairs.
http://ec.europa.eu/economy_finance/publications/publication11151_en.pdf. Accessed 10.3.09.

The task is major. According to analysis using ECFIN's ageing model, on the basis of unchanged policies, *The EU Economy: 2002 Review* saw potential growth rates falling from an underlying rate of 2-2½ per cent to around 1¼ per cent. This dismal outlook for EU was not mirrored in the US, where annual average potential growth rates of 2½ per cent were predicted over the next 50 years.[61] Latest real GDP growth rates from Eurostat are consistent with this projection: in 2010 the percentage changes on the previous year were 2.9 per cent (US) and 1.85 (EU27).[62] In terms of the distribution of global output these persistent differences would result in large changes in their relative economic importance in the world, with the EU's present share of 18 per cent of world production falling to 10 per cent in 2050, while that of the US showing a rise from 23 per cent in 2002 to 26 per cent in. 2050.[63]

Demographics do not represent the whole picture. It is rather the balance between economically active people in employment and the inactive who must be supported. The negative impact of demographic change can be partially offset by the participation of more people of working age in the labour market. Since the population of the working-age in Europe will start to shrink as of 2020 when the post-war baby-boom cohorts enter their retirement years, the 'window' of opportunity is limited. "The costs of dealing with the issue mount exponentially with delays, to the detriment of both current and future generations." [64]

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[61] European Union (2002b) The EU Economy: 2002 Review, p.21. Directorate-General for Economic and Financial Affairs, Brussels.
http://ec.europa.eu/economy_finance/publications/publication489_en.pdf. Accessed 17.09.09.
[62] Eurostat (2011a) Real GDP growth rate.
http://epp.eurostat.ec.europa.eu/tgm/table.Accessed 09.05.11.
[63] European Union (2002b) The EU Economy: 2002 Review. op. cit.
[64] European Union (2003b) Cox, P: Address to Conference on "The economic and budgetary implications of global ageing", p.5. 4 March, Brussels.
http://ec.europa.eu/economy_finance/events/2003/brussels0303/doc6en.pdf. Accessed 05.08.09.

3.4. Policy Initiatives

3.4.1. The Lisbon Strategy

The European Union has developed a wide variety of policy responses to population ageing. Ageing is not regarded as a separate and isolated issue. The overall strategy of the Union is one of mutually reinforcing policies. The objective is to mobilise the full potential of people of all ages. The 1997 Treaty of Amsterdam introduced an express basis for EU legislation to combat age discrimination. This is now Article 19(1) (ex Article 13 TEC). The Union also recognises the rights, freedoms and principles set out in the Charter of Fundamental Rights.[65] The Charter proclaimed in Nice in December 2000, asserts the principle of non-discrimination (Article 21 of the Charter), and the rights of the elderly to lead a life of dignity and independence is acknowledged (Article 25 of the Charter). The Council had previously adopted in November 2000 a directive outlawing discrimination in employment, including discrimination on the grounds of age.[66] It also agreed an action programme that will target discrimination in all spheres of life including that directed against older persons.[67] The Charter came into force on 1 December 2009. A protocol limits justiciability of the Charter in the UK in respect of employment law.

These measures put forward in Europe should be seen as part of an emerging international consensus on the necessity for changes in social attitudes. Demographic

[65] Article 6 (ex Article 6 TEU)
[66] European Union (2000a) Council Directive 2000/78/EC establishing a general framework for equal treatment in employment and occupation. 27.11.00, Brussels. http://eur-lex.europa.eu. Accessed 10.08.09.
[67] European Union (2000b) Council Decision 2000/750/EC establishing a Community action programme to combat discrimination (2001 to 2006). 27.11.00, Brussels. http://europa.eu/legislation_summaries. Accessed 10.08.09.

realities imply that:

"Society of the future will have to value more the contributions of its older members so as to ensure that they remain active and engaged for most of their lengthy life span." [68]

In March 2000, the European Council held a special meeting in Lisbon to agree on a new strategic goal for the Union in order to strengthen employment, economic reform and social cohesion as part of a knowledge-based economy. The Council believed that the Union was confronted with a quantum shift resulting from globalisation and the challenges of a knowledge driven economy. The rapid and accelerating pace of change called for urgent action. Although the macroeconomic outlook was good, the level of unemployment – over 15 million then out of work – was a major weakness. The employment rate was too low, and was characterised by the insufficient participation by women and older workers. The aims should be to raise the employment rate from an average of 61 per cent to as close as possible to 70 per cent by 2010 and to increase the number of women in employment from 51 per cent to over 60 per cent by 2010. The new strategic goal for the coming decade was to become the most competitive and dynamic knowledge-based economy in the world. The number of 18 to 24 year olds with only secondary level education who are not in further education and training should be halved by 2010. An average economic growth rate of around 3 per cent was held to be a realistic prospect.[69]

In order to implement these objectives the Council sought to introduce a new open method of coordination at all levels. By benchmarking national policies, best practice

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[68] United Nations (2004b) *World Population in 2300,* p.25. Proceedings of the United Nations Expert Group Meeting on World Population in 2300. 24 March. ESA/P/WP.187/Rev.1 United Nation Headquarters, New York.
http://www.un.org/esa/population/publications. Accessed 11.08.09.

[69] European Union (2000c) Lisbon European Council, Presidency Conclusions. 23 and 24 March.
http://www.vitae.ac.uk/researchers/1272-3049/Lisbon-European-Council-Presidency-Conclusions.html. Accessed 12.09.09.

would spread amongst Member States. It was also decided that there would be a meeting of the European Council every spring to ensure more strategic direction and effective monitoring.

Article 121 (ex Article 99 TEC) of the Treaty provides the legal basis for this course of action. Article 121(2) requires the drafting of broad economic policy guidelines (BEPGs) for the Member States and the Community. The BEPGs, therefore, play a central role in the system of economic policy co-ordination, using the process of "multilateral surveillance" by which economic development in individual Member States is monitored (Article 121(3)). The BEPGs are enforced through political sanctions by way of non-binding recommendations that the Economic and Financial Affairs Council (ECOFIN) can adopt under Article 121(4) in the event of a breach.[70]

In 2002 changes were introduced in the way in which BEPGs were adopted. First, the BEPGs now cover a three-year period. Second, they are to be published at the same time as the Employment Guidelines in order to emphasise the need for co-ordination between the two.[71] The Employment Guidelines have three primary objectives: full employment, quality and productivity at work, and social cohesion and an inclusive labour market.

It was thought that the main reason why GDP per capita was well below the US level was that fewer people were in employment, and those that were employed tended to work fewer hours. Furthermore, many workers were effectively encouraged to leave the

[70] Deroose S., D. Hodson and J. Kuhlman (2005) *The Broad Economic Policy Guidelines: Past, Present and Future,* p.3. IEP WP 05/02. International Economics Programme, Chatham House. www.chathamhouse.org.uk/research/europe. Accessed 23.06.09.

[71] European Union (2002c) Communication from the Commission. *Streamlining the annual economic and employment policy co-ordination cycles*, p.4. COM (2002) 487 final, 23.06.02, Brussels. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2002:0487:FIN:EN:PDF. Accessed 10.08.09.

labour market or to remain inactive. Non-participation was caused by relatively generous or loosely enforced benefit systems, or through incentives to take early retirement. Even when individuals sought work, they were often faced with the prospect of high labour taxes plus the withdrawal of benefits. There was a need for less regulation of the labour market and a more flexible organisation of work.[72]

The Stockholm European Council 2001 decided that a three-pronged strategy should be followed, focusing on increasing employment rates, on the reduction of public debt, and on reforming pension and health care systems. The Council agreed to set an EU target for increasing the average EU employment among men and women (55-64) to 50 per cent by 2010. The Brussels European Council in March 2003 stressed that ensuring long-term financial sustainability is not only important in its own right, but is also a necessary precondition for the adequate provision of pensions in the future.

The annual report *Employment in Europe* is the main tool of the Employment, Social Affairs and Equal Opportunities DG for the analysis of employment and labour market developments in the European Union. The *2008 Report* stated that employment in the EU grew by 1.6 per cent in 2007 – the same rate as the previous year, resulting in a total net increase of 3.5 million people in employment.[73] In 2007 the overall employment rate averaged 65.4 per cent. The employment rate for female workers stood at 58.3 per cent and that for older workers at 44.7 per cent, still short of the Lisbon targets. The Report recognised that due to the uncertainty concerning commodity and energy prices,

[72] European Union (2003c) Communication from the Commission. *The future of the European Employment Strategy (EES); A strategy for full employment and better jobs for all*, p.12. COM(2003)6 final. 14.01.2003, Brussels.
http://europa.eu/legislation_summaries/employment_and_social_policy/community_employment_policies/c11316_en.htm. Accessed 15.08.09.
[73] European Union (2008d) *Employment in Europe 2008 Report,* p.13. 18.11.08, Brussels.
http://ec.europa.eu/social/main.jsp?catId=113&langId=en&newsId=415&furtherNews=yes. Accessed 7.10.09.

as well as financial market volatility, employment growth was projected to decelerate markedly in 2009.[74]

There remain wide divergences in labour force participation among the Member States. The 2008 report found that the 60 per cent target for female workers was met in 15 Member States, but in Greece, Italy and Malta the rate was more than 10 percentage points below the target. 10 Member States failed to achieve the 50 per cent target for older workers, and these included big Member States – France, Italy and Poland, where the gap from target exceeded 10 percentage points.[75]

With respect to labour mobility in the context of EU enlargement, the Report finds that practically all of the available evidence suggests that the economic impact of recent intra-EU mobility has been positive on balance. Between 2003 and 2007 the average population share of EU10 citizens resident in EU15 increased from around 0.2 per cent to 0.5 per cent. There is no indication that these recent intra-EU mobility flows have exceeded labour market absorption capacities, and their impact on local workers' wages and employment has been very small. Increasing convergence in income and employment between old and new Member States is already reducing the economic incentive to move. Indeed, the substantial shrinking in the near future in the numbers of the young cohorts will reduce the pool of potential mobile workers from central and eastern Member States.[76] This will act as a break on geographical mobility within the EU, since almost 80 per cent of recent EU10 and close to 70 per cent of recent EU2 mobile workers have been under the age of 35.[77]

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[74] ibid.
[75] ibid. p.14.
[76] ibid. p.16.
[77] ibid. p.127.

The present economic downturn wiped out much of the steady gain in economic growth and reduction in unemployment witnessed over the last decade. 23 million people - or close to 10 per cent of the economically active population - are now unemployed, though consistent signs of labour markets stabilising in several Member States have been observed.[78]

The high level of youth unemployment continues to be a matter of concern. It "constitutes a waste of human capital. Over the last 25 years, no real breakthrough has been achieved".[79] Young adults (ages 15-24) are more than twice as likely to be unemployed as prime-age adults. The Commission urges all Member States to give high priority to the integration of young people into the labour market.[80] *The 2010 Report* analyses the effects of market segmentation between "temporary" and "permanent" contract holders (insiders and outsiders), particularly in relation to young people. During past decades reforms of employment protection legislation (EPL) introduced by Member States have often been "partial" or "two-tier", i.e. they have substantially deregulated the use of temporary contracts, while maintaining stringent dismissal rules for permanent ones, rather than reforming EPL 'across-the-board'. EPL reforms have led, first, to a large expansion of temporary employment and, second, to the emergence of dual labour markets, i.e. one for permanent employees (or 'insiders') with stable employment and good career and earnings prospects, and another for temporary employees (or 'outsiders') who tend to be 'trapped' into temporary jobs with precarious attachment to the labour market (Spain being the most prominent example of this). Often temporary contracts can simply be a cheaper production factor relative to

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[78] European Union (2010b) *Employment in Europe 2010*. Chapter 1: EU labour markets in time of economic crisis.
http://ec.europa.eu/employment_social. Accessed 15.01.11.

[79] European Union (2007b) Communication from the Commission. *Promoting young peoples' full participation in education, employment and society*, p.4, COM (2007) 498 final. 04.09.07, Brussels.
www.eurlex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfinal&an_doc=2007&nu_doc=498. Accessed 17.11.09.

[80] European Union (2008d) *Employment in Europe 2008*. op. cit. p.36.

permanent employment, acting as a buffer to adjust employment levels to labour demand shocks. *The 2010 Report* finds that temporary workers receive less training and earn lower wages than permanent ones. Labour market segmentation increases the risk that many young people will become trapped (even into their thirties), spending years alternating between temporary jobs and unemployment interludes with limited career prospects. A precarious start to adult life is likely to exacerbate perceived insecurity, thereby impacting on individuals' behaviour. Evidence from a number of countries suggests that young people with temporary jobs (rather than permanent ones) tend to have a higher incidence rate of co-residence with their parents. In 2002 co-residence rates for men aged 25 to 29 years old were at very high levels in southern Member States: Italy (73 per cent), Greece (70 per cent), Spain (67 per cent), and Portugal (58 per cent). This may reflect the reduced access of young people holding temporary contracts to renting or mortgage borrowing.

In the opinion of the *2010 Report*, co-residence tends to delay emancipation, household formation, and procreation, thus reinforcing the trend of population ageing. *The Report* notes that "total fertility rates declined significantly in Southern Europe between 1980 and 2000". It agrees with the findings of Giuliano: "this postponement of adult life may critically impact the youth labor supply, the overall fertility level and the European pay-as-you-go pension systems".[81] *The 2010 Report* stresses the need for an exit strategy from segmentation, and observes that a number of prominent labour economists advocate the "single contract", that is, one which is open-ended but providing for a gradual build-up of employment protection rights. Extending the use of open-ended contractual arrangements with a sufficiently long probation period and a gradual

[81] Giuliano, P. (2006) *Living Arrangements in Western Europe: Does Cultural Origin Matter*? p.1 Discussion Paper No. 2042. March. International Monetary Fund and IZA (Forschungsinstitut zur Zukunft der Arbeit, Institute for the Study of Labor) Bonn. http://www.jstor.org/pss/40005027. Accessed 12.04.11

increase of protection rights, access to training, life-long learning and career guidance for all employees could reduce the existing divisions between those holding temporary and permanent contracts.[82] The Report regards the concept of flexicurity as highly relevant. Flexicurity promotes a combination of flexible labour markets and a high level of employment and income security, and is thus perceived as the resolution of the EU's dilemma of how to maintain and improve competitiveness whilst preserving the European social model. The aim is to replace a job security mentality with an employment or employability security mentality. The Report believes that labour market segmentation can be corrected through the implementation of comprehensive flexicurity policy packages.

In February 2011, the youth unemployment rate was 20.4 per cent in the EU-27. The lowest rates were observed in the Netherlands (7.4 per cent) and Germany (7.9 per cent), and the highest in Spain (43.5 per cent) and Greece (36.1 per cent in the fourth quarter of 2010). It is submitted that these wide derivations emphasize the need for labour market reform in Southern Europe.[83]

3.4.2. The Role of the Stability and Growth Pact

The broad framework for ensuring budgetary sustainability in the face of substantial age-related spending pressures would appear to be in place in the form of the Stability and Growth Pact (SGP). The rule established under SGP calls on countries to achieve "balanced budgets or surplus over the medium term" (with a maximum allowable overall deficit of 3 per cent in any given year). Adherence to this rule should lead to the gradual reduction of the net public debt-to GDP ratio, and should facilitate the

[82] European Union (2010b) *Employment in Europe 2010.* op.cit. Chapter 3: Youth and Segmentation in EU labour markets.

[83] Eurostat (2011b) Unemployment Statistics, Data up to February 2011. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Unemployment_statistics. Accessed 21.04.11.

requirement that gross public debt is not to exceed 60 per cent of GDP. Respecting the SGP's 3 per cent deficit rule will demand additional budgetary consolidation by many Member States. Continual compliance will be difficult once the demographic situation starts to worsen. Such efforts are vital for both avoiding the development of unsustainable debt positions and for helping to finance age-related spending increases.

These concerns lie behind the decision of the Stockholm European Council that "the Council should regularly review the long-term sustainability of public finances, including the expected strains caused by the demographic changes ahead".[84] On a mandate given by the Council, the Economic Policy Committee (EPC) established the Working Group on Ageing Populations (AWG) to examine the economic and budgetary consequences of ageing. AWG's age-related expenditure projections provide a long-term assessment of the sustainability of public finances. This assessment is integrated into the surveillance of individual Member States' budgetary positions and takes place annually on the basis of the stability and convergence programmes. Public expenditure projections cover pensions, health care, long-term care, education, unemployment transfers, and, where possible, contributions to pensions/social security. The projections are not forecasts. Instead they offer an indication on the timing and scale of budgetary changes that could result from an ageing population based on a "no policy change" scenario, i.e. without assuming any future changes in the behaviour of economic agents over time.

Account is also taken of the starting underlying budgetary positions and outstanding debt levels of Member States. Running down public debt can contribute to the

[84] European Union (2001) Stockholm European Council. 23-24 March 2001. Presidency Conclusions, para. 41. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/00100-r1.per cent20ann-r1.en1.html. Accessed 17.11.09.

sustainability of public finances. Sustainability also requires that tax burdens remain at reasonable levels and that other non-age-related expenditure (infrastructure, and innovation, and research and development) is not squeezed out. The Commission regards the closing of the technology gap with the United States and Japan as crucial. The EPC notes that the Lisbon target to rise overall spending on R&D and innovation to approach 3 per cent of EU 27 GDP in line with spending levels in the US and Japan is unlikely to be met by 2010.[85]

In its 2006 Report the EPC stated that anticipated higher employment rates of women and older workers would temporarily cushion the economic effects of ageing, but the ageing effects will dominate as of 2018, when both the size of the working age population and the numbers employed will start on a downward trend. [86] The 2009 Report projects the downward trend to commence in 2020. In the 2009 Report the annual average potential GDP growth rate in the EU is projected to decline sharply, from 2.4 per cent in the period 2007-2020, to 1.7 per cent in the period 2021-30, then reducing to 1.3 per cent in the period 2041-2060. For EU 10 the projected decline is steeper, falling from 4.2 per cent (2007-2020) to 2.1 per cent (2021-2030) and eventually to 0.6 per cent (2051-2060).[87] Over time labour productivity (due to technological advances) will become the dominant source of growth.[88]

The ageing of population is projected to lead to increases in public spending, assuming no policy changes occur. In EU 27 the cost of ageing is estimated at 4¾ per cent of

[85] European Union (2007c) *Report on the Second Progress Report on the Lisbon National Programmes 2005-2008,* p.5. Economic Policy Committee. 20.11.07, Brussels. http://europa.eu/epc/pdf/report_2007_en.pdf. Accessed 16.11.09.

[86] European Union (2006b) *European Economy: the impact of ageing on public expenditure: projections for the EU25.* op.cit. Summary Report, pp.7-8. Economic Policy Committee. ECFIN/EPC (2006) REP/238 final. 06.02.2006, Brussels.

[87] European Union (2009a*) The 2009 Ageing Report: Economic and budgetary projections.* op.cit. p.104

[88] European Union (2006b) *European Economy: the impact of ageing on public expenditure: projections for the EU25.* op.cit. Summary Report, p.6.

GDP in respect of the period 2007 to 2060. Over this period most of the projected increase in public spending will be on pensions (+2.4 p.p. of GDP), healthcare (+1.5 p.p. of GDP) and long-term care (+1.1 p.p. of GDP). Future healthcare expenditure is especially difficult to estimate, being highly sensitive to other non-demographic drivers of expenditure, such as pharmaceutical prices and technological advances. In respect of long-term care, the projected increase in female labour market participation may cause increased demand for formal care services. Potential offsetting savings in public spending on education and unemployment benefits are likely to be very limited (-0.2 p.p. of GDP for each item). In respect of expenditure on education, although falling numbers of the young might be expected to lead to savings in this area, significant savings are unlikely. Government efforts to raise skill levels will cause an expansion of education at tertiary level, more than cancelling out any potential slight savings at primary and secondary levels. Projected reduced spending on unemployment benefits reflects the assumed lower proportions of unemployed persons over the projected period. These aggregate rates mask large differences between Member States.

a) The age-related increase in public spending will be very significant in nine Member States (Luxembourg, Greece, Slovenia, Cyprus, Malta, Romania, the Netherlands, Spain and Ireland) with a projected increase of 7 p.p. of GDP or more, although for some countries the large increase will be from a fairly low level. These Member States have so far made only limited progress in reforming their pension systems or have maturing pension systems.

b) For a second group of countries (Belgium, Finland, the Czech Republic, Lithuania, Slovakia, the UK, Germany and Hungary) the age-related increase in public spending is more limited, ranging from 4 p.p. to 7 p.p. of GDP. Several of these countries have taken significant steps in reforming public expenditure systems to limit the increase in future expenditure.

c) The increase is more moderate, 4 p.p. of GDP or less, in Bulgaria, Sweden, Portugal, Austria, France, Denmark, Italy, Latvia, Estonia and Poland; substantial pension reforms have been implemented, and for many of these countries, the projected increase in expenditure on health-care and generally on long-term care is higher than increases in pensions.[89]

The Ageing Working Group comprises at least two representatives from each of the 27 Member States and Norway. Statistical information is provided by each state and from Eurostat. Contributions to the AWG's deliberations and reports are also made by the World Bank, the OECD, the IMF and the ECB. The 2009 report is only the third such since 2001. The analysis of each country's present and projected future budgetary expenditure is extremely detailed and comprehensive. It is probably the most accurate indicator available of future difficulties that a Member State, in the absence of reforms, will face in complying with the SGP. "The projections for pensions are run by the Member States using their own national model(s). In this way, the projections benefit from capturing the country specific circumstances prevailing in the different Member States as a result of different pension legislation, while at the same time consistency is ensured by basing the projections on commonly agreed underlying assumptions".[90] Member States would be unwise not to take the Report's findings seriously, and make every endeavour to implement reform strategies in those areas of state expenditure where the Report predicts highly escalating costs. Indeed, the 'Code of Conduct' on the content and format of the Stability and Convergence Programmes stipulates that the common budgetary projections by the AWG provide the basis for the assessment by the

[89] European Union (2009a) *The 2009 Ageing Report: Economic and budgetary projections.* op.cit.p.24.
[90] European Union (2011a) *The 2012 Ageing Report: Underlying Assumptions and Projection Methodologies*. Joint Report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee (AWG), p.16. European Economy 4/2011.September, Brussels. Accessed 31.10.11. On the basis of these underlying assumptions and methodologies, age-related expenditures covering pensions, health care, long-term care, education and unemployment transfers will be calculated and presented to the ECOFIN Council in May 2012.

Council and the Commission of sustainability of the Member States' public finances, within the context of the Stability and Growth Pact.[91]

3.4.3. An Imperfect Vision.

> "Forecasts or projections…. are notoriously unreliable. In fact they almost always are wrong….Nonetheless,…without forecasts, we would be totally at sea." [92]

Any assessment of a country's fiscal sustainability in the longer term requires an understanding of the extent of the government's fiscal commitments in the future. The difficulty here is that all attempts to assess the size, and possibly also the nature, of those future commitments must rest on judgements that can never entirely avoid having a subjective element. Yet despite these inherent uncertainties AWG's projections are of value if they alert policy makers to the budgetary pressures that are likely to occur in the future if labour market and social security reforms are not implemented.

3.5. Underlying Issues

3.5.1 Entrepreneurship in an Ageing Society.

In June 2000, the Fiera European Council adopted the European Charter for Small Enterprises. The Charter calls on Member States and the Commission to take action to support and encourage small enterprises. The "think small first" is seen as one way to progress towards the Lisbon objectives. "Europe's competitiveness depends strongly on small businesses, which are a key source of jobs, a breeding ground for business ideas and a main driver for entrepreneurship."[93] It is estimated that Europe has 20 million

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[91] European Union (2011b) Economic Policy Committee. Working Group on Ageing Populations and Sustainability.
http://europa.eu/epc/working_groups/ageing_en.htm. Accessed 22.10.11.
[92] Aaron, H. (2000) Presidential address: See through the Fog: Policy Making with Uncertain Forecasts, p.193. *Journal of Policy Analysis and Management*.19(2).
[93] European Union (2003d) Communication from the Commission. *Thinking Small in an Enlarged Europe, p.2*. COM (2003) 26 final. 21.1.2003, Brussels.
http://ec.europa.eu/enterprise/policies/sme/files/sme-package/doc/com26_en.pdf. Accessed 17.09.09

small and medium-sized enterprises (SMEs), defined as firms employing less than 250 people. "Small and new enterprises serve as an engine of employment creation on both sides of the Atlantic."[94]

Entrepreneurship takes on a new importance in a knowledge-based economy because it acts as a key mechanism by which knowledge created in one organisation becomes commercialized in a newer enterprise. Although there is no generally accepted definition of entrepreneurship for the developed countries,[95] Schumpeter remains ever pertinent:

> "The function of entrepreneurs is to reform or revolutionize the pattern of production by exploiting an invention, or more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way. To undertake such new things is difficult." [96]

He had previously described those who did undertake such tasks as the "agents of creative destruction". Are we likely to encounter many of these agents in an ageing society?

Evidence suggests that the ageing process tends to depress the rate of technological innovation. Each year the Global Entrepreneurial Monitor (GEM) provides international research data on entrepreneurial activity. The GEM programme seeks to describe and analyse entrepreneurial processes within a wide range of about 40 countries. Its index measures the percentage of a country's population involved in either the start-up phase or the managing of a new business that is less than 42 months old. *The 2003 GEM Annual Report* highlighted the distinct correlation between countries with a high ratio of older workers and a low level of entrepreneurial

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[94] Audretsch, D. B., M. C. Keilbach, and E.Lehmann (2006) *Entrepreneurship and economic growth,* p.25.
[95] OECD (1998a) *Fostering Entrepreneurship*. Policy Brief No.9.
http://www.oecd.org/document/26/0.Accessed 19.08.09.
[96] Schumpeter, J.A. (1942) *Capitalism, Socialism and Democracy*, p.82.

engagement.[97] *The 2008 Report* finds that some European countries - most notably Belgium, Germany and France - consistently have the lowest rates of entrepreneurial engagement. Gem's index also reveals that India and China with their younger populations rank as highly entrepreneurial countries. [98]

The *2003 Report* finds the impact of age very predictable. Data from several hundred thousand interviews completed in 40 countries illustrate that those aged 25–44 years of age are more likely to engage in business start-ups than any other age group. A marked and progressive decline was observed amongst age cohorts 45–54 and 55–64.[99]

The GEM Reports can be criticised for their emphasis on the role of incipient entrepreneurs and start-ups, ignoring the considerable amount of change and innovation contributed by incumbent enterprises. Baumol agrees that "the major breakthroughs have tended to come from small new enterprises", but finds strong evidence that "the invaluable incremental contributions that multiply capacity and speed, and increase reliability and user-friendliness have been the domain of the larger firms". In seeking to explain the growth performance of the free-market economies, he views the contributions made by large and small firms as complementary. "Together, the two have contributed far more than either would have by itself."[100] The entrepreneurial innovations of the small firm continue to play a critical part in economic development.

[97] Global Entrepreneurial Monitor (2003) *Executive Report*, p.80. Ed.by P.D.Reynolds, W.D. Bygrave and E. Autio. Babson College and London Business School. http://www.gemconsortium.org/about.aspx?page=global_reports_2003. Accessed 17.09.09.
[98] Global Entrepreneurial Monitor (2008) *Executive Report*, p.13. Ed. by N.Bosma, Z. J. Acs, E. Autio, A. Coduras and J. Levie. Babson College, Universidad del Desarrollo, and London Business School. http://www.gemconsortium.org/download/1259869357292/GEM_Global_08.pdf. Accessed 17.09.09.
[99] Global Entrepreneurial Monitor (2003) op. cit. p.32, Table 14.
[100] Baumol, W.J. (2008) Prize Lecture, p.2. Global Award for Entrepreneurship Research. www.e-award.org. Accessed 10.10.09.

Research undertaken by economists in the University of Tokyo considered the degree to which information and communication technology could effectively substitute for workers. Although IT investment might overcome shortage of young workers with a low educational level, during the 1990s Japanese firms reached the limits of what productivity increases could be achieved by developing the skills of the highly educated but ageing, component of the labour force. "The proposition that IT 'revolution' can pop up productivity growth and can counter the pressure of ageing population is not supported by our data."[101]

3.5.2 Towards a Sustainable Society

Low fertility presents a threat to the continuing viability of countries affected. Low fertility rates are the result of individual decisions concerning childbearing, which reflect an implicit calculus by parents about the private costs and benefits of children. Individual decisions have collective consequences for society as a whole. Overall fertility might be regarded as a public good, if its level as determined by private decisions is too high or too low in terms of the collective interest.

Population stability, over many millennia, was achieved by the typical human family only producing about two children, who survived to reproductive age. "It is certainly true that 2.1 children per woman is not 'hard-wired' with the human constitution. But the two child family may well be."[102]

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[101] Nishimura, K.G., K.Minetaki, M.Shirai and F Kurokawa. (2002). *Effects of Information technology and Ageing Work Force on Labour Demand and Technological Progress in Japanese Industries: 1980 – 1998*, pp.1-2. Discussion Paper CIRJE-F-145. University of Tokyo. http//www.e.u-tokyo.ac.jp/cirje/research/03research02dp. Accessed 17.09.09.

[102] United Nations (2004b) *World Population in 2300,* op.cit. p.21. Griffith Feeney, Rapporteur of the Expert Group Meeting on World Population in 2300.

In the early 1990s, the United Nations conducted a series of Fertility and Family Surveys in 15 developed countries, largely in Europe together with the USA and Canada. The Surveys sought evidence on the childbearing intentions of women aged 30 – 34 and compared these intentions with actual fertility achieved. The stated desired average ultimate family size for these women showed little variation over this group of countries, ranging from 2.0 children per woman in Austria and Germany to 2.5 in Sweden. "In an ideal world women would bear the number of children they want, but this clearly is not the case in contemporary developed countries."[103] These findings suggest that efforts to help women overcome the various obstacles to the implementation of their preferences would lead to higher fertility.

Paul Demeny of the Population Council, New York, states that:

> "the earliest clear formulation of the population problem as a problem of coordination among individual preferences, hence the establishment of the rationale for potential state intervention in the matter of fertility, was given by William Foster Lloyd, an Oxford mathematician and economist, in an essay published in 1833."[104]

Although Lloyd was concerned with the problems of over-population, his view seems equally apposite to those of a shrinking population. Lloyd refused to accept that over-population was in itself sufficient to attach blame to the people themselves: "the fault may rest, not with them as individuals, but with the constitution of society, of which they form part"[105].

Without question, increased female labour force participation creates the potential for greater economic growth. But if this additional growth is accompanied by below-

[103] Bongaarts, J. (2001) *The End of the Fertility Transition in the Developed World*, pp.426-427. Policy Research Division Working Paper no. 152. Population Council, New York. http://www.popcouncil.org/archives/publications/pdfs/wp/152.pdf. Accessed 15.09.09.

[104] Demeny, P. (2003) *Population Policy. A Concise Summary*, p.6. Working Paper no. 173. Population Council, New York. http://www.popcouncil.org/pdfs/wp/173.pdf. Accessed 15.09.09.

[105] Lloyd, W.F. (1833) 'Two lectures on the checks to population', in *Lectures on Population, Value, Poor Laws and Rent,* pp. 22-23. (1968).

replacement level fertility, which is likely when the high opportunity costs of childbearing act as a big disincentive to fertility, increased female labour force participation will merely succeed in providing a temporary boost to growth. In the longer term, over one generation, or possibly longer depending on the degree of fertility decrease, economic growth will have been achieved at the cost of the depletion of human capital. The inevitable shrinkage of the working age group will gradually slow the economy. The provision of adequate age-related transfer payments will become increasingly difficult to sustain. And although old age provision would be a problem for the overall society, inadequate provision would have a greater impact on women than men. Ageing is a "progressively gendered process".[106] In retirement, women outnumber men at all ages, with female predominance most striking amongst the old-old. The continuance of a disjunction between the desired family size and actual fertility achieved could raise the spectre of poverty in old age, blighting the lives of older women, especially those in extreme old age.

The experience in the former communist bloc strengthens this conclusion. In central Europe, fertility fell during the transition from centrally planned to market-orientated economies. Under Communism, the direct costs of raising children were subsidised. Governments provided (or required firms to provide) childcare facilities at low or no cost, offered generous maternity leave and benefits, and provided incentives for families to have more children and for women to work. With the end of Communism, these policies lapsed. As childcare facilities became more costly and maternity benefits more parsimonious, the direct costs of children increased. To illustrate, the Czechoslovak Socialist Republic had pursued increasingly pro-natalist policies during the 1980s.

[106] House of Lords (2003) *Aspects of the Economics of an Ageing Population. 4th Report.* A Joint Women's Budget Group and Fawcett Society Response to the House of Lords Select Committee on Economic Affairs (I March) para.11. HL Paper 1789-1. 5 November.

After the division of the former state into two separate countries, the Czech Republic and Slovakia, the relevance of government policy to fertility rates became even more apparent.[107] The Czech Republic changed social policy more rapidly than Slovakia, allowing childcare costs to increase more rapidly. TRF in the Czech Republic declined from 1.9 (1987) to 1.16 (1998), whereas TRF in the Slovak Republic declined from 2.15 (1987) to 1.38 (1998).[108]

Can the situation be changed? If, as Lloyd suggests, the fault rests with the constitution of society, wide-reaching socio-economic changes are essential. The challenge, and it is immense, is to restore the balance of the reproductive and the productive roles of women. Not only must childbearing be accorded a more central role in society, but also that national resources need to be reallocated so as to ease the burden presently borne by individual parents. The costs will be substantial, and the political difficulties of implementing such a shift in spending priorities are considerable, especially at a time of age-related pressures. The political process tends to be myopic, focusing mainly on the next election, and will not easily accommodate a policy of whose economic benefits to society as a whole will not be seen for at least twenty years. Nevertheless, while the increase in the numbers of the old is inevitable, the shortage of the young is not, and can be rectified, if the political will exists.

> "As the reality of global aging and its consequences seeps into public understanding, policies that today might seem bizarre and impractical may well come to seem obvious and overdue." [109]

The European Union has finally acknowledged that current low rates of fertility will have serious adverse consequences for society. Its policy response is discussed in the final chapter of this thesis.

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[107] Chase, R.S. (2003) Household fertility responses following communism: Transition in the Czech Republic and Slovakia. *Journal of Population Economics*,16(3), pp. 579-595.
[108] ibid. p.580.
[109] Longman, P. (2004) *The Empty Cradle*, p.172.

3.5.3 Intergenerational Equity

Ageing has a direct financial impact on a pay-as-you-go system (PAYG). Current pension benefits are financed from current revenues – usually via taxes on labour. There is rarely a reserve fund. For the sustainability of a PAYG system, the labour tax rate should equal the pension bill divided by the wage bill. This is equivalent to the ratio of pensioners to workers multiplied by the ratio of the average pension to the average wage. The ageing process increases the ratio of pensioners to the employed. In the absence of changes to the ratio of the pensions to wages, increases in labour taxes are required to maintain the balance between revenues and expenditure. In many Member States, labour tax increases necessary to keep PAYG schemes financially balanced have been a cause of labour market distortions, exacerbating the ageing problem by reducing labour force participation.

Government exposure to the unfunded liabilities of the PAYG system is the single greatest source of expenditure pressure over the coming decades. If retirement income was derived from a fully-funded pension system, ageing would only significantly impact on health expenditures and old age poverty relief. Intergenerational equity considerations arise. A change from the PAYG system to a fully funded one would place a double burden on the present generation of workers. They would be required to fund their own pensions while continuing to finance the pensions of those already retired under the previous PAYG system. Democratically elected governments would find it difficult to get support for the transition. A gradual phasing in of policy measures, and announcing these measures early, would seem the only feasible option for government.

There is another consequence of demographic change that may prove problematic for government. The ageing process will increase the political weight of older persons. Older people – over 50 years of age – will represent the majority of active voters in many Member States within the next two decades, once the differing voter turnout between the age groups is taken into account. This may well make the implementation of pension reforms that adversely affect older people increasingly difficult, assuming that the over-50's vote for their personal benefit and voter turnout remains the same.[110]

Sinn and Uebelmesser confirm these concerns by analysing German population shifts. They note that "Germans will have the oldest population on earth by around 2030".[111] This impending demographic crisis, they insist, calls for fundamental reforms of the pension system. Movement towards a partially funded system is essential. In a democracy reforms require the support of the majority of the electorate. Sinn and Uebelmesser construct a model to determine whether the majority would be in favour of pension system reform. They calculate for each year the 'indifference age' as the age of the cohort that is not affected by the reform and the 'median age' as the age of the politically decisive cohort. Until 2016, a pension reform in Germany can be democratically enforced. After 2016, "the old can, through their majority, exploit the young by increasing the pension burden".[112] German society becomes a gerontocracy.

