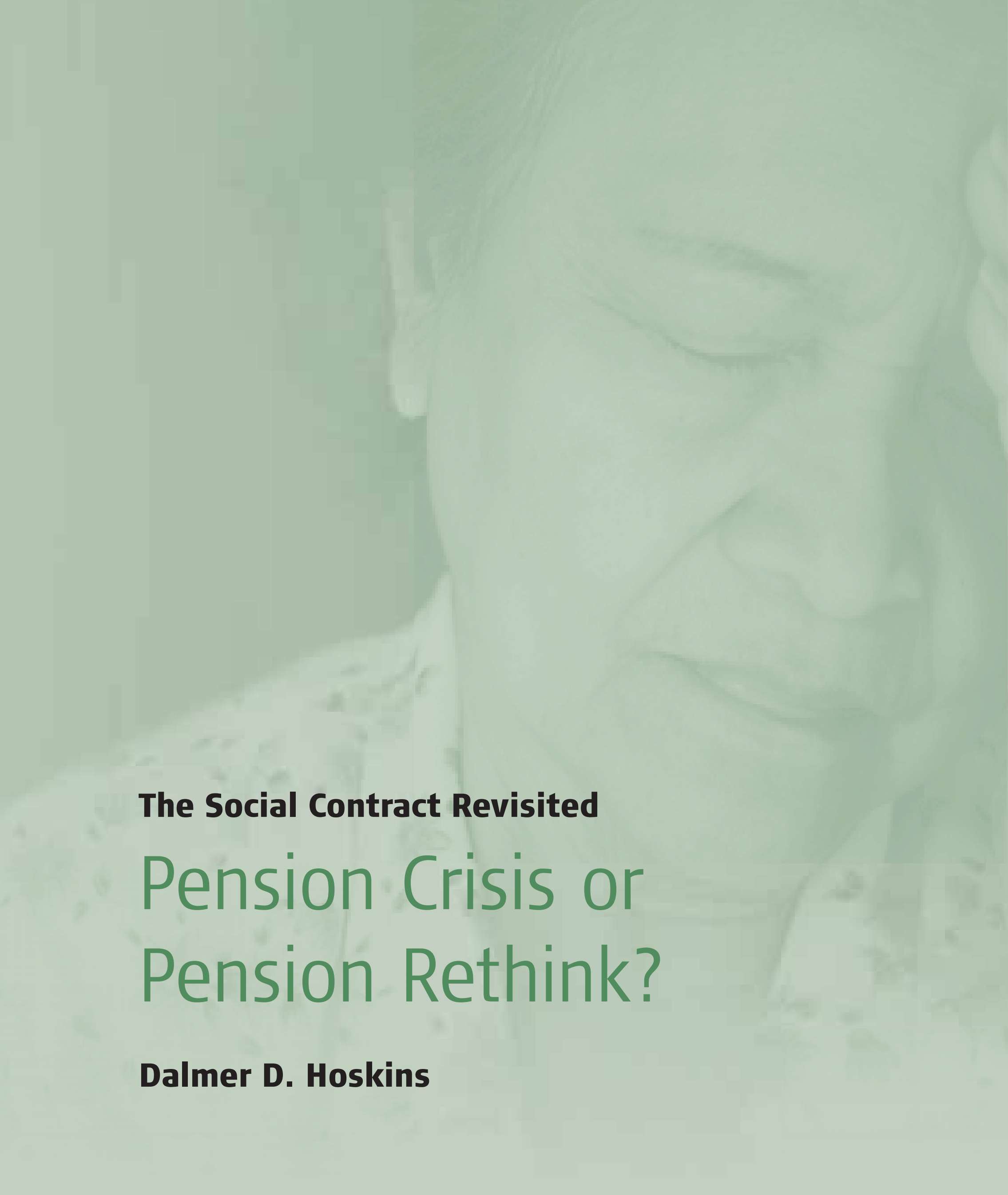

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The Social Contract Revisited

Pension Crisis or Pension Rethink?

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Executive Summary

- There exists a widespread conviction that pension protection, along with many other social benefits, is slowly being eroded as responsibility for insurance and the associated costs are shifted from government and employers to individual citizens and their family members. But was there really a 'golden age' of pension protection? If so, what are the causes that undermined these guarantees, and what are the policy parameters and defining characteristics that have shaped pension policies during the last couple of decades?