The question here is whether such a use of electoral power would be wise. Intergenerational equity assumes the existence of a sustainable contract between the generations, each bearing its share of burdens in return for a range of social benefits.

[110] International Monetary Fund (2004) *World Economic Outlook: The Global Demographic Transition*, p.164. September.
http://www.imf.org/external/pubs/ft/weo/2004/02/. Accessed 17.11.09.
[111] Sinn, H-W. and S. Uebelmesser (2003) When Will the Germans Get Trapped in Their Pension System? *European Journal of Political Economy*, p.153. 19(1), March.
[112] ibid p.157.

The sustainability of the contract requires that the sharing of burdens is perceived as fair and equitable. There is a real risk that the burden of support imposed on the current generation of workers could be far higher than that previously imposed on the retired when they were part of the working age group.

Governments may find it difficult to motivate the employed to support increasing numbers of the elderly. A tax revolt is one possible result; while another may be that young and mobile individuals may migrate to countries with less ambitious welfare states, thereby eroding the tax base of the welfare programmes. Although both are possible, it is certain that additional burdens in the form of increased taxes and social security contributions generate considerable disincentives in terms of labour supply and work effort.

In a society that has largely socialized the costs of ageing, the need to address long-term risk factors sufficiently early is imperative. Any system of old age provision that places a burden on the younger generation that they will be unable, and possibly unwilling, to support must eventually implode.

> "Ultimately not morals but the fact that the young supply the police and the army will decide the issue." [113]

3.6 Conclusion

With regard to its stated primary objectives, this chapter first revealed a world population growing rapidly, though at a declining rate. Contrary to this global trend, it was found that more than half the world's developed countries would experience population decline. These differentials in population growth would force reassessment of many existing economic, social, and political policies. Three fundamental factors

[113] Hayek, F.A. (1960) *The Constitution of Liberty.* op. cit. p.297.

were identified as the causes of demographic change: births, deaths, and migrants, of which migration would be the least predictable. Global numbers of the elderly would rise steeply. The relative size of the elderly in the population would show the most significant increase in the developed world and Eastern Europe.

Second, it was observed that the present total population of the European Union will be roughly the same in 2060 at about 500 million, but significantly older. The lowest fertility rates and the highest life expectancies in the world were found in many Member States. Low fertility and increasing life expectancy would reverse the age pyramid, leading to a shrinking number of younger people, an ageing and eventually shrinking work force, and an increasingly greater proportion of elderly people. Projections revealed that the demographically defined old age dependency ratio which stood in EU 27 at 25 people in the age group 65+ per 100 people of working age (15 - 64) in 2005 would reach 72 people by 2050. It was asked whether inward migration could offset these demographic changes. It was found that inward migration would alleviate the demographic deficit, but not solve it.

Third, it was noted that the Commission presented an annual report on migration and integration. The Commission has established a common framework to create a coherent European policy on integration. Employment policy was seen as a key part of the integration process. The European Council has adopted the European Pact on Immigration and Asylum to organise legal immigration in accordance with the needs and reception capacities determined by each Member State. It was understood that an ageing population, with an increasing share of its population aged over 65, and a reducing youth population, would place demands on public expenditure for pension provision and health care. Public pension and health care expenditures combined represented about one third of all government spending, and fell within the responsibility of individual Member States. Without policy changes, potential growth rates were predicted to fall from an underlying rate of 2-2½ per cent to around 1¼ per cent. It was realised that to consider only the demographic ratio would be misleading. It was rather the balance between economically active people in employment and the inactive who must be supported. It was concluded that the negative impact of demographic change could be partially offset by the participation of more people of working age in the labour market.

Four, it has been shown that the European Union has developed a wide variety of policy responses to population ageing, all with the common aim of increasing labour market participation at all ages. Attention was drawn to the Council directive outlawing discrimination in employment, including discrimination on the grounds of age, and the action programme to target discrimination in all spheres of life including that directed against older persons. The importance of the Lisbon Strategy was explained. Its aims were to raise the employment rate of women and older workers, and the number of young persons in further education and training. The Council has introduced an open method of coordination at all levels. Broad economic policy guidelines would spread best practice amongst Member States. Employment Guidelines were to be published at the same time to emphasise the need for co-ordination between the two. It discovered an acknowledgment that non-participation in the labour market was caused by relatively generous or loosely enforced benefit systems, or through incentives to take early retirement. The annual report *Employment in Europe* offered an analysis of employment and labour market developments in the European Union. It was observed that wide divergences in labour force participation existed among the Member States, with some achieving their target levels of employment, and others not. The European

Union viewed the high level of youth unemployment as a matter of concern. Young adults (ages 15-24) were more than twice as likely to be unemployed as prime-age adults. The 2010 *Report* analysed the effects of market segmentation between "temporary" and "permanent" contract holders (insiders and outsiders), particularly in relation to young people, and considered it an unintended consequence of national employment protection legislation (EPL). The *Report* advocated the reform of EPL.

The view was taken that the broad framework for ensuring budgetary sustainability in the face of substantial age-related spending pressures was in place in the form of the Stability and Growth Pact. The Working Group on Ageing Populations (AWG) has been established to examine the economic and budgetary consequences of ageing. AWG's age-related expenditure projections provided a long-term assessment of the sustainability of public finances. This assessment was integrated into the surveillance of individual Member States' budgetary positions and took place annually on the basis of the stability and convergence programmes. While accepting that all budgetary projections rest on assumptions, AWG's projections were considered of particular value if they alerted policy makers to future budgetary pressures likely to occur in the absence of labour market and social security reforms.

Finally, it was admitted that difficult questions remained unanswered: would the ageing societies of Europe stay dynamic and sufficiently innovative to thrive in the global marketplace; would fertility rates return to the replacement levels essential for societal survival in the longer term; and was intergenerational strife avoidable as the burden of old age dependency increased? Since population ageing is a hitherto unknown phenomenon, there are no examples from past experience to offer guidance on these matters.

The overall conclusion can be summarised. Ageing populations will have profound economic, budgetary and social consequences. The 2006 Ageing Report is specific: "the rise in the old age dependency ratio is the dominant factor pushing up public spending in the coming decades". Yet compliance with the Stability and Growth Pact requires Member States to continue running balanced budgets without resort to excessive borrowing. As ageing populations make demands on governments to allocate a growing share of public spending to transfer programmes benefiting the elderly, compliance will be challenging. The 2006 Report offers a degree of relief to governments by taking the view that changes in factors such as the employment rate, the eligibility rate and the relative benefit level, will partly offset demographic pressures. In EU15 it projects that these factors will curtail some 70 per cent of the demographic pressure, and that in EU10 they will offset all of it.[114]

Yet modifications to existing transfer programmes have often proved difficult to carry out. Public pension schemes involve substantial and very long-term commitments to members of the current labour force. The political difficulties of changing such well-established schemes have tended in the past to dissuade governments from reform initiatives. The realisation that current pension schemes in many cases will not be fiscally sustainable has forced governments to start the process of legislative reform.

The following chapter looks at the design of public pension schemes, analysing the difficulties such schemes present to governments that wish to implement reform. A particular emphasis is given to innovation, since by learning from the efforts of other countries to reform their systems of old age provision policy makers can gain new insights into tackling their own problems.

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[114] European Union (2006) *European Economy: Impact of ageing populations on public spending.* op.cit. Summary report, p.10.

CHAPTER FOUR: PENSION DESIGN

Having investigated in chapter three the demographic shift occurring in Europe, and revealed the mounting costs of old age provision, chapter four analyses the mechanics of public pension systems designed to provide effective support to the elderly at a level sustainable over the longer term.

Pensions are for the long term. With rising longevity, six decades may pass between an individual member's first contribution to a scheme and the receipt of the final benefit payment. It becomes the task of government to design pension systems that do not place too heavy a burden on members of working age, while still offering an adequate level of benefit to retired members. As population ageing occurs gradually, countries have time to rectify their systems. Much fiscal pressure and political discontent in the future can be avoided by early reform.

The objectives of the chapter are as follows:

First, it defines the nature and purpose of pensions, with reference to the classic analysis of Samuelson. It reflects on the wide prevalence of Pay As You Go schemes among the Member States. The schemes form the basis of old age provision in Europe, and their diverse types are surveyed. As Chapter Three has shown, the elderly are continuing to increase in numbers, making the schemes increasingly expensive to operate, and forcing governments to reduce the scale of their pension commitments. It demonstrates that while numerous parametric modifications to schemes are possible, each change has particular consequences, limiting the range of reform options available to policymakers. It argues that ad hoc adjustments made in response to short-term financial disequilibria, and lacking a clear policy direction, do little to inspire confidence in a system's future sustainability.

Second, the chapter then offers accounts of two radical innovations in pension provision, both of which attracted international interest. A short study of the privatisation of the Chilean pension system is presented. It discusses the deficiencies of the former pension system in Chile, and explains the management of the transition to the new system. The main features of the present system – contribution levels, pension savings accounts, and the minimum pension guarantee –are outlined. It considers the inadequacies of the reform, and the latest modification of the system. It suggests the main reason for the overall success of the privatisation of the Chilean pension system.

Third, a short study of the reform of the Swedish pension system is presented next. It describes the previous system considered unaffordable in the long term. It discusses the new system called the Notional Defined Contribution Plan which is a defined contribution scheme financed on a pay-as-you-go basis but with an additional funded component. It indicates the salient features. It explains the concept of notional defined contributions. It analyses the operation of the annuity divisor and the automatic balancing mechanism. It explains the administration and regulation of the funded component. It describes contribution levels and the guarantee pension. It concludes with an appraisal of the advantages and potential drawbacks of the Swedish reform.

Four, a comparative evaluation of the Chilean and Swedish pension reforms is presented. Issues that arise from the preceding studies are discussed. These include the continuing necessity for some form of residual publicly-financed pension provision; the desirability of offering tax incentives to employers to engage older workers; the vulnerability of pension schemes to unanticipated increases in longevity. The intention is be not merely to evaluate the strengths and weaknesses of the two systemic reforms selected, but more importantly to discover the insights that these reforms give to policy makers in other countries, whose governments seek to reduce the financial burden of pensions caused by population ageing.

Five, attention is drawn to recent developments in EU10 states where are several instances of attempts to reduce budget deficits with the help of pension funds.

4.1. The Economics of Pensions.

4.1.1. Theoretical Analysis

From an individual perspective, the economic function of pensions is consumption smoothing. As Samuelson points out: "men will want to consume less than they produce during their working years so that they can consume something in the years when they produce nothing".[1] In principle, there are only two ways of realising this desire: first, current production could be stored. "If there were only Robinson Crusoe he would hope to put by some durable goods which could be drawn on in his old age."[2] But often goods do not keep perfectly, and storage can be expensive. It is also impossible to store services deriving from human capital, medical services being particularly important for the elderly. With the possible exception of home ownership, and even here maintenance costs are ongoing, storage as a means of transferring consumption over the longer term offers few solutions.

[1] Samuelson, P. A. (1958) An Exact Consumption-Loan Model Of Interest With Or Without The Social Contrivance Of Money, op.cit. p.468.
[2] ibid.

Individuals are left with the alternative: exchange current production for a claim on future output. "We live in a world where new generations are always coming along" [3] and why "cannot men during their productive years give up some of their products to bribe other men to support them in their retirement years".[4] There are two means of effecting intergenerational transfer. First, an individual can accumulate a sum of money that can be exchanged for goods and services produced by younger people after the retirement of the fund holder. Second, an individual can obtain a promise that on retirement goods and services will be transferred from those working to him. The organisation of pension provision falls broadly parallel to these two types of claim on future production – funded schemes follow the first, and Pay As You Go (PAYG) or unfunded follow the second.[5]

Both mechanisms of transfer are subject to the same constraint: "there is realistically a limit on the proportion of national output that will flow to retirees, which may be reached as old age dependency ratios rise."[6] The level of national output is the crucial variable. At the very least, all pension schemes, funded or unfunded, must be designed so as not to impede economic activity; instead the design should strive to encourage economic growth, since only by increasing output can a country sustain the provision of adequate old-age security over the longer term. All pension schemes, however designed, remain vulnerable to demographic change and macroeconomic instability.

4.1.2. Public Pension Provision

Pension schemes that are mandatory, publicly managed, defined benefit, largely Pay As You Go and backed by the power of taxation, are virtually universal throughout the

[3] ibid.
[4] ibid.
[5] Barr, N. (2004) *The Economics of the Welfare State*, p.187. 4th edition.
[6] OECD (2005) *Ageing and Pension System Reform; Implications for Financial Markets and Economic Policies*, Supplement, p.11.November.

Member States. Continental Europe relies strongly on unfunded schemes. To explain more fully: current pension payments are provided by current contributions, usually imposed as payroll taxes, but sometimes financed by general taxation. Generally, these PAYG schemes were instituted during periods of rapid population growth and increasing real wages, and allowed governments to make immediate benefit payments to old people who had contributed little or nothing to the scheme. From the very beginning, the link between contributions and benefits was weak. Public pension plans typically use a defined benefit formula that promises a specified pension to retirees. These future pension obligations are set out in the social security legislation of each Member State.

From an aggregate point of view, the state is simply taxing one group and transferring the revenues to another. Samuelson states that this makes it possible in principle for every generation to receive more in pension benefits than it has paid in contributions, provided that real income rises steadily, and this should occur where there is technological innovation and/or population growth[7] (though the later is unlikely to be experienced in present - day Europe). This capacity of the state to increase pensions in line with real economic growth means that public pension provision can offer pensioners full protection against inflation. The mandatory nature of public pension provision stems from government awareness that large numbers of elderly poor would be a burden on state treasuries. Legally enforced obligation is deemed necessary to counteract the myopic attitude toward old age provision shown by many individuals during their working lives. Public pension schemes can also minimize impediments to labour mobility by determining benefit entitlement on an individual's overall earnings and years of labour market participation, and not on particular jobs held.

[7] Samuelson, P. A. (1958) op.cit. p. 482.

Another source of support for public pension provision arises from its ability to redistribute to low-income individuals. In many Member States social solidarity is a frequently stated goal of public policy.[8] There exists an entrenched, ideological commitment to the view that benefits should depend on criteria that are unrelated to socio-economic status, and should allow recipients to participate fully in the life of society. The state with its power to impose taxes has the unique capacity to create "a situation which is ethically optimal in terms of a social welfare future,"[9] "which can never be reached by the competitive market".[10]

Many regard poverty relief as the main function of public pension provision, and certainly the relief of poverty will continue as a responsibility of government. There will always be individuals whose disabilities or domestic circumstances prevent any, or only allow slight, labour market participation. If benefits are linked to contributions, then the total contributions of persistent low earners are likely to result in very low pensions. In consequence, a conflict of objectives is unavoidable: while the aim of consumption smoothing implies that those with higher earnings should receive higher benefits, poverty relief requires that benefits should be directed to those with lower lifetime incomes. Yet as Esping-Andersen explains:" the welfare state is mainly.....

[8] Holzmann, R. and R. Hinz (2005) *Old Age Income Support in the 21st Century -An International Perspective on Pension Systems and Reform.* op.cit. p.60
[9] ibid. p.479.
[10] ibid. pp.477-8.

designed to insure against social risks and therefore not a vehicle for equality”. [11]

The defined benefit formula can be expressed in several forms:

- Universal flat, with the same benefits paid to all those above a certain age, regardless of income and work history.
- Employment–related flat, with the same benefits for everyone per year of covered employment.
- Means-tested, with higher benefits for those individuals with lower incomes or smaller assets.
- Minimum pension guarantee or top-up to a mandatory saving scheme.
- Earnings–related, with higher benefits for those who have earned and contributed more.

The form chosen by a country reveals the relative weight that country accords to a particular objective. Universal flat and means-tested schemes have the limited goal of alleviating poverty; whereas, earning-related schemes with their ability to provide high rates of income replacement will facilitate the dominance of public provision as the source of old-age security. Although universal flat and means-tested benefits are often financed out of general revenues in accordance with their redistributive function, earnings-related benefits are typically financed through a payroll tax assigned for that purpose.

Policy makers recognise that these public schemes enjoy wide support. One explanation could be that the workers who pay the tax to fund the programmes regard

[11] Esping –Andersen, G and J. Myles (2011) *The Welfare State and Redistribution*, p.1 .Unpublished paper. Personal Webpage.
http://dcpis.upf.edu/~gosta-esping-andersen/articles.htm#notpubl. Accessed 12 .03.11.

them as implicit, ongoing intergenerational contracts. Middle-aged workers, who have built up substantial entitlements in existing PAYG programmes, will consider it in their interests for these arrangements to continue. Nevertheless, these implicit contracts are not enforceable by individuals vis-à-vis government. Governments can alter the terms of their commitments, and often do. The risk of income uncertainty in old age remains, since, in practice, public defined benefits are largely undefined.

Governments cannot ignore the mounting costs of public pension plans. As countries age, these plans consume an increasingly large share of GDP, and a much larger share of their total tax revenues. The burden is heavy. To illustrate, the contribution rate (employer plus employee) for mandatory pensions is now 16.55 per cent of gross wages in France, 19.9 in Germany, and 32.7 in Italy.[12] By pushing up the cost of labour, these high rates can have a negative impact on growth and employment creation. Additionally, pressures on pension expenditure are compounded by foreseeable increases in health care outlays. Governments have acknowledged the need to move towards more sustainable pension schemes; at the same time they wish to avoid adverse reactions from their electorates, and have preferred a cautious approach to reform. Fortunately, demographic transition proceeds slowly. Aside from migration, the future age profile of a population is highly predictable in the medium term, allowing governments the opportunity to undertake a gradual implementation of parametric reforms to existing schemes.

4.1.3. Reform Options

Though no Member State places total reliance on PAYG funding to finance old age security provision, an analysis of the mechanics of a pure PAYG scheme helps to

[12] U.S. Social Security Administration (2008) *Social Security Programs Throughout the World: Europe 2008.* www.ssa.gov/policy/docs/progdesc/ssptw/2008-2009/europe/guide. Accessed 03.07.09.

elucidate the various parametric reforms available, and also to reveal that reform choices are limited. Disney suggests that one method of examination is to calculate the average contribution rate – that is, the average rate required to finance current spending on public pensions, without resort to transfer from general tax revenues or the accumulation or decumulation of public pension reserve funds.[1] In a standard approach to financing an individual pension programme where

B = number of beneficiaries
L = number of workers
W = average wage rate
P = average pension
C = contribution rate

then $\frac{B}{L}$ is the inverse of the support ratio

and $\frac{P}{W}$ is the average replacement rate,

equilibrium requires $C = (\frac{B}{L})(\frac{P}{W})$

For example, where the inverse of the support ratio is:

1 pensioner: 4 workers, and the average pension paid is 40 per cent of the average wage, then a 10 per cent contribution rate will cover –

10% contribution rate = $(\frac{1}{4})(\frac{40}{100})$.

Should the inverse of the support ratio become

1 pensioner: 2 workers,

then the contribution rate would increase to 20 per cent, or the benefit replacement rate would fall to 20 per cent of the average wage.

It follows that to reduce the contribution rate requires any of, or a combination of, reducing P or B, or increasing W or L.

[1] Disney, R. (2000) Crises in Public Pension Programmes in OECD; What are the Reform Options? p.F.14. *The Economic Journal,* 110(461). February.

To increase the support ratio it is necessary

1) to reduce B – by raising the state pensionable age or by reducing entitlements for dependants.

or

2) to raise L – by increasing the proportion of the working-age population that is economically active. This can be achieved by restricting early retirement and by introducing stricter criteria of eligibility for disability benefits. More female labour market participation will increase the number of contributing workers, but will not increase the future number of beneficiaries nearly as much, because many women would have been eligible for pension benefits as dependents of their spouses.

To reduce the replacement rate it is necessary

1) to reduce P - by reducing benefits directly, or indirectly by adopting less generous post-retirement indexation

or

2) to raise W - by increasing the fraction of the wage, or wage bill, liable for contribution. Germany uses net wages instead of gross for indexation in order to hold steady the relative after-tax position of workers and pensioners.

When pensions are in payment, change of indexation is usually the only politically feasible means of benefit reduction. Indexation to prices, instead of wage levels, protects pensioners' absolute standard of living, but will allow the relative value of benefits to fall as real wages rise. A compromise formula has been adopted in Switzerland where pensions are indexed to the arithmetic average of price inflation and wage growth. This gives pensioners partial protection against inflation, and allows them a share in the country's growing prosperity.[14]

The contribution financing of a pure PAYG scheme is highly sensitive to changes in the age distribution of the population. A reduction in the size of the work force could lead to lower payroll receipts. Any fiscal shortfall may be better met by increasing reliance on consumption taxes (e.g. VAT). Given the generally higher average propensity to consume of the elderly, this may result in a lesser deterioration of the revenue base. To the extent that ageing is characterised by a rise in the number of consumers relative to producers, greater resort to general revenue financing would seem a more efficient and equitable distribution of the fiscal burden.[15]

The parametric reform that will deliver the greatest fiscal return is a raising of the state pensionable age. This will reduce the number of pensioners and increase the number of workers. Not only will the amount of pension benefit payments fall, but also the larger number of workers should increase tax receipts. It should be accepted that any consequent fiscal improvement might well be offset to some degree by a rise in the numbers of those claiming disability benefits in place of the pension benefit payments that they would otherwise have received.

4.1.4. The Reponses of Governments

Often governments carry out pension scheme reforms that retain the benefit structure, public administration, and the unfunded nature of the scheme, and merely alter the system's parameters. Ad hoc adjustments usually made in response to short-term

[14]OECD (2011) *Pensions at a Glance 2011*.Switzerland. http://www.oecd. Accessed 19.5.11
[15] Group of Ten (1998) *The Macroeconomic and Financial Implication of Ageing Population,* p.3. April. Bank of International Settlements.

financial disequilibria, and lacking a clear policy direction, do little to inspire confidence in the system's future sustainability.[16] Parametric reforms can have three main drawbacks. First, they are often not fully completed. Politicians are disinclined to implement pension scheme reforms that may damage their electoral popularity, and only produce gains after the retirement of the politicians responsible. Second, and because of incomplete parametric reforms, many labour market distortions will persist. For example, such reforms seldom lead to a common and harmonized scheme for the public and private sector workers. Third, adequate responses to ageing require long-term changes in retirement age and other system parameters – again unlikely to be welcomed by the electorate.[17] In order to prove of lasting benefit, parametric reforms must form part of a carefully designed overall strategy for old age provision. A preliminary step in the reform process should be to articulate the primary goals of a public mandated pension scheme. Proposals can then be evaluated on the basis of how effective they will be in achieving those goals. But what should these primary goals be?

In the opinion of the World Bank, public mandated schemes should provide benefits that are adequate, affordable, sustainable, and robust.

- Adequate
  No person should be allowed to fall into extreme poverty in old age. As an initial target, the World Bank suggests that the average full-time worker's pension should be a net-of-tax income replacement of about 40 per cent.
- Affordable
  Higher replacement rates come at a cost. The World Bank considers a mandated contribution rate of over 20 per cent of wages puts too great a

[16] Robalino, D.A. (2005) Reform Option 1: Parametric Changes. Implementation issues with parametric reforms (II).Core Course on Pensions.7-8- November. World Bank, Washington. info.worldbank.org. Accessed 30.03.10

[17] Holzmann, R. and R. Hinz (2004) *Old Age Income Support in the 21st Century: the World Bank's* perspective *on Pension Systems and Reform*, p.51.

restriction on individual life-style choices, and leads to higher levels of evasion.

- Sustainable
  Adjustments in contribution rates, benefit payment, and the age of retirement will be necessary from time to time. The manner of dealing with these changes should be an integral part of the pension programme design.
- Robust
  The system must be capable of withstanding economic shocks, demographic changes, and political risks. Countries should undertake a credible analysis of the financing of reform measures across the full range of likely scenarios. [18]

Ad hoc parametric reforms are unlikely to deliver this level of provision. Policy-makers now understand that the characteristics of a pension system – the type and level of benefit provided, the method of financing, and administrative implementation – all impact on labour market participation and the development of financial markets. Unfortunately, for any country with a reform agenda "there is not yet enough empirical evidence to unequivocally guide the design and implementation in detail".[19] Comparative assessments of reform initiatives and knowledge sharing become imperative. It is proposed to discuss and appraise the pension system reforms undertaken by Chile and Sweden, whose radical innovations have been of international interest.

[18] ibid. pp.55-56.
[19] ibid. p.58

4.2. Chile

4.2.1. The Old System

The Chilean pension reform in 1981 formed part of the major economic restructuring that took place in the country between 1973 and 1990. The early 1970s had been a period of economic chaos and hyperinflation. Chile also experienced high levels of unemployment in the late 1970s. Prior to 1981 the country had a traditional PAYG defined benefit system, albeit one that displayed a marked lack of uniformity. Fragmentation by occupation and sector had resulted in a system that by 1979 comprised 32 funds with more than 100 different retirement programmes. Total contributions (by employer and employee) varied between 16 per cent and 26 per cent of wages.[20] In the largest sub-system, Services Seguro Social, which covered two-thirds of total contributors, workers (mainly manual) were eligible for benefits after only 16 years of contributions. In spite of high payroll taxes, the system was insolvent and required 40 per cent of its costs to be funded from general tax revenues.[21] Whereas in 1955 the system had enjoyed a ratio of 12 active contributors to each pensioner, by 1979 the option of early retirement together with increasing participation in the underground economy had caused this ratio to shrink to 2.2 contributors to each pensioner. In 1980, the discounted present value of the system's contingent liabilities exceeded gross domestic product. The need for reform had become pressing.[22]

4.2.2. Transition

In 1981 Chile approved a law to replace the state managed PAYG system with a privately administered, national system of Pension Savings Accounts (PSA). The

[20] Congressional Budget Office (1999) *Social Security Privatization: Experiences Abroad- The Privatization of Pensions in Chile,* pp.19-20. January. http://www.cbo.gov/doc.cfm?index=1065&type=0&sequence=2. Accessed 18.08.09.
[21] James, E. and A. C. Edwards (2005) *Do Individual Accounts Postpone Retirement? Evidence from Chile*, p.51, endnote ii. Revised version of MMR WP 2005-098 . www.estellejames.com. Accessed 15.07.09.
[22] Congressional Budget Office (1999) *Social Security Privatization.* op.cit. pp.19-20.

transition from the old system to the new one was carefully planned. First, it was seen as essential that every retired worker was assured that the state would guarantee continued payment of his pension. Second, every worker already contributing to the PAYG system was given the choice of staying in that system or moving to the new PSA system. Those who moved to the new system received a ‘recognition bond’ that acknowledged their contributions to the old system. The bond was deposited in the individual worker’s PSA. It is indexed and earns 4 per cent real interest. The government redeems the bond only when the worker reaches the normal retirement age (age 65 for men, age 60 for women). The bonds are traded in secondary markets, enabling them to be used for early retirement.[23] Third, all new entrants to the labour force were required to enter the PSA system.

Chile resorted to two methods of financing the short-term fiscal costs of transition. First, debt was used in order to allow the burden to be shared by future generations; roughly 40 per cent of the cost was financed by the issuance of government funds at market rates of interest. Second, aware that the level of contribution required to maintain adequate pensions in the new system would generally be lower than the current payroll taxes, the government used part of the difference as a temporary transition tax, avoiding reducing net wages or increasing the cost of labour to the employer. Over the longer term, the real transition costs came from the guarantee of continued state provision of benefits to the already retired and to those workers in the old system who would retire in the future. The state would obviously cease to receive contributions from workers who had moved to the new system. This loss was calculated as being about 3 per cent of gross national product. The proceeds of a

[23] Iglesias-Palau, A. (2009) *Pension reform in Chile revisited: What has been learned?* p.22. OECD Social, Employment and Migration Working Papers No 86. DELSA/ELSA/WD/SEM (2009)14. www.oecd-ilibrary.org/pension-reform-in-chile-revisited. Accessed 22.07.10.

programme of privatisation of state assets financed the transition without raising taxes, causing inflation, or forcing interest rates higher.[24]

4.2.3. The New System.

All new entrants to the labour force and those workers who have opted out of the old system must contribute 10 per cent of their wages to a private investment fund. Workers must also contribute another 3 per cent of their wages to cover term life disability insurance. The previous mandatory employer contribution has been eliminated. The self-employed may voluntarily set up retirement accounts with the same basic features. A worker's contributions are invested in a private investment firm, called an Administradora de Fondos de Pensiones (AFP), chosen by the worker. The function and operation of the AFPs are precisely defined; their sole purpose is the administration of the accounts of workers in the pension system; they may not conduct any other business.

The entire account balance of an individual worker must be held with one firm, though switching between firms is allowed. AFPs are responsible for contracting with insurance companies to provide disability and survivor insurance for account holders. Retirement fund assets managed by the AFPs are strictly separated from their own assets. Should any AFP fail, the workers' investments are safe.[25] The AFPs charge fees solely on the basis of contributions. They may not charge an exit fee or impose management fees on accounts according to the value of the funds held. They may not enter into marketing agreements with other commercial entities, including banks.[26]

[24] ibid. p.27.
[25] Sullivan, M. (2004) *Understanding Pensions,* p.41.
[26] Iglesias-Palau, A. (2009) op.cit.p.34.

The Superintendancy of AFPs regulates them and their investment portfolios. It also regulates new entrants into the industry.[27] There is Registry of AFP salespeople. Staff can only be hired from the Registry, and the Superintendancy regulates sales practices.

4.2.4. The Minimum Pension Guarantee

This sets a pension floor guaranteed by the state. General tax revenues fund this guarantee, which is about 25 per cent of the average wage (or about 75 per cent of the minimum wage) after contributions to social security. The value of the minimum pension is adjusted for inflation, but in practice it has also been raised in real terms over the years to keep pace with wage growth. Workers who have contributed to the pension system for at least 20 years and whose accumulated funds cannot cover a minimum pension receive a transfer from the state that raises their pension to that minimum.[28] Workers with less than 20 years of contributions qualify for the PHASIS scheme, a means-tested benefit financed out of general taxation. Minimum pension guarantee (MPG) raises a moral hazard issue. Lower income workers have an incentive to minimize their contributions and rely on the minimum pension. Any marginal contributions will simply displace the public subsidy. Until the reforms of 2008 those persons that did not qualify for the minimum pension, and were without means, were eligible for assistance pension, which was far less generous.

4.2.5. The Investment Strategy of the PSAs

When the personal account system began in 1981, Chile's financial markets were undeveloped. Almost all of the contributions received by the PSAs were invested in

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[27] ibid. p.20.
[28] Edwards, A. C. and E. James (2006) *Crowd-out, Adverse Selection and Information in Annuity Markets: Evidence from new retrospective data set in Chile*, pp.5-6. Working Paper 2006-147. December. Michigan Retirement Research Center, University of Michigan.
www.mrrc.isr.umich.edu. Accessed 10.07.09.

bank deposits and government bonds – little else was available.[29] Partly in response to pension reforms, financial markets have developed considerably. Funds are now invested in a wide range of instruments, including mortgage–backed securities, equities and foreign securities.

At the start of the scheme each AFP could offer only one investment portfolio, and all portfolios were similar. "Herding" or copycat behaviour among AFPs was inevitable; but investment choice was deliberately limited in order that financially inexperienced workers did not mistakenly speculate on specific firms or sectors. Similarity was reinforced by another restriction placed on the AFPs. The permissible deviation from the average rate of return among all firms in any given year is limited to 2 percentage points or one-half of the average rates of return among all firms. Any AFP exceeding the maximum rate of return must deposit the excess funds in a "profitability reserve". Each AFP must hold a cash reserve of 1 per cent of its assets.[30] If returns fall below the average rate, the company must transfer funds first from the profitability reserve and then from the cash reserve.[31]

In 2002 Chile modified the rules to allow each AFP to offer 5 different portfolios with varying levels of risk. Multiple portfolios clearly extended investment choice, but regulatory control was retained by setting different rate-of-return bands for each type of portfolio. Supervision of asset allocation in portfolio remains; while the allowed proportion in equities for prime-age workers is up to 80 per cent, the equity limit is lowered to 60 per cent for workers nearing retirement.[32]

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[29] Iglesias-Palau, A. (2009) op.cit. p.28.
[30] OECD (1998b) *The Chilean Pension System,* pp.8-9. WP AWP 5.6. PUMA/SBO(97)5/FINAL. http://www.oecd.org/dataoecd/21/38/2429310.pdf. Accessed 07.05.09.
[31] ibid. p.10.
[32] ibid. p.18.

These supervisory controls aim to reduce volatility across time and disparities across individuals - reasonable objectives in a mandatory system. They have not prevented the AFPs from delivering high rates of return on their funds. Between May, 1981 and December, 2007 the annual rate of gross return has averaged 10.1 per cent in real terms.[33] By December, 2008 the AFPs managed over $74 billion in assets.[34]

4.2.6. Withdrawals

Starting to withdraw the pension does not mean that an individual worker withdraws from the labour market. Pension withdrawal and labour market exit are separate decisions. Chile exempts pensioners from the pension payroll tax. As a result, the reform has lead to a significant increase in labour force participation by older workers.[35]

At the time of retirement, a worker may chose from two payment options. First, a retiree may use the capital accumulated in his PSA to purchase an annuity from a private life insurance company. The annuity guarantees a constant monthly income for life, indexed to inflation. The provision of price indexing by life insurance companies is facilitated by the majority of both public and private long-term financial instruments in Chile being priced-indexed. Married men are required to purchase joint annuities that provide 60 per cent of the primary benefit to surviving widows, which reduces their own pension by an actuarially fair amount. Widows are allowed to retain any pension based on their own employment, and still receive survivors' benefit. This provision gives widows a high level of income security, and is especially valuable to women who form the majority of the very old.[36] Alternatively, a retiree may leave his funds in his

[33] Iglesias-Palau, A. (2009) op.cit.p.35.
[34] Business News Americas (2009) Chile Asset Allocation - Pension Funds. http://www.bnamericas.com/research/en/Celfin. Accessed 23.04.11.
[35] James, E., G. Martinez, and A. Iglesias-Palau (2006) *The Payout Stage in Chile: Who annuitizes and why,* p.11. www.estellejames.com. Accessed 07.05.09.
[36] ibid. p.6.

PSA and make programmed withdrawals subject to limits based on the life expectancy of the retiree and his dependants.

Before reaching the normal retirement age, a worker can start withdrawing from his PSA as soon as his account can finance a pension equal to 70 per cent of his own wages and 150 per cent of the minimum pension. In consequence, the majority of Chilean workers start claiming pensions in their 50s. Lump sum withdrawals are permitted where the worker has already purchased a pension that exceeds 70 per cent of his own wage and 120 per cent of the minimum pension, but few can meet this requirement.[37] The Government insures the annuities up to the level of the minimum pension plus 75 per cent of the value of the annuity in excess of the minimum pension, in case the insurance company should become insolvent. To avoid this happening the government imposes stringent reserve, equity and asset-liability matching requirements. By 2003, the assets of the life insurance companies totalled $14 billion, equivalent to 20 per cent of GDP, with 80 per cent of their reserves backing annuities.[38]

The Chilean pension reformers saw annuities with their provision of investment and longevity insurance as preferable to programmed withdrawals. Accordingly, the insurance companies have been given competitive advantage. Individual sales agents receive a commission from an insurance company when they sell annuities, but not from the administrators of the PSAs when they sell programmed withdrawals. Furthermore, the highly competitive market forces insurance companies to offer a high rate of return. "As of 2002, two-thirds of all retirement pensions, including 85 per cent of all early retirement pensions, were annuities".[39]

[37] OECD (1997) *The Chilean Pension System*. op.cit. p.8.
[38] James E., G. Martinez, and A. Iglesias-Palau (2006) *The Payout Stage in Chile*. op.cit. p.2.
[39] ibid. p.7.

One category of worker may choose not to annuitize. Retirees with low wages or only a few years of pension entitlement may opt for programmed withdrawals. The overestimating of mortality and interest rates has reduced the actuarial factor, enabling high payouts initially. These workers may also be attracted to the riskiest investments available, knowing that the MPG protects them from investment and longevity risks whilst at the same time they are not prevented from receiving any gains. If a PW payout falls to the level of MPG (which is rising because of wage growth), then the PW payout will stay at MPG level until the individual's account is exhausted. The cost of unwise investment decisions will ultimately be borne by the taxpayer. Public finances may also be put under strain if the MPG continues to move with wages. If the MPG rises above the annuity level during retirement, the government will top up the payout.[40] Many annuitants will become eligible for a top-up at some point in their 80s, because rising MPG will have overtaken their annuity payouts.

With regard to programmed withdrawals, the maximum permissible monthly withdrawal is recalculated every year, in accordance with a formula that is set by the regulations.[41] Investment volatility is therefore reflected in the annual payment. Annuities also do not enjoy insulation from market conditions. Payouts declined 15 – 20 per cent between 1999 and 2003, a period of dramatically falling interest rates.[42] The lottery element is unavoidable. Though once started monthly annuity payments will remain constant in real terms, the size of the pension remains very sensitive to the interest rate prevailing on the date of annuitisation.

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[40] ibid. pp.10-11.
[41] ibid. p.7.
[42] ibid. p.17.

4.2.7. Inadequacies

The system's promise that salaried workers will receive a pension of 70 per cent of working income rests on the assumption that contributors will pay into the system for at least 80 per cent of their working lives. The administration under President Bachelet (2006-2010) realised that this assumption was over-optimistic. Many workers, especially women with domestic responsibilities, had big gaps in their contribution records. In 2008 almost half of those in the 6.3 million workforce were not contributing; only 3.3 per cent of the 1.8 million self-employed were contributing.[43] Without policy change, a large segment of the population would not be able to self-finance a pension greater than the MPG, nor would they satisfy the coverage requirements of the PHASIS scheme.[44] President Bachelet sought to widen the coverage of the system, to make it fairer, and to improve the efficiency of the AFPs.

4.2.8. The Reforms of 2008

The Chilean pension system has been subject to constant modification. Between 1981 and 2008 pension law has been changed 44 tines.[45] In March 2008 the most substantial reforms so far were introduced. Among the many changes, certain measures stand out:

a). The minimum pension scheme for AFP members and the PHASIS scheme, the assistance pension, have been replaced by an income-tested scheme (the 'Solidarity Pension System'), which covers all individuals over 65 years and the disabled. The scheme will be funded by general taxation.[46] The amount of this single basic pension will be reduced for those already in receipt of some pension

[43] Iglesias-Palau, A. (2009) op.cit. p.30.
[44] ibid. p.32.
[45] ibid. p.45.
[46] ibid. p.46.

benefit. The level of the new benefit is 1.5 times the current level of the PHASIS benefit.[47]

b). Starting in 2012 mandatory coverage will be extended to the self-employed who pay income tax. Their contribution rate will be the same as employed workers and calculated on the basis of 80 per cent of annual income.[48]

c). Women members of the AFP programmes will receive a bonus from the State for each child equal to 10 per cent of 18 weeks' minimum wages.[49]

d). To increase price competition, from 2010 all new entrants to the labour force will be enrolled in the AFP that offers the lowest fee. Since all members must pay the same level of fees, an AFP wishing to offer the lowest fee will also be required to reduce prices for its existing members [50]

e). The rules on AFP investments are further relaxed. New asset classes now include derivatives, and foreign investments are permitted up to 80 per cent of the fund.[51]

f). To encourage voluntary pension saving, workers will be given the choice whether or not to defer income tax on the part of income saved for pensions. Workers choosing not to defer will benefit from a subsidy equal to 15 per cent of the amount saved.[52]

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[47] ibid. p.52.
[48] ibid. p.47.
[49] ibid. p.48.
[50] ibid. p.49.
[51] ibid.
[52] ibid. p.50

Chile remains a country of wide income disparities (Gini Index 52.4 in 2009). 11.5 per cent of the population were below the poverty line in 2009.[53] Chile is ranked 15th in terms of family income inequality on a list of 139 countries.[54] Despite these persisting problems, former Labour Minister Osvaldo Andrade expresses the confidence of Chile in its reformed pension system: "No one is thinking of going back to the old system".[55]

4.2.9. An Appraisal

Although careful planning, close regulation and a cautious approach to investment contributed to the successful privatisation of the Chilean pension provision, it is submitted that the fundamental reason for the programme's success was that the pension designers did not consider pension provision in isolation, but saw it as an integral part of the economy. The designers focused on the long-term fiscal impact of pension provision, convinced that fiscal discipline was an essential prerequisite for a sustainable pension programme. A well executed reform strategy would result in pension privatisation not only reducing public debt, but also encouraging economic growth. Public debt was first sold to the AFPs, whose holdings of government bonds rose from US$ 2.2 million in 1981 to US$ 864 million in 1986.[56] By running a budgetary surplus the government was able to gradually withdraw its debt securities from the markets. In 1985 investment of pension fund assets in equities was permitted, enabling the AFPs to purchase shares in the privatised entities. The demand for financial assets driven by the AFPs caused a rapid expansion of capital market infrastructure. The resultant increase in the productivity of capital stimulated the rate of economic growth.[57]

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[53] Central Intelligence Agency (2009b) World Factsheet.
www.cia.gov/chile. Accessed 24.04.11.
[54] Index Mundi (2009)
www.indexmundi.com/chile. Accessed 24.04.11.
[55] Fox News (2006) Chile to Revamp Private Social Security System. 26 May.
www.foxnews.com/archive/0,4567,052606,00.html. Accessed 11.07.09.
[56] Iglesias-Palau, A. (2009) op.cit. p. 27.
[57] Piñera, J. (1996) Empowering Workers: The Privatization of Social Security in Chile. *The Cato Journal,* vol.15 (2-3), Letter No.10.

The Chilean privatisation has served as a useful reference model in other Latin American countries, and in Central and Eastern Europe, where a similar transition from socialist to market-oriented economies has occurred. World-wide about 30 countries now favour a hybrid system of state and personal provision. Sweden became one of these, when it decided on a fundamental restructuring of its pension system.

4.3. Sweden

4.3.1. The Old System

The pre-reform public pension system in Sweden provided a flat rate benefit (FP), intended to protect old-age income security, and a supplementary benefit (ATP) to provide earnings-related benefits. The two benefits offered a minimum benefit level equivalent to 30 per cent of the average wage. Benefits were indexed to consumer prices. The FP and ATP were financed primarily by the imposition of payroll taxes on employers. In 1997 payroll taxes were 5.68 per cent for the FP and 13 per cent for the ATP. The financing of the FP was supplemented by general taxation. Though the payroll tax was levied on all earnings, pension rights were earned only up to a ceiling of approximately 1½ times the average wage. The contribution rate was set to generate a surplus to act as a buffer against cyclical contribution changes. At the time of reform in 1998, assets in the buffer funds amounted to over five years' benefit payments.[58]

By the early 1990s it became apparent that the buffer funds would be exhausted within 20 – 25 years, thereby forcing the contribution rate to increase significantly in order to pay the promised benefits. The absence of a link between benefits and real wage growth made the pension system sensitive to changes in the rate of output growth. Lower growth of the contribution base could put the system under pressure. Another

[58] Sunden, A. (2006) The Swedish Experience with Pension Reform, p.134 -5. *Oxford Review of Economic Policy.* 22(1).

concern was the slow erosion of the principle underlying earnings-related benefits: the previous 30 years of real wage growth meant that an increasingly larger proportion of the working population earned wages above the earnings ceiling, weakening the system's stated aim to provide income replacement. Benefits were also based on the 15 years of work with the highest earnings; reducing labour force participation did not necessarily result in lower pension payments. Realising that the existing pension system would in time become unaffordable, policymakers sought to design a system that would be financially and politically sustainable in the long run.[59]

4.3.2. Transition

The reform process started in the mid-1980s. In 1991 the Riksdag (Swedish Parliament) appointed a commission to propose ways to improve pension provision. It was considered important that a reformed system should have broad political support so that it would be insulated against future change. The pension reformers aimed to design a fiscally sustainable pension system tied to economic growth with a clear link between contributions and benefits. They wished the system to continue to be public and mandatory, and be so devised as to allow the level of contributions to remain unchanged in the long run. In June, 1998 the Riksdag approved a Notional Defined Contribution Plan (NDC) which was a defined contribution scheme financed on a pay-as-you-go basis but with an additional funded component.[60]

4.3.3. The New System

In the new system, the total mandatory contribution rate is 18.5 per cent of earnings. Contributions are split between employees and employers; though employee contributions are limited by a ceiling, the employer's share is levied on all earnings.

[59] ibid. p.136.
[60] ibid .p.137.

Contributions are divided into two portions, with 16 per cent credited to the notional account, and 2.5 per cent to the Premium Pension (the funded component).[61]

4.3.4. The Notional Defined Contribution Scheme

The innovative concept in the new pension scheme is that of the notional defined contribution (NDC). An NDC scheme is an accounting device that treats a PAYG scheme as though it is a defined contribution scheme. Pension benefits are paid out of current contributions, as in a conventional PAYG scheme, but the link between benefits and contributions is individualised and defined by the NDC accounting mechanism. Each contributor has a separate account, the balance of which is fictitious (or 'notional') since no capital is accumulated. The accumulated sum in the account represents the fictitious pension wealth. Interest is credited to the account. Since claims on future benefits are not collaterized with real capital, there is no market mechanism to determine the rate of interest on the account. The 'natural' rate of return for an NDC scheme is the implicit rate of a PAYG scheme, that is, the growth rate of the contribution bill.[62] Sweden chose the higher rate of wage growth in order to link earned pension rights to workers' earnings.[63] To ensure financial stability, an automatic balancing mechanism will result in the abandonment of wage indexation if the stability of the system is at risk.

Under the new system, retirement ages are flexible; benefits can be claimed at 25, 50, 75 or 100 per cent starting at age 61. The size of the annual pension will increase the later a person chooses to retire. No definite retirement age exists. If an individual continues to work after beginning to draw the pension, new pension rights are earned.

[61] ibid. pp.137-8.
[62] Palmer, E. (2006) 'Conversion to NDCs – Issues and Models', in *Pension Reform: Issues and Prospects for Non-Financial Defined Contribution* (*NDC) Schemes*, p.170. Ed.by R. Holzmann and E. Palmer. February. www.go.worldbank.org/K9HH10CS70. Accessed 10.07.09.
[63] ibid. p.177.

At retirement the account balance is converted into an annuity, which is calculated by dividing the notional account balance by an annuity divisor. Two factors determine the divisor: the cohort's age 65 life expectancy at retirement, and an imputed real rate of return of 1.6 per cent (the assumed long-term real growth rate of the economy).[64] Because a unisex mortality table is used, the divisor is the same for men and women.[65] The divisor is fixed at age 65; no adjustments are made for unanticipated increases in cohort longevity after age 65.[66] Flexible indexing is applied to pensions in payment - these are adjusted upwards in relation to average income growth, but deducting the 1.6 percentage points which have already been taken into account.[67]

The pension reformers realised that two design features were potential sources of financial imbalance. First, pension rights increase in line with per capita earnings; whereas contributions are linked to the total wage bill. If the numbers of those in the workforce fell, average wages would increase at a faster rate than the total wage bill, causing benefit payments to rise faster than the contributions financing them. Second, if the actual longevity of a retirement cohort exceeded expectations, benefit payments to that cohort would be more than their total contributions.

If short falls are projected, an automatic balancing mechanism is activated. The device requires an annual calculation of the balance ratio of the system's assets to its liabilities. This is defined as:-

Balance Ratio = Capitalized Value of Contributions & Buffer Fund ⁄ Pension Liability

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[64] ibid. p.186.
[65] Government of Sweden (2005) *The Swedish National Strategy Report on Adequate and Sustainable Pensions,* p.11.Regeringskansliet. July. www.ec.europa.eu/employment_social/social_protection/docs/2005/sv_en.pdf. Accessed 10.07.09.
[66] ibid. p. 21.
[67] ibid. p. 6.

- The capitalized value of contributions is equal to the pension benefits that the annual contributions will finance in the long term.
- The capitalized value is obtained by multiplying annual contributions by the turnover duration.
- The turnover duration is the estimated average time between a contribution to the system and the date of the benefit payment based on that contribution. At present the time lag is assessed as being about 32 years.
- Accordingly, the pension liability is the system's current vested liability.
- If the balance ratio drops below one, the system is in imbalance. Indexation of earned pension rights and current benefits will be reduced from the level of average wage growth. The degree of reduction will be determined by multiplying the changes in average wage growth by the balance ratio. Reduced indexation will continue until the financial stability of the system is restored.[68] These provisions have been incorporated into Swedish Law, where all terms used are defined precisely, and the mathematical formulae to be employed are set out.[69]

4.3.5. The Funded Component – The Premium Pension

This part of the system is administered by a government body, the Premium Pension Agency (PPM). To keep administration costs low, the PPM acts as a clearing house. Individual contributions of 2.5 per cent of earnings are invested by the PPM in lump sums. The fund companies do not know the identity of each individual investor. The PPM keeps all individual records. Individuals are given a wide choice of funds -

[68] Settergren, O. (2001a) *The Automatic Balance Mechanism of the Swedish Pension System – a non-technical introduction.* 20. 8. 2001. The National Social Insurance Board, Sweden.
[69] Settergren, O. (2001b) *Comment to the English Translation of the Legislation on the Automatic Balance Mechanism*. 18. 9. 2001. The National Social Insurance Board, Sweden.

currently about 700, of which the majority are equity funds.[70] International diversification of investment is allowed. There is a default fund for those who do not choose a fund.[71] At retirement, any time after age 61, the account balance is converted to either a fixed or variable annuity with survivor options under standard insurance practices. Annuitisation is mandatory, and the PPM is the sole provider.[72] Financial market returns tend to be higher than the rate of average earnings growth, and despite the relatively small size of the funded component, with only about 14 per cent of the contributions being directed into the individual funded accounts "30 per cent of total benefits are projected to come from the accounts".[73]

4.3.6. The Guarantee Pension

This exists to ensure basic security in old age. Individuals who have not earned any or only a few pension entitlements have in principle the right to a guaranteed pension, payable from the age 65 at the earliest. Unlike the NDC and the funded component, which are outside the state budget, the guaranteed pension is tax-financed. The guarantee pension is offset by the income pension an individual receives; at low levels of income pension, the offset is one-for-one. The design of this component distorts the link between contributions and benefits under NDC, since the benefit is paid regardless of labour market activity. Individuals likely to receive part of their benefit from the income pension and part from the guarantee pension will realise that an increase in work

[70] Pension Funds Online (2010)
http://www.pensionfundsonline.co.uk/countryprofiles/sweden.aspx. Accessed 15.06.10
[71] Sunden, A. (2004) *The Future of Retirement in Sweden*, p.249. Pension Research Council Working Paper 2004-16. The Wharton School of the University of Pennsylvania .
www.ssc.wisc.edu/cdha/caar/caar254-sep-16-2004. Accessed 19.07.09.
[72] ibid. p.17
[73] James, E. (2005) *Reforming Social Security; Lessons from Thirty Countries,* p.14. National Center for Policy Analysis. Report No. 277. June.
www.ncpa.org/pub/st277. Accessed 17.07.09.

effort may not increase their benefit one-for-one. In order to guarantee at all times a certain level of purchasing power, the guarantee pension is indexed to prices.[74]

4.3.7. Information

"The wide dissemination of basic knowledge about the principles of the system is a precondition for individuals' pension planning and also for the effectiveness of the incentive to increased work that the system generates".[75] All those insured receive annual information about their own pension through material dispatched by the National Insurance Office (known as the orange envelope). The envelope contains information on pension rights earned and a forecast of future benefits from the income-based pension and the premium pension. Since December, 2004 an Internet portal has been available, providing forecasts of the total pension that an individual will receive, given different assumptions of growth and rates of return, from the age 62, 65, 67, and 70.[76]

4.3.8. An Appraisal

The Swedish pension reformers have sought to design a dynamic system capable of responding to changing demographic and economic circumstances. They wished to ensure that the system enjoyed a high degree of credibility with the electorate. By introducing automatic adjustments, they have aimed to impede any future attempts to manipulate the system for political advantage. By abandoning the concept of a mandatory retirement age, politicians avoid the unpopular task of raising the retirement age. The hope is that the financial persuasion of actuarial adjustments to individual pension payments will be sufficient to raise the effective age of labour market exit. But the rejection of any future increase in contributions could be problematic. If the system

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[74] Government of Sweden (2005) *The Swedish National Strategy Report on Adequate and Sustainable Pensions*, op.cit. p.38.
[75] ibid. p.29.
[76] ibid.

encounters stress, this design feature could result in substantial benefit cuts, which in turn could threaten retirement security.

In Sweden the public pension is a significant portion of retirement income – responsible for 75 per cent of the average monthly benefit for men at 17,000 kronor (equivalent to €1946 at 16.02.11.) and women at 12,000 kronor.[77]

4.4. A Comparative Evaluation

(i). Poverty relief will continue as a function of public pension provision. No country will be able to dispense with a residual publicly-financed safety net. Life-time earners and those who have slight, if any, participation in the formal economy will require basic support in old age. In the case of Chile, the claim that the pension system has been privatised should be questioned. Notwithstanding the 2008 reforms the coverage of its funded scheme remains too limited. The reality should be recognised: Chile has a mixed public-private system. Furthermore, it is probable that minimum pension provision, if price-indexed as in Sweden, or wage-related as it is in practice in Chile, will assume increasing importance over time. As more retirees receive it, pressure on government budgets will mount.

(ii). Neither country appears to deal satisfactorily with the moral hazard encountered by those just above basic state pension. These workers face a 100 per cent tax on incremental retirement accumulations, which simply displace the subsidy. This gives a wrong signal to those on lower earnings. It suggests to significant numbers of the workforce that there is little point in even trying to fund their retirement. A lesser reduction that would permit the pensioner to receive some benefit from personal savings

[77] CTV News (2011) In Sweden, pension problems are so 1989. http://www.ctv.ca/generic/generated/static/business/article1878540.html. Accessed 16.02.11.

might encourage more lower-earners to save, and could over time lead to fewer claims for state subsidy.

(iii). In Chile the exemption of those in receipt of a pension from the payroll tax allows an employer to reduce the gross wage by the amount of payroll tax previously levied. An individual worker suffers no financial loss since the worker's take home pay remains the same. It is cheaper to employ older workers, even if their productivity has declined due to ageing. Among pensioners age 55-64 the labour market participation rate tripled between 1982 and 2002.[78] In Sweden employers' social security contributions amount to a total of 31.42 per cent (2011) of the tax basis, calculated as the gross wage including taxable benefits. After the age 65 reduced employers' contributions of 10.21 per cent (2011) are payable; though any beneficial impact on the labour market participation of older workers in Sweden is largely offset by the requirement that older employees make substantially higher premium contributions to defined–benefit occupational pensions.[79] Policy makers should consider not merely making labour market participation financially beneficial for older workers, but also offering tax incentives to employers to engage older workers. A two-pronged approach would be more effective.

(iv). The reformed schemes of both countries remain vulnerable to unanticipated increases in longevity. It is not possible to insulate any pension system from the impact of demographic change. There will always be a risk that mortality rate assumptions will be overtaken by medical advances. Many pensioners who live beyond the expected age

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[78] James, E. & A. C. Edwards (2005) *Do Individual Accounts Postpone Retirement? Evidence from Chile.* op.cit. p.15.
[79] Invest in Sweden Agency (2011) Running a business in Sweden. April. http://www.investsweden.se. Accessed 23.04.11.

of death will require additional state funding, and the earlier pensions are received, the greater the likelihood.

(v). Both systems face up to a crucial issue – the link between personal effort and reward. Both facilitate the break-up of the rigid division separating economic participation and retirement leisure. Neither system punishes job interruptions and return to the labour market at older ages. By giving individuals financial incentives to make rational choices, the pension designers hope to de-politicise the individual choice of retirement age. Nevertheless, politicians may have to deal eventually with the fiscal consequences of large numbers opting for early retirement.

(vi). Variants on the Swedish NDC system have been established in Italy, Poland and Latvia. These countries have followed Sweden by including a funded DC component as part of their reforms. They wish to emphasise personal accountability and savings. Accordingly, they intend that the funded component will play a bigger role in their pension plans: Poland 7.3 per cent (now 2.3 per cent) of payroll and Latvia 2 per cent planned to grow to 9 per cent. Sweden may have been too timid in allotting such a small role to its funded component.

(vii). An important reason for counties' adoption of NDC is that it avoids "the transition cost problem", which arises when contributions are diverted to a funded account. Countries must then decide on ways of financing their obligations already owed to pensioners and workers under the previous PAYG system. The present value of the pension obligations of the state to these contributors is termed the implicit debt. This legacy of the previous system can be funded by the issuance of government stock. The use of debt finance will spread the burden across many age cohorts. From an economic prospective, implicit and explicit debt are largely interchangeable, and the conversion of implicit to explicit debt will not increase a government's interest costs, since debt must be repaid. Explicit debt is more transparent and measurable than implicit. While it is legally possible for a state to reduce its level of implicit debt by altering the parameters of its public pension scheme, explicit debt cannot be made to similarly disappear. Furthermore, the Maastricht criteria take into account only explicit debt. For many countries the level of explicit debt is a major consideration that will determine the choice of pension policy reform.

(viii). Sweden's introduction of the clearing house mechanism as a means of reducing transaction costs is a highly promising innovation. The clearing house not only greatly reduces direct marketing costs, but also places a lighter burden on employers, who deal with a sole collection entity. Centralized account administration is also highly cost-effective. Although competition among private providers is in principle desirable, there seems to be strong indications of a trade-off between choice and costs. In Chile over the 1990's average marketing costs varied from 3 to 6 per cent of premiums across years, and in 2001 ranged from 2.5 to 4 per cent across companies.[80] Indeed, the structure of Chile's private investment firms with their almost identical portfolios encourages expensive marketing campaigns, the costs of which are passed on to the workers through lower rates of return. Chile has witnessed consolidation and concentration in the number of AFPs from over 20 some 10 years ago to 5 in 2009. This reduction may have delivered economies of scale, but poses a challenge to ensure continued supply of competitive and efficient services. A suggested solution is to allow other financial institutions, such as banks or regular mutual firms, to enter the

[80] James, E., G. Martinez and A. Iglesias -Palau (2006) *The Payout Stage in Chile: Who Annuitizes and Why?* op. cit. p.14.

industry.[81] Where countries decide not to adopt the clearing house mechanism, any restriction on market participation by investment entities needs to be objectively justified, if costs are to be curtailed.

(ix). For any reform proposals to gain widespread and lasting support by the electorate, the reform should be transparent and credible. José Piñera, Chile's Labour Minister (1978 – 1980), the leading designer of the country's reformed pension system, used every medium within his reach – newspapers, magazines, classrooms, academic journals, television and radio – to argue for privatising the pension system.[82] Once implemented, the reformed system should be insulated from political risk. One way to achieve protection is by identifying individuals' accounts as private property entitled to the same protection as their private assets. Any subsequent attempt by politicians to confiscate these pension assets would be strongly resisted by a large proportion of the workforce. While a high level of protection may be feasible for funded accounts, can the notional balances of unfunded accounts also be safeguarded against political tampering? Sweden seeks to foster a similar sense of personal ownership by the annual despatch of the orange envelope. Its intention is commendable; but can the fictitious ever attain the credibility of the real? Yet recent action by the Hungarian government shows that even identifying individuals' accounts as private property gives scant protection against virtual sequestration by a government in fiscal crisis.

(x). Pension policy forms an integral part of a country's overall economic strategy. The experiences of Chile and Sweden demonstrate the need for pension reforms to be underpinned by long-term commitments by government to pursue sound

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[81] Rodriguez, L. J. (1999) *18 Years of Private Pensions in Chile*, p.2. 12 June. Cato Institute, Washington. www.cato.org/dailys/07-12-99. Accessed 18.07.09.
[82] Investor's Business Daily (1997) Economist Jose Pinera - Chile's Pension Reformer Is No Stranger to Tough Sells. 27 March.
www.josepinera.com. Accessed 17.07.09.

macroeconomic policies. Compliance with the Stability and Growth Pact should help create the desired economic climate. The World Bank warns of the consequences of failure: "The experience of Argentina in 2001 and 2002 shows that when….the economy becomes virtually dysfunctional, no system of financing pensions is robust, whether public or private".[83]

4.5. Recent Developments

Many EU10 states had reformed their pension systems a decade ago by forcing workers to put part of their mandatory social security contributions into private funds. EU accounting rules do not treat those funds as public, increasing public debt.

In October, 2010 nine Member States negotiated a compromise that did not alter the rules but did allow a five-year period during which the debts created by pension overhauls could be taken into account when enforcing the Stability and Growth Pact.[84]

In April, 2011 at a meeting of the European Federation for Retirement Provision (EFRP), Central and Eastern European Countries (CEEC) Forum in London, the group agreed that the Euro-Plus Pact takes a "very short-term view".[85] The forum chairman Csaba Nagy said the Stability and Growth Pact should take into account the introduction – as well as the reversal - of funded pension systems on a permanent basis. Nagy said:

> "Europe cannot afford to encourage short-sighted policies that threaten the adequacy and sustainability of future retirement income." [86]

Some eastern EU members are seeking to cut deficits with the help of pension funds.

[83] Holzmann, R. and R. Hinz (2005) *Old Age Income Support in the 21st Century -An International Perspective on Pension Systems and Reform*. op.cit. p.160.
[84] Financial Times (2010b) Pension reformers want EU rule change, 22 November. www.ft.com. Accessed 24.04.11.
[85] The Euro-Plus Pact is a 2011 plan in which the Member States make concrete commitments to a list of political reforms which are intended to improve the fiscal strength of the country. It is designed as a more stringent successor to the Stability and Growth Pact.
[86] European Pensions (2011a) Euro Plus Pact 'short sighted' - EFRP, 4 April. http://www.europeanpensions.net/ep/euro-plus-pact-short-sighted-EFRP.php. Accessed 24.04.11.

- Hungary has implemented measures designed to force 3 million people now in private pension schemes back into the state system to help it meet budgetary targets. The 18 funds offering pension services in Hungary will find it difficult to continue operating, since severe restrictions will be imposed on their fees and operating expenses. Fund holders will be automatically transferred into the state system unless they opt out. At present, 10 per cent of most employees' wages go into a private pension fund, while employers pay another 24 per cent into the state scheme. Employees staying with the private pension funds will lose social security contributions their employers pay to the state. The government will continue to transfer the contributions made by employees to the funds. Admittedly, the Hungarian action stops short of the 2008 Argentinian outright nationalisation of private pension funds , whereby the state took over $23 billion of fund assets, but only just.[87]
- In April, 2011 Poland reduced the proportion of an individual's salary that can be paid into private pension funds from 7.3 to 2.3 per cent. The difference will instead be paid into Poland's national social security scheme.
- Estonia diverted state contributions to the mandatory funded second pension pillar to the general government budget in order to control escalating public debt and satisfy the criteria for Euro entry.
- Lithuania reduced contributions to private funds last year in order to ensure sufficient funds for the fulfilment of present budget commitments of the State Social Insurance Fund. The rate of a portion of state social pension insurance contributions transferred to pension funds was temporarily reduced from 5.5 to 3 per cent of the employee's salary in 2009–2010.

[87] Associated Press (2010) Hungary takes aim at private pension funds. 24 November. http://www.businessweek.com/ap/financialnews/D9JMMGS83.htm. Accessed 24.04.11.

- In Bulgaria, private occupational pension funds will put 20 per cent of their assets under state control to cover early retirement until 2014 to curb a widening deficit.[88]

It is submitted that these revisions of pension reforms are retrograde measures, and should be rescinded as soon as practicable.

4.6. Conclusion

In respect of its overall objectives this chapter has demonstrated that:

First, while it may seem self-evident to state that the purpose of pensions is to provide support in old age, there are abundant examples of pension schemes being used for purposes for which they were not designed. Governments in many Member States have facilitated early retirement for workers in order to reduce their official rates of unemployment. Costs can be substantial, since pension payments are often higher than unemployment benefits, and may continue for many years. Governments now realise that such policies cannot continue. The analysis of the nature of pensions produced a definition of pensions as transfers of wealth from those of working age to the retired, whether pensions are tax-financed or funded. It was held that the proportion of national wealth transferred was determined by the workers' willingness to surrender part of their incomes. It was realised that as old age dependency ratios rise, the limit on the acceptable proportion of wealth transferred might be reached, and then only by the growth of the economy could the amount transferred be increased. It was ascertained that the long term sustainability of a pension system rested on its design complying with this restriction on generosity. The diversity of public pension schemes in Europe was then explored, and their wide electoral support acknowledged. It was shown that a

[88] European Pensions (2011b Estonia urged to lift contributions to second pillar pension, 18 April. http://www.europeanpensions.net/ep/estonia-urged-to-lift-contributions-to-second-pillar-pension.php.Accessed 24.04.11.

number of possible modifications to schemes were available to policy makers, who sought to maintain sustainability. Each modification was discovered to have consequences that were not always desired, and that none provided a perfect solution. It was concluded that ad hoc responses to fiscal pressures would always be inadequate in the absence of an overall pension plan with agreed objectives. It was suggested that the World Bank's recommended primary goals of a public mandated pension scheme provided suitable guidance.

Second, with regard to both the Chilean and Swedish pension reforms, it was established that a public pension scheme has a central role in the overall efficient functioning of the wider economy. The reforms revealed the benefits of good design. Both schemes ensured that those of working age were not overburdened with contributions, and could remain confident of receiving adequate pension provision in retirement. In addition, it was found that a funded scheme, whether full or partial, would increase the amount of investable funds ready to be utilised in a country's further economic development. The Chilean pension reforms showed the important contributions made by careful initial planning and continuing tight supervision towards the success of the scheme. The success in the development of capital market infrastructure in Chile provided further confirmation that a state pension scheme formed an integral part of the national economy, and a well designed scheme could act as an engine of economic growth. In the case of Sweden, it was found that an innovative approach to reform had resulted in a state pension system that enjoyed popular support and still remained fiscally sustainable. The absence of a definite retirement age permitted individual choice of retirement age, but by individualising the link between contributions and benefits, the reform guaranteed that postponement of retirement would increase the size of an annual pension. The Swedish pension reform also recognized that regular information regarding individual entitlements was essential for individuals' pension planning and for the encouragement of longer working lives.

Third, the comparative evaluation of the Chilean and Swedish pension reforms revealed that common strengths and difficulties exist, despite the wide differences between the privatisation of state pension provision and a notional defined contributions scheme. Since the difficulties faced by each country might well be encountered elsewhere, the reforms offered guidance on pension design to policy makers in other countries. Both Chile and Sweden have had to retain a tax-financed safety net. Indeed, it is unlikely that any system of old age provision could do otherwise. Common system flaws were also discovered: neither reform offered a solution to the problem of those on the borderline of minimum state provision, where any additional income resulted in 100% reduction in state benefit, and both reformed systems remained vulnerable to unanticipated increases in longevity. The definite strength of both reforms was to establish a clear link between contributions and benefits, and to allow individuals the freedom to choose when to exit the labour market. The Chilean and Swedish reforms also demonstrated the importance of gaining and retaining widespread and lasting popular support. Both reforms showed that one of the ways of achieving this was by identifying individuals' pension accounts as private property entitled to the same protection as their private assets, thereby fostering a sense of proprietorship. Above all, the success of the reforms could be attributed to the realisation that a state pension system should not be treated as an appendage but regarded as an integral part of the general economy, with a part to play in the efficient functioning of that economy. The warning issued by the World Bank that no pension system, however designed, could be insulated from the troubles of the economy, of which it formed part, served to further stress this.

Finally, the account of recent developments in EU10 States showed that EU accounting rules require to be drafted so as to facilitate private pension saving, and not to deter Member States from implementing private funded provision. These present difficulties in compliance demonstrated the need for a flexible response from the Commission when problems of this type appeared. Attention was also drawn to the measures adopted by certain Member States who sought to reduce budgetary deficits by reducing transfers to private pension funds. Though understandable in the present downturn, such action was thought undesirable in the longer term.

As this chapter has elucidated, the main features of a well-designed public pension system are now known, as are the pitfalls to avoid. The task of instigating the required legislative changes falls to politicians. Yet knowing the correct agenda for reform does not make implementation any easier to accomplish. Although governing parties may acknowledge the necessity of reform, they are also conscious of the widespread constituency of support for pension provision. They tend to proceed cautiously, realising that legislative reform might lead to electoral defeat. The political vision can be myopic, since the costs of reform often fall in the short term, whereas the benefits to society as a whole may only be evident many years after the life of the administration responsible for the reform. Two strategies are commonly employed by governments to avoid electoral retribution. First, they attempt to evade full responsibility for any retrenchment in pension generosity by gaining the support of other political parties and organized labour for pension policy changes. Second, reforms are typically modest for current retirees and those approaching retirement, but often substantial for younger workers as reforms are gradually phased in. Examples of both strategies are shown in the following chapter, which discusses the public pension systems of Germany and the United Kingdom. In each country from the 1990s onwards the issue of how to ensure the long term sustainability of the pension system in the face of demographic change has been high on the policy agenda. As Chapter Five will illustrate, pension system reform has often proved a particularly difficult and awkward political undertaking. It is also often protracted.

CHAPTER FIVE: CONTINUITY AND CHANGE: PENSION PROVISION IN GERMANY AND THE UNITED KINGDOM

Having described in chapter four the design specifications of a public pension system that is capable of providing an adequate and sustainable level of old age support, and in so doing revealed the limited reform options available to policy makers, chapter five explores the process of pension reform in two major European economies.

In the following chapter the Member States discussed, Germany and the United Kingdom, have similar demographics, but different systems of pension provision, and different problems. This chapter is divided into two parts. In the first part it explains the form and purpose of the German pension system; it examines the gradual evolution of the system as it attempts to adjust to a changing environment; it reveals that Germany faced with demographic shift and economic pressures has been forced to accept that its previous level of provision was over generous and could not continue.

The objectives of this study of the German pension system are:

First, it presents an overview of the German pension system. It explains that state pensions are classified as public retirement insurance, and that the pension scheme operates as an institution separate from the federal budget. It discusses the wide coverage of the scheme and its high contribution rate. It explains the concept of the Eckrentner, a fictive model used as a basis for government computations. It describes the four factors that ensure a pension benefit payment relates to an individual's lifetime earnings, adjusted according to the type of pension and the age of retirement. Attention is drawn to the stress faced by the system: Germany is ageing, and the numbers of workers relative to pensioners declining.

Second, it maintains that the German pension system facilitates the preservation of status differentials. It provides examples of special pension arrangements, such as separate schemes for the professions, farmers and artists. Germany's 1.6 million civil servants are also exempted from the main public pension system, and enjoy a more generous level of benefit than that of private sector workers. An outline of the main features of the civil service pension scheme is given. It observes that the maximum replacement level of a civil service pension has been reduced.

Third, Germany has implemented a series of reform measures that aim to contain state expenditure on pensions. The study examines the main initiatives in order of occurrence, commencing with the first major retrenchment in 1992. Especial consideration is given to the recommendations of the Riester and Rürup Commissions, and the subsequent eponymous reforms. The study exposes a process of state pension reform prolonged by political and legal obstacles.

Four, it reviews the current pension situation in Germany, and finds that the retired continue to enjoy a living standard close to that of the working-age population. It questions whether this will be the case in the future. It acknowledges anxieties that the constitutional conformity of the public pension system would be jeopardised if the future rates of return became negative for the contributions of younger cohorts. While it discovers that most econometric research indicates that rates of return remain positive, it also accepts that probable constitutional conformity alone will not dispel all misgivings about the future direction of pension policy in Germany. It finds that periods of unemployment could have a significant negative impact on future individual pension benefit. It notes that in the future a marked percentage of pensioners, even after contributing to the scheme for many years, will only receive a pension roughly equivalent to (present) social assistance benefit. It voices the concern that the legitimacy of a scheme based on an insurance principle and a close link between individual contributions and pension benefits may be endangered.

Five, it maintains that the redesigning of the old-age provision in Germany should be seen in the context of the wide-ranging changes occurring in the economy overall. It contends that a reformist agenda has become pervasive, driven by an economic philosophy of neo-liberalism. Finally it evaluates the significance of the balanced-budget provision introduced into the German constitution.