- In spite of the considerable heat and light surrounding debates about the future of public pensions, the schemes have proved to be amazingly durable. Few countries have undertaken revolutionary reforms of their national systems. Very few countries have 'privatized' their old-age pension obligations. In fact, the elderly tend to fare better in maintaining their standards of living than other categories of the population, particularly low-income workers with children.

- Negative indicators are, however, to be seen almost everywhere as employers freeze or terminate their defined benefit pension schemes. Employees themselves claim to prefer defined contribution plans; although there is much evidence that they do a generally poor job of managing their pension assets and that many cannot or will not save enough to ensure an adequate income stream in the future. Furthermore, provision for the increasing cost of health care has already begun to erode the funds available to improve pension benefits for the elderly most in need.

- Income security and pension policies do not operate in a policy vacuum and the pension reform debate must be placed within the overall context of the search for a new social consensus. What will be expected from employers in the future beyond paying a decent compensation for work and providing a healthy, accident-free workplace? Survey results in the United States reveal surprisingly low expectations that government will be the principal guarantor of pension benefits. What will be the future roles of the principal players: individuals, employers, and the government?

- Current public discussion seems to be characterized by 'the sky is falling' rhetoric, rather than proposals articulating the outlines of a new social contract. It is clear that it is not simply a matter of passing new laws. Political leadership and consensus building around how much is to be provided to older citizens and how it will be financed must advance to meet the demands of a new social contract.

Pension Crisis or Pension Rethink?

It has become a universally repeated mantra in the Organisation for Economic Co-operation and Development (OECD) countries that the national pension systems are experiencing a crisis of underfunding and are on the verge of bankruptcy. And yet, the monthly cheques continue to be paid, significant percentages of new beneficiaries leave the workforce each year before the legally defined 'normal' age of retirement, and the sixty-five and over population has generally done better than many other categories of the population in terms of maintaining their living standards.

The constant decrying of the unsustainability of public pension systems is particularly striking when one takes into the consideration the fact that the financial solutions necessary to achieve sustainability are not nearly as intractable as, for example, dealing with health care reform or the reform of local, regional, and national tax systems. While they acknowledge the unpalatable political choices involved in most pension reform efforts, the pension experts and policymakers are generally rather optimistic that the systems can be financed; that we can indeed afford to grow old. This optimism is, however, not reflected in the public rhetoric nor in many of the public opinion surveys in the OECD countries which reveal that older citizens fear that their children and grandchildren will be less well off than they are in their retirement years.

Clearly the pension debate needs to be placed within the broader context of the debate about the deteriorating social contract, to assess the shifting of greater responsibility for providing for old age (and other contingencies such as illness, disability, and unemployment) from the employer or the state to the individual. Does national experience with pension reform, which has taken place in almost all of the OECD countries and many other countries with national old-age income security systems during the past ten to fifteen years, offer some insight into the search for a new social consensus?

The parameters of pension reform

When discussing pension reform, it is useful to keep in mind certain defining characteristics of pension policy that heavily influence the decision-making.

The long-term nature of pension policies

National pension policies by nature stretch over generations of contributors and beneficiaries, and (unlike health insurance, unemployment insurance, disability insurance, and other forms of social insurance) rarely introduce immediate and dramatic changes. They represent contractual arrangements between the social partners that extend over decades. Seemingly small adjustments can be made to the entitlement conditions or the benefit formulas which nevertheless have a profound impact on the level of income security that is delivered in the long term. On the other hand, the long-term nature of pension commitments also makes it possible to make corrections and to introduce gradual change without fundamentally revamping the entire system. This long-term nature of pension commitments may also lead to a certain complacency and lack of transparency on the part of the policymakers when it comes to taking unpopular decisions regarding pension benefits. A few 'technical corrections' by means of decrees or regulations may sometimes appear preferable to reaching a consensus through the legislative process.

Historical inertia in pension reform

Much research has focused on the reasons for the very different pension policies adopted through history by countries in similar geographic and economic situations. The diversity in national pension policies represents a particular challenge to the European Union, where important differences in approach, levels of protection, and future financial sustainability are apparent, in spite of convergent theories and the fears about a 'race to the bottom' among member states.