5.1. The Reform of the German Pension System

5.1.1. Overview

The German pension system is one of the most important pillars of the German welfare state. Twenty-five per cent of all social expenditure is assigned to the pension system.[1] Although the country's pension system is undoubtedly complex, its design objective is clear: to extend the standard of living enjoyed during working life to the time of retirement. Accordingly, public pensions are roughly proportionate to labour income averaged over the entire working life. Redistributive features are few. The system faces stress: Germany is ageing. "There are 2.8 Germans aged 20-59 to support each pensioner. By 2030 there could be half as many."[2] Changes in the provision of old-age security are unavoidable. Although the country's pension system is undoubtedly complex, its design objective is clear: to extend the standard of living enjoyed during working life to the time of retirement. Accordingly, public pensions are roughly

[1] Hegelich, S. (2004) Can Welfare Expansion Result in Disintegration? The Integration of East Germany into the German pension System. *German Politics, p.83.* 13(1), March.
[2] Economist (2002) We Know What's Best for Your Old Age, Why Can't You see it? p.41. 8/3/2002, Vol. 364, Issue 8284

proportionate to labour income averaged over the entire working life. Retrenchment carries considerable political risk.

Originally a scaled premium system, the German public pension system converted to a de facto pay-as-you-go scheme during the interwar period when most of the funds were invested in government bonds. In 1957, the German Bundestag formally acknowledged the transition. A dynamic earnings-related pension was introduced, linking pension calculation and regular pension adjustment to gross earnings. Within the next ten years the remaining capital stock was exhausted[3]; today the system operates with a very small reserve amounting to 20 per cent of monthly expenditure.[4]

Classified as "public retirement insurance" – Gesetzliche Rentenversicherung (GRV) operates as an institution separate from the federal budget. GRV covers about 80 per cent of the workforce (33 million people). Participation is mandatory for all dependently employed workers in the private sector, and for those public sector workers who are not regarded as civil servants. In retirement most of these workers will receive the main part of their income from the public system. Prior to recent reforms, two features of this system stood out: the effective retirement age was early, and the effective replacement ratio was high. The cost of the high level of old-age provision is 11.4 per cent of GDP [5](more than 2.5 times as much as the US Social Security System). This results from a high contribution rate of over 28 per cent of gross income made up of 19.9 per cent direct contributions and 8.5 per cent in state subsidy. The use of early retirement and disability pensions as a means of tackling high unemployment caused a large discrepancy to emerge between the system dependency ratio i.e. the ratio between

[3] Quiesser, M. (1996) *Pensions in Germany*, p.5.
[4] Pensions ' Emergency Bill' (2004)
[5] OECD (2011b) *Pensions at a Glance 2011.* Online Country Profiles. Germany. www.oecd.org/data. Accessed 10.05.11.

the number of pensioners and the member contributors, and the demographic dependency ratio. The financing of the system is distinctive. Contributions are administrated in a way similar to a payroll tax, half paid by the employer, and half by the employee. In consequence, the employer not only pays the wages, from which the contributions of the employee are deducted by the state, but also the so-called non-wage labour costs in the form of half of the social insurance contributions. In economic terms, these non-wage labour costs form part of the total wage costs, which the employer has to take into account. The outcome would be the same if the employer increased the amount of wages paid by these non-wage costs, leaving the employee to pay 100 per cent of the required contribution, provided the total amount of the contribution did not change.

Approximately 70 per cent of the GVR budget comes from these contributions. There is an upper earnings threshold set at about twice the average monthly gross wage. Over the last thirty years the contribution rate has risen steadily. Additional funding has been obtained by raising the upper earnings threshold at a rate considerably faster than that of wage growth.[6] Despite its independent status the remaining 30 per cent of the GVR budget is provided by the federal government. The federal subsidy is meant to cover benefits not directly related to the notion of old age insurance, such as credits for non-contributory periods due to education, military service or childcare, the cost of medical rehabilitation benefits, and the health insurance pensions.

In 1972 a major expansion of the system took place. A relaxed approach was taken to early retirement. Workers with a long service history could retire from age 63. Older

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[6] Börsch-Supan, A.H. and C.B. Wilke (2003) *The German Public Pension System; How it Was, How it Will Be,* p.9. 25 August. Discussion papers / Mannheim Research Institute for the Economics of Aging (MEA); 034. http://www.mea.uni-mannheim.de/publications/meadp_034-03.pdf. Accessed 20.07.08.

workers who could not be appropriately employed for health or labour market reasons could retire from age 60. Pensions were divided into five types: normal retirement age (65) and four types of early retirement. All pensioners would enjoy a very generous level of provision, with pension benefits set at a replacement rate of 70 per cent. This quoted rate does not correspond to the economic notion of a replacement rate that relates pension benefits to the wage received immediately before retirement. Official government computations rely on a fictive model: the Eckrentner, who has worked and paid contributions for 45 years and had average earnings each year. The replacement rate is calculated by dividing the current pension of the Eckrentner by the current average earnings of all dependently employed workers. In reality, the average number of years of contribution is about 38. Moreover, as a measurement of generosity the official replacement rate is becoming less meaningful, since, due to the changing employment careers of men and women, the "standard case" corresponds less and less to the representative case.[7]

The expansionary measures of 1972 had costly consequences. Oil price hikes led to the sudden death of full employment in 1974. The twin problems of increasing outlays and declining contribution revenues, which have beleaguered all social insurance schemes in Germany, put the pension system under strain.

The 1992 Social Security Reform was the first major attempt at retrenchment. The age limits of early retirement were to be gradually raised to age 65. The first cohorts would be affected in 1997. By 2012, with the exception of the seriously handicapped, all provisions for early retirement without reduced benefit are scheduled to be phased out.

[7] Hinrichs, K. and O. Kangas (2003) When Is a Change Big Enough to Be a System Shift? Small System – shifting Changes in German and Finnish Pension Policies, p.588. *Social Policy and Administration*, 37(6). December.

The permanent deduction is 3.6 per cent for each year of premature retirement.[8] Deferral after 67 now earns a 6 per cent increment for each extra year of work.[9] Though steps in the right direction, neither the deduction nor the increase is actuarially fair; the 3.6 per cent deduction being too low to eliminate the incentive for early retirement.

Since social security contributions were projected to increase to 40 per cent of gross earnings by 2035, if accustomed replacement rates and indexation to gross wages continued, the reform introduced indexation to net wages. An automatic adjustment mechanism that linked government subsidy to contribution rates was devised. Higher contribution rates would cause an increase in government subsidy; at the same time, higher contribution rates would result in lower net wages, which in turn would mean lower pension increases.[10] The mechanism sought to distribute the burden of an ageing population among workers, pensioners and government. This assumes that government will always be able to increase its participation in the pension system as required. Furthermore, wage indexation, irrespective of whether based on gross or net wages, rather than cost of living indexation makes it impossible to finance the retirement burden by productivity gains.

In order that pension benefits are strictly work-related, the amount of each pension is based on the individual's lifetime earnings, adjusted according to the type of pension and the age of retirement. Four factors are considered:

1) Earnings Points (EP)

   Since 1992 a system of personal points has been adopted. A worker earning the

[8] Börsch-Supan, A.H. and C B. Wilke (2003) op. cit. p.14.
[9] OECD (2009) *Pensions at a Glance*, p.200.
[10] Queisser, M. (1996). op.cit. p.6.

average wage gets one point (1EP). Workers with less or more than average earnings receive points on a pro rata basis.

2) Years of Service Life (SY).

   SY are defined as years of active contribution, years of contribution made on behalf of the employee, and years that are deemed SY despite no contributions being made. These years include periods of unemployment, military service, childcare, and a limited number of years spent in advanced education. An element of redistribution appears.

3) Adjustment Factors (AF)

   These variables are determined by the type of pension. AF will reduce the level of benefit for early retirement, and increase it for late retirement. Similarly, AF will decrease pension benefit in the case of survivors' pensions, e.g. multiplied by an adjustment factor of 0.55.

4) Current Pension Value (PV)

   PV was calculated in December 1991, immediately before the 1992 pension reform. It corresponds to the pension entitlement that an average income worker earned by contributing for one year according to the old pension formula. The 1992 reform indexed PV to annual changes in the level of wages net of pension contribution. The mathematical formula used to calculate PV forms part of German law. Each pension is adjusted in line with the change of PV, irrespective of when the pensioner retired. Therefore, all pensioners with the same sum of EP have an identical pension benefit irrespective of when they retired.[11]

The Pension Reform Law, which came into effect in 1992, was passed on 9 November, 1989, the same day as the fall of the Berlin Wall. All the assumptions and model

[11] Börsch-Supan, A.H. and C.B Wilke (2003) op. cit. pp. 12 - 13.

calculations that underlay the reform had been based on the Western part of Germany.[12] In the newly unified country they became untenable. The integration of the five new states placed a heavy financial burden on the system. East German pensions were re-valued in 1990 and 1991, producing an average increase of 60 per cent within a year. Large transfers were required from West to East; about 10 per cent of contribution revenue raised in West Germany was used to finance about 45 per cent of East German pension spending.[13]

A deteriorating labour market situation caused a significant influx of the elderly unemployed into early retirement schemes. Another round of retrenchments was triggered, including an omnibus bill enacted in 1996. The bill accelerated the phasing-out of retirement options without permanent benefit deduction before age 65. Various non-contributory entitlements were reduced; periods of education after age 17 were to be credited at a lower value, and for not more than 3 years (previously 4 years). Three years of the first four in covered employment (for example, during an apprenticeship when earnings are low) were to be re-valued to a level of 75 per cent of average earnings (previously 90 per cent).[14]

5.1.2. Special Groups

The German pension system facilitates the preservation of status differentials. Institutionally separate compulsory schemes exist for farmers and artists. Professional associations of doctors, lawyers, and other groups of the self-employed run independent schemes. Membership is compulsory, and the majority of these schemes are funded to different degrees. Investment of reserves is subject to the guidelines of the private

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[12] Quiesser, M. (1996) op.cit. p.19.
[13] Taylor-Gooby, P. (1999) Policy Change at a Time of Retrenchment: Recent Pension Reform in France, Germany, Italy and the UK, p.10. *Social Policy and Administration,* 33(1). March.
[14] Hinrichs, K. and O. Kangras (2003) op. cit. p.577.

insurance supervision law. Contributions and benefits are usually higher than for the general scheme. The most prominent case of special treatment is that of civil servants.

5.1.3. Civil Service Pensions

Germany's 1.6 million civil servants are exempted from the public pension system already described. They do not pay explicit contributions for their pensions, though gross wages paid to civil servants tend to be lower than gross wages of other public sector employees with a comparable education, since civil servants have lifetime tenure. They are also exempt from unemployment insurance contributions. Standard retirement age is 65. Early retirement is permitted. Discount factors for early retirement will eventually reach 0.3 percentage points per month of early retirement, the same as the private sector.

There are three crucial differences between civil service pensions and private sector ones. First, the benefit base remains gross income. Second, pensions are taxed the same as any other source of income. Third, benefits are calculated on the last salary, and not on the lifetime average, and subsequently increased according to the growth rate of the net earnings of active civil servants.[15]

But possibly the favourable status enjoyed by civil servants in Germany is best shown by the very generous replacement rate of their pension benefits. Until recently, the maximum replacement rate was 75 per cent of gross earnings, significantly higher than the official replacement rate of about 70 per cent of net earnings in the private sector.[16]

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[15] Börsch-Supan, A.H. and C.B Wilke (2003) op. cit. pp.19 -20.
[16] ibid. p 21.

In consequence, gross pensions of civil servants were around 25 per cent higher, ceteris paribus, than those received in the private sector.[17]

5.1.4. The 1999 Reforms

In 1997 another series of pension reforms were enacted. These are described as the 1999 Reform, the year of intended implementation. The federal government planned to reduce the replacement rate in accordance with a pre-defined "demographic factor", which would integrate rising longevity at age 65 into the annual pension-adjustment formula. Over time, the demographic factor would have reduced the replacement rate from nearly 70 per cent to 64 per cent, allowing a projected contribution rate of 22.4 per cent by 2030. The Red-Green coalition that took office in 1998 revoked this controversial measure. The demographic factor was eventually replaced by discretionary manipulations of the adjustment formula; the consequence of which would be the same in the longer term – a lowered standard replacement rate.

Other aspects of the planned reforms were not revoked. There was to be a gradual increase in the age of eligibility for pension benefit from age 60 to 65 for women and the unemployed, which would be fully implemented by 2017, and would effectively leave a "window of retirement" open for healthy workers only if they had at least 35 years of service. The government also widened the contribution base to include casual jobs with a pay of less than 630 DM per month, and some of the self-employed. A gradually increasing energy tax (Ökosteur) was imposed, and earmarked as a supplementary federal grant to the public pension scheme in order to stabilise the contribution rate. This allowed a reduction of the contribution rate to 19.1 per cent in

[17] ibid. p.22.

2001, but due to the state of the economy, it had to be increased to 19.5 per cent in 2003.[18]

It was becoming clear that the financial limits of the unfunded pension system had been reached. In 2001, the then labour minister, Walter Riester, succeeded in steering through the legislature a major pension reform bill. The aim of the bill was ambitious and radical: to change the monolithic German pension system into a genuine multi-pillar one. This would require a partial substitution of PAYG-financed pensions by funded pensions. Participation in funded pension schemes would not be compulsory. Given the popular title – the Riester Reform, the bill came into effect on January 1, 2002. The transition was to be effected by three major policy initiatives:

1) Contribution rates were to be stabilized, since it was believed that any further significant increase in the contribution rate would have a negative impact on economic activity. It was enacted that contribution rates must stay below 20 per cent until 2020 and below 22 per cent until 2030. At the same time, the net replacement level must stay above 67 per cent. If these targets were not met, then the government would be legally bound to take action to resolve the problem. In such circumstances, government would have a limited repertoire of responses: federal subsidy could be increased, standard retirement age raised, or further selective cuts made in entitlements.

2) The long-term stability of pension levels would be secured by a gradual reduction of the net replacement level from the current 70 per cent to around 67-68 per cent by 2030. This stated target could be thought misleading, since it was also intended to change the method of calculating reference earnings. Treating the voluntary private contributions to funded pension schemes as though they

[18] Hinrichs, K. and O. Kangras (2003) op.cit. p.580.

were mandatory levies, a fictitious 4 per cent of gross earnings was to be deducted. Use of the previous definition of net earnings would mean that PAYG pension levels would fall by some 10 per cent, giving a replacement level of about 63.5 per cent.[19] Changing the pension adjustment formula to reduce benefit affects all pensioners, both present and future. This 4 per cent deduction will not only be felt by present pensioners, but also by those near retirement age who cannot compensate for the loss in public pension provision by additional private savings for old age.[20]

3) The spread of supplementary occupational and private pensions was to be actively promoted by government in order to offset the declining role of public pension.

5.1.5 The Main Changes Made In 2001

5.1.5.1. The PAYG Pillar

Prior to the Riester reform, the pension system had sought to safeguard standards of old-age provision by adapting the contribution rate to achieve a 70 per cent replacement rate - an objective that characterised the system as a defined benefit scheme. A more complex adjustment formula is now used to calculate the current pension value (PV). Changes in PV are related to lagged changes in gross income, modified by the actual contribution rate to public pensions, and a fictitious contribution rate to private pension plans. It was realised that indexation to net wages would have the adverse impact of increasing pension expenditure if the government should try to decrease the tax burden on gross wages. In addition, by incorporating into the formula a "sensitivity factor" that

[19] Börsch-Supan, A.H. and C. B. Wilke (2003) op. cit. p.25.
[20] Schmähl, W. (2007) Dismantling an Earnings-Related Social Pension Scheme: Germany's New Pension Policies, p.327. *Jnl. Soc. Pol.* 36(2). April.

take into account the rapid rise in the system dependency ratio after 2010, this complicated formula aims to strike a balance between the two opposing reform objectives: to keep contribution rates below pre-determined maxima, while maintaining the redefined standard replacement level above 67 per cent until 2030.[21]

5.1.5.2. Grundsicherung

A means-tested basic income was proposed for those persons age 65 and over who lacked adequate income. Germany has had no specific minimum income protection scheme for the elderly. The main supplement for low-income pensioners has been social assistance. About one-half of social assistance expenditure goes to pensioners. Financed at local level, increasing pressure has been put on the budgets of municipalities. It was recommended that a guaranteed minimum pension should be introduced and set at the level of social assistance plus 15 per cent. In addition, adult children would not be required to pay back the whole sum or part of it until their income exceeded €100k per year. The subsidiarity principle (the legal obligation of adult children to support their parents) would be virtually lifted. In an explanation of the reform bill, the government mentioned the probability that the lowered target replacement rate and the effects of various retrenchments already enacted would increase the number of new retirees with insufficient insurance entitlements.[22] The proposal to introduce a minimum pension was dropped in favour of a means-tested benefit scheme for those aged 65 and over, as well as for disabled persons, in 2003. At present, the number of those considered to be in need of this safety net amounts to only 1 per cent of the pensioner population.[23]

[21] Börsch-Supan, A.H. and C.B. Wilke (2003) op. cit. p.28.
[22] Hinrichs, K. and O. Kangras (2003) op.cit. p.580.
[23] Peaple, N. (2004) *European Pension Reform and Private Pensions,* p.13. May. Association of British Insurers.

5.1.5.3. Supplementary Funded Private Pensions

These can be occupational or individual. Since coverage in the past has been relatively low, the state offered fiscal inducements to persuade people to take supplementary private pension cover. Incentives take two forms: direct savings subsidies, and tax-deductible special allowances; the tax authorities calculating which is the better one for the individual.[24]

i). Direct Savings Subsidy

All dependently employed and certain self-employed workers who pay a personal contribution to a certified retirement pension plan are eligible for a direct retirement savings subsidy. To qualify for the maximum subsidy the worker must invest a specified percentage of gross earnings. Starting at 1 per cent in 2002, this percentage increased in four steps to reach 4 per cent by 2008. The amount invested is at present exempt from income tax and social security contributions. Direct subsidies during the contributing period will be very useful for those with children, since an extra subsidy will be paid for each child. It had been realised that special support for families with children was required, since their scope for saving is often very limited. For the lowest income households the subsidy is almost as large as the contribution itself.[25] The OECD comments: "Germany has been particularly successful at getting lower-income groups to save for their old age." Coverage of private pensions for lower-income groups is more than double the proportion achieved in the United Kingdom and the United States.[26]

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[24] Börsch-Supan, A.H. and C. B. Wilke (2003) op cit. p.28.
[25] Börsch-Supan, A.H. and C. B. Wilke (2003) op cit. p.35.
[26] OECD (2009) Germany. Highlights from OECD *Pensions at a Glance 2009*. http://www.oecd.org/dataoecd/39/20/43126017.pdf. Accessed 30.03.11.

ii). Tax-deductible special expenses.

Qualifying retirement savings can be deducted as special allowance from income taxes. High subsidy rates of around 40 – 50 per cent of the contribution are paid.[27] The more affluent will benefit.

Individual retirement accounts will only qualify for tax subsidy/deferral if they satisfy criteria set out in the Certification of Retirement Contracts Act. The list of rules is lengthy and somewhat complicated, and includes, for example, requirements that:

- the investor must make regular contributions to the plan;
- benefits are only to be paid on retirement;
- at the start of disbursement, the nominal value of the accrued contributions must be guaranteed, which means that the nominal rate of interest must be nonnegative;
- the plan must provide lifelong benefits either in the form of a life annuity, or a disbursement plan that provides lifelong annual instalments combined with an annuity at age 85.

Eligible products include pension insurance and capitalization accounts, bank accounts with accumulated interest, and shares in growth and distributing investment funds.

The certification rules merely serve to create a formal product standard and do not create the transparency needed to compare different investment vehicles. The high degree of regulation is unlikely to foster the development of new private insurance

[27] ibid.

products. Furthermore, the guarantee of the nominal value of an individual fund does not ensure that the value of the pension benefits will be protected from inflation.[28]

5.1.5.4. Occupational Pension Schemes

In the past, these have played only a minor role in German old-age provision. Membership of company pension plans was granted individually and at the discretion of the employer.[29] To widen participation, the Riester reform gives a general right to employees to convert part of their salaries into direct contributions to pension plans. The government has skewed the tax subsidies in favour of company schemes over personal pensions. Employees in company schemes were given tax relief on contributions of up to 4 per cent of salary from the introduction of such schemes in 2001.[30] Where the employee is covered by a binding collective agreement, the right of earnings conversion must be explicitly provided for in the agreement. The inclusion of occupational pensions in collective agreements gives the trade unions significant influence over the design and implementation of these pension plans, and, therefore, a strong interest in the expansion of the second pillar.[31]

There are five options for occupational pension:

1) Direct Pension Promise (direktzusage).

   The pension benefit is paid directly from the company's funds. Pension assets are not legally separate from the company's other assets, but it is compulsory to insure against insolvency, and the employee has a legal right to accumulated benefits.

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[28] Börsch-Supan, A.H. and C.B.Wilke (2003) op. cit. pp.30-31.
[29] Busemeyer, M.R. (2005) Pension Reforms in Germany and Austria: System Change vs. Quantitive Retrenchment, p.585. *West European Politics*. 28(3).
[30] Peaple, N. (2004) op.cit. p.18.
[31] Busemeyer, M.R. (2006) Moving the Unmovable: Political Strategies of Pension Reform in Germany, p.415. *German Policy Studies*. 3(3).

2) Support Fund (unterstützungskasse)

   The accumulation of assets is external to the company. Contributions are paid only by the employer.

3) Retirement Fund (pensionskasse)

   Assets are held separately from the company's other assets, and are invested to achieve capital appreciation. Employees have a legal right to accumulated rights.

4) Direct Insurance (direktversicherung)

   These are life assurance saving products taken out by the employer on behalf of the employee. Funds are operated by the insurance company. Premiums can be paid by both the employer and the employee.

5) Pension Fund (pensionsfonds)

   The Riester reform introduced this form of investment vehicle to Germany. Funds are held separately from the company's other assets. Pension Funds can invest in a greater variety of assets than the other retirement funds, and are expected to achieve higher investment returns. The beneficiary has a legal right to the accumulated benefits. On retirement, the accumulated money must be used by the beneficiary either to buy a life annuity or to enter into an income drawdown contract combined with the purchase of an annuity at age 85. Lump sum withdrawal is not permitted.

Neither Direct Pension Promises nor Support Funds are eligible for Riester incentives. Both are free of state supervision. Retirement Funds, Direct Insurance, and Pension Funds are subject to supervision by the Federal Insurance Authority, and are eligible for Riester incentives. Since employers must offer their workers the opportunity to benefit from the Riester incentives, the proportion of retirement assets in eligible occupational plans is expected to rise substantially, and decline in Direct Pension Promises and Support Funds.

5.1.6. Public Sector Pension Reforms (Arbeitnehmer)

Occupational pension schemes in the public sector are based on collective agreements. These schemes are funded by a notional premium of 4 per cent of gross salary. Since these pensions were integrated with the public insurance pensions, a reduction in the public insurance pension was compensated for by higher supplementary pensions. The combined total pension benefit was targeted at the level of civil service pensions (a final salary scheme). After the Riester reforms a new collective contract was negotiated between the public employers and the trade unions that abolished this integrated approach. Supplementary pensions will no longer target the replacement rate of civil service pensions, becoming defined contribution schemes.[32]

5.1.6.1. Civil Service Pension Reforms (Beamte)

The replacement rate has been reduced from 1.875 percentage points to 1.79375 percentage points of final salary. Since the maximum number of service years that count for entitlement may not exceed 40, the maximum pension replacement rate fell from 75 per cent of gross earnings to 71.75 per cent in 2009.[33]

5.1.7. An Appraisal of the Riester Reform

1) The voluntary nature of the supplementary pension plans means that not all workers will participate. It was thought that if participation had been mandatory, many workers would have looked upon their compulsory

[32] Schmähl, W. (2007) op.cit. p.321.
[33] Ministry of the Interior and Kingdom (2004) *Sustainability of Pension Schemes for Public Sector Employees in EU Member States. Concise Report: for the Directors-General,* p.20.

contributions to savings plans as a tax. This could have endangered the purpose of supplementary provision as a way of reducing the contribution burden in order to stimulate economic growth. It seem probable that many of those who lack supplementary provision seek help from social assistance

2) Model calculations show that a savings rate of 4 per cent of gross income will be sufficient to close the gap that will open as a result in state pension benefit, but only in the long run. Older cohorts, the transition generation, will need to save more than 4 per cent in order to close this gap entirely during their retirement.[34]

3) Even at full uptake, the German PAYG pillar remain the main source of support for the majority of pensioners, with Riester pensions providing about 35 per cent of state-organised retirement income.[35]

4) It was soon apparent that the Riester reform would fail to deliver the promised result – stabilization of the contribution rate at acceptable pension benefit level. The fault lay in certain assumptions adopted by Riester. Although academic demographers considered the reform's demographic projections of fertility, mortality, and migration to be realistic, its projected rates of economic growth and employment were higher than could be reasonably expected.[36] Model calculations of the long-term impact of the reform showed that the 20 per cent contribution rate to the PAYG pillar would be exceeded by 2014, and the 22 per cent by 2022.[37] In fact, the new adjustment formula would cause pension benefit level to fall more than government predictions, eventually reaching 62 per cent.[38] Börsch-Supan believes that the over-favourable view taken of the

[34] Börsch-Supan A.H. and C.B.Wilke (2003) op. cit. pp.38-39.
[35] ibid. p.39.
[36] ibid. p.40.fn 36.
[37] ibid. p.41.
[38] ibid. p.40.

economic outlook was not accidental, but put forward deliberately in order to enable the reform package to clear parliamentary obstacles.[39]

5) In the shorter term, the impact of the 2001 reform on contribution rates and benefit levels was limited. But the reform set in motion a gradual transformation of the German pension system from a monolithic PAYG scheme towards a public-private mix, where the private sector play an increasingly larger role.[40]

5.1.8. The Rürup Commission

The 2001 reform was not sufficiently far-reaching to ensure the long-term fiscal sustainability of the public pension system. Germany's perilous state finances soon created strong pressure for further action.[41] In April, 2002, the Federal Government established "The Commission on Sustainability in Financing the Social Security System" – commonly named the Rürup commission after its chairman, Bert Rürup, a professor of economics and a member of the Council of Economic Advisors. Mr Rürup had stated that

> "The key to solving the unemployment problem in Germany lies to a very large extent with non-wage labour costs. If we do not succeed in getting subsidiary wage costs under control, we will not be able to solve our unemployment problem." [42]

Accordingly, although the objectives of the Rürup commission were the same as those of the Riester reform: to stabilize contribution rates at acceptable benefit levels, the Rürup commission stressed the stabilization of contribution rates as its primary concern.

[39] ibid.p.41
[40] Busemeyer, M.R. (2005) Pension Reforms in Germany. op. cit. p.575.
[41] Busemeyer, M.R. (2006) Moving the Ummovable. op. cit. p.403.
[42] Eironline (2003a) L.Funk: Rürup Commission proposes later retirement age. 20.05.03. ID: DE0305104F. www.eurofound.europa.eu/eiro/2003/country/germany.htm. Accessed 25.08.09.

In future, the distribution of benefits would be conditional on the availability of resources.[43]

The commission published its proposals at the end of August, 2003. The recommended reforms had two main components: an increase in the normal retirement age, and a modification of the indexation formula.

1. The Increase in Normal Retirement Age

   The increase will be slow and gradual; commencing in 2001 with monthly steps until age 67 is reached in 2035. This will limit to some extent future increases in the total value of accumulated claims resulting from longer life expectancy. Life expectancy in Germany is currently rising 2.5 years in each decade.[44] The commission wished to restrict the use of early retirement schemes and disability pensions to circumvent the increase in normal retirement age. It proposed to raise early retirement age to the same extent and time schedule as normal retirement age. Actuarial adjustments for disabled and long-term insured workers would also be increased. There was one small relaxation: a new pension type should be introduced for workers in extremely demanding physical occupations. These workers who had a service life of at least 45 years would be permitted to retire two years earlier with additional actuarial adjustments.[45]

2. Change of Benefit Indexation Formula

   The commission recommended the extension of the Riester benefit indexation formula to include a new factor, the sustainability factor (SF). While the previously rejected "demographic factor" would have reduced pension benefit

[43] Capretta, J. C. (2007) *Global Aging and the Sustainability of Public Pension Systems. An Assessment of Reform Efforts in Twelve Developed Countries*, p.18. A Report of the Aging Vulnerability Index Project. Center for Strategic & International Studies, Washington. http://csis.org. Accessed 10.05.11.
[44] Bräuninger, D. (2006) *German pensions policy more in tune with reality.* 7 February, No. 533. Deutsche Bank Research, Frankfurt. www.dbresearch.com. Accessed 26.08.09.
[45] Börsch-Supan, A.H. and C.B.Wilke (2003) op cit. p.43.

levels only in proportion to changes in longevity, the proposed SF would consider all demographic developments, such as changes in birth rates, longevity, migration and labour market activity. In consequence, the higher the rate of unemployment, the lower would be the increase in pension benefits.[46] The SF would link, therefore, the number of contributors to the number of pensioners. It is this ratio, the system dependency ratio, which is the major determinant of pension financing. In effect, the SF would act as an automatic stabilizing device. SF is multiplied by another factor (α); α is at present set at 0.25 so as to achieve the Riester targets of contribution rates under 20 per cent until 2020 and under 22 per cent until 2030.[47] The introduction of a weighted factor (α) suggests that the given definition of SF is not decisive. These refinements to what was already a complex formula result in a lack of transparency.[48]

What cannot be disguised is that the reforms will have been accomplished at the cost of further reductions in pension benefit levels. By 2030, the projected level of statutory pensions will be slightly over 40 per cent of gross earnings. "It is obvious that future pensioners themselves will be the main 'victims' of the aging process."[49] It became essential to strengthen the roles of second and third-pillar pensions. Since it was widely thought that the poor take-up of personal pensions was in part due to product complexity resulting from administrative overregulation, the commission recommended a number of administrative changes to occupational and private pensions to facilitate greater participation. For example, all taxpayers should be entitled to join, pension benefits should take account of inflation, and private pension provision should be more transparent. A parallel commission, also chaired by Bert Rural, proposed to keep

[46] Busemeyer, M.R. (2006) Moving the Unmovable op.cit. p.427.
[47] Börsch-Supan, A.H. and C.B. Wilke (2003) op.cit. p.44.
[48] Schmähl, W. (2007) op.cit. p.328.
[49] Hinrichs, K. and O.Kangas (2003) op.cit. p.578.

pension contributions and capital gains tax-exempt, and to tax benefits. In the opinion of Börsch–Supan, the Rürup proposals will succeed in delivering a future income level for the retired comparable to that of the present. This assumes an increase in the normal retirement age to 67, and a savings rate of 4 per cent into second and third pillar pensions. Projections show that will only be the case after 2030. The cohort with the highest transition burden will need to save about 8 per cent to maintain their total retirement income when income from statutory pensions declines.[50]

5.1.9. After Rürup

By the autumn of 2003, the deficit in the public pension system was estimated at 8 billion Euros.[51] Immediate action had to be taken in order to avoid an increase in the contribution rate anticipated for 2004. In December of that year the Pension 'Emergency Bill' was passed.[52] This package of short-term measures included:

- restricting federal support for the pension system by 2 billion Euros in order to stabilize public finances;
- increasing the contribution rate of pensioners to long-term care schemes from half the rate to the full rate of 1.7 per cent (previously half of the contribution had been paid by pension insurance on behalf of the pensioner as in the case of health insurance);
- reducing the system's reserve fund from 50 per cent to 20 per cent of one month's payments;
- suspending pension increases in 2004;
- moving the date at which new pensioners would receive their benefit payments from the start of the month to the end. The effect of this

[50] Börsch-Supan, A.H. and C.B. Wilke (2003) op.cit. pp. 46-47.
[51] Busemeyer, M. R. (2006) Moving the Unmovable. op.cit. p.403.
[52] ibid.

> seemingly slight change was a reduction of pension expenditure by an estimated 500 to 700 million Euros.[53]

In 2003 and 2004 two other pension laws were passed.

5.1.9.1 The "Sustainability of Pensions" Law

This introduced the sustainability factor, as recommended by the Rürup commission. The law guarantees a minimum benefit level, similar to that of the Riester reform. From a present level of 53 per cent of adjusted gross income, the fall of pension benefits will be limited to 46 per cent in 2020 and 43 per cent in 2030.[54] Accordingly, the federal government is charged to report to the legislative bodies every four years from 2008 onwards, regarding compliance with the target level of pension benefit provision. In order to avoid pension reductions, it is stipulated that the SF can lower the pension adjustment factor down to zero, but cannot go beyond this point. The importance of this safeguarding clause was soon apparent. Application of SF in 2004 and 2005 would have caused pensions to decline nominally.[55] This would have been politically unacceptable.

5.1.9.2. The "Old Age Income" Law

The German Supreme Court had ruled that the taxation of civil service pensions was unconstitutional if pensions from the public insurance system were largely exempted from tax liability. The government was forced to act, since if no decision was taken, the Supreme Court held that pensions of civil servants had to be freed from taxation by 2005. This would have resulted in a loss of revenue of 10 billion Euros.[56] A shift in the

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[53] ibid. p.423.

[54] Since the phasing-in of the taxation of pension benefits results in different tax rates on benefits and pre-pension income depending on the age of the pensioner, it is no longer possible to compare pension levels as percentages of income. The average pension benefit is now calculated using the "adjusted gross income" (gross income less social security contributions) of pensioners and workers as reference.

[55] Bräuninger, D. (2006) op. cit.

tax regime was unavoidable. Implementation be very gradual. Full taxation of benefits only be reached by 2040, and total exemption of pension contributions be reached 2025.

From 2005, each age cohort of pensioners has had a specific combination of taxation rates of pension benefits and contributions. Once their rates of taxation have been calculated, pensioners are taxed under the same conditions for the rest of their lives. During the disbursement period when benefits are taxed, pensions in the lower half of the income distribution probably pay little or no tax, since their pension income will probably be below the generous tax exemption for retired households. For the more affluent, progressive taxation may lead to retirement income, which is likely to be less than that received during working life, being taxed at a lower rate.

The Law also contains provisions regarding the portability of occupational pension rights and individual pension savings. The employer now has to transfer the cash value of pension savings, financed by the employee, towards the new employer or the pension institution of this new employer, provided this later guarantees the value of the transferred capital. Therefore, the employee is entitled to a transfer but only where the occupational pension relies on a funded system financed by the employee. This right is valid for labour contracts signed after 1 Jan 2005. There is no retrospective effect. The new portability rules indicate that preference is given to a single benefit paid by a single institution at the time of retirement.[57]

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[56] Busemeyer, M.R. (2006) Moving the Unmovable. op. cit. p.437.

[57] Euro Pension Bulletin (2004) National Update-Germany. No.19. August. European association of public sector pension institutions, Bordeaux. http://portal.versorgungskammer.de/portal/pls/portal/!PORTAL.wwpob_page.show?_docname=1629645.PDF. Accessed 20.10.09.

The government has decided to accept the Rürup commission's recommendation to raise the official retirement age from 65 to 67, but to implement more quickly than was recommended. The transition period is now to last only 18 years rather than 24 years. It is still set to commence in 2012. The government does not plan to accelerate the pace of change until 2024. From that time, the retirement age is to be increased each calendar year by 2 months instead of one month, with the result that the retirement age of 67 will apply from 2029.

From 2004 statutory pension insurance institutions have been required to inform insured persons (from the age of 27) on an annual basis about their individual pension entitlements and the amount of their future pensions. Insured persons can now check their pension details online.[58] As regards private pensions, providers must supply more information prior to the conclusion of a contract (for example, on investment policies and the risk potential).[59]

5.1.10. Current Pension Situation

The retired in Germany continue to enjoy a living standard close to that of the working-age population. Less than 10 per cent of people aged 65 and over in had incomes below the OECD poverty threshold (half of median household income) in 2005 (OECD average 13.3 per cent). The gross replacement rate for a worker with a service life of 40 years at the average wage and retiring at 65 is 43 per cent (63 per cent net) as of 2005.[60] One welcome development has been the steady growth since 2000 of the employment

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[58] European Union (2006b) *Germany: Main Characteristics of the Pensions System,* p.3-4. http://ec.europa.eu/employment_social/spsi/docs/social_protection/2006/germany_en.pdf. Accessed 24.08.09.

[59] Federal Republic of Germany (2005) *National Strategy Report on Old-Age Pension Provision 2005*, p.47. http://ec.europa.eu/employment_social/spsi/docs/social_protection/2005/de_en.pdf. Accessed 20.10.09.

[60] OECD (2009) Germany. Highlights from OECD *Pensions at a Glance 2009*.op.cit. http://www.oecd.org/dataoecd/39/20/43126017.pdf.Accessed 30.03.11.

rate of older people. The 2009 employment rate of the age group 55- 64 years old was 56.2 per cent, well above the EU27 average of 46.0 per cent for this age group.[61]

Since 2001, the coverage rate of occupational pension schemes has increased from 38 per cent to 46 per cent in the private sector. At present about 10.3 million workers in the private sector and 5.4 million public employees pay into an occupational pension plan (roughly 60 per cent of all employees). Earnings conversion was used by about 1.7 million employees at mid 2004, with the average amount being converted standing at 1,100 Euro per year.[62] The tax incentives offered with the "Riester pension" have proved attractive. Currently 14 million "Riester contracts" have been concluded.[63] Other forms of private provision remain popular. Since 2002, for example, about 8 million private annuity contracts have been concluded in addition to the "Riester contracts".[64] Monika Queisser, head of the social policy division at the OECD comments: "The coverage of private pension plans in Germany is the highest among OECD countries for voluntary schemes".[65]

The recent reforms of the public pension system, especially the introduction of the sustainability factor in 2004, will help considerably in ensuring the continuing viability of the system. 2010 projections indicate that the expected increase of public spending on pensions from 2010 to 2060 is 2.5. p.p. of GDP.[66]

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[61] Eurostat (2010c) News Release: Employment rate in the EU27 fell to 64.6% in 2009. 117/2010, 4 August. http://epp.eurostat.ec.europa.eu. Accessed 08.05.11.
[62] European Union (2009c) 2009 *Ageing Report***:** *economic and budgetary projections for the EU-27 Member States (2008-2060)*, p.190. Joint Report prepared by the European Commission. http://ec.europa.eu/economy_finance/publications/publication_summary14911_en.htm. Accessed 24.09.09.
[63] Financial Times (2010c) Pensions: Demographic timebomb's ticking muted by reforms, 26 November.www.ft.com. Accessed 22.02.11.
[64] European Union (2006b) *Germany: Main Characteristics of the Pensions System*. op.cit. p.2
[65] OECD (2009) Germany. Highlights from OECD *Pensions at a Glance 2009*.op.cit.
[66] European Union (2010c) *Public Finances in EMU 2010*, p.68. Table: Increase in age-related expenditure, 2010-2060, % of GDP. http://ec.europa.eu/economy_finance/publications/european_economy/2010/pdf/ee-2010-4_en.pd. Accessed 22.02.11.

5.1.11. A Public Debate

In the aftermath of the 2004 pension reform, there has been a public debate about whether the sustainability factor would decrease pension levels to such an extent that future cohorts would receive benefits that were smaller than their contributions. German law treats pension benefits as property rights; each pension contribution generating a right to a future benefit payment. The nominal value of future benefits must at least equal the total amount paid in contributions. Although as in every PAYG scheme each contribution goes towards funding a pension already in payment, the transfer mechanism used in Germany is an insurance scheme. Juridical anxiety has arisen. In the summer of 2004, the chairman of the Federal Constitutional Court, Hans-Jürgen Papier, declared that the constitutional conformity of the public pension system would be jeopardised if the future rates of return became negative for younger cohorts.[67]

Are these fears justified? What method of calculation is to be used to ascertain the rate of return of the public pension system for a specific cohort? In general, the term "rate of return" describes the amount of gains or losses on an investment. In respect of the German PAYG system, the investment is the sum of contributions paid into the system (negative payment flow) whereas the benefits received during retirement (positive payment flow) are the dividend from the investment. The rate of return can be calculated as the proportion of the amount of benefits to the amount of contributions.

Since contributions into and benefits from the system occur at different times, the flow of negative and positive payments needs to be discounted to a common date. The date chosen is generally the date of entry in the labour force, which is the beginning of the

[67] Wilke, C.B. (2005) *Rates of Return of the German PAYG System – How they can be measured and how they will develop*, p.2. Mannheim Research Institute for the Economics of Aging. 097-05. July. http://www.mea.uni mannheim.de/fileadmin/files/publications/meadp_097-05.pdf. Accessed 17.05.09.

payment flow. The rate of return thus calculated is usually called "the internal rate of return". The capital value of the payment flow is zero.[68]

A study undertaken by the Centre for Economic Studies for the Council of Advisors to the German Ministry of Economics calculated the real internal rates of return for alternative age cohorts of average German pension contributions.[69] In theory, the rate of return should equal the rate of growth of the sum of wages. The study found this is to be roughly true if the compound annual growth rate over a 50-year period starting at the respective date of labour market entry serves as a standard for comparison. Those who entered the system at the age of 20 in 1957 and who received their pensions in 2002, will have earned a return of 2.8 per cent.

Rates of return offered by the PAYG system show in general a downward trend. Though in the past the decline could be ascribed to the development of contribution rates, future rates of return will be affected by both the development of contribution rates and the decline of pension levels.

Is it probable, or indeed possible, that future rates of return will become negative? As to an answer, there is a lack of agreement. From among the diverse responses, Christina Wilke's analysis is chosen. Her calculations are based on the MEA-PENSIM model, which is a pension simulation programme that was developed at the Mannheim Research Institute for the Economics of Ageing (MEA).[70] The MEA-PENSIM model was used to cross-check the calculations of the Rürup Commission. Wilke employs the model to present a stochastic calculation that takes into account the rate of return on the

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[68] ibid. p.6.
[69] Sinn, H.-W. (1999) *Pension Reforms and Demographic Crisis: Why A Funded System Is Needed and Why It Is Not Needed*, pp.2-3. CESifo. Working Paper no.195. September. Munich. www.ifo.de/link/pension_reform.pdf. Accessed 15.02.11.
[70] Wilke, C. B. (2005) op. cit. p.5.

expected payment flows (allowing for longevity, survival and invalidity risk as well as age of retirement).[71] Use of the model permits a consideration of the wide range of possible scenarios simultaneously. In particular, the non-representative concept of the Eckrentner is replaced by a (weighted) average of pensioners in each cohort. Wilke notes that Papier had previously pointed out that only if future rates of return become negative for the "average" or "typical" pensioner would doubt be cast on the system's constitutional conformity.[72] Using the same underlying demographic and labour market assumptions as those accepted by the Rürup commission, Wilke projects a real rate of return for the 1980 cohort of under 2 per cent. Future nominal rates of return will be considerably higher. Her projections show these nominal rates clearly staying above 2 per cent for all demographic groups. She concludes that, since the juridical debate refers to nominal rates of return, the public pension system will conform to constitutional demands, though adding a proviso that continuing conformity will rest on no further demographic or labour market shocks occurring.[73] She acknowledges that academic opinion remains divided with other studies calculating (partly) negative rates of return for younger cohorts.[74]

Nevertheless, probable constitutional conformity alone is not sufficient to dispel all misgivings about the future direction of pension policy in Germany. Winfried Schmähl, chairman of the Social Advisory Council of the German Government on pension policy from 1986 to 2000, expresses some of these concerns. He points out that in regard to individual pensions, a decisive factor is the number of EP accumulated during working life. A high level of unemployment and an increase in long-term unemployment will reduce EP considerably. Health considerations may also prevent a significant number

[71] ibid.
[72] ibid. p.3.fn.8.
[73] ibid. p.33.
[74] ibid. p.2.

of people from remaining employed up to the age when full pension is paid without any deduction; the increase in standard retirement age to 67 can only exacerbate this problem. In cases of receipt of unemployment benefit, the maximum period of receipt is now 12 months (18 months for those 55 and over). Thereafter, means-tested benefit can be claimed, which provides a pension entitlement of $^{1}/_{6}$ EP, planned to fall to $^{1}/_{12}$ EP. A person on means-tested benefit for 3 years have at present a pension entitlement equivalent to that received by an average earner in three months. An interrupted employment record can have a drastic negative impact on future individual pension benefit.[75] The OECD confirms these concerns: "In the long run, future adjustment of the pension-point value is expected to be 14 per cent below the increase of average earnings"[76]

Schmaltz argues that the intended scaling down of the benefit level will fundamentally change the pension scheme. On the assumption that all the changes decided upon between 2001 and 2004 were fully implemented today, the pension of the Eckrentner would no longer be 70 per cent of average net earnings, but instead will be 52 per cent if pension is claimed at standard retirement age. Since means-tested social assistance is at present about 40 per cent of average net earnings, about 35 EP would entitle receipt of a pension equivalent to means-tested social assistance, a benefit that can be claimed without the making of any prior provision.[77] He notes that Bert Rürup, now chairman of the German Council of Economic Advisers states that the ratio of pensions to social assistance will not be changed because social assistance will be reduced by the same percentage as the pension level. Schmähl comments that "then …….social assistance

[75] Schmähl, W. (2007) op.cit. p.329.
[76] OECD (2011b) *Pensions at a Glance 2011.* op.cit. Germany. p.1. www.oecd.org/data. Accessed 10.05.11.
[77] ibid. p.330.

could no longer be an instrument that fulfils it objective, namely to avoid (income) poverty".[78]

Today about two thirds of all women and about one third of men have fewer than 35 EP. It can be anticipated that a significant percentage of pensioners, even after contributing to the scheme for many years, will only receive a pension roughly equivalent to (present) social assistance benefit. This can only lead to questioning the legitimacy of a scheme that is based on an insurance principle and a close link between individual contributions and pension benefits.[79] Whereas in the past workers tended to regard their contributions to the pension scheme as insurance premia, attitudes have changed, particularly among younger workers who are coming to regard their contributions, not as insurance premia but rather as taxes. "The effects of the new strategy in pension policy…. stimulate the question of political sustainability, even if the social pension scheme seems to be fiscally sustainable."[80]

5.1.12. The Wider Context

The redesigning of the old-age provision in Germany should be seen in the context of the wide-ranging changes occurring in the economy overall. A reformist agenda has become pervasive, driven by an economic philosophy of neo-liberalism. The reforms of the welfare state that started under the Social Democratic administration of Gerhard Schröder have continued under coalitions led by Angela Merkel. A political consensus has developed that accepts the necessity for reform in all sectors. There has been significant corporate restructuring, together with real wage cuts that have taken the form of longer working hours and trimmed benefits. Seasonally adjusted unemployment

[78] ibid. p.338. Note 32.
[79] ibid. p.332.
[80] ibid.

dropped to less than 3million in April 2011– for the first time since 1992. The unemployment rate was 7.1 per cent.[81] In 2007 a three percentage point rise in value-added tax only temporarily dampened consumption, and soon helped balance the federal budget. The IMF considers it important to keep in mind that the unemployment insurance tax was cut by 2.3 percentage points in January 2007, softening the impact of the VAT increase. The IMF supports the switching in taxes from direct taxes to indirect taxes, such as VAT, as this is a positive structural measure that will limit labour costs and bolster employment in the long run.[82] By promoting this broad agenda of economic, fiscal, and labour market reforms, Germany is now in a stronger position to deal with the financial pressures caused by the ageing of its people.[83]

The economic outlook appears favourable. Government deficit is projected to continue falling; and a rise in exports of 18.5 per cent in 2010 lead the German economy to grow by 3.6 per cent.[84] Germany hopes to have a budget deficit of 2.5 per cent of GDP in 2011, falling to 0.5 per cent by 2015.

5.1.13. The New Fiscal Rule

Since 2002 public debt has continuously exceeded the SGP reference value for government debt of 60 per cent of GDP. The main political parties and the public at large consider this level of public debt to be unacceptable. It has been decided to introduce a balanced-budget law (a debt brake) into the German constitution. A constitutional provision can only be overturned by a two-thirds majority. From 2016, it will be illegal for the federal government to run a deficit of more than 0.35 per cent of

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[81] Financial Times (2011) German unemployment falls below 3m. 28 April. www.ft.com.Accessed 11.05.11.
[82] International Monetary Fund (2006) Transcript of a Conference Call on the Launch of the 2006 Article IV Consultation Report for Germany. 14 December. Washington, DC.
https://www.imf.org/external/np/tr/2006/tr061214.htm. Accessed 25.10.09.
[83] Financial Times (2009a) Berlin weaves a deficit hair-shirt for us all. June 21.
www.ft.com. Accessed. 25.06.09.
[84] BBC News (2011) German exports rose 18.5% in 2010.
http://www.bbc.co.uk/news/business-12401835. Accessed 07.05.11.

GDP. From 2020, the länder will not be allowed to run any deficit at all. Under the assumption of a nominal annual growth rate of 3.25 per cent, which implies a structural real rate of 1.25 per cent, public debt would fall to about 40 per cent of GDP.[85] It may be inferred that by enshrining its aversion to debt in the constitution, Germany is ensuring that however great the pressures on state expenditure caused by the ageing of its population, provision for the elderly will not be allowed to create fiscal imbalance. A less generous welfare regime can be envisaged.

Germany's new fiscal rule is consistent with the European fiscal framework and could work to strengthen that framework. The rule formalises the preventive arm of the Stability and Growth Pact. Germany's lead could well induce other Member States to formalise their strategies either to restore or to maintain a fiscal position close to structural balance, while also strengthening multilateral discipline within the Union.

5.1.14 Conclusion

In respect of its stated objectives, this study of the German pension system demonstrated that:

First, it described and explained the institutional structure and desired aim of the German public pension system. It gave details of the method of calculating individual pensions. It revealed a highly complex system. It drew attention to the strain being placed on the system by demographic shift.

Second, it noted the privileged status accorded to civil servants in Germany. Favourable terms of employment were found to extend into retirement provision. Pension arrangements continued to be highly favourable, as evidenced by the very modest

[85] Eurointelligence (2008) A new ultra-tough fiscal framework for Germany. 12.02.08. www.eurointelligence.com/Article3.1018+M556a9e49d56.0.html. Accessed 17.08.09.

reduction in the maximum pension replacement rate from 75 per cent of gross earnings to 71.75 per cent.

Third, it presented an account of prolonged process of pension reform in Germany. Particular emphasis was given to the Reister and Rürup reforms, and their effectiveness assessed. It was evident that the German strategy on pension reform had made extensive use of two tactics: increases in retirement age and reductions in benefit indexation.

Four, it established that the constitutional conformity of the public pension system was highly likely. Yet it discovered that many German workers, particularly the younger ones, doubted the ability of the pension system to deliver satisfactory levels of provision for subsequent generations. It found that many workers resented the high level of social security contributions.

Finally, it observed that Germany had attempted to rebalance its economy in response to the challenges of a global market place, and argued that pension reform should be perceived as a vital part of that rebalancing. Moreover, as a mark of its determination to succeed, by the insertion of a debt brake provision into the constitution Germany had prevented state debt from rising to a level that would imperil the well-being of its people.

Two Final Comments

1). The impact of demographic shift on the system prompts the following comment. Although the German pension system may seek to extend the standard of living enjoyed during working life to the time of retirement, this goal may prove problematic looking forward. With increasing numbers of pensioners, costs of provision will inevitably rise.

Approximately 70 per cent of financing comes from the contributions of workers and employers. As the relative number of workers declines, pressure to increase those contributions will increase. Yet amongst workers there has been a loss of credibility in respect of the system's ability to deliver in the future its promised level of benefit payments. Workers are starting to resent providing generous benefits for the elderly that they themselves cannot hope to receive (Schmähl - ch.5.1.11). The employers' contribution is a significant non-wage cost, and high non-wage costs are considered to a very large extent to be the cause of unemployment (Rurüp - ch.5.1.8). Indeed, an increase in the level of social security contributions would act as a disincentive to economic activity. The remaining 30 per cent of the pension budget is provided by the federal government. Could this subsidy be increased? This may prove challenging. The recent introduction of the debt brake provision into the constitution exerts a rigid fiscal discipline. Though pensioners now comprise over 30% of the electorate, the warning given by Sinn and Uebelmesser (ch.3.5.3) that after 2016, "the old can, through their majority, exploit the young by increasing the pension burden" would appear to have been heeded. The debt brake provision ensures that German society will not become a gerontocracy. It is concluded that in the future the need for economic growth and the desire for intergenerational equity will dominate to the detriment of old age provision.

2). In respect of the German pension reform strategy, has its resort to the tactics of increased retirement age and indexation reduction almost come to an end? With retirement age now planned to reach age 67, it is reasonable to doubt whether any further significant age increases are practicable. It is equally questionable whether further reductions in benefit indexation are possible. In Germany net pension replacement rate by earnings (median earner) now stands at 58.4. In Denmark, by comparison, this rate is 94.5. The German net replacement rate also falls below the

EU27 average of 75.7 and the OECD34 average of 72.[86] Whereas in the past it might have been correct to portray German pension provision as generous, that description has ceased to be appropriate. Any future reductions in German benefit indexation would run the risk of creating a public pension scheme that succeeds at remaining fiscally sustainable by offering inadequate provision. Moreover, the extent to which benefit payments from private and occupational pensions will counteract shortfalls in public provision is uncertain.

5.2. The Reform of the United Kingdom Pension System

In this second part the chapter discusses the reform of the United Kingdom public pension system, with emphasis given to the Pensions Commission's reform recommendations. The United Kingdom maintains a public pension system that is fiscally balanced, but government now admits this desirable situation is only possible by offering increasingly inadequate pensions for many people.

The objectives of this study of the United Kingdom pension system are:

First, it discusses the work and reports of the Pensions Commission. It then outlines the main features of public pension provision in the United Kingdom. It contends that the high degree of reliance on means-tested additions to the Basic State Pension acts as an impediment to private saving. It considers the Commission's advice that a more generous form of indexation made possible by an increase in retirement age offers a partial solution.

[86] OECD (2011) *Pensions at a Glance 2011*: Retirement-Income Systems in OECD and G20 Countries, p.125.
http://www.oecd-ilibrary.org. Accessed 30.11.11

Second, it finds that the low level of Basic State Pension reflects a well-developed system of occupational pensions. It discusses the expansion of company pension schemes from the early 1950s to the start of this century, and explains their subsequent decline. An account of the civil service pension scheme is offered, and changes to that scheme explained.

Third, it finds that the increasing reluctance of companies to continue operating pension funds means that the state must act to encourage more private saving. It maintains that inertia and myopia make mere exhortation to pension savings unlikely to be heeded. It investigates the findings of the behavioural economists, whose insights into encouraging additional saving interested the Commission, and lead to its recommendation that the device of automatic enrolment be used in a national pension savings plan.

Fourth, it offers a detailed examination of the recommended National Pension Savings Scheme. It describes and explains the salient provisions of the scheme. These include the automatic enrolment of all eligible employees, the default contribution level, the applicable earnings band, the range of investment funds, and annuitisation arrangements. It lists the key features of Pensions Act 2007 and Pensions Act 2008, which broadly follow the recommendations of the Commission. The deferred commencement of the scheme is noted.

Finally, attention is drawn to recent developments in state pension provision. These include the calculation of state pension increases, proposed increases in statutory retirement age, the abolition of default retirement age, and the proposed relaxation of annuity rules. It also notes the establishment of the Nest Trust Corporation, and its proposed modifications to the pension saving scheme. It concludes with a consideration of the reform options put forward in a recent Green Paper on the future of the state pension.

5.2.1. The Turner Report

The Government established the independent Pensions Commission in December, 2002. It consisted of three Commissioners and a small secretariat. The Chair was Adair Turner. The Commission's task was to review the regime of private pensions and long-term savings, and to consider whether the existing voluntary approach would be adequate for future needs. *The First Report of the Pensions Commission, 'Pensions, Challenges and Choices'*, published in October, 2004, was a deliberately detailed and wide-ranging examination of the pensions system.[87] The Report did not make policy recommendations, since the Commission intended that the Report and subsequent consultation phase were to be used to develop a consensus approach which would be sustainable across parliaments and governments. In *The Second Report, 'A New Pension Settlement for the Twenty-First Century'*, published in November, 2005, the Commission set out its conclusions on the likely evolution of the UK pension system if policy remained unchanged, and its recommendations for new policy directions.[88] Although the Commission found that current pension arrangements were not in danger of imminent collapse, change in the medium term was unavoidable, because the current voluntary private funded system, combined with the current state system, was not fit for purpose looking forward. *The Final Report*, *'Implementing an integrated package of pension reforms'*, published in April, 2006, detailed the Commission's response to

[87] The Pensions Commission (2004) *Pensions: Challenges and Choices. The First Report of the Pensions Commission.*
[88] The Pensions Commission (2005) *A New Pension Settlement for the Twenty-first Century. The Second Report of the Pensions Commission*.

specific issues which had arisen in the debate subsequent to the publication of the Second Report.[89]

The Commission's reports are often collectively referred to as the Turner Report. The Commission has been wound up. In the following discussion, the UK pension system will be considered in the light of the findings and recommendations of the Commission.

5.2.2. The UK's Unique Development.

In most advanced economies public pension policies seek to achieve two objectives, namely, to prevent poverty in old age, and to ensure that most pensioners receive a reasonable level of earnings replacement in retirement. Generally, the second objective has been deemed to require some degree of compulsory earnings-related provision. The UK pension system developed in a distinctive way. The 1942 Beveridge report established a flat-rate state pension scheme. This reflected the significant prior existence of a well–developed system of private pensions provided by insurance companies, of occupational schemes provided by companies, and by the government itself as an employer. Today UK pension assets are among the largest in the world. The Pensions Commission estimated that UK pension assets at the end of 2003 were approximately 120 of GDP or £1.3 trillion.[90]

5.2.3. The Existing Public Pension System

In contrast, state pension provision is one of the least generous in the developed world, with a net replacement rate of 41.1 per cent for a man on 100 per cent of average earnings, compared with an OECD 30 average of 69.7 per cent (2007). As the OECD

[89] The Pensions Commission (2006) *Implementing an integrated package of pension reforms. The Final Report of the Pensions Commission*.
[90] The Pensions Commission (2005) *Second Report*. op.cit. p.120, fn.1.

points out, “the UK has the lowest public pensions in the 30 OECD countries”.[91] The contrast with German expenditure on pension provision of 11.4 per of GDP is considerable: UK public pension spending is 5.4 per cent of GDP.[92] The UK state system is comprised of three main elements – the basic pension, earnings-related pension, and pension guarantees.

Basic State Pension (BSP):

This is a “contribution based” benefit, the level of which is determined by an individual recipient’s National Insurance (NI) contribution record. For an individual with the full number of qualifying years - previously 44 years for a man and 39 for a woman, but reduced to 30 years for both sexes from 6 April 2010 - BSP is payable at a flat rate of £97.65 a week (2010/11). A reduced pension is paid to someone with fewer qualifying years. State Pension can be claimed from State Pension Age (SPA). This is currently 65 for men and 60 for women (gradually rising to 65 for women between 2010 and 2020). It is possible to defer claiming BSP at SPA. Deferral gives an enhancement of approximately 10.4 per cent to the pension payable per year deferred, or the pensioner can elect to receive a lump sum and an unenhanced pension.

Additional Pension

Three different schemes have been introduced to provide extra pension benefit above the BSP. Known collectively as Additional Pension, these are available to employees paying NI contributions and certain exempted groups, typically those with caring responsibilities, but not including the self-employed.

[91]OECD (2007) *Pensions at a Glance*. *Highlights – United Kingdom.* www.oecd.org.els/social/ageing/PAG. Accessed 30.08.09.

[92]OECD (2011b) *Pensions at a Glance 2011.* Online Country Profiles. United Kingdom. www.oecd.org/data. Accessed 10.05.11.

i). Graduated Pension

This was in place from 6 April, 1961, until 5 April, 1975. Qualification was based on payment of a number of NI contributions. Graduated Pension provides only a minimal benefit (about £1 a week) to recipients.

ii). State Earnings Related Pension Scheme (SERPS)

In operation from 6 April, 1978 to 5 April, 2002, SERPS provided an additional pension benefits related to the recipient's previous earnings via NI contributions. Qualification was based on a band of earnings above the Lower Earnings Limit (LEL) in each year. The LEL is usually set at about the same level as BSP. There is an Upper Earnings level (UEL) at which NI contributions in the past ceased to be paid by the employee. Adjusted annually, the UEL is £844 a week (2009/10). UEL now refers to a threshold at which reduced NI contributions are required, instead of ceasing completely. Any SERPS entitlement already acquired is guaranteed and re-valued each year in line with changes in average earnings until SPA. It is then added to BSP and the combined amount up-rated in line with the index of retail prices.

While SERPS was PAYG in form for those employees not enrolled in occupational schemes, it resulted in compulsory saving for those employees whose employers chose to contract out. The contracting-out option was extended in 1988 to allow individuals to contract-out into personal pensions; that is, to choose compulsory savings on an individual basis, instead of the PAYG option.

The introduction of SERPS was accompanied from 1981 by a policy of indexing BSP to prices. The two developments were linked: it was appreciated that the addition of a significant earnings-related element to the system (provided at least for some employees in a PAYG form) would cause a growth in public expenditure. As the long-term impact on public expenditure of SERPS became a matter of concern to government, SERPS was reformed in a number of steps which reduced its generosity.

iii). State Second Pension (S2P)

Introduced on 6th April, 2002 to replace SERPS, the level of pension payable is related to the recipient's earnings via NI contributions; as with SERPS, qualification is based on earnings at, or above the LEL, but no band earnings calculation is made until earnings reach a higher base level called the Lower Earnings Threshold (LET). Earnings between the LEL and LET are credited as though they are at the level of LET. S2P provides a more generous level of benefit than SERPS, offering an accrual rate of 40 per cent on the band of earnings between LEL and LET (SERPS had offered 20 per cent on this lower earnings band). Indeed, the main aim of the change from SERPS to S2P was to enhance Additional Pension benefits to low and moderate earners and to extend access to include certain carers, including those who are receiving Child Benefit for a child aged under 6, and people with long-term illness or disability. In 2006, the government announced that S2P would gradually cease to be "earnings-related". In reality, it is only slightly so for those with low or moderate incomes at the present time. S2P is to become flat rate, with an accrual rate of £73 per annum in current real terms for each year of membership.

5.2.4. Pension Credit

Pension Credit is a means-tested benefit available to people over 60. It has two elements: the Guarantee Credit and a Savings Credit, the later only available to people aged 65 and over. These two components of the Pension Credit top up people's income to a particular level of income and taper it away at 40p for every extra pound of pre-benefit income above. The Government introduced measures such as the Pension Credit to tackle pensioner poverty. In 1997, 27 per cent of pensioners were in poverty (defined as 60 per cent of contemporary median income after housing costs). Since 1997, growth in pensioner incomes has exceeded earnings growth, and "1 million pensioners have escaped from relative poverty and over 2 million from absolute poverty".[93] Currently a pensioner is less likely to be in poverty than a non-pensioner. With Pension Credit, savings of £6000 or less are ignored, and as a result most pensioners receiving Pension Credit find that any income received from their savings be ignored entirely.

In 2010/11 Pension Credit tops up a single person's income to £132.60 and the income of a couple to £202.40. If current indexation rules continue, pensions become increasingly generous. This is because the different thresholds used to calculate it are up-rated in different ways. The Guarantee Credit is up-rated in line with average earnings; the start point of Savings Credit is up-rated in line with price inflation. Over time the gap between the Guarantee Credit and the start of the Savings Credit will widen. As a result, the Savings Credit will extend over a wider range; therefore, more people will be entitled to it.[94] This will of course boost people's income, and would mean that more people's net income would keep pace with average earnings. But it will

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[93] House of Lords (2007) Lord McKenzie of Luton. HL Debate, 14 May 2007. Hansard, Volume no. 692, Part no. 85.
www.publications.parliament.uk/pa/ld200607/ldhansrd/text/70514-0002.htm#0705143000002. Accessed 12.08.09.

[94] The Pensions Commission (2004) *First Report*. op.cit. p.226.

also mean that more people will experience a reduced benefit in their net income from private saving. To restrain this development, the Commission recommended freezing the maximum level of Savings Credit payments in real terms (which implies that the lower Savings Credit threshold increases at a faster rate than the growth in average earnings).[95]

The First Report contains four tables showing the impact on incentives to save for four different groups affected by the Pension Credit. The groups relate to different levels of income. The tables demonstrate that Pension Credit improves incentives for some people but worsens them for others.[96] The Report's analysis reveals a situation that is highly complex, and "perhaps unsurprisingly, poorly understood".[97] The main implication of its analysis is that "for most people, the state significantly adds to their savings if they make them through a pension, or at worst leaves them in much the same position as they would have been in through other kinds of savings".[98] In fact, as the Report recognises, "some people may believe that the existence of pension credit withdrawal no longer makes saving via a pension worthwhile".[99]

On average current pensioners' income is at an historic high relative to average earnings.[100] Recently retired pensioners with fully paid-up BSP and SERPS/S2P will be receiving combined state pensions considerably more favourable than those received 30 years previously, or indeed will be received in 30 years hence. At the time of the First Report, current plans for the state system assumed public expenditure as a percentage of GDP rising from 6.1 per cent in 2004 to 6.9 per cent in 2054, a rise of only 13 per

[95] The Pensions Commission (2005) *Second Report.* op.cit. p.21.
[96] ibid. pp 228-229.
[97] The Pensions Commission (2004) *First Report.* op.cit. p.239.
[98] ibid. p.238.
[99] ibid. p.239.
[100] Parliament (2007) *Pensions Bill – Regulatory Impact Assessment (2007*).
http://www.dsdni.gov.uk/ria-pensions-bill-nov07.pdf. Accessed 10.11.09.

cent.[101] Since the number of people aged over 65 years is projected by then to have risen by 45 per cent, this implies a 27 per cent fall in average pension relative to average earnings.[102] The Pensions Commission assumed that the position of the poorest pensioners would be protected by government continuing the link of the Guarantee Credit to average earnings. The Commission believed that this link was the most effective way to ensure that poverty in old age did not increase. Inevitably the system will become increasingly means-tested. The percentage of pensioner households subject to means-testing of state benefits would rise to over 70 per cent in 2050,[103] because BSP will, under current price indexation arrangements, fall steadily relative to Guarantee Credit.[104] In fact, over the long term, the system will become flat-rate, as the UEL is indexed to prices, and will fall relative to the growth in average earnings.[105] The Commission regarded the spread of means-testing as undesirable, and recommended that BSP should be indexed to average earnings growth. The change in indexation arrangements should ideally start in 2010 or 2011 as the public expenditure savings resulting from the rise in women's SPA will begin to flow through.[106]

The Second Report showed public expenditure on pensions rising to 7.6 per cent of GDP in 2050, with the most rapidly growing element within the total being expenditure on the Pension Credit (and specifically on the Savings Credit component within it).[107] Pressure on public finances can only increase. The ratio of people aged over 65 to those aged 20-64, which stood at 27 per cent at present, is anticipated to rise to 47 per cent in

[101] The Pensions Commission (2004) *First Report.* op.cit. p.16.
[102] The Pensions Commission (2005) *Second Report.* op.cit. p.46.
[103] ibid. p.64.
[104] ibid.
[105] ibid. p.46.
[106] ibid. p.21.
[107] ibid. p.60.

2050. When old-age dependency ratio rises, some mix of four responses is unavoidable.[108]

- Taxes/National Insurance contributions devoted to state pensions must rise.
- Private funded pension saving must rise.
- Average retirement ages and pension ages must rise.
- Pensioners will become poorer relative to average earnings.

The Pensions Commission totally rejected the last response. It believed strongly that a relative decline in pension income would create hardship for the poorer pensioners, a situation that the electorate would find unacceptable.

The Commission regarded later retirement and higher pension ages as essential, but not by themselves sufficient response to the coming demographic challenge. Rather the reform of the state system should be a mix of two options – higher taxes and higher SPA. Deciding the precise balance poses major problems. Further rapid decreases in mortality among older age groups over the last few years have increased estimates of life expectancy for those aged 65 today. On the assumption that this trend of increasing longevity will continue, an average man aged 65 in 2050 is now projected to live a further 23.6 years beyond that date, and the average woman a further 25.9 years. Because of the wide range of uncertainty about future longevity, flexible response to increased longevity must form a fundamental part of pension policy design. The Commission found much merit in the case for SPA rising over time proportionally with longevity. It suggested the ratio of working years to retirement years should be 2:1; that

[108] ibid. p.94.

is, if life expectancy rises 3 years, then SPA should increase by 2 years. The gradual raising of SPA should make the earnings growth indexation of BSP more affordable.[109]

Nevertheless, even if the PAYG system fully adjusts for life expectancy, fertility rates below replacement level will cause public pension provision to become less generous, or more expensive. The Commission calculated that in order to keep the costs of pension expenditure as a percentage of GDP stable, while at the same time retaining the present generosity of the state pension, the pension age would have to rise to 72.6 years by 2050.[110]

The UK Government has hoped to avoid the full burden of rising costs of pension provision. Its policy on pension provision has been based on the assumption that private provision will grow, allowing the State to play a reduced role. The stated objective of government is that 60 per cent of pension income should derive from private sources and only 40 per cent from the state, compared with over 60 per cent from the state today. As the following section will attempt to explain, this is highly unlikely to happen. The UK pension system will remain state dominated.

5.2.5. The Shift from Defined Benefit to Defined Contribution Schemes

From the early 1950s to the late 1960s membership of occupational pension schemes rose significantly. In 1953 3.1 million people were members of private sector occupational schemes; by 1967 membership was over 8 million.[111] While most of these schemes were defined benefit (DB) in nature, average salary-related schemes and schemes giving a flat sum for each year of service were more prevalent than final salary

[109] ibid. p. 98.
[110] ibid. p. 100.
[111] ibid. p.122.

schemes. By 1979 final salary schemes, always the main form of provision in the public sector, had come to dominate the private sector also.[112]

Companies saw these schemes as a means of attracting and retaining staff; trade unions saw them as important negotiating objectives. A combination of regulatory requirements and specific economic circumstances facilitated the rise of the occupational schemes:

- At a time of high rates of income tax, the tax benefits enjoyed by pension schemes provided a tax-efficient way of rewarding employees, especially those employees at a senior level.
- Pension fund contributions allowed companies to smooth profits over the economic cycle, thereby reducing corporate tax liability.
- Companies could circumvent the cash element of wage restraint policies by increasing non-cash pension right accrual.
- Only salary-related schemes could be contracted-out from the Graduated Retirement Pension, and later from SERPS. Not until 1987 were DC schemes permitted to contract-out.
- Final salary schemes were a means of preserving the real value of pension accrual rights up to the point of retirement. At a time of rising inflation, company executives, the major beneficiaries, found this feature of final salary schemes highly attractive.

When initially introduced, the final salary schemes appeared easily affordable. Prior to 1975 there was no requirement to preserve pensions for early leavers. The schemes did not have to be offered to women, and surviving spouse benefits were often not

[112] The Pensions Commission (2004) *First Report,* op.cit. p.116.

provided. The price indexation of contributions up to retirement and of pensions in payment was at the discretion of the pension fund trustees, offering a readily available means of cost containment.[113]

From the mid 1970s these inequalities in pension provision were removed and the generosity of the pension promise was increased by regulatory intervention:

- Women and part-time workers were granted the same pension rights as full-time male employees under the Social Security Act of 1975 and the European Community Directive of 1976.
- The Social Security Acts of 1973 and 1985 gave the right to a refund of contributions to employees who left within five years of service, later reduced to two years. A preserved pension was to be awarded to those early leavers who had served longer.
- The Social Security Act of 1985 required indexation of any preserved pension accrued after 1985. The Social Security Act of 1990 gave employees who left after 1 January, 1991, the right to revaluation of their entire deferred pension.
- From 1978 schemes were required to provide widow's benefits in order to contract-out of SERPS, and from 1988 this requirement was extended to the provision of widower pensions.
- In order to contract-out of SERPS, the Guaranteed Minimum Pension (GMP) is required to be revalued at the point of retirement in line with average wage growth. GMP aimed to be 'broadly equivalent' to the amount the member would have received had they not been contracted out. Prior to 1988 the cost of post-retirement increases in GMP was borne by government, but in 1988 this burden was transferred to the occupational schemes, which were then required to index

[113] The Pensions Commission (2005) *Second Report,* op.cit. p.122.

any GMP accrued since 1988 by up to 3 per cent. The Pensions Act of 1995 has obliged DB schemes to provide indexation of up to 5 per cent for all pension accrued since 1997.[114] With effect from 6 April 1997, Guaranteed Minimum Pensions no longer accrued and the system was replaced by the Reference Scheme Test.[115] Schemes were still liable to pay GMP for those members who had accrued it between 1978 and 1997. The Pensions Act of 2004 limited price indexation of pensions in payment to a 2½ per cent increase in any one year. For deferred pensions, the yearly ceiling remained at 5 per cent.