The systems that are in place today in most of the OECD countries are deeply rooted in programmes that can be traced back to the immediate post-war period or even to the latter half of the nineteenth century. Few countries (some would argue that Italy and Sweden may be the exceptions) have undertaken pension 'revolutions'. The privatization of public pension programmes, which was both promoted and feared in different quarters, has not occurred in the OECD countries. Not only is it apparently politically difficult to pull off a 'paradigm shift' in the pension system, but there are also strong fiscal and financial obstacles to assuming the commitments made to current beneficiaries while simultaneously introducing a fundamentally different system for future beneficiaries.

Public and private pension conglomeration

Although we often speak of national pension policies, most countries have a conglomeration of pension schemes, both public and private, which result in very uneven levels of income security for different categories of the population. This fact is particularly relevant when discussing any new social contract with regard to income security, since we may in fact have a romanticized view of the so-called 'golden age' of pension protection. This 'golden age' is often placed sometime around the mid-twentieth century when union membership was at an all-time high; when most workers in large enterprises were covered by defined-benefit (DB) employer-sponsored plans; and when there was an expectation of working a considerable number of years, if not an entire career, for a single employer.

The question, of course, is whether there was ever a 'golden age' for pension protection. Researchers at the Employees Benefits Research Institute (EBRI) in the United States estimate that workers participating in a DB plan who had a vested right to a pension benefit may never have exceeded about 20 per cent of the labour force. In the Anglo-Saxon countries (notably Canada, the UK, and the US), which have eschewed mandating employer provision of retirement benefits, participation in a retirement plan has tended to hover around 50 per cent of the workforce.

Typically, plan participation has been concentrated in larger employers and in the public sector. And, even in countries such as France, which has a long tradition of mandatory second-pillar pension protection, the level of protection varies significantly across occupational categories and according to the size of the enterprise.

Confused objectives for pension programmes

Any debate about national pension policies is also vexed by the lack of clear objectives as to what the pension system should deliver. While there may be a general consensus that the public pension programme should prevent older people from falling into poverty, there is seemingly little agreement as to how much should be promised to future generations of retirees and from where the guaranteed income stream should be derived: public pensions, employer-sponsored plans, or individual savings.

Traditionally, the US social security policy was that the public social security system should deliver about one-third of the retirement income, the employer plan another third and that the remaining amount would be derived from individual savings and investment. This unofficial consensus has clearly broken down under the uncertainty of how much income will be derived from employer-sponsored plans, how much will future health care costs eat into individual retirement income, and how much can be counted on from individual efforts when the national savings rate has plummeted to an historic all-time low.

A similar lack of clarity about income maintenance goals has also affected other countries as health care costs have risen faster than pension costs and as the lack of any national consensus regarding long-term dependency care casts doubt on what level of resources people will need, particularly at advanced ages. A telling illustration of this lack of clarity regarding target levels for retirement income is the near-total irrelevance of the old international standards. The International Labor Organization in its standard-setting instruments relating to social security used to recommend to member states that public programmes should ensure a retiree with roughly 60 per cent of pre-retirement income. While not abandoned, the 60 per cent goal no longer seems feasible or relevant as a goal for most public income security programmes.

Co-optation of social security policy

An additional parameter to be taken into account when debating the future of pension policies is that pension programmes have never operated in an independent and autonomous policy context, regardless of the political system. Pension programmes have almost always been used for a number of other purposes, sometimes only tenuously related to income security objectives. Many public pension schemes were legislated initially in the hope that paying a benefit would help keep older workers out of the labour market and free up more employment prospects for younger workers.

Public policy memory seems notoriously short in this regard since early retirement options introduced in the 1950s and subsequently abandoned as being too expensive and ineffective were tried once again by several European countries in the 1990s, with more or less the same ambiguous results. In many countries the social security reserves have come to be the single most important source of capital investment and the revenue cushion on which the national government relies to deliver all of its other commitments. The greatest fear of Treasury officials in these countries is that the social security contributions would actually have to be spent as originally intended; that is, to pay benefits. Public pension systems often incorporate quite inconsistent and even contradictory objectives as the result of ad hoc solutions and the gradual evolution of systems over time, including incentives to remain in the labour force, to retire early, to get married and to stay married, to acquire individual pension rights, and to be credited for periods spent studying, unemployed, or caring for family members.

What drives the search for a new consensus about pensions?