Inevitably, the cost to companies of the pension promise rose significantly. Costs were further increased by two other developments: falling inflation and rising longevity. First, there was a marked drop in the rate of inflation during the 1980s and the 1990s. When inflation fell below 5 per cent, compulsory indexation meant that pensions in payment would no longer be eroded by inflation. This prevented companies from controlling the cost of pension provision by allowing the real level of benefit to fall. Second, "longevity estimates were not fully informed by the evidence emerging in the medical research communities".[116] In the 1950s male life expectancy at 65 was 12 years. The Pensions Commission noted that this has increased to 19 years.[117]

It would have been reasonable to expect that companies sponsoring DB schemes would have reacted to the rising cost of their pension plans by increasing fund contributions, reducing the generosity of benefits, or increasing the retirement age of their employees. Retrenchment did not occur, largely because of the investment policy of the pension

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[114] The Pensions Commission (2004) *First Report,* op.cit. Chapter 3 Annex – The Rise and Decline of the Defined Benefit Final Salary Pension: A Brief History, p.122.
[115] To pass this test, a scheme must do better than the reference scheme, which means it must have an accrual rate of at least 1/80th and provide a half pension for surviving spouses.
[116] Clark, G.L. and A.H.B. Monk (2006) The 'crisis' in defined benefit corporate pension liabilities. Part I: Scope of the problem, p.53, fn. 31. *Pensions: An International Journal.*12(1).
[117] The Pensions Commission (2004) *First Report,* op.cit. p.123.

funds. From the beginning U.K. pension funds invested heavily in equities. The long equity bull market that ran from 1974 to 2000 produced on average annual real returns of 13 per cent (compared with a twentieth-century annual average real return on equities of 5.5 per cent).[118] In this period of remarkable growth, the increasingly expensive pension promises still seemed easily affordable. Often companies decreased their contributions; many took 'contribution holidays'. Indeed, in some cases they were required to do so by government policy, since HM Treasury objected to the use of managing contributions to lower corporate tax liability when profits were high. Nor did HM Treasury wish to give tax relief on contributions to overfunded schemes. The test of a scheme's solvency was the Minimum Funding Requirement, which took a long-term discounted view of the liabilities of the scheme and compared this with the current realisable value of the present assets of the scheme. The Finance Act of 1986 required funds with a surplus of 5 per cent or more (on the basis of actuarial assumptions) to remove the surplus within 5 years, or else loose part of their tax-exempt status.[119]

Surpluses were often used to pay for early retirement packages, especially during the corporate downsizing of the early 90s. The financial health of the funds seemed so robust that government increased tax on them via the dividend tax changes of 1997. Subsequent events have shown both employers and government to be over-optimistic. The strength of the equities market and relatively high interest rates had distorted perceptions of costs and risks. When the stock market bubble burst in 2001 and real interest rates dropped, the additional costs and risks of the occupational pension funds were finally exposed as huge burdens on their corporate sponsors. The decline in long-term interest rates between 1999 and 2002 alone increased DB pension fund liabilities

[118] ibid.
[119] ibid. p.124.

by 30-40 per cent.[120] The First Report makes a scathing comment: "the fool's paradise of irrational exuberance has come to an end".[121]

The continuing survival of defined benefit schemes has not been helped by changes in accounting standards covering the presentation of these schemes in company accounts. The previous Statement of Standard Accounting Practice 24 (SSAP 24) kept apart the accounting and funding objectives of DB funds and merely required companies to disclose actuarial assumptions underlying the ratio of pension assets to liabilities in the notes to the financial statements. SSAP 24 allowed considerable actuarial discretion over both the frequency (a minimum of once every three years) of valuation of fund assets, and the anticipated rate of return used to discount pension liabilities on the basis of prudent funding assumptions. SSAP 24 could give rise to anomalous results: for example, a company taking a 'contribution holiday' on account of overfunding would report a charge against profits in its published accounts despite not having made a contribution.[122]

The Accounting Standards Board became concerned that SSAP 24 was failing to reveal the full extent of a company's potential liability arising from its DB pension scheme. In 2003 the Board introduced a new standard, Financial Reporting Standard 17 (FRS 17). FRS 17 limits the previous flexibility permitted to plan sponsors. Actuarial assumptions are now largely prescribed. The main requirements of FRS 17 are:

1) pension scheme assets are measured using market values;

[120] Clark, G.L. and A.H.B. Monk (2006) op.cit. p.52, fn. 10.
[121] The Pensions Commission (2004) *First Report.* op.cit. p.125.
[122] Institute of Chartered Accountants in England and Wales (1988) *Accounting for Pension Costs.* Statement of Standard Accounting Practice No.24.
www.frc.org.uk/documents. Accessed 10.08.09.

2) pension scheme liabilities are measured using a projected unit method[123] and discounted at an AA corporate bond rate;

3) the pension scheme surplus (to the extent it can be recovered) or deficit is recognised in full on the balance sheet;

4) the movement in the scheme surplus/deficit is analysed into

   a) the current service cost and any part service costs; these are recognised in operating profit;
   b) the interest cost and expected return on assets; these are recognised as other finance costs;
   c) actuarial gains and losses; these are recognised in the statement of total recognised gains and losses. They are not recycled into the profit and loss account in subsequent periods. [124]

Recent legislation has placed further restrictions on the discretionary powers of fund trustees. Section 132 of the Pensions Act 2008 amends section 231 of the Pensions Act 2004 to clarify that the Pensions Regulator can direct the actuarial assumptions which must be used in the calculation of a scheme's technical provisions, "where the sole ground of concern is that the actuarial methods or assumptions do not appear to be prudent".[125]

Many companies have not welcomed the greater transparency in corporate accounting imposed by FRS 17. The appearance of a DB scheme's deficit on a company's balance

[123] Projected unit method. An accrued benefit valuation method which makes allowance for projected earnings.
[124] Financial Reporting Council (2006) Accounting Standard Board Technical Standards FRS 17. http://www.frc-pob.org.uk/asb/technical/standards/accounting.cfm. Accessed 17.08.09.
[125] Parliament(2008a) Pensions Act 2008. Explanatory Notes. Para.446. http://www.opsi.gov.uk/acts/acts2008/en/ukpgaen_20080030_en_1#div1. Accessed 14.11.09.

sheet will reduce profits for that year, and could restrict its ability to pay dividends.[126] Credit rating agencies may downgrade the company's credit rating on account of the underfunding of its pension scheme, limiting the company's access to capital markets. The volatility of a pension scheme fund can be lessened by a reallocation of its assets from equities to bonds, but this is usually at the cost of lower returns. FRS 17 has further increased companies' awareness of the potential risks of a DB pension scheme, and made them even more reluctant to provide one.

5.2.6. Decline

Since the 1970s membership of private occupational pension schemes, particularly those of a defined benefit type had been in a gradual, though at the time largely unnoticed, decline. In recent years the rate of decline has accelerated greatly. From about the year 2000, companies have been forced to face the true cost of defined benefit pension liabilities. The Association of Consulting Actuaries(ACA) notes that two-thirds of companies with DB schemes have increased employer contributions, and that fund deficits have been reduced by additional regular or annual contributions (by 34 per cent of schemes) and significant lump sum contributions (by another 31 per cent of schemes).[127]

The adverse impact of corporate withdrawal from final salary schemes has not been evenly distributed. The most significant falls in provision occurred among those on middle or higher earnings rather than on those with below average earnings. Men have been more adversely affected than women, since women are more likely to be employed in the public sector. The decline has been concentrated in large and medium -sized

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[126] Leach R. (2004) *The Investors Guide to Understanding Accounts*, p.115.
[127] Association of Consulting Actuaries (2007) *Review and Pension Trends Survey Report,* p.9. www.aca.org.uk. Accessed 17.08.09.

firms, though coverage in small firms was always slight.[128] In 2009 just under 50 per cent of employees in companies with fewer than 25 employees had access to an occupational pension, compared with more than 95 per cent of those where there were more than 1000 employees.[129]

In 1995 there were 5 million employees of private sector firms in open defined benefit schemes. By 2004, the number had fallen to 2 million. Data collected in November 2007 by the ACA show the number down to around 900,000.[130] The number of defined benefit schemes closed to new entrants stood at 87 per cent in 2009. Of these, some 18 per cent were also closed to future accrual for existing employees. 14 per cent of schemes had reduced forward accrual rates and/or increased their scheme's pension age.[131]

Defined benefit schemes can be closed in three different ways:

1) closed to new members but still open to further accruals for existing members. This is the most likely form of closure.

2) closed to both old and new members.

3) fully closed or wound up. At present this type of closure is rare.

A scheme could also become insolvent. In such circumstances, the Pension Protection Fund would take over.

[128] The Pensions Commission (2004) *First Report,* op. cit. p.96.
[129] OECD (2009) *Pensions at a Glance* op.cit. p.109.
[130] Association of Consulting Actuaries (2007) op.cit. p.4.
[131] Association of Consulting Actuaries (2009a) *2009 Pensions Trends Survey. Report 1*, p.3. September . www.aca.org.uk. Accessed 24.04.11.

In the main companies wishing to cap their pension costs have taken a simple decision: to move their employees, wherever possible, into defined contribution schemes. This simple decision can only lead to a substantial reduction in the level of future pension benefits, since the level of contribution made to a DC scheme is far lower than that to a DB scheme. The Pensions Commission found that average combined employer and employee contributions into DB schemes were 29 per cent of earnings, almost double the level of the previous 5 years. Employer contributions have risen the more quickly, doubling, on average, to 23 per cent of earnings. In stark contrast DC contributions are, on average, about a third of those to DB schemes.[132] The Pensions Commission estimated that contributions totalling 22 – 26 per cent of earnings were required to fund a final salary pension based on an accrual rate of $^1/_{60}$ and a retirement age of 65.[133]

A major reallocation of risk has occurred. In private DB schemes with price-indexed benefits, the corporate provider bears almost all of the risks of poor investment returns on accumulated funds, earnings progression during employment, and increasing longevity. The individual both as an employee and as a pension recipient bears no risk. In DC schemes invested in equities or bonds, the individual only avoids the risk of longevity post-retirement. The risks to the individual of changing annuity rates, falling equity returns, and decreasing rates on bonds, all these risks are borne by the individual. And though the insurance companies, the providers of the annuities, absorb longevity post-retirement risk, this is only the case in real terms if an indexed-linked annuity is purchased.

[132] ibid. p.8.
[133] The Pensions Commission (2004) *First Report*, op.cit. p.123.

5.2.7. Corporate Withdrawal

In an era of heightened market competition, many companies see final salary pension schemes as a threat to their long-term survival. The potential dangers of running a risky fund management operation have become only too apparent. Even the type of defined contribution scheme being offered in replacement points to the desire of companies to distance themselves from pension provision. Increasing evidence is emerging of closures of trust-based defined contribution schemes as employers opt for the more lightly regulated contract-based arrangements. No longer do most companies wish to act as surrogate social welfare providers. It is this change in corporate attitudes that makes the government target of reversing the present public/private 60:40 ratio of pension expenditure very difficult to achieve.[134]

5.2.8. Civil Service Pensions

Pressure on funded pension schemes in the private sector has drawn attention to the special circumstances of the unfunded civil service pension scheme. Increased longevity has imposed on the Government a huge and unforeseen pension cost. The Government Actuary's Department (GAD) estimated that the unfunded liabilities of the civil service, teachers, NHS and emergency services totalled about £530 billion as at March 2005.[135] The precise size is open to question. Applying the same methodology as GAD, a more recent, non-government, estimate by Towers Watson is £993 billion as at March, 2010.[136] A more immediate concern is the cash flow gap. The Office for Budget Responsibility's figures suggest that the Treasury's obligation to plug the shortfall between contributions and public sector pensions in payment will jump from

[134] Association of Consulting Actuaries (2007) op.cit. p.4.

[135] Government Actuary's Department (2007) *Unfunded Public Service Schemes 2006 cash flow projection. Methodology, assumptions and data,* p.5. 26 January. http://www.gad.gov.uk/Documents/Occupational%20Pensions/Public_Sector_Pension_Cashflow_Projections_Methodology_2006.pdf. Accessed 08.09.09.

[136] Johnson M. (2011) *Self-sufficiency is the key. Addressing the public sector pension challenge*, p.5. Centre for Policy Studies. The discount rate used was 1.8% over RPI. http://www.cps.org.uk/cps_catalog/selfsufficiency%20is%20the%20key.pdf. Accessed 24.04.11.

£4 billion a year in 2010-11 to £9 billion a year by 2014-15.[137] The fiscal implications of this burden are only too clear. The reform of pension provision in the public sector has become a political imperative.

Those employees, who joined the civil service before July, 2007, remain members of an unfunded, inflation-proofed, final salary scheme. Pensions are normally payable from age 60. Salaries are reduced to allow for notional pension contributions, and many civil servants also make real pension contributions (re surviving spouse pension, and child benefit), which are deducted from their salaries. Salary savings and contributions made are used by H M Treasury to reduce current government expenditure. Pensions are paid out of general taxation as they fall due. The budgets of individual departments include employers' contributions to the pension scheme. Employers' contributions were on average 19.4 per cent in 2007, employees typically paying a further 3.5 per cent out of their salaries. The scheme is closed to new members.

The government has announced that there will be a cap on any future increase in taxpayers' liabilities if costs rise more than anticipated. Initially any extra cost would be split 50:50 with employees, but with the restriction that the employers' contributions will not exceed 20 per cent of salary from the present 19.4 per cent.[138] Any additional increase in required funding will fall on employees. It is thought unlikely that any adjustment to the contributions rate will be needed before 2012, and will be made in the light of changes in life expectancy for those aged 60 or more.[139]

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[137] ibid. p.3.
[138] Cabinet Office (2007) *Civil Superannuation: Resource Accounts 2006-2007,* p.5. HC 876. 25 July. www.official-documents.gov.uk/document/hc0607/hc08/0876/0876.pdf. Accessed 10.09.09.
[139] Civil Service (2009) *Civil Service Pensions. Questions and Answers for scheme members - no.6.* www.civilservice.gov.uk.pensions. Accessed 10.08.09.

From July, 2007 new entrants have been offered a choice of pension arrangements: either Nuvos, a defined benefit scheme, or Partnership, a defined contribution arrangement (partnership pension account).

Nuvos.

Employees contribute 3.5 per cent of pensionable earnings. Nuvos is not a final salary scheme. Instead, pensions will be based on pensionable earnings throughout a career. Pension benefits earned in a particular year will be indexed to the Retail Price Index. Pensions will be payable from age 65. The scheme is contracted-out, lowering National Insurance contributions but offering no State Second Pension. Nuvos offers a level of pension provision significantly less generous than the previous pension scheme.

Partnership.

This scheme was first made available as an alternative to employees joining from October 2002. The employer pays an age–related contribution of between 3 and 12.5 per cent of earnings to the employee's partnership account, even if the employee does not wish to contribute. If the employee decides to contribute, then the employer will match contributions up to 3 per cent of earnings. The employee will receive tax relief on any voluntary contributions. Partnership is delivered via stakeholder pensions from a choice of pension providers. An annuity may be purchased from the individual accumulated fund at any age from 55 to 75. Partnership is contracted-in to the State pension scheme; higher National Insurance contributions are required, but State Second Pension will be received in addition.

Data supplied by the Cabinet Office showed that on 31 March, 2007, membership of the old final salary scheme included 594,000 active members and 316,000 persons with deferred pensions.[140] It will be some time before the recent changes in Civil Service pension provision result in any meaningful reduction in government expenditure.

Most of the other public sector schemes (local government, teachers, NHS, fire fighters, and the police) have undergone some significant changes in the past decade to reduce the cost to the employers. The general trend has been to introduce a less generous accrual rate and a higher pensionable age, usually 65, but in the main the changes are only applicable to new entrants.

5.2.9. The Problem of Undersaving for Retirement

The decline of occupational pension provision in its present form will inevitably lead to increasing numbers of retirement undersavers, defined as those who are likely to receive an income that does not provide for their reasonable expectations of a quality of life during retirement. Acknowledging that these expectations may differ to reflect different circumstances and aspirations, the Pensions Commission suggested benchmark replacement rates which vary according to income levels enjoyed during working life – 80 per cent for the lowest earners, two-thirds for average earners, and 50 per cent for the highest (these replacement rates are based on gross income).[141] Analysis undertaken by the Commission found that between 9.6 million and 12 million people were saving at a rate insufficient to deliver retirement income in line with those benchmark rates.[142] Since few people will be content with a retirement income that is significantly less

[140] Cabinet Office (2007) *Civil Superannuation.* op. cit. p.6.
[141] Department for Work and Pensions (2006a) *Security in retirement: towards a new pensions system,* p.36. May. Cmnd. 6841.
[142] ibid. p.37.

than that received while employed, it becomes crucial that Government encourages and enables higher levels of private pension saving.

5.2.10. The Insights of the Behavioural Economists

Raising levels of private saving for future old age provision is not an easy task. Many people will still find saving difficult, even if aware that they are failing to make adequate provision. Their reluctance challenges an assumption of standard economic theory: that people wish to smooth consumption over their life cycles, solving the relevant optimization problems in each period before deciding how much to consume and how much to save.[143] In reality, spending tends to track income. Behavioural economics, a combination of economics and psychology, argues that standard economic theory ignores important factors that affect decision-making. In relation to saving for retirement, behavioural economists have explored the various psychological impediments to saving.

First, it is difficult to compute the appropriate savings rate; even for the financially sophisticated the complexity of the calculation may act as a deterrent. Second, saving for retirement requires self-control, and many people admit to a lack of the necessary power. A third problem, closely associated with self-control, is procrastination, that common human tendency to postpone unpleasant tasks.[144]

Self-control and procrastination have become concepts of increasing theoretical interest. Behavioural economics theorists have developed models of these problems that incorporate the concept of hyperbolic discounting. Whereas standard dynamic decision

[143] Thaler, R.H. and S. Benartzi (2004) Save More Tomorrow: Using Behavioural Economics to Increase Employee Saving, p.165. *Journal of Political Economy*,112(1), pt 2.
[144] Department for Work and Pensions (2006) *Security in retirement,* op. cit. p.42.

theory assumes that intertemporal choices do not depend on the decision date, modern models of decision making relax this assumption in the light of empirical evidence of an "immediacy effect" in behaviour.[145] People display time–inconsistent behaviour, weighing current and near–term consumption especially heavily, leading them to largely disregard the future when it requires sacrifices in the present. [146]

The findings of the behavioural economists have been confirmed by research undertaken in the subfield of neuroeconomics. Technology now allows researchers "to open the black box of the mind and observe brain activity directly".[147] Extensive experiments with animals, and later with humans, have established that the response of the mind to immediate rewards is processed by a different part of the brain from that which reacts to future rewards.[148] The discovery of this dual process undermines the classical view of homo economicus as a utility-maximizing individual with a single goal.

Procrastination creates a strong tendency to inertia, which has also been termed as status quo bias, since the easiest decision is often to leave matters as they are. Procrastination and inertia act to entrench existing patterns of consumption and saving. Attempts to raise savings levels must deal with the fact that people become accustomed to a particular level of disposable increase. Increased saving will cause a cut in take-home pay. Among the less well-informed where the degree of hyperbolic discounting tends to be greater, this loss of income will be felt more keenly than it will be among the more

[145] Pesendorfer, W. (*2006) Behavioural Economics Comes of Age,* p.2. May. Princeton University, New Jersey. http://www.princeton.edu/~pesendor/book-review.pdf. Accessed 15.09.09.
[146] Thaler, R.H. and S. Benartzi (2004) op.cit. p.167.
[147] Camerer, C. F. (2006) *Neuroeconomics: using neuroscience to make economic predictions*, p.2. Paper prepared for the Hahn lecture, Royal Economic Society, Nottingham, April 20. www.economics.uchicago.edu/pdf/Camerer_051606.pdf. Accessed 10.05.09
[148] ibid. p.7

financially sophisticated.[149] Government is faced with a dilemma. Procrastination and inertia make a purely voluntary approach to boost savings unlikely to have any real success. On the other hand, compulsory saving for retirement may result in pension contributions being perceived as yet another tax. The political backlash could be damaging.

Observations drawn from field studies undertaken in the U.S. offer a solution to this dilemma. Corporate savings plans have been specifically devised to help employees who would like to save more but lack the power to do so. When employees first become eligible for the savings plans they are automatically enrolled in the plans, unless they explicitly opt out. This is in contrast to the standard enrolment procedure that prevails in most U.S. companies, where savings plan participation requires an active election by the employee. With standard enrolment if an employee does nothing, then that employee is presumed not to wish to join the plan. Automatic enrolment reverses that presumption, and presumes that the employee who does nothing does wish to join. This simple change in the default participation status of those employees who take no action has dramatically increased levels of participation.[150] The default option rests on the simple notion that "when given a choice, people disproportionately choose the option that involves the least effort".[151]

Although plan designers felt that the knowledge that employees could always opt out of the savings plans would make them more comfortable about their participation, few

[149] Thaler, R.H. and S. Benartzi (2004) op.cit. p.168.
[150] Beshears, J., J.J.Choi, D.Laibson and B.C.Madrian (2005) *The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States*, p.6. Paper 43/05. 24 October. Centre for Research on Pensions & Welfare Policies (CERP) University of Turin. www.nber.org/papers/w13976.pdf. Accessed 05.04.09.
[151] Disney, R. (2005) *Back to the Future? The Pension Commission's Report on Pension Reform.* Policy Briefing, 6 December. Centre for Policy Evaluation, University of Nottingham. http://www.nottingham.ac.uk. Accessed 12.02.10.

have opted out.[152] The same behavioural characteristics, procrastination and inertia, that induce people to postpone saving indefinitely serve also to induce the majority of participants to remain in the plans.[153]

The use of automatic enrolment as a device to raise participation levels has not met with universal approval. Some economists have called automatic enrolment paternalistic. Two of its leading advocates, Sunstein and Thaler, accept the description but point out that since no coercion is employed, automatic enrolment is a good example of what they term libertarian paternalism. Sunstein and Thaler argue that though their chosen name might be thought an oxymoron, such is not the case.[154]. It is both possible and legitimate for private and public institutions to steer people's choice in a welfare-promoting way, while at the same time respecting their freedom to choose.[155] The Pensions Commission was persuaded by the argument, and recommended that Government implement a National Pension Savings Scheme based on these principles.

5.2.11. The National Pension Savings Scheme: Main Features

The Government proposes to introduce a new pension savings scheme of low-cost personal accounts. The key features of the scheme will be as follows.

- Automatic enrolment of all eligible employees but with the right to opt out.
- A minimum overall level of contribution from employers, employees and the state. This will be set at 8 per cent on a band of earnings between the Primary Threshold (currently £5720 a year) and the Upper Earnings Limit (for the purposes of Personal Account Earnings Band (PAEB) regarded as £33,540).

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152 Thaler, R. H. and S. Benartzi (2004) op. cit p.171.
153 ibid. p.185.
154 Sunstein, C. R. and R. H. Thaler (2003) *Libertarian Paternalism is Not an Oxymoron.* A.E. Brooking Joint Center for Regulatory Studies. WP No. 03-2. May.
www status-quo-bias.behaviouralfinance.net. Accessed 19.05.09.
155 Thaler, R. H. & C. R. Sunstein (2003) Libertarian Paternalism, p.179. *American Economic Review.* 93(2). May.

The Government has announced that the PAEB will be set in line with the Primary Threshold and Upper Earnings Limit as at 2006/07. The PAEB will not be increased to the new level of the Upper Earnings Limit.[156] The band will be up-rated in line with future increases in earnings.[157] Employees will contribute 4 per cent, employers will make a minimum matching contribution of 3 per cent, and a further 1 per cent will be contributed by normal tax relief.

- Opt-in access will be available to, among others, the self-employed and those not currently in paid work.
- The accounts will be portable to fit in with the likelihood of people moving between jobs.

The Government wishes to promote personal responsibility for old age provision. By helping to overcome the barriers to savings faced by many individuals, the scheme will provide a way of building private retirement income in addition to state pension entitlement. Research undertaken by the Department for Work and Pensions shows that a majority of people – some 72 per cent of a representative selection of the UK population – agreed with the proposal that employees should be automatically enrolled into personal accounts with the choice to opt out.[158] Personal accounts will be particularly targeted at groups whose participation in private pension savings is low. These include employees on moderate to low incomes, especially those with incomes below about £15,000; younger people, especially those in their 20s and 30s; and women, who are a significant majority of those with lower earnings in this target group.[159] American research into 401(k) schemes[160] shows that auto-enrolment had the

[156] Parliament (2008b) *Pensions Bill: Committee Stage Report*, p.7. Library Research Paper 08/027.
[157] The Pensions Commission (2005) *Second Report.* op.cit. p.355.
[158] Department for Work and Pensions (2006b) *Personal Accounts: a new way to save,* p.114. Cmnd. 6975. December.
[159] ibid. p.48.
[160] employer sponsored, defined contribution plans.

greatest impact among people with low incomes, minority ethnic groups, and women.[161] The following sections discuss the key elements of the National Pension Savings Scheme (NPSS) in more detail.

5.2.11.1. Alternative Provision

Despite the clear intention that the NPSS has wide coverage, the introduction of the scheme not prevent individuals or companies that currently have good pension arrangements in place continuing with these.[162] Individuals who decide to opt-out of the scheme are free to enter into whatever alternative arrangements they choose. Existing legislation relating to personal pension provision will not require amendment.

In regard to companies wishing to retain their current pension schemes instead of auto-enrolling their employees in the NPSS, legislation will be needed to make sure that the existing company pension provision is at least as favourable as that offered by the NPSS. A company which wishes to stay outside the NPSS must ensure, either for all its employees or for some, that the pension arrangements satisfy two sets of conditions:

1. Overall benefits in and contributions to its scheme must be equal to or above NPSS levels. DB scheme benefits accrued by most members must exceed estimated default level NPSS benefits as assessed by the Government Actuary's Department. Almost all DB schemes will meet this requirement.[163] In DC schemes employer contributions must at least be at the compulsory matching level; and total employee and employer contributions must also at least equal the

[161] Department for Work and Pensions (2006b) *Personal Accounts.* op.cit. p.51.
[162] The Pensions Commission (2005) *Second Report*. op.cit. p.358.
[163] ibid. p.306.

level of default contributions in the NPSS. Many but not all DC schemes will pass this test.[164]

2. To opt-out of auto-enrolment, the company must either:

   Auto-enrol all employees who would otherwise qualify for the NPSS with the company scheme;

   Or, if the company scheme restricts access to its employees (for example, by imposing a waiting period), the employer must operate two schemes. Employees eligible to join the company scheme must be auto-enrolled into it. Employees not eligible for the company scheme must be auto-enrolled into the NPSS.[165]

The Pension Commission also recommends that individuals who have accumulated funds in a variety of occupational schemes should be allowed to transfer those funds to the NPSS, thus allowing them to consolidate their pension saving.[166]

5.2.11.2. Contribution Rates

In the view of the Pension Commission, a reasonable aim of public pension provision should be that median earners achieve in retirement an income replacement rate of at least 45 per cent. Any decision to save to achieve a higher rate should be a matter of individual choice. Since the reformed state pension is projected to provide a median earner with an income replacement rate of 30 per cent, the NPSS will be required to provide the additional 15 per cent. The minimum default contribution rate should be designed, on reasonable rate of return assumptions, to achieve this replacement rate. Additional contribution rates should be allowed by employees and employers.

[164] ibid.
[165] ibid. p.363.
[166] ibid. p.364.

Although additional employee contributions will not attract compulsory matching by employer contributions, the availability of tax and NI relief may encourage many employers to do so voluntarily.[167]

The justification for starting auto-enrolment contributions at above the Primary Threshold (PT) was that the Commission believed that auto-enrolment contributions levied on earnings below PT would generate very small value accounts, and probably result in a high opt-out rate.[168] For earnings above UEL a laissez-faire attitude was considered more appropriate, since the market offered a wide range of pension plans to higher earners. The band of income selected for auto-enrolment covers the earnings of 80 per cent of the work force, and a significant proportion of the income of those with higher earnings.[169]

A crucial assumption is the rate of return on funds accumulated in the individual accounts. Here the Commission made the rather cautious estimate that the average real rate of return would be 3.5 per cent before the deduction of an annual management charge (AMC).[170] This will demand significant equity exposure at least at younger ages, and equity returns are not guaranteed.

The level of the default contribution rate recommended was also based on other assumptions, such as the age at which saving would be likely to start, and the age of retirement. The Commission thought that saving would start on average at about age 25, though there might be interruptions in the employment record. The scheme

[167] ibid. p.274.
[168] ibid. p.276.
[169] ibid. p.277.
[170] ibid. p.287.

projections assume that savings will be continuous from age 30. Annuitisation was assumed to occur at State Pension Age, which itself will rise over time.[171]

The employer contribution of 3 per cent of earnings is equivalent to about 2.3 per cent of the total gross earnings of a median earner on £22,000. Since pension contributions are not subject to employers' National Insurance contributions, the additional cost of employing a median earner will only be about 2 per cent. The impact on aggregate labour costs is estimated to be slight at 0.6 per cent. Employer contributions and normal tax relief effectively doubles the individual's contributions and scheme members should receive back more than they contributed.[172] Experience in the US has shown that the employer contribution adds greatly to the attractiveness of schemes, thereby boosting participation levels. The Government intends to encourage participation by highlighting the value to employees of this feature.[173]

The Pension Commission was concerned that the default contribution rate might be seen as a standard by many individuals, who might assume that its choice by government implied that it was adequate. Evidence from the U.S. of occupational schemes with auto-enrolment shows that contribution rates tend to cluster round default levels. It will be necessary to stress that the default rate should be looked on as a minimum level, and that additional contributions may be required to achieve desired income replacement rates.[174]

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[171] ibid. p.274.
[172] Department for Work and Pensions (2006b) *Personal Accounts.* op. cit. p.54.
[173] House of Commons (2006) *Annex 1: Response to the House of Commons Work and Pensions Select Committee Report: recommendations and conclusions*, p.156. http://www.dwp.gov.uk/docs/pa-annex1-responsetoselectcommittee.pdf. Accessed 16.11.09.
[174] The Pensions Commission (2005) *Second Report.* op.cit. p.360.

5.2.11.3. The Governance and Mechanics of Auto-Enrolment

The Pensions Commission considered that the most appropriate institutional structure for the NPSS would be that of a non-departmental public body. The entity should be managed by its own board, and be non profit-making.[175] It must be seen by the public as clearly separate from direct government influence. Political interference in investment strategy and on how the voting rights of the scheme investments are exercised would not be acceptable.[176]

A new pension payment scheme specifically designed to process contribution payments to the NPSS should be set up. Contributions should be deducted from the payroll, and then sent to the NPSS monthly using a unique account number identifier (almost certainly the individual National Insurance Number). Individual accounts would be held at the NPSS, which would invest individual contributions in the chosen funds. At regular intervals the NPSS should inform contributors of the capital value accumulated in individual accounts.[177]

Those wishing to opt out would need to notify the NPSS of their intention. Auto-enrolment for those who opt out should be triggered every 3 to 5 years in recognition of the fact that people's circumstances can change.[178] The Government has decided on a trigger every 3 years.[179]

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[175] ibid. p.402.
[176] House of Commons (2006) *Annex 1*, op.cit. p.163.
[177] The Pensions Commission (2005) *Second Report,* op.cit. p.364.
[178] ibid. p.368.
[179] Pensions Act 2008. Section 6.

5.2.11.4. The Range of Funds

In an individual account funded system, individuals are free to make their own asset allocation. They can choose, for example, between the high risk and potentially high returns of an equity fund, or the low risk and low returns of a fund invested in index-linked government bonds. There can be little doubt that a significant proportion of the population is ill-equipped, and recognises itself as such, to make an informed choice.[180] Because many people feel overwhelmed and confused by the complexity of choice, the Pension Commission advised that the number of funds in the scheme be restricted to about six to ten.[181] Evidence from US 401(k) schemes shows participation rates were particularly low when fund options exceeded 30.[182]

The NPSS should bulk negotiate a small number of fund management mandates focusing on major investment categories (bonds, equities in UK, European, and global markets), and probably on index rather than actively managed funds. By choosing tracker funds the US Thrift Savings Plan (a DC plan for Federal employees) achieves an AMC of below 0.1 per cent.[183] The Pension Commission was impressed; one of the key rationales for creating the NPSS is the potential to make pension saving possible at substantially lower AMCs. By eliminating high initial advice costs and reducing contract proliferation costs, the NPSS should be able to achieve an AMC of 0.3 per cent.[184] To illustrate the beneficial impact of low charges, an individual saving for 40 years in a fund subject to an AMC of 1.5 per cent will suffer a 20 per cent reduction in capital accumulated compared with an AMC of 0.5 per cent.[185]

[180] ibid. p.195.
[181] ibid. p.376.
[182] Department for Work and Pensions (2006b) *Personal Accounts.* op.cit. p.103.
[183] The Pensions Commission (2005) *Second Report,* op.cit. p.108.
[184] ibid. p.396.
[185] Department for Work and Pensions (2006b) *Personal Accounts*, op cit. p.91.

The NPSS will need to have a default fund into which individuals are invested if they do not select an asset allocation. Some people will simply not return asset allocation forms, and many others will welcome the investment decision being made on their behalf. For many people the default fund will be regarded as implicit advice by government as to suitable investment. In Sweden over 90 per cent of new members now make no active selection, instead accepting the default fund.[186] The default fund should be a "lifestyle" smoothing fund, which automatically moves members from relatively high equity weighting at early ages to bonds as people approach retirement.[187] Equity market volatility can result in a lottery element at the point of annuitisation. An individual heavily invested in equities who retired in March, 2002 would have had a pension fund about one-third lower than an equivalent investor retiring in March, 2000. Although "lifestyling" seeks to avoid such adverse outcomes, minimum returns are never guaranteed, and government should stress that it cannot underwrite them. In order to reduce specific investment risk, the default fund should be diversified among many asset classes.[188]

Highly risk-adverse individuals should be given the choice of a fund invested solely in index-linked government bonds, where returns, though low, can be guaranteed.[189] People should also be given the option of investing in private equity funds or hedge funds, or in funds designed to be ethical, environmentally responsible, or appropriate to particular religious groups.[190]

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[186] ibid. p.374.
[187] The Pensions Commission (2005) *Second Report,* op.cit. p.378.
[188] Department for Work and Pensions (2006b) *Personal Accounts,* op.cit. p.106.
[189] The Pensions Commission (2005) *Second Report*, op.cit. p.378.
[190] ibid. p.376.

5.2.11.5. The Self-Employed and Those Not in Work

The Commission noted that the UK workforce included 3.2 million self-employed, of whom a disproportionate percentage appeared to be in danger of inadequate pension income in retirement. Only 38 per cent of the self-employed were covered by private pensions compared with 56 per cent of employees. It is difficult to design a system of auto-enrolment for the self-employed, since they settle up for tax and most of their NI Contributions after the end of the tax year. Nevertheless, the Pensions Commission thought that the self-employed should be able to gain the benefit of low cost saving via the NPSS, and should therefore be free to make voluntary contributions.[191]

Individuals, who are not at a given time active in the labour market, including those with caring responsibilities, may wish to commence or to continue to save in the NPSS during interruptions in their working lives. Such individuals should be able to contribute to personal accounts in the scheme. Tax relief on pensions is given to those who are outside of the labour market, and the self-employed. The receipt of £28 from the state for every £100 of contributions made, up to a maximum of £3,600 of total contributions in any one year could act as an incentive to participate in the NPSS.

5.2.11.6. People over State Pension Age and Young Employees

Individuals over SPA who are in employment will not be automatically enrolled, but remain entitled to opt-in to the scheme and receive an employer contribution. Those still in employment with a personal account when they reach SPA will stay within the scheme unless they decide to opt-out. People over 74 will not be able to remain in the

[191] ibid. pp.278-281.

scheme, since all individual accumulated pension funds must be annuitised by the age of 75.[192]

Young persons aged between 16 and 21 will be allowed to participate in the scheme on an opt-in basis. Those deciding to do so will be entitled to a matching employer contribution.[193]

5.2.11.7. Early Death

As regards the assets of people dying before retirement, the Pensions Commission firmly believed that the attractiveness of the scheme would be significantly enhanced if fund holders knew that their savings would pass to their family (or to other specified beneficiaries) in the event of death before the commencement of pension payments.[194]

5.2.11.8. The Decumulation Phase

The detailed design of the NPSS will need to include rules and arrangements relating to the decumulation phase of an individual's account. Since the purpose of the savings scheme is to ensure that people who at present accrue little or no replacement private pension rights will at least achieve a basic level of income replacement, annuitisation at the point of retirement should take place. Members will be able to take up to 25 per cent of their pension fund as a tax free lump sum on retirement.[195] In the interests of consistency, annuitisation should be according to the same rules that apply to private pension plans. These rules cover choice between the first and last ages of retirement,

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[192] Department for Work and Pensions (2006b) *Personal accounts,* op.cit p.54.
[193] ibid.
[194] ibid. p.386.
[195] The Pensions Commission (2005) *Second Report,* op.cit. p.381.

drawdown before annuitisation, the choice of either level or index-linked annuities, and also of either single or joint-life annuities. [196]

The ages of first allowed and last possible ages of annuitisation will be set at age 55 and at age 75, with this age range being raised in line with increasing life expectancy. As regards indexation, the Pension Commission believed that most people would be well-advised to take out an index-linked annuity. As the Commission pointed out, the NPSS will be a planned replacement for a compulsory earnings-related scheme which is index-linked, and the NPSS should be the same.[197] The Commission felt that individuals should be free to choose. A similar view was taken on whether married individuals should purchase a single or joint-life annuity. Reasoning that if its recommendations to expand the generosity of the flat-rate State Pension are followed by Government, freedom of choice would again seem appropriate.[198] Currently the majority of annuities taken out are single life and non-indexed, and these annuitants will face declining real income in retirement. The Commission suggested that all individual estimates of future pension income produced by the NPSS should assume that index-linked annuities will be purchased.[199]

The Commission took the firm view that the NPSS should not involve itself with the actual provision of annuities. It considered that the annuity market was reasonably efficient and competitive, and people should be permitted to choose their provider. Moreover, free market price differentiation should play an increasingly useful role in sending signals to individual fund holders about the benefits of later annuitisation.[200]

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[196] ibid. p.37.
[197] ibid. p.380.
[198] ibid. p.382.
[199] ibid.
[200] ibid. p.384.