While there may be few examples of pension 'revolutions', almost all of the OECD countries and the economies in transition are actively working on public pension reform. The driving forces vary according to the country but most are faced with a common set of challenges.

Demographic ageing of the population

While most retirees expected to be in receipt of a pension cheque for ten years or so after withdrawing from the labour force, this period has steadily lengthened to well over twenty-two years in most of the OECD countries. The pressures exerted on the system by this increasingly aged population are exacerbated by the maturing of many national social security systems. Furthermore, nowadays, the majority of workers cease working full-time well before the official statutory retirement age of sixty-five to sixty-seven; commonly, the 'normal' retirement age is sixty in many countries. This increase in the level of early retirement is extremely expensive to the social security system. As actuaries are always quick to point out, extending the working life by one to two years would go a long way to solving the future solvency problems of most public pension systems: a simple calculation but a more difficult solution to legislate.

Changing expectations about the burden of risk sharing

The principal concern in many of the developed countries of the world is how to keep employers involved in providing pension protection for their employees in the future. The trend worldwide is for employers to freeze, terminate, or reduce their obligations to provide defined benefit pensions for their employees. The reasons behind this trend are well known but difficult to assess: volatility of investment returns, international competition, the decline in unionization, shorter work histories with individual employers, and so on. Moreover, an increasing number of employers no longer feel obligated to provide pension plans, nor do they feel that offering such benefits is key to attracting and retaining the qualified workers they need to ensure their success in the marketplace.

A recent survey to be published in 2008 conducted by AARP among larger employers in the United States revealed that pensions rank fairly low in their list of priorities for employees, well after their commitment to provide adequate compensation, heath insurance benefits, annual leave, and on-the-job training. The United States may be a unique case among the advanced industrialized countries of the world in that most American workers count on their employer for health insurance protection. While over three-quarters of American workers continue to be covered for health benefits through their employment, the percentage is slowly diminishing, particularly among small employers, accounting for many of the estimated 45 million Americans without any health insurance coverage.

Among the other significant findings of the AARP survey was that neither employers nor worker representatives had much expectation that the government would step in to fill the need for income security in retirement, but when asked about health benefits, the majority of both employers and workers predicted that the government would have to assume a bigger role in the future than is currently the case to ensure coverage. What is the reason for this relatively low expectation on the part of American employers and workers to have pension benefits as an important part of the total employment package? The burden of providing for income security in retirement would seem to be shifting increasingly to the individual citizen, although there is abundant evidence that a significant proportion of the population is ill-prepared to take on this burden in the United States, as well as elsewhere.

Rising health care costs and the implications for public pension reform

OECD expenditure surveys confirm that social expenditures in most of the member states have stagnated during the past two decades, in spite of the ageing of the population and, in many instances, persistent high levels of unemployment. However, the share of health care expenditures in this envelope of social outlays has continued to increase at the expense of providing more generous benefits in other social protection programmes, notably unemployment benefits, rehabilitation, family allowances, and low-income family support. The upward spiralling of health care expenditures is clearly undermining efforts to improve pension benefits, particularly for those among the elderly who are most at risk of falling below the poverty line. The United Kingdom may be different in this respect as significant increases were made under the Blair government to bring many older persons above the poverty line; this effort has not, however, been duplicated in the United States, where the Supplemental Security Income (SSI) benefit has not kept up with increases in average earnings.

Crisis intervention or adjusting the pension system to new realities?

The United States represents an unusual case among the developed economies of the world for not having carried out a major social security reform since 1983 (i.e., the Greenspan Commission reform). Most countries have experienced steady changes to their pension systems by raising contribution rates, extending the normal retirement age, encouraging workers and employers to set up thrift savings plans, and so on. A few countries have undertaken extensive investigations and overviews of the pension system (for instance, the Turner Commission in the UK) which will have far-reaching long-term consequences if the recommendations aimed at keeping employers involved in providing pension benefits are implemented. Whether done in a piecemeal fashion (as in Germany, Denmark, France, Japan, Switzerland) or in a more comprehensive manner (Sweden), certain unavoidable issues hold the key as to how a new social contract will be built on the foundations of long-standing pension commitments.

I would identify three key issues that policymakers must resolve to bring pension arrangements into line with the new realities of an ageing population: (1) advancing the early retirement age; (2) reforming the disability insurance branch; and (3) facilitating, enabling, and advising individuals on how to save for their own retirement.