The long-term shift of post retirement longevity risk from the state and from the DB funds to the annuity market poses a question. Are there any limits to the capacity of the annuity market to absorb these risks? The Pension Commission's analysis suggested that there was no inherent block on the expansion of the market, though government policies could help transitional problems.[201] Level annuities can only be written if there is a sufficient supply of nominal bonds of appropriate maturities. Index-linked annuities require an underlying supply of real indexed securities. Unfortunately, the supply of very long bonds, and very long real-indexed bonds, is small relative to the demand for long term annuities.[202] The Pensions Commission found evidence that index-linked annuities often represented poor value relative to level annuities.[203]

The Debt Management Office (DMO), the Government's debt issuance office, an executive agency of the Treasury, has a debt management policy that aims to minimise government financing costs over the long term. The Pensions Commission expressed the wish that a higher proportion of debt be issued in the form of very long bonds and very long index-linked bonds. In May, 2005, the DMO sold via auction a 50 year Treasury bond, the longest dated bond in more than four decades.[204] The present time offers government debt issuers the opportunity to lock-in to low interest rates. On 22 May, 2008, the DMO stated that its auction of 900 million pounds in index-linked Treasury gilts maturing in 2037 was covered by bids 1.99 times.[205] In a market saturated by demand, yields are inevitably low.

[201] ibid. p.225.
[202] ibid. p.226.
[203] ibid p.228.
[204] Carnevale, F. (2005) Smoothing the Way for Ultra Long Bonds, pp. 60-63. *FTSE Global Markets*, July/August.
[204] London South East (2008) UK Money News. 22 May.
lse.co.uk. Accessed 12.08.09.
[205] ibid.

5.2.12. Response

In its Final Report, the Commission noted that its Second Report had been widely discussed, and that the response to its recommendations has been on the whole favourable.[206] There was a general consensus that future policy needs should be based on significant reforms to the state system and on a new approach to private pension saving that went beyond the purely voluntary. The Commission stressed that the reforms proposed in either the state system or in the private savings schemes were not to be considered in isolation, but rather as complementary, forming an integrated set of policies designed to create a long-term pension settlement for the 21st century. Further modelling of the Commission's proposals suggested that the percentage of GDP devoted to state pensions might need to rise to between 7.5 and 8 per cent of GDP in 2050, depending on the level to which SPA was increased.[207]

5.2.12.1. Implementation: Pensions Act 2007 and Pensions Act 2008

These two Acts broadly follow the recommendations of the Pensions Commission.

Pensions Act 2007

It is the government's stated intention that measures implemented in the Act make the state pension system more generous, fairer to women and carers, and more widely available.

Basic State Pension.

Key changes include:

- A reduction in the number of qualifying years required for a full BSP to 30 years for those persons who reach SPA in 2010 and after;
- Any number of years give entitlement to at least some BSP;

[206] The Pensions Commission (2006) *Final Report of the Pensions Commission*. op.cit. p.10
[207] ibid. p.15.

- A new weekly National Insurance credit introduced for carers;
- Indexation of BSP to earnings, instead of prices, from 2012 at the earliest and by 2015 at the latest;
- The SPA for both men and women will increase by one year per decade between 2020 and 2050 - with the third increase, from 67 to 68, to be phased in over two years from April 2044.

As a result, 75 per cent of women retiring in 2010 received a full BSP. By 2025 over 95 per cent of men and women will retire with a full BSP.[208] By 2050, the BSP could be worth twice as much as it would have been if it had remained linked to prices,[209] and it is anticipated that only about 30 per cent of pensioner households be entitled to Pension Credit by then.[210]

State Second Pension.

The Act changes the way S2P builds up in the future. The flat rate element of S2P will be replaced with a new fixed rate amount. This provides a weekly pension of £1.50 for each year of qualification. This amount (which is in 2007/08 earnings terms) will be uprated by earnings during working life and by prices when in payment. Accruals to the earnings-related element of S2P will continue to start at earnings of £13,000 (the current level of the Lower Earnings Threshold) and end at a new Upper Accrual Point (set at the same level as the Upper Earnings Limit on introduction but then frozen). This will allow for the gradual withdrawal of earnings-related pension as recommended by the Pensions Commission. This change will occur between 2012 and 2015. People will then build up entitlement on a flat-

208 House of Commons (2008a) The Secretary of State for Work and Pensions (Mr. Peter Hain). 7 Jan. Hansard, col. 54. http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080107/debtext/80107-0008.htm. Accessed 10.06.09.
209 Department for Work and Pensions (2006) *Security in Retirement.* op. cit. p.20.
210 Department for Work and Pensions (2006b) *Personal Accounts.* op. cit. p.33.

rate basis by around 2030. will The consolidation of S2P will increase benefit expenditure by about £200 million annually on average in the years 2020 – 2035 and reduce it thereafter. Overall, consolidation will have a neutral impact on Government expenditure.[211]

From 2012 at the earliest, contracting-out into a private pension scheme on a defined contribution basis will no longer be permitted. The Act also creates the Personal Accounts Delivery Authority (PADA) to enable preparatory work on the new system of personal accounts.

Pensions Act 2008

This Act gives all eligible workers between 22 years of age and SPA access to a National Pension Savings Scheme from 2012.

Key measures include:

- employers must automatically enrol jobholders into a qualifying workplace pension scheme and to offer a minimum pension contribution equal to 3 per cent of earnings between £5,035 and £33,540 (2006/07 earnings terms);
- "personal accounts" be introduced in 2012;
- a compliance regime be established for the new employer duties introduced by the Act;
- the remit and powers of the Personal Accounts Delivery Authority are widened to enable it to oversee the establishment of the personal accounts scheme;

[211] House of Commons (2008b) *Pensions Bill 2008. Explanatory Note 328*, p.49. 23 April . http://www.publications.parliament.uk/pa/ld200708/ldbills/050/en/2008050en.pdf. Accessed 22.06.09.

- the cap applying to revaluation of deferred pensions is reduced from 5 to 2.5 per cent for future accrued rights. This took effect from January 2009 and only apply to rights accrued after that date;
- a contribution limit of £3,600 (by reference to the level of earnings in 2005) will be imposed. This will apply to all members.[212]

The significance of the NPSS can be seen from the scale of its likely, initial costs – employers' contributions £5.5 billion, individual contributions £7 billion, and government tax relief £2 billion, resulting in an average annual cost estimated at £10 - £15 billion.[213] The Government estimates that 6 – 9 million people will participate.[214]

Rather this was the planed schedule. Sadly even the best-laid scheme can go astray if the political will to move it forward is lacking.

5.2.12.2. The Deferral of the Personal Accounts Scheme

Citing the added cost of providing benefits, in addition to the task of administering the changeover to the new system, business groups have long argued for the planned 2012 commencement date of personal accounts to be re-considered. They have succeeded. The government has delayed the introduction of the scheme. Under the changes, employers will have to contribute a minimum of 1 per cent of a worker's salary into a pension plan from October 2012, then 2 per cent by 2015, and finally the full 3 per cent

[212] ibid. p.370.
[213] Department for Work and Pensions (2009) Pensions Bill: Impact Assessment of Pension (Automatic Enrolment) Regulations 2009. 29 March. www.dwp.gov.uk/docs/pension-auto-enrol-imp-assess.pdf. Accessed 16.09.09.
[214] Department for Work and Pensions (2008) *Factsheet. People benefiting from private pension reform: explanation of participation estimates*, p.1. www.dwp.gov.uk/policy/pensions-reform/factsheets-and-supporting. Accessed 21.08.09.

only from October 2016. Employee contributions will be also be staged. The 4 per cent will only required in 2016.[215] The Trades Union Congress comments on the deferral:

> "We understand that there are practical issues that need to be discussed about its implementation, but the pension's crisis is getting worse with every day that employers retreat from providing decent pensions".[216]

The Government announced in January, 2010 that it was rebranding personal accounts as Nest (The National Employment Savings Trust). Nest will have a 0.3 per cent annual management charge to cover running costs. In addition, those who join the scheme in the beginning will have to pay an additional 2 per cent on all of their contributions to cover Nest's start-up cost, a deduction hardly likely to encourage participation.

The concerns of the TUC are confirmed in a report from the Association of Consulting Actuaries. Its survey found that 41 per cent of smaller employers are considering the closure of their existing scheme in favour of offering just personal accounts to all employees, and 54 per cent are likely to revise benefits to mitigate the costs if, instead, they auto-enrol all employees into an existing scheme. As most UK pension schemes are run by smaller employers – 90 per cent of UK schemes have fewer than 100 members –the impact of such changes in occupational pension provision would be significant.[217]

It is submitted that the delay inevitably lead to lower savings, and potentially a lower standard of living in retirement for many of today's workers on low to average earnings.

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[215] Financial Times (2009b) Pension delay cuts workers' savings. 26 September. www.ft.com Accessed 11.11.10.

[216] Guardian (2009) Bosses force government to defer pension plan for low-paid until 2016. 24.September. www.guardian.co.uk. Accessed 11.11.10.

[217] Association of Consulting Actuaries (2009b) *Pensions Trends Survey – Report No.2*, p.3. September. www.aca.org.uk. Accessed 25.09.09.

5.2.13. Recent Developments

5.2.13.1. Calculation of State Pension Benefit

From April 2011, there will be a 'triple guarantee' that the basic State Pension will rise by the highest of the following:

- earnings – the average percentage increase in UK wages that year;
- prices – the percentage the cost of living increases by that year;
- 2.5 per cent.

From April 2011 the government will use the Consumer Price Index (CPI) as the measure of prices.

5.2.13.2. Statutory Retirement Age

The proposed changes to the State Pension age timetable, announced in November 2010, affect those born between 6 April 1953 and 5 April 1960. Under the new proposals, from December 2018 the State Pension age for both men and women will start to increase to reach 66 by April 2020. This would mean that women's State Pension age will increase more quickly to 65 between April 2016 and November 2018.

These proposed changes to the timetable still require the approval of Parliament. The government is considering the current timetable for future increases to the State Pension age from 66 to 68. Any change to the timetable would require the approval of Parliament.

5.2.13.3. Default retirement Age

The government is planning to scrap the default retirement age in the UK from October 2011. Under the proposal, employers would not be allowed to dismiss staff because they had reached the age of 65.

5.2.13.4. Proposals to relax annuity rules

Previous rules stated that those with a personal or company defined contribution pension fund must purchase an annuity by the age of 75. The government has increased this age from 75 to 77. Further proposed changes include:

- no specific age deadline for buying an annuity;
- a cap on the amount "drawn down" annually from a pension fund by an individual without buying an annuity;
- a withdrawal of this cap if the individual can prove they have enough income to never run out and rely on the state.[218]

Saga director-general Dr Ros Altmann comments: "less than one per cent of people have enough money in their retirement funds to benefit from such schemes".[219]

5.2.13.5. Nest

PADA, the transitory body, has ceased to operate. Nest Trust Corporation has been established. NEST is a non-departmental public body accountable to Parliament through the Department for Work and Pensions. NEST has a chair and up to 14 Trustee Members. Together they form the trustee of the scheme. As a trustee they have an over-riding legal duty to act in the best interests of scheme beneficiaries. NEST will be regulated by the Pensions Regulator.

The process of auto enrolment of employees will be staged, dependent on employee head count, from 1 October, 2012 to 1 September, 2016, with large employers being the first to have to take action. All jobholders working in Great Britain aged at least 22 years old who have not yet reached State Pension age and are earning more than

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[218] Information from dirct.gov.uk. Accessed 22.02.11.

[219] Altmann, R. (2010) End of compulsory annuity purchase 'will not help most savers'. *My Finances*. 14 December.
http://www.myfinances.co.uk/pensions/2010/12/14/end-of-compulsory-annuity-purchase-will-not-help-most-savers. Accessed 21.02.11.

£7,475 a year (the income tax threshold at 2011, 2012 figure to be confirmed) need to be automatically enrolled into either an employer's workplace pension or NEST. It is proposed that contributions from those enrolled should be levied on their earnings over the National Insurance earnings threshold (£5,715 in today's prices). This will avoid automatically enrolling those not earning enough to pay income tax, and will ensure that the very tiny levels of pension contribution possible under the current proposals are avoided. The concern is that very small pension funds could damage "the credibility of the reforms".[220]

The upper limit of the band of eligible earnings will be £33,540 a year (based on 2006 levels - 2012 figure to be confirmed). There will be an annual contribution limit of £3,600 (in 2005 earnings' terms) into NEST. This will be uprated by earnings year on year. This limit will be reviewed in 2017.

The NEST Trust believes that there is a strong case for giving employers the opportunity to have a waiting period of up to three months. This vesting period would avoid automatically enrolling the large numbers of workers who leave very quickly after starting employment, and include many seasonal workers. The waiting period would also allow workers more opportunity to decide whether they want to opt out, allowing them to respond quickly and possibly reducing the number of refunds.[221]

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[220] Department for Work and Pension (2010) *Making automatic enrolment work – a review for the Department for Work and Pensions.* Executive Summary, p.4. 27 October. Cm 7954. http://www.dwp.gov.uk. Accessed 10.03.11

[221] ibid.p.6

Some of the details of the scheme are still being finalised and may change.[222] The NEST Trust considers "it particularly important that Government have in place a comprehensive programme of monitoring and evaluation".[223]

5.2.13.6. Green Paper

The government has published a green paper on the future of the state pension. This consultation paper entitled '*A state pension for the 21st century'* seeks the views of members of the public, employers and pension providers.[224] The paper makes clear that any options for reform must be cost neutral to avoid placing an unsustainable burden on future taxpayers. The aim is to deliver a simple, flat-rate contributory state pension that lifts the majority of future pensioners above the standard means-test. Two broad reform options are offered for discussion:

> Option 1 – Faster flat rating.
>
> The pace of existing reforms would be accelerated. State Second Pension would become flat-rate by 2020. All those with 30 qualifying years would build up the state pension, currently estimated at around £140, albeit through two tiers. This would keep the current basic state pension, and then add a state second pension at a flat weekly rate for every year of National Insurance contributions.
>
> Option 2 – One single tier state pension.
>
> All pensioners with at least 30 qualifying years would receive the same flat-rate pension (£140) with the payment being set above the basic level of support provided by Pension Credit.

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[222] Nest (2011)
www.nestpensions.org.uk. Accessed 22.02.11.
[223] Department for Work and Pension (2010) *Making automatic enrolment work – a review for the Department for Work and Pensions.* Executive Summary. op.cit. p.8.
[224] Department for Work and Pensions (2011) *A state pension for the 21st century.* April. Cm. 8053.

The government believes that the present system is too complex and uncertain, making it more difficult to plan for retirement. The high levels of means testing can deter people from saving. Women, the low-paid and the self-employed, all of whom tend to have lower state pensions, would benefit from a higher level of flat-rate pension. But not all workers will benefit. There is a possibility of increased National Insurance rates for the self-employed from the present 9 per cent to the 12 per cent paid by most of the dependently employed workers. Those workers on higher than average earnings continue to pay high rates of national insurance as a percentage of their earnings, but only receive the small flat top-up pension in return. Those who work for more than 30 years could continue to pay national insurance contributions for no further pension entitlement.

Nevertheless, whatever the future shape of the state pension, a safety net will continue to be needed to protect the poorest. Pension Credit will continue for those who lack sufficient resources for their basic needs in retirement. Existing pensioners and anyone who retires before these measures are implemented will receive their state pension under existing arrangements.

Since increases in longevity are ongoing, the Government must continue to consider the State Pension age and believes that an objective process is the best way of making these decisions. The Green Paper invites views on how to build into a new state pensions system a more automatic mechanism for ensuring that further revisions in life expectancy are taken into account in a way that is timely and transparent. Two options are put forward for discussion:

- Increasing the State Pension age through a legislated formula linked to life expectancy, or
- Increasing the State Pension age through a review at regular, predetermined intervals.[225]

While there is no clear timetable by which these changes will be implemented, the Government is firmly convinced that:

> "Automatic enrolment will only succeed if today's workers feel confident that it will be worth their while saving and if they understand how much they need to save to fund their aspirations for retirement". [226]

5.3. Conclusion

In respect of its stated objectives this study of the United Kingdom pension system has demonstrated that:

First, it took note that the Pensions Commission assessed current pension arrangements as not fit for purpose looking forward. State pension provision was found to be one of the least generous in the developed world, making heavy use of means–tested additions. It reported that the Commission regarded the spread of means-testing as undesirable, and recommended that Basic State Pension should be indexed to average earnings growth. It found that the Commission believed strongly that a relative decline in pension income would create hardship for the poorer pensioners, a situation that the electorate would find unacceptable. It held that government policy on pension provision had been based on the assumption that private provision would grow, which the Commission considered highly unlikely.

Second, it found that by 1979 final salary schemes, always the main form of provision in the public sector, had come to dominate the private sector also. When initially

[225] ibid. p.46
[226] ibid. executive summary, p.8.

introduced, the final salary schemes had appeared easily affordable, and over time the generosity of their pension promise was increased by regulatory intervention. It reported that falls in share prices and real interest rates in 2001 showed occupational pension funds to be huge burdens on their corporate sponsors. It discovered that companies in the main had moved their employees, wherever possible, into defined contribution schemes. It maintained that this decision would lead to a substantial reduction in the level of future pension benefits, since the level of contribution made to defined contribution schemes was lower. It also discovered that increased longevity had greatly increased the cost to government of operating an unfunded, inflation-proofed, final salary scheme in the civil service. It reported that from July, 2007 new entrants have been offered a choice of either a defined benefit scheme based on pensionable earnings throughout a career, or a defined contribution arrangement.

Third, it held that the decline of defined benefit schemes would lead to increasing numbers of retirement undersavers, defined as those who were likely to receive an income that did not provide for their reasonable expectations of a quality of life during retirement. It found that estimates of the number of retirement undersavers varied from 9.9 to 12 million. It examined the work of the behavioural economists, who had explored the various psychological impediments to saving, and found one insight of particular value. The same behavioural characteristics, procrastination and inertia, that induced people to postpone saving indefinitely could serve also to induce the majority of participants to remain in savings plans. Their advice was to presume that those employees who did nothing did wish to participate in a savings plan. The Commission recommended the use of automatic enrolment as a device to raise participation levels in a state-sponsored pension savings plan.

Four, the national pension savings scheme devised by the Commission was comprehensive and detailed. It received government approval. Research showed that most people favoured the device of automatic enrolment with the choice to opt out. It found a general consensus that future policy needs should be based on significant reforms to the state system and on a new approach to private pension saving. It noted that the Pensions Act 2007 and Pensions Act 2008 broadly implemented the Commission's recommendations: future BSP would be earnings –linked, reducing reliance on Pension Credit; all eligible workers between 22 years of age and SPA would have access to a national pension savings plan. It observed with regret that government had delayed the introduction of the pension savings plan. It contended that delays would lead to lower savings, and potentially a lower standard of living in retirement for many of today's workers.

Finally, the account of recent developments in pension provision demonstrated that the process of pension reform was ongoing as the United Kingdom system responds to changing socioeconomic circumstances. A welcome feature of the recent Green Paper was the proposal to introduce an automatic mechanism for ensuring the system reacts to increases in longevity in a predetermined manner.

5.4 An evaluation

This chapter has demonstrated that pensions have moved to the forefront of the policy agenda in Germany and the United Kingdom. Both countries are facing higher old age dependency ratios, with Germany facing the more severe challenge. The chapter has revealed the differing responses of their respective governments. This reflects the variance in the degree of demographic shift occurring and the type of pension system established in the country.

1) With its aim of providing earnings-related pensions in return for earnings-related contributions, the Bismarckian welfare regime in Germany is especially vulnerable to demographic shift. An increasing ratio of pensioners relative to workers results in ever rising levels of social security contributions. The generosity of the state PAYG promise becomes more difficult to deliver. Germany was forced to offer lower pensions relative to average earnings, and ones that commence at higher pensionable ages. The funded component should ease budgetary strain.

2) In contrast, the United Kingdom does not have the problem of an overly generous pension promise. The Pension Commission saw the future potential problem of its Beveridgean system as growing numbers of poor pensioners. Changed indexation and increased saving should reduce reliance on means-tested additional benefits.

3) Both pension reforms reflect the political cultures of their respective countries. Despite retrenchment, the German pension system will continue to provide a high degree of earnings-related benefit. It is unlikely that the British electorate would accept the taxation or contribution levels required to support this level of earnings-related benefit. In the United Kingdom neither wage indexation nor automatic enrolment will impose an excessive burden on the taxpayer. Both countries have accepted the principle of a proportionally rising state pension age, and have secured broad political consensus across the major parties in support of the reform plans. Organised labour has been in agreement.

By these reform initiatives public confidence in the long-tem viability of the state pension systems should be retained. It is submitted that the German and United

Kingdom pension reforms are sensible and appropriate responses to the specific political expectations of their respective electorates.

CHAPTER SIX: CONCLUDING OBSERVATIONS

This final chapter addresses issues that arise from the investigation undertaken into demographic change and pension provision. It also considers the impact of the current economic downturn. It concludes by addressing the issue of a long-term solution to the difficulties of providing old age support in ageing societies. The discussion is presented in four parts:

First, it considers the importance of maintaining public confidence in the long-term viability of a public pension system. It points to the necessity of securing and retaining political consensus. It explains how the incorporation of automatic stabilizing mechanisms will prevent the undermining of public confidence by reducing the number of sudden changes in pension policy. It stresses the need to provide all scheme contributors with regular information on future pension entitlement.

Two, it investigates and analyses the role of a funded component in a public pension scheme. It notes that countries have introduced a funded component into their existing pension systems in order to relieve pressure on PAYG financing. It questions whether there is a fundamental difference between unfunded and funded schemes. It ascertains that only the mechanism of wealth transfer differs. It acknowledges that empirical evidence is insufficient to support theoretical argument in this area. It finds that overseas investment can only partially counteract the adverse impact of demographic shift. It maintains that a funded component allows governments to emphasize the link between effort and reward.

Third, it discusses the impact of the current economic downturn. It maintains that social services are likely to suffer as governments cut back on expenditure, and that public pension provision will not be immune. It argues that governments should avoid structural changes in pension policy at a time of much uncertainty. It finds that defined benefit schemes are under stress, and that certain members of defined contribution plans are affected adversely. It discusses the measures taken by the ECB and the Member States to stabilise financial systems. It contends that the downturn has highlighted the disparity between a centralised monetary authority and the political independence of the Member States. Aware that fiscal union may be difficult to achieve, it advocates that Member States create fiscal regimes based on constitutionally-enshrined debt targets**.** It notes that the euro has emerged as a key international currency, and considers the probability of its long-term survival.

Four, an outline of the argument developed in the thesis and a summary of its findings is provided. It offers a long-term solution to demographic decline. It discusses government policy initiatives to increase the number of births in Europe.

6.1. Maintaining Public Confidence

The Pensions Commission considered that the present problems of the British public pension system reflected the impact of multiple short-term decisions made over the last several decades.[1] A pensions system of bewildering complexity has resulted, creating confusion and mistrust amongst the electorate. Government has realised that public confidence can only be restored by coherent and comprehensive policy reforms, which, it is hoped, will come to be generally regarded by the electorate as sustainable over the longer term. By broadly accepting the Commission's recommendations, and passing

[1] Pensions Commission (2004) *First Report*. op. cit. p.vi.

the Pensions Acts of 2007 and 2008, a legislative framework has been established, which should command continuing consensus across parties, and therefore should be sustained, across Parliaments of different political complexions.[2] Accordingly, the need for discretionary interventions by government in the pension system has been reduced significantly.

Notwithstanding these welcome changes in the British system, it is submitted that the formal mechanisms of benefit adjustment introduced by Sweden and Germany are likely to inspire a greater degree of confidence with their respective electorates. The incorporation of automatic stabilizing devices into the calculation of pension benefits makes the response of the Swedish and German systems to changing demographic and economic circumstances largely pre-determined. In Sweden the three factors that automatically adjust the level of pension benefit – the annuity devisor, the expected turnover duration, and the automatic balancing mechanism – produce a dynamic system capable of responding to change in a transparent manner. The announcement made in the recent Green Paper, *A state pension for the 21st century,*[3] that the British government has decided to incorporate an automatic mechanism for response to increased longevity into its state pension system is to be welcomed.

In Germany, as in Britain, frequent and unsystematic adjustments to public pensions in the recent past have undermined confidence in the future viability of the system. The Riester Reform that established a multi-pillar system of old age provision, and the implementation of the Rürup Commission's recommendations to raise retirement age and to change the benefit indexation formulas have placed the German public pension

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[2] ibid. p.xiii.

[3] Department for Work and Pensions (2011) *A state pension for the 21st century*. op.cit.p.46.

system on firmer foundations. The new factor in the indexation formula, the sustainability factor, will act as an automatic stabilizing device.

Automatic stabilizing devices help minimize the number of ad hoc measures, and so inspire confidence that the design of the reformed public pension system is sufficiently robust to cope with changing circumstances. Börsch –Supan puts forward a political reason. He suggests that such mechanisms allow society to first set rules for pension reform which a majority of the voters finds reasonable in the abstract, and later to apply these rules even if concrete changes would not find a majority.[4] It is essential that a country's public pension system is viewed by workers, especially younger workers, not just as a means of providing support for today's elderly, but as a credible source of future support for younger workers when they themselves reach retirement in the decades to come.

Confidence can also be boosted by informing those of working age of the projected level of their future pensions. Regular forecasts will serve to heighten a sense of involvement in the scheme. In Britain the Pension Commission has recommended that the Personal Accounts Delivery Authority should inform contributors of the capital value of their individual accounts at regular intervals, together with the projected amount of individual future pensions. In Germany pension insurance institutions must provide similar information on an annual basis. Contributors are also able to check their pension details online. Sweden goes further. Not only is the annual information about individual pensions despatched in a distinctive envelope (the orange envelope) so as to engage the recipient's attention, but an internet portal provides forecasts of individual

[4] Börsch-Supan, A. (2007) *Rational Pension Reform*, p.2. Sonderforschungsbereich 504 Working Paper Series No. 07-25. May. Mannheim Institute for the Economics of Aging (MEA), Universität Mannheim, and National Bureau of Economic Research (NBER), Cambridge, Mass., USA. www.mea.uni-mannheim.de/publications/meadp. Accessed 15.12 09.

pensions at four different ages of retirement. This makes the costs of early retirement and the benefits of later retirement clear, and may well serve to lessen resistance to later retirement. It is submitted that Sweden's wider measures to inform and educate contributors should serve as an exemplar for other Member States.

6.2. Funding

As social and economic change accelerates, pressure on state budgets could become unsustainable. Countries have implemented changes, such as increases in statutory retirement age, and reductions in replacement rate, so as to avoid further increasing the contribution burden borne by the diminishing proportion of workers. Among policymakers, there appears a general agreement that the limit on contribution levels has been reached. Indeed, some commentators believe that this limit has already been exceeded because the public pension schemes have lost credibility in respect of their ability to deliver in the future their promised level of benefit payments.[5] Disillusionment amongst younger workers is especially prevalent in Germany. In consequence, the younger generation may be unwilling to surrender a large portion of their income to finance existing schemes. And "with an unfunded scheme, pensioners, collectively, can never have larger pensions than the next generation of workers is prepared to give them",[6] policymakers are forced to consider the possibility that the younger generation, even if they do not entirely renege on their generation's contract, could still in the future severely reduce the generosity of the pension payment.[7] Poverty in old age might then re-emerge.

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[5] Siebert, H. (2002) 'Introduction: A European Perspective', in *Social Security Pension Reform in Europe*, op.cit. p.10.
[6] Blake, D. & J. M. Orszag (1998) *The Simple Economics of Funded and Unfunded Pension Systems*, p.6. Discussion Paper, 2 PI-9802. January. Pensions Institute, Cass Business School, City University, London. www.pensions-institute.org. Accessed 27.10.09.
[7] Siebert, H. (2002) Introduction: A European Perspective. op. cit. p.10.

Such fears have lead countries to introduce, or to consider introducing, a funded component into their existing pension systems, hoping that funded provision will relieve some of the pressure on PAYG financing. As a means of averting budgetary crises, funding seems prima facie an attractive policy option. But whether there is a fundamental difference between unfunded and funded schemes is questionable. It can be argued that all public pension schemes are PAYG. A pension fund is in reality a deferred PAYG scheme. Instead of using current contributions to finance pension benefits, a funded scheme pays for pensions using contributions collected up to about forty years previously. The purpose of both PAYG financing and funded schemes is the same – to obtain for pensioners goods and services produced by the next generation of workers. Unfunded or funded, each generation remains wholly dependent on the next generation. Only the mechanism of transfer differs. In an unfunded scheme it occurs via tax transfers. In a funded scheme transfer occurs via the market for capital assets and the rate of return earned on those assets. Funded schemes are not immune, therefore, from the consequences of demographic change. The precise type of stress will be determined by the transfer mechanism used. A tax-financed PAYG scheme can create fiscal tensions leading to budgetary imbalance. In theory, the capital market transfers of a funded scheme should influence asset prices and returns. Yet a funded scheme has some advantages over an unfunded scheme.

<u>At an individual level.</u>

An unfunded scheme on average cannot offer its participants a rate of return on their contributions greater than the rate of growth of the overall economy. In contrast, neo classical growth theory holds that in a well-run economy the average rate of return on productive assets will be greater than the growth rate of the economy. To achieve this higher rate, a funded system must be significantly invested in the equity market.

Although a higher rate of return will be delivered on average, market volatilities imply that on occasions some individuals may receive substantial returns, while at other times other individuals may fare considerably worse

From an aggregate perspective.

If extra savings are used to purchase existing assets, no increase in aggregate savings or investment will occur, since one individual's decision to save is offset by another individual's decision to dissave. If instead individual savings in a pension fund result in extra investment in productive assets, then aggregate savings and investment will increase. Additional resources will be available to support future pensioners. These extra resources will result in an increase in future national income generated either from greater domestic capital investment or from investment in other countries. It should be emphasised that for a scheme to be funded in any real sense, its assets must be invested in physical assets and/or in investments, such as company shares and bonds that give the holder a claim on physical assets. If increased savings are invested in government bonds that offer a yield equal to the rate of growth of the economy (a level of yield often found in developed economies), the funded scheme would be the precise economic equivalence of a PAYG scheme.

Even where individual pension funds are funded in a real sense this may only be an accurate description of the asset allocation strategy of a fund at the accumulation stage. At present in the UK annuitisation must take place by age 77. At the decumulation stage the need to ensure a steady flow of income to the saver in retirement means recourse to tax-financed government stock, as the following sequence reveals. At the point of annuitisation, the accumulated funds are used to purchase an annuity contract. The insurance company that acts as the annuity provider uses the government bond markets to protect itself against both interest and inflation risk during the life of the annuitant. The company tries to match its assets against liabilities: for example, riskless (government) fixed income bonds are used to provide the payment on level annuities, and index-linked are needed if index-linked annuities are to be serviced effectively.[8] Just as the recipient of a PAYG pension is the beneficiary of tax transfers, the annuitant is similarly dependant. This tax dependency can only be avoided by use of an income withdrawal plan, though this is a course of action usually only suitable for individuals with larger than average pension savings.

Although demographic change will cause both funded and unfunded schemes to be subject to stress, there are several types of demographic change, and the different types can have different implications. If the only demographic change were increased longevity with no fall in fertility, a proportionate increase in retirement age would be sufficient to keep a pension system stable. No increase in contributions and no reduction in the level of pension benefit would be required. In contrast, economic theory suggests that fertility at below replacement level will have far wider consequences. When the current generation of workers wishes to finance its retirement by selling its accumulated assets to a smaller next generation (which because it is smaller will have in total a smaller asset accumulation requirement), capital asset prices will tend to fall. A small next generation will cause the capital stock/labour supply ratio to increase, tending to reduce the rate of return on investment. As the labour force relative to the adult population falls, and the ratio of the elderly increases, consumers will adjust the intertemporal path of their consumption. Their marginal propensity to consume out of lifetime wealth will fall, and the ratio of savings to output will rise. Increased savings,

[8] Blake, D. (1999) Annuity Markets: Problems and Solutions, p.361. *Geneva Papers on Risk & Insurance*, 24(3), July.

falling asset prices and asset returns should be permanent features of an economy with a permanently falling population.

The empirical evidence to support this theoretical prognosis is insufficient. With only one period of fertility increase (the post-war baby boom) and one of fertility decline, there are not enough data points in the history of stock market capitalism to discern clear patterns.[9] The resultant limitations imposed on empirical analysis forces reliance on theoretical models. Most models tend to indicate small but non-trivial changes in underlying rates and somewhat larger changes in asset prices.[10] Two studies, one in the UK and the other in the US, show that interest rates might fall by about 0.5 per cent in the face of projected demographic change.[11] Axel Börsch-Supan's simulation for Europe predicts a fall of around one and a half percentage points in the real rate of return over the next thirty years.[12] Other models suggest a baby boom effect which first raises asset prices, and then later on that generation's retirement, causes a fall in asset prices. James Poterba regards the conclusions of theory as directionally robust, but acknowledges that much uncertainty remains as to the magnitude of demographic effects on asset returns and prices. [13]

Can the adverse impact of these demographic developments be avoided by investing overseas? Probably not by investing in other developed economies; since all developed economies are confronted with much the same ageing process, there are limited gains

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[9] Pensions Commission (2004) *The First Report* .op.cit. Appendix B. Macro-theory and Macro-modelling, p.31.
[10] ibid. p.30.
[11] Young, G. (2002) *The implication of an ageing population for the UK economy*, p.36. Bank of England Working Paper No. 159. July.
Yoo, P. (1994) *Age Distributions and Returns of Financial Assets*, p.10. Federal Reserve Bank of St. Louis. Working Paper 94-0026. February.
[12] Bean, C. R. (2004) *Overview*, p.450. Paper presented to Federal Reserve Bank of Kansas, Jackson Hole Economic Symposium. August.
[13] Poterba, J. (2004) *Population Ageing and Financial Markets,* p.183. Paper presented to Federal Reserve Bank of Kansas, Jackson Hole Economic Symposium. August.
[14] Turner, A. (2006) Pension Challenges in an Aging World, *Finance and Development,* 43(3). September. http://www.imf.org/external/pubs/ft/fandd/2006/09/turner.htm. Accessed 15.05.10.

from mutual investment. In the developing world, however, ageing is occurring with delay and in a differentiated manner. This has created expectations that investment in emerging markets may offer a way of circumventing, or at least of substantially easing, the problem of pension provision in the economically advanced countries. To the extent that capital is internationally mobile, population ageing will induce capital flow between countries, with the different timing of demographic change in different countries helping to smooth equity market adjustments. Furthermore, the export of capital stock to developing countries which have younger and expanding labour forces should accelerate their catch-up with the advanced economies.

A global order of mutually beneficial capital transfers might seem to be in prospect. It is not a likely reality in the medium term. Increasing longevity and falling fertility are spreading to all economically successful developing countries. United Nations projections show fertility rates below replacement level within 10 - 15 years in countries as diverse as Brazil and Turkey.[14] There has been a remarkable demographic shift in Iran. Between 1986 and 2000, the country's TFR plummeted from well over 6 to just over 2. The current TFR in Iran is under 1.9, which is lower than the United States.[15] Fertility rates are already well below replacement level throughout East Asia in China, South Korea, Hong Kong and Singapore. In China, the ratio of 20 – 64 year olds to those aged 65 plus was 8.8 at 2000 and is predicted to fall to 2.8 by 2050. Over the same period in South Korea the fall in the support ratio is expected to be even more precipitous – from 9.0 to 1.7.[16] The future similarity with the UK support ratio (projected fall from 3.7 at 2000 to 2.1 in 2050) is striking. In 2004 the only country in

[15] Eberstandt, N. (2004) *Four Surprises in Global Demography.* American Enterprise Institute for Public Policy Research.
http://www.aei.org/issue/21076. Accessed 25.08.09
[16] Pensions Commission (2004) *First Report* op.cit. Appendix B, p.33.

Europe with an estimated TFR above 2.0 was Albania;[17] latest estimates show a marked decline in that country's TFR to 1.48 (2011).[18] Adair Turner considers that wherever three conditions are satisfied: reasonable economic growth, high female literacy, and readily available family planning supplies, the fertility choices made by women in successful economies appear to be remarkably similar. Throughout the world, despite often wide cultural diversity, economic success is accompanied by a rapid decline in the birth rate.[19] As these economically successful countries experience the same demographic changes as the advanced economies, it is reasonable to anticipate that falls in asset prices and asset returns will be experienced throughout global markets. The savings rates of these countries will also increase. Countries that were previously capital importers will become capital exporters. The consequent glut of worldwide savings will tend to further reduce rates of return.

There are parts of the world that do not conform to the general trend. Some developing countries in Western Asia (Pakistan and Afghanistan), the Middle East and Africa still show fertility rates above replacement level, and this is likely to remain so until the second half of this century, with their labour forces continuing to expand rapidly.[20] Unfortunately, a significant number of countries in these areas are politically and economically unstable. Often their monetary policies for restraining inflation and their fiscal policies for establishing responsible state budgets are ineffective. Prudential supervision and regulation of financial institutions and markets may be lacking. Business contracts may be less secure. All these adverse factors tend to lessen their appeal as investment destinations.

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[17] Eberstandt, N. (2004) op.cit.
[18] Central Intelligence Agency (2011) The World Factbook: Albania. www.cia.gov. Accessed 29.04.11.
[19] Turner, A. (2004) *Commentary: The Impact of Population Aging on Financial Markets*, p.218. Paper presented to the Federal Reserve Bank of Kansas, Jackson Hole Economic Symposium. August.
[20] Pensions Commission (2004) *First Report*. op.cit. Appendix B, p.34.

The conclusion is inescapable. Global capital flows may help countries manage the impact of demographic change, but they are not a substitute for domestic reforms to pension systems. Since individual national governments will always tend to have only a very limited influence on global macroeconomic developments, the way forward for public pension provision lies in national policies targeted at macroeconomic mechanisms. Labour market reforms are key. The two countries discussed in the preceding chapter are both experiencing significant increase in their old age dependency ratio. This ratio is determined not only by the numbers and life expectancy of the elderly, but also by the definition of working age. To regard the definition of working age (15 – 64 years of age) as fixed assumes that no behavioural changes will occur. Such changes may occur. Governments are likely to encourage and promote longer working lives. Given the manifest unpopularity of mandatory increases in retirement age, governments will probably adopt the technique of persuasion in preference to compulsion. A feasible policy initiative is to make social security systems actuarially neutral so that workers who work for longer receive on retirement higher benefits based on their longer contribution records. In Sweden a person on average earnings will increase his yearly pension benefit by nearly 60 per cent if he postpones his retirement decision till 67 compared with leaving at age 61.[21]

Funding harmonises with this strategy. It has an added appeal to governments: it is a politically acceptable means of taking a greater proportion of workers' earnings to fund old age provision. By the introduction of personal retirement accounts, governments again emphasize the essential link between effort and reward. Governments should also

[21] European Union (2009) *2009 Ageing Report: Economic and budgetary projections*.op.cit.p.70.

explain that:

> "The compound interest effect makes it all the more important to begin building up provident savings as early in life as possible."[22]

Moreover, workers, who can decide when to retire, will react to the prospect of lower retirement income by delaying retirement, thereby increasing the number of years of working and earning. The provisions of the Stability and Growth Pact become highly relevant to potential retirees. As retirement approaches, they will wish to avoid the lottery element of equity market investment by holding a greater fraction of their portfolios in bonds rather than equities. Assuming that the majority of bonds will remain nominally-denominated, the constituency for keeping inflation low will be large. It is a matter of concern that if the present downturn leads to a period of significantly higher inflation, confidence in private pension saving could suffer lasting damage.

The favourable demographic conditions that allowed governments to provide expanded benefits without imposing a disproportionate burden on those of working age no longer exist. Faced with a demographic shift governments must now rise to the macroeconomic challenge of continuing the improvement in living standards achieved during the twentieth century into the twenty-first. It is submitted that the answer lies in allocating the increased burden of provision across various segments of the population in a manner perceived as equitable by the majority of the electorate. Fortunately, the "slow burn" of demographic change gives time for the necessary policy adjustments.

6.3. The Economic Downturn

These are challenging times for the global economy. The process of credit expansion that began after the end of World War II has stalled, causing an economic downturn that

[22] Bräuninger D. (2010) Fully-funded provision is vital. Deutsche Bank Research. 26 February. http://www.dbresearch.de. Accessed 26.04.11.

has reduced the revenue streams of governments.[23] Social services are likely to suffer as governments cut back on expenditure. Public pension provision will not be immune. Pay as you go pensions are just one of the many competing demands on the now reduced public funds. Indeed, the levels of contributions to schemes will fall as the numbers of unemployed continue to rise. Budgetary pressures may force governments to partially default on their pension promises by failing to index benefits. In the extreme case of Latvia, which experienced an economic contraction of about 20 percent in 2009, state pensions have been reduced by 10 percent.[24] Hopefully, this will remain an isolated event in Europe. Ad hoc measures of a temporary nature would seem an appropriate response to deal with the effects of the crisis. Public pension systems should be designed to function over the long-term; structural changes in pension policy should be avoided at a time of much uncertainty.

Occupational schemes are also under stress. Defined benefit schemes show increasing deficits. Few schemes are remain open to new members. Some schemes are not permitting further accruals by existing members. Although the required mark-to-market asset valuation greatly increases the value of disclosure, it may be counterproductive in the current crisis. Plan sponsors might be more willing to continue operating DB schemes if the rules permitted some degree of smoothing valuations when extreme short term price movements occur. Short term losses are not always an indicator of the overall performance of a fund.

The impact of the current situation on members of defined contribution plans depends on the age of members and their individual fund allocation. Younger members can take

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[23] Soros, G. (2009) *The Crash of 2008 and What it Means: The New Paradigm for Financial Markets,* p.158 .
[24] Deutsche Welle (2009) Latvia cuts pensions, salaries to avoid bankruptcy. 12 June. www.dw-world.de/dw/article/0,,4320882,00. Accessed 14.08.09.

a relaxed view of lower equity prices. It will be many years to their retirement. The categories of workers most affected are those with high equity exposure who have to retire in the present crisis. If possible, these workers should delay annuitisation. Purchase of an annuity at the present time will lock them into losses and preclude them from the opportunity to benefit from any recovery in prices.[25] Current market turbulence serves to emphasise the need for the adoption of a life styling investment strategy in the years leading to retirement.

In order to support recovery the ECB and the Member States have had to take strong measures to stabilise financial systems. Policymakers took a renewed interest in Keynesian economics. The mandate to combat inflation above all else was suspended. The ECB lowered interest rates explicitly to stem the downturn, and among the Member States deficit- financed stimulus plans were common. The high level of support given has led to a rapid deterioration of the progress achieved by governments towards balanced budgets and reduced public debt. The Commission believes that once the crisis is over the long–term growth prospects of the EU require all Member States to make every effort to facilitate a swift return to sound public finances.[26]

Levels of public debt in Southern Europe are especially high. The PIGS - Portugal, Italy, though this could also be Ireland, Greece and Spain - all boast public debt above or headed for 100 per cent of GDP. Though the PIGS acronym was apparently coined by British bankers, Britain has also been moving towards debt sustainability limits. Greece is only the worst example. The Greek public debt to GDP ratio is estimated as

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[25] World Bank (2009) *Averting a Human Crisis during the Global Downturn,* p.87.
[26] European Union (2010d) Communication from the Commission. Press Release: Commission assesses Stability Programme of Greece; makes recommendations to correct the excessive budget deficit, improve competitiveness through structural reforms and provide reliable statistics. IP/10/116, 3 February, Brussels. http://europa.eu/rapid/pressReleasesAction. Accessed 05.02.10.

at 2010 to be 140.2 per cent.[27] Moody's credit rating agency calculated that Greece needed to allocate 15.1 per cent of all its revenue just to service its debts in 2010.[28]

Markets have become nervous about Greece's capability to fulfil its commitments. On 27 April, 2011 Greek two-year yields were at 25.53 per cent in London; ten-year yields rose to 16.34 per cent. Portuguese 10-year yields had risen to 9.71 per cent, and in Ireland to 10.573 per cent.[29]

Fear of spreading debt crisis in the euro zone has caused the Commission to take emergency action. The European Commission has adopted a series of recommendations to ensure that the budget deficit of Greece is brought below 3 per cent of GDP by 2012, that the government timely implements a reform programme to restore the competitiveness of its economy and implements policies that take account of its long-term interest and the general interest of the euro area and of the European Union as a whole.

More specifically, the Commission adopted

- an opinion on the Greek Stability Programme for 2010- 2013,
- a Recommendation under Art 126(9) of the Treaty on the correction of the excessive deficit,
- a Recommendation under Art 121(4) of the Treaty on structural reforms.

The Commission also launched an infringement procedure to ensure the authorities comply with their duty to report reliable budgetary statistics. It is the first time that the budgetary and economic surveillance instruments foreseen in the Treaty are being used

[27] Economist (2011) Bite the Bullet.13 January. http://www.economist.com. Accessed 30.04.11.
[28] Yahoo News (2010) Greece in debt tug-of-war with EU. 15 February. http://news.yahoo.com/s/afp/20100215/bs_afp/financeeconomyeu. Accessed 17.02.10.
[29] Bloomberg (2011) Greek, Portuguese Yields, CDS Reach Records as El-Erian Sees 'Lost Decade'. http://www.bloomberg.com/news/2011-04-27. Accessed 30.04.11.

simultaneously and in an integrated way. The Commission has stated that it intends to monitor the execution of the budget and of the reforms very closely and regularly.[30]

The Greek crisis has brought into sharp focus a fundamental flaw in European monetary union – a mismatch between a centralised monetary authority and the political independence of its Member States. It was never envisaged that the enforcement of fiscal discipline in a currency union of sovereign states would be easy. The Maastricht criteria were designed to overcome this problem. Yet at present twenty of EU-27's nation states are in breach of the 3 per cent deficit ceiling.

It is difficult to co-ordinate diverse economies and compel them to operate under a "one-size fits all" monetary policy. Nevertheless, the euro area countries have shown substantial political willpower to get together, and it would be unwise to underestimate their willingness and their ability to succeed.

The euro area does not fulfil all the criteria for an optimal currency area (OCA), defined as a geographical zone where the benefits of a single currency outweigh the disadvantages. In consequence a single currency should maximize economic efficiency over the entire region. OCA theory claims that a single currency is more appropriate in an area with high factor mobility. Instead, the euro area is characterized by significant rigidities in labour and product markets, limited labour mobility, differing rates of productivity growth, and lack of a risk-sharing system such as an automatic fiscal transfer mechanism, which usually takes the form of taxation redistribution to less developed areas of a country/region. On the contrary, Article 125(TFEU), the no-bail-out clause, prevents Member States from providing financial

[30] European Union (2010) Communication from the Commission. Press Release: Commission assesses Stability Programme of Greece; makes recommendations to correct the excessive budget deficit, improve competitiveness through structural reforms and provide reliable statistics. IP/10/116, 03/02/2010, Brussels.

assistance to each other. These are all impediments to the overall economic efficiency of the single market that requires the adjustment of relative prices to economic shocks. Nevertheless, "eliminating currency risk within the greater European Economy is a remarkable benefit". [31]

The ECB's euro area-wide mandate demands that it must set rates for the euro area as a whole, but a one-size-fits-all monetary policy means that rates can never be perfectly tailored for any individual Member State. In practice, since German and French economic output together comprise almost half the aggregate GDP of the euro area, rates set tend to be about right for Germany and France, but not for all others. For Greece, Spain and especially Ireland, rates were too low for much of the 2000s. "After a decade or more of easy credit growth which led to housing and construction bubbles, the subsequent economic implosions in some Member States have left them with spiralling debt problems." [32] Controlling inflation in fast-growing economies, such as Greece and Spain, would have needed a far tighter monetary policy than in northern Europe. Yet the present economic difficulties in Greece and Spain cannot be attributed solely to low interest rates. Greece, for example, needs to implement a more effective system of tax collection, and Spain requires a more vigorous reform of its two-tier labour market.

Labour market reform is prerequisite to countries restoring their competitive advantage. By improving productivity (output for each hour of work) and restraining wage increases, Germany has made itself much more competitive than other euro area economies. The average labour cost of making something in Germany, a measure

[31] McKinnon, R. (May 2000) *Mendel, the Euro, and Optimum Currency Areas*, p.11. http://www-econ.stanford.edu/faculty/workp/swp00009.pdf. Accessed 4.10.11.

[32] European Union (2011) Opinion of the European Economic and Social Committee on 'The implications of the sovereign debt crisis for EU governance' (own-initiative opinion) (2011/C 51/03) para.2.6. Official Journal of the European Union. 17.2.2011.

called "unit labour costs",[33] has risen about 6% since the advent of the euro in 1999. In France, unit labour costs during the 2000s rose 25%; in Italy, 33%; in Ireland, 34%; in Spain, 36%, and in Greece, 41%. In consequence, Germany has become the export powerhouse of Europe.[34]

Monetary union could work more effectively if it was combined with a fiscal union, a mechanism for reallocating tax and spending that would harmonise the different economies. Yet proposals for fiscal co-ordination tend to meet with objections, as the following two examples illustrate. First, the suggestion of a common corporate tax rate is strongly resisted by Ireland, which views its 12.5 per cent corporate tax as the cornerstone of Irish industrial policy; whereas some of Ireland's fellow Member States, especially France, regard the low rate as enabling Ireland to compete unfairly in attracting international investment. Second, the European Parliament has voted for a tax on financial transactions, to be levied directly by Brussels. Popularly referred to as the Tobin Tax, a minimum tax rate on trading of bonds and shares would be set at 0.1% and 0.01% for derivative products and be levied on trades where at least one of the institutions is based in the EU. The UK has said that it will resist any attempts to introduce the tax on a non-global scale.[35]

The unanimity required to achieve fiscal harmonization seems elusive. Nevertheless, the present sovereign debt crisis requires an effective response. Since the crisis "has highlighted the inadequacies of the Stability and Growth Pact as a mechanism for

[33] Unit labour costs measure the average cost of labour per unit of output and are calculated as the ratio of total labour costs to real output.
[34] Wall Street Journal (2011) Euro Zone Confronts Limits of 'One-Size-Fits-All' Policies. 17 March. http://online.wsj.com. Accessed 10.10.11.
[35] Accountancy Age (2011) Tobin tax is likely, says banking chief. 5 October http://www.accountancyage.com/aa/news/2114583/tobin-tax-banking-chief. Accessed 6.10.11.

ensuring fiscal responsibility in Member States" [36], is there another means of strengthening the commitment of Member States to observe budgetary discipline?

Debt brake

It is submitted that one solution is to create fiscal regimes based on constitutionally-enshrined debt targets. National governments are then prevented from pursuing short term political advantage by relaxing fiscal discipline. Government policies in all Member States must remain consistent in the pursuit of the goals that they, or society, have set for them.

A debt brake is an expenditure rule which sets a limit on government expenditure both during boom and during recession periods. Switzerland introduced a debt brake in 2002. The debt brake is anchored in the Swiss constitution, and aims to prevent chronic deficits and thereby an increase in debt. Switzerland had realised that the dynamic growth in areas of social provision with strong statutory commitments, in particular social welfare due to the ageing population, meant that the long-term fiscal policy challenge would be to meet other requirements as well, such as developing and maintaining the transport infrastructure, so that financing state services for public and private budgets remained sustainable.

It has been a success story as regards fiscal policy. Swiss federal debt has declined by approximately CHF 20 billion since 2005. The rule permits budget deficits in a recession, but requires surpluses in better economic times so that over the cycle fiscal balance is achieved.[37]

[36] European Union (2011) Opinion of the European Economic and Social Committee on 'The implications of the sovereign debt crisis for EU governance' (own-initiative opinion) op.cit. para 1.1.
[37] Swiss Confederation (2011) The debt brake – a success story. Federal Department of Finance. http://www.efv.admin.ch. Accessed 13.10.11.

Because of its flexibility in allowing for surpluses and deficits, the Swiss debt brake rule evades one of the shortcomings of a typical balanced budget rule, which is that they are inherently pro-cyclical and often do not allow governments to respond to economic downturns.

International interest in this instrument has been immense in view of globally high national debt levels. The success of the Swiss model inspired Germany to enshrine a debt brake provision in its constitution. The provision introduces numerical targets directly in the Basic Law. Some flexibility to use automatic stabilizers is provided by the reference to the structural deficit (for predictable cyclical variations), and a control account (for unexpected deviations). An escape clause is also defined for natural catastrophes or other emergency situations.[38]

The French National Assembly has passed legislation on the "golden rule" (balancing the budget for non-investment expenditures only), requiring that the Parliament votes a “public finance balance framework act” (*loi-cadre d’équilibre des finances publiques*), whose target is to implement, over the medium term, the SGP. The intention is to endow these provisions with constitutional status.[39]

In the summer of 2011 French and German leaders asked that a golden rule be enshrined in the constitution of all euro area countries by mid-2012, to restore the markets' faith in the common currency. The view is that “only independently enforced,

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[38] Cepparulo A., and L. Giuriato (2011) *Debt brakes and expenditure rules for Italy: new perspectives after the Great Recession*, p.12. ECSPC Conference: “New Perspectives on Public Debt”, 26-28 September, 2011. Department of Law and Economics of Productive Activities, Faculty of Economics, Sapienza University of Rome.
http://w3.uniroma1.it/ecspc/Giuriato_Cepparulo_ECSPC2011.pdf . 30 September.
[39] ibid.

constitutionally-grounded, ex post balanced budget rules are likely to effectively constrain the deficit tendencies within democratic politics”.[40]

Spain is in the process of undertaking constitutional reform to limit structural deficits at central and regional government levels. The reform will force Spain to keep its structural deficit within limits established by the SGP, although it allows exceptions in case of natural disasters, a recession or emergencies. The debt brake provision is widely expected to receive legislative approval, and will be only the second change to the constitution since Spain became a democracy in 1978.[41]

In Italy the Berlusconi government announced that anchoring a debt brake in Italy's constitution was part of the country's most recent expenditure reduction plan. [42]

In respect of the monetary policy of the ECB and constitutional amendments in the Member States, further expansion of the discussion would exceed the bounds of this thesis.

Compliance with the Stability and Growth Pact will require fiscal consolidation. But the imposition of increased taxes and a reduction in public expenditure will tend to dampen economic activity, an unwelcome development in an economic downturn. It is also difficult to see how current high levels of unemployment can be lowered when budgetary restraint demands labour force reduction in the public sector. The current social and political unrest in Greece shows that a government that attempts to

[40] Poterba, J. M. (1996), “*Do budget rules work?”* p.29. NBER Working Paper, No. 5550.
[41] XE (2011) Spain’s Senate approves constitutional debt-brake. http://www.xe.com/news/2011-09-07%2014:18:00.0/2141225.htm. Accessed 28.09.11.
[42] Spiegel Online (2011) The Great Debt-Brake Swindle. 18 August. http://www.spiegel.de/international/europe/0,1518,781069,00.html. Accessed 30.09.11.

implement necessary austerity measures can face political backlash. It is submitted that throughout Europe the need of governments to run balanced budgets and reduce levels of public debt may well result in a period of subdued economic activity. For many countries fiscal consolidation may also result in a period of political turbulence. Two other Member States in the euro area, Ireland and Portugal, followed Greece in requiring bailouts. The possibility of contagion is causing unease. The IMF considers that:

> "financial spillovers from sovereign debt problems remain a tangible risk. Banks in the core countries of advanced Europe carry substantial exposure to the euro area periphery on their books, and a shock to confidence could spread quickly throughout Europe".[43]

Euro

The euro has emerged as a key international currency, second only to the US dollar. It is also the second most actively traded currency in foreign exchange markets, acting as counterpart in around 40% of the daily transactions.[44] With economic and financial integration, the trade volume within the euro area countries has surpassed 1 trillion euro a year, showing the huge development potential of the single market. Member States have benefited significantly in the absence of foreign exchange rate fluctuations and large reductions in transaction costs.[45] For the past 12 years, the average annual rate of inflation has been 1.97 per cent, which compares favourably with the UK, where annual inflation is now running at 4.4 per cent (22.03.11). As a result, millions of the citizens

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[43] IMF (2011) *Outlook for Europe: Strengthening the Recovery for Europe*. IMF Survey Magazine. 12 May. http://www.imf.org/external/pubs/ft/survey/so/2011/CAR051111B.htm. Accessed 13.05.11.

[44] European Union (2011f) Communication from the Commission. Economic and Financial Affairs: International Economic Issues. http://ec.europa.eu/economy_finance/euro/world/index_en.htm. Accessed 24.09.11.

[45] China Daily (2011) Xiao Gang: Save euro, save globalization. February 11. http://www2.chinadaily.com.cn/thinktank/2011-02/11/content_11981128.htm. Accessed 24.09.11. Though not the Central Bank, Bank of China Limited is one of the big four state-owned commercial banks of the People's Republic of China. These views of its chairman can be assumed to be representative of those held by central government.

of euro area countries have seen their purchasing power and the value of their savings preserved.

It is not surprising that despite present difficulties in certain peripheral euro area Member States, the level of European and international support for the continuance of the euro is enormous. French President Nicholas Sarkozy illustrates the strength of European commitment:

> "The consequences of the euro failing would be so cataclysmic, we can't even imagine them, we can't even play with this idea."[46]

China, whose export-driven growth has been made possible by access to open markets, offers unequivocal support. Xiao Gang, Chairman of the Bank of China believes that:

> "To some extent, saving the euro is akin to saving globalization. The creation of the euro can be seen as one of globalization's greatest achievements over the past decades".[47]

And US Treasury Secretary Timothy Geithner viewed the survival of the euro as the pan-European currency as "absolutely" in the US interest, when asked on Bloomberg TV.[48]

It is submitted that given this degree of political support the survival of the euro is assured. Indeed as George Soros warns:

> "There is simply no alternative. If the euro were to break up, it would cause a banking crisis that would be totally outside the control of the financial authorities."[49]

But what is not so certain at the time of writing (17.10.11) is the future configuration of the euro area. In the midst of "the most serious financial crisis we've seen at least since

[46] CNN (2011) Sarkozy: We will never abandon the euro. 27 January. http://edition.cnn.com/2011/BUSINESS/01/27/switzerland.davos.sarkozy.euro/index.html. Accessed 24.09.11

[47] China Daily (2011) Xiao Gang. op.cit.

[48] Financial Express (2011) Euro's survival in U.S. interest: Geithner. 10 September http://www.financialexpress.com/news/Euro----s-survival-in-US-interest--Geithner/844336/. Accessed 24.09.11.

[49] Spiegel Online International (2011) Interview with George Soros: 'You Need This Dirty Word, Euro Bonds'. 15 August. http://www.spiegel.de/international/europe/0,1518,780189,00.html. Accessed 24.09.11.

the 1930s, if not ever,"[50] speculation on possible final outcomes is beyond the scope of this thesis.

6.4. In conclusion: The Long-Term Solution

This thesis set out to examine the difficulties that will be encountered by the Member States of the European Union as they strive to maintain a high level of old age provision in the ageing societies of Europe. The thesis explored the relationship of price stability, demographic change and welfare provision, and reasoned that they formed interdependent elements of an economic order. Given these interconnections, the thesis argued that an imbalance in one element, namely, the age structure of a society, will impact adversely on the overall functioning of the system.

The argument was developed in the following manner:

First, the interplay of ideas and events that led to the maintenance of price stability becoming the foundation stone of European monetary policy was explained.

Second, sound monetary policy helps to create a favourable economic environment, which in turn secures one of the broad objectives of the Community laid down in Article 3 of the Treaty– the promotion of social justice and protection. The discussion of the various methods of welfare delivery in Europe revealed a common concern among the Member States: the increasing cost of provision caused by rapid population ageing threatened the long-term sustainability of these welfare systems.

Third, the nature of this demographic shift within Europe was analysed, with consideration given to the impact of inward migration. Demographic shift was forcing governments to accept that many current pension schemes will not be fiscally sustainable. Legislative reform of public pensions had become imperative.

[50] MyFinances.Co.UK (2011) Mervyn King: Financial crisis the 'worst ever'. www.myfinances.co.uk/cut-your-bills/2011/10/07/mervyn-king-financial-crisis-the-worst-ever. Accessed 7 October.

Four, an examination of the nature and purpose of pensions was made. Each reform measure was found to be of limited efficacy. While the main features of a well-designed public pension system were known, as were the hazards to avoid, the study revealed that governments implemented changes cautiously in the realisation that legislative reform might lead to electoral defeat.

Five, accounts and critical evaluations of the public pension systems of Germany and the United Kingdom were presented. The case studies demonstrated that pension system reform is a particularly difficult and awkward political undertaking, and that the reform process is often protracted.

The investigation found that:

First, many Member States experience the lowest fertility rates in the world, while enjoying the highest life expectancies in the world. Eurostat projects these increases in longevity to continue, though at a decelerating pace (Ch.3.2). The inevitable consequence will be a shrinking number of younger people, supporting an increasing number of elderly people.

Second, data provided by the UN report *Replacement Migration* revealed that the high numbers of migrants required to correct the demographic deficit would be beyond Europe's integration capacity. The investigation concluded that replacement migration can help alleviate the shortage of younger workers; it cannot provide a solution. (Ch.3.2.1).

Third, anticipated higher employment rates of women and older workers will only temporarily cushion the economic effects of ageing. The 2009 Ageing Report projects that both the size of the working age population and the numbers employed will start on a downward trend to commence in 2020 (Ch.3.4.2).

Four, in the area of public pension provision, reform strategies aimed at expenditure reduction often encounter difficulties. Some factors, such as reduced generosity of pensions relative to wages and higher retirement ages, are expected to mitigate the projected increase in public pension expenditure. In the thesis the examination of reform strategies made clear that cost savings generated by parametric modifications were limited. In order to highlight the challenges faced by governments, it is useful to summarise the results of the consideration of cost reduction measures, together with the role of funding and contribution levels.

Replacement rate

If we accept that the primary purpose of state pension provision is that no person should be allowed to fall into extreme poverty in old age, then it follows that there is an income replacement level below which pension benefit must not fall. It is submitted that the World Bank's suggested target of net-of-tax income replacement of about 40 per cent of average full-time worker's wage is that minimum level (Ch.4.1.4). Otherwise, as Schmähl comments in respect of overall social assistance in Germany, pension benefit "could no longer be an instrument that fulfils it objective, namely to avoid (income) poverty" (Ch.5.1.11). Similarly, the Pensions Commission found that a relative decline in UK pension benefit would create hardship for poorer pensioners, a situation that was not acceptable to the electorate (Ch.5.2.4)

Retirement Age

The United Nations report, "*Replacement Migration: Is It a Solution to Declining and Aging Populations*," calculated that, in the absence of migration, the upper limit of the working age would need to be raised to about 76 years in order to obtain in 2050 the same potential support ratio observed in 1995 in EU15, which was 4.3 persons of working age per older person (Ch.3.2.1). A similar calculation in respect of the United Kingdom indicated a retirement age of about 72 years.[51] Yet will it be feasible to attempt to extend working life to such ages? Admittedly, inward migration will allow some reduction of the extension of working life. It is submitted that there is much merit in the Pensions Commission's suggestion that the ratio of working years to retirement years should be 2:1; that is, if life expectancy rises 3 years, then state pension age should increase by 2 years (Ch.5.2.4). A government proposing a steeper rate of increase might meet with strong resistance from the electorate. Indeed, the number of older persons claiming invalidity benefits could be anticipated to rise, offsetting much of the savings made by increasing the retirement age.

Nor can funding, the major systemic reform, offer a full respite from the demands of over-burdened Pay As You Go schemes.

A funded component

Theoretical misgivings discussed in Section 6.2 prevent funding from being perceived as a panacea. Funding is now regarded as an element of old age provision that has certain advantages, such as establishing a firm link between contributions and future benefits. But funded provision also creates new challenges and risks for both

[51] United Nations (2001) *Replacement Migration*. op.cit. Chapter 4 – Results. A – Overview.

contributors and governments. Regulation of pension funds and careful surveillance of their performance in securing adequate retirement income become continuing tasks.

In addition, it appears that governments will find workers reluctant to part with a higher proportion of their earnings in support of state pension schemes (Ch.5.1.11 and 6.2).

Contribution Levels

The World Bank considers a mandated contribution rate of over 20 per cent of wages puts too great a restriction on individual life-style choices, and leads to higher levels of evasion (Ch.4.1.4). The Riester Reform in Germany stabilized contribution rates at below 20 per cent until 2020 and below 22 per cent until 2030, since it was believed that any further significant increase in the contribution rate would have a negative impact on economic activity (Ch.5.1.4).

Is there an answer? As stated in Chapter Three in the section: the mechanics of population change, three fundamental factors can be identified as the causes of population change: births, deaths, and migrants (Ch.3.1.2). Since it has been established that longevity will probably continue to increase and migration will have limited impact, then the only remaining variable is that of births. In fact, as it has been argued (Ch.3.6), if demographic imbalance is the root cause of the fiscal pressures placed on governments, who wish to maintain high levels of old age provision, the answer must lie in the rectification of that imbalance. And this leads to the question: can government policy initiatives increase the number of births in Europe?

Policymakers now regard the low fertility rates of many Member States with concern. Previously, an awareness of former abuses by fascist and other authoritarian regimes had tended to stifle discussion of governmental interventions to influence family size. A common attitude was that "the unique sanctity of private life pre-empts policies that can increase fertility".[52] The prospect of a declining population has caused a change in attitude, and the low birth rate is now seen as "a challenge for the public authorities".[53]

In March, 2005 the European Commission launched an open debate on demographic change with the Green Paper, *Confronting Demographic Change; a New Solidarity between Generations*. The Green Paper notes that surveys have revealed the gap which exists between the numbers of children Europeans would like (2.3) and the numbers that they actually have (1.5). It considers that the low fertility rate is the result of obstacles to private choice: late access to employment, job instability, expensive housing, and a lack of incentives (family benefits, parental leave, child care, equal pay). If appropriate mechanisms were put in place, couples would be able to achieve their desired family size. Public policies should strive to create an environment which families find conducive to child-rearing.[54]

The Commission presented its conclusions in a 2006 communication, *'the Demographic Future of Europe – From Challenge to Opportunity'*.[55] The Communication argues that the prevention of demographic decline is a realistic objective, because international comparisons underline the effectiveness of family and other policies consistently implemented by some countries over several decades. The evidence from France and the Nordic countries suggests that it should be possible to maintain a reasonably high

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[52] Hoem, J.M. (2008) The impact of public policies on European fertility, p.250. *Demographic Research*, 19.
[53] European Union (2005b) Green Paper *'Confronting Demographic Change; a new solidarity between the generations'*, p.5. Com(2005) 94 final .16 March, Brussels.
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2006:0571:FIN:EN:PDF. Accessed 05.08.09.
[54] ibid. p.7
[55] European Union (2006c) *The demographic future of Europe – from challenge to opportunity*. Com (2006) 571 final. 12 October, Brussels.
http://europa.eu/legislation_summaries/employment_and_social_policy/situation_in_europe/c10160_en.htm. Accessed 05.08.09

TFR by the co-ordinated use of public policies. France and the Nordic countries currently have TFRs of around 1.8 – 2, compared with TFRs of around 1.2 – 1.5 in Eastern and Central Europe and in Mediterranean countries. The communication voices the fear that solidarity between generations could be jeopardised if the burden of ageing has to be carried by a younger population decreasing in numbers and economic strength.[56] Yet does the demographic shift imperil solidarity?

The Flash Eurobarometer *Intergenerational solidarity* (Flash No 269) was conducted in order to examine EU citizens' opinions about relations between the younger and older generations. Over 27,000 citizens were interviewed in the 27 Member States. The findings were on the whole positive. In reaction to the statement - 'older people are a burden on society'**-** at least two-thirds of interviewees in each Member State *somewhat* or *strongly* disagreed.[57] Roughly half of EU citizens disagreed that 'because there will be a higher number of older voters, decision-makers will pay less attention to young people's needs'**.** Slightly more than 6 in 10 EU citizens also thought that 'the media exaggerates the risk of a conflict between generations'.[58]

Certain responses indicate an awareness of the need to reform pension systems. Roughly half agreed that **'**people in employment will be increasingly reluctant to pay taxes and social contributions to support older people', and also agreed that 'older people accept the need for major pension reforms to ease the financial burden on working-age people'.[59]

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[56] ibid. p.8.
[57] European Union (2009e) Communication from the Commission. The Flash Eurobarometer: *Intergenerational solidarity* (Flash No 269), p.5. April. http://ec.europa.eu/public_opinion/index_en.htm. Accessed 12.05.11.
[58] ibid. p.6.
[59] ibid. p.8.

The European Parliament adopted a Resolution on the demographic future of Europe on 21 February, 2008.[60] The Resolution notes with concern the demographic projection of population decline, but stresses that the projections are not irreversible; rather they are serious warnings to which society must respond.[61] The Resolution accepts the views expressed in the Green Paper and the Communication, and calls on Member States to introduce policies that counteract the obstacles confronting families today. It acknowledges that a society that places children at the centre of its policies is the precondition for a healthier birth rate. It insists on the need to create a family-friendly environment and to improve living conditions for families and children.[62]. Accordingly, the resolution calls on Member States to seek to provide a high standard of childcare at affordable prices, as laid down in the objectives of the Barcelona European Council of March 2002. The Barcelona Council called upon Member States to provide childcare by 2010 for at least 90 per cent of children from age three to the start of compulsory schooling and for at least 33 per cent of children under three. These measures must be such as to enable parents to adjust their working patterns according to their way of life.[63] It is submitted that there is much merit in the assertion: "Look after women's interests, it may be said, and the population will look after itself".[64]

Among the plethora of statistics in this area, one is offered as particularly pertinent. In 2007 the number of people in the UK over the age of 65 exceeded the number of people below 16 for the first time. The world is on course to match this trend by around

[60] European Parliament (2008) Resolution of 21 February 2008 on the demographic future of Europe. (2007/2156(INI)). Brussels.
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:184E:0075:0087:EN:PDF. Accessed 05.08.09.
[61] ibid. General Considerations Para 1.
[62] ibid. General Considerations Para.3.
[63] ibid. General Considerations Para.10.
[64] Coleman, D. (2001) Population Ageing: An Unavoidable Future, p.11. *Journal of Social Biology and Human Affairs*, 66.

2080.[65] There has been a surprising demographic development in the UK. The Total Fertility Rate (TFR) in the UK reached 1.96 children per woman in 2008, the highest level since 1973. The UK TFR has increased each year since 2001, when it hit a record low of 1.63.[66] The Office of National Statistics considers that the rising trend is partly due to rising fertility among UK born women and partly because there are more women of childbearing ages due to inflows of female migrants to the UK.[67]

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[65] HSBC Insurance (2009) *The Future of Retirement. It's time to prepare*, p.10. HSBC, London.
[66] Office of National Statistics (2010a) Fertility. Rise in UK fertility continues. http://www.statistics.gov.uk/cci/nugget.asp?ID=951. Accessed 12.06.10.
[67] Office of National Statistics (2010b) Population Change. UK population increases by 408,000. http://www.statistics.gov.uk/cci/nugget.asp?ID=950. Accessed 12.06.10.

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— (2011b) HIV and AIDS in Africa. Avert Charity. http://www.avert.org/hiv-aids-africa.htm. Accessed 20.04.11.

Bank for International Settlements (1986) *Recent Innovations in International Banking.* Summary of Study Group Report, April. Basel.
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