The real costs of early retirement

The citizens of most developed countries with universal public pension systems have, over the course of the last four to five decades, increasingly opted to take early retirement, five to seven years before they would normally become eligible for their full retirement benefit. Only a minority of older workers remain in full-time employment in the United States or in Europe, with an even smaller percentage taking advantage of the very significant actuarial increases in their benefits if they opt to work to the age of seventy.

Legislators have frequently taken steps to gradually increase the normal retirement age from sixty to sixty-five or even to sixty-seven, while at the same time equalizing the retirement ages for men and women, but they have been reluctant to cut back too sharply on early retirement. There are multiple reasons for this reluctance, but perhaps the most salient being the political repercussions of legislating against such a popular option as early retirement, as some of the candidates for the American presidency learned to their cost in 2008. Beyond the political sensitivity of the issue, there is the well-grounded concern that the early retirement component of the population is, in fact, masking a variety of serious issues in the present-day workplace environment and that reducing the possibility of an early retirement will have catastrophic repercussions on the disability insurance programme or, in some countries, on the unemployment insurance programme. Employers are apparently silent supporters of early retirement options, enabling them to better exercise workforce planning, to withhold training for older workers, and to hire younger replacement workers at lower earnings. For trade unions, early retirement options are integral aspects of their gains in collective bargaining agreements and they are reluctant to see any part of these guarantees sacrificed for the greater good of social security solvency.

How to modify the early retirement options in a way that encourages people to stay in the workforce longer and to save longer for their retirement, that encourages employers to retain and train older workers, and that is not anti-social for the low-skilled and low-paid, will truly be one of the key challenges facing social security systems in coming years.

Putting disability insurance back on track

Disability insurance schemes have become one of the most striking examples of how a public programme can start with one set of objectives and evolve over time into a very different programme with a different set of objectives. Disability insurance schemes administered under the social security system were put in place primarily for the worker who was obliged to withdraw from the labour force prematurely due to ill health. Later, many countries expanded these schemes to include non-workers suffering from ill health and other problems, who could substantiate their inability to do any paid work. As the definition of disability has been expanded to take into account mental illness, pain, and the general inability to cope in a workplace setting, the number of applications has steadily grown over the decades, as have the appeals and the litigation associated with the disability application process. An astounding three-quarters of all the administrative expenditures related to the administration of pensions by the US Social Security Administration are devoted to the disability application and appeals process. Furthermore, in spite of a great deal of advocacy by the disabled community and in spite of a firm belief in the benefits of mainstreaming disability beneficiaries in the workplace and society, the fact remains that only a tiny percentage (barely 1 per cent in the US) ever returns to paid employment once they become eligible for disability benefits.

While some countries have introduced both partial disability and non-medical criteria for establishing eligibility for cash benefits and rehabilitation, results have nevertheless been disappointing in terms of returning beneficiaries to active employment. And everywhere the trend is heading in the same direction: new beneficiaries tend to be younger, less educated, more likely to suffer from mental and nervous disorders, and more likely to be born outside the country where they apply for disability benefits.

Some close observers of the current disability insurance arrangements estimate that 15 to 20 per cent of the population may be unable to work for one reason or another and that the price will have to be borne by society. Others argue that our current disability arrangements are further contributing to an unacceptable waste of human resources in societies where there will be fewer workers in the future to support larger numbers of dependent persons. Would it be more effective to simply provide any dependent person, young or old, with a minimum social benefit and to focus the energies of the social security systems on identifying, training, and assisting those persons who have the most likelihood of achieving a degree of independence in their lives?

Motivating and educating citizens to save for retirement

If the state is increasingly constrained in guaranteeing retirement income security and if employers are increasingly eager to get out of the benefits game, the individual is clearly going to be expected to bear more of the burden for saving for retirement. However, past experience does not provide us with a very encouraging picture as to whether people will actually do it on their own and whether, even if willing, they would know how to do it effectively.

In the AARP survey previously referred to, the workers surveyed overwhelmingly preferred having a defined contribution scheme (DC) for their retirement savings rather than a traditional defined benefit (DB) or end of service plan provided by their employer. This overwhelming preference for DC schemes regardless of age has been confirmed by other research conducted in the United States, notably by the EBRI. Was there a real understanding among these workers as to who bears the risk for financing future benefits under DC and DB schemes? Were they motivated by an awareness that they are unlikely to remain with a single employer long enough to earn an adequate DB pension benefit? Were they aware that many workers in the United States often tap the DC retirement accounts for other reasons (health, education, etc.) long before they reach a retirement age? Were they fully aware how much in savings would be needed to create an adequate future income flow in retirement (the average DC savings amount in the US is only US$60,000)?

It is estimated by the US Social Security Administration and other sources of research on retirement behaviour that approximately 50 per cent of the US population is not adequately saving for retirement and will continue to rely for almost all of their retirement income on the public social security system. Is it likely that this population will change its behaviour in the future unless there are mandatory or strong tax incentives for them to save for their retirement? How would a future greater reliance on individual retirement savings affect women, who continue to balance family and work life in ways quite different from men?

The search for a new consensus regarding old-age income security

Although upwardly mobile, well-educated, and well-paid Americans will no doubt enter their retirement years with adequate income, most indicators point to the increasing vulnerability in retirement of those workers and their families who are no longer covered by DB plans; have not saved adequately or ever participated in DC plans; and who, moreover, will probably be paying increased amounts out of pocket for health care in their old age. The United States may therefore be faced with a growing gap between the better off and the poor in the older population; a problem which could be exacerbated by the fact that fewer of tomorrow's elderly will have benefited from DB plans; that lower replacement rates by the public social security system will be in effect; and that higher out-of-pocket health payments will, in all likelihood, increase. In an ideal world, the new social contract in most countries would continue to rely on participation by employers to help pay for health insurance, including retiree health care, and would count on them as well to provide a combination of defined benefit and defined contribution pension plans, as well as flexible, family-friendly workplaces and benefits. While some employers are currently fulfilling some of these expectations, practically none are doing all of them.

It is no doubt imperative that we understand the forces that have transformed the 'golden era' of pension policy into the current situation, but in my opinion, the reality is that, to the extent that there is a social contract, it is one primarily created by the government through mandating partnerships between employers and workers, principally through legislation. In the United States this legislation would currently include old-age income security benefits, disability benefits, unemployment benefits, workmen's compensation, and Medicare.

While this contract can be both explicit and implicit, based on collective bargaining agreements and long-standing employment practices, it is, in essence, a government-guaranteed engagement among citizens.

At the time the US old-age income security programme was legislated in 1935, in the throes of the Great Depression, it was poverty among the elderly rather than income replacement that motivated the legislators, since an estimated one-third to one-half of the older population had inadequate income to support themselves. Then, as now, there was no easy panacea to overcome the new set of problems, and social innovations on the scale of the New Deal were necessary to redress the decline.

While current circumstances are not as catastrophic as those of the Great Depression, it is fairly clear that the old social contract is no longer working for a growing number of workers in lower- and middle-income categories. For large segments of the workforce, jobs are less stable than they were in the past and the protections employers once provided are less secure. Fuelled by growing perceptions about the risks of international competition, workers are being asked to take on more responsibility and to absorb more of the risk for health and retirement income security. Some observers argue that the social contract has seriously begun to unravel because power is shifting from large corporations and their union leaders to consumers and investors. Consumers can shop with ease and find better deals that depend on low labour costs, either by buying products produced in developing countries or from producers that use technology to get the job done more cheaply. The prime example of this transformation is probably the automobile industry, which, in the United States, is desperately trying to extricate itself from its once highly admired and emulated social contract obligations. The consumer has of course benefited enormously from this transformation, but not necessarily in their lives as employees.

The challenge now is to begin the daunting task of building a new social contract that reconciles the new economic realities with basic moral commitments about the kind of society and world that we would want for ourselves and our children. As pointed out by some critics, the alternative to a new contract is no contract: a society in which the owners and managers take as much as they can and the less fortunate live out their existences on what remains.

The speculations outlined here serve to underline the fact that no new social contract will be constructed in the future by merely passing a new set of laws. Rather, a new social contract will have to be articulated by the political leadership to overcome the increasing disenchantment of electorates with the models offered by many countries at the start of the new millenium.

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The views expressed in this article are solely those of the author and do not represent the official policies or positions of the US government or of any of its agencies.

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