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Postponing retirement: the political effect of aging

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ABSTRACT

Conventional economic wisdom suggests that because of the aging process, social security systems will have to be retrenched. In particular, retirement age will have to be largely increased. Yet, is this policy measure feasible in OECD countries? Since the answer belongs mainly to the realm of politics, I evaluate the political feasibility of postponing retirement under aging in France, Italy, the UK, and the US. Simulations for the year 2050 steady state demographic, economic and political scenario suggest that retirement age will be postponed in all countries, while the social security contribution rate will rise in all countries, but Italy. The political support for increasing the retirement age stems mainly from the negative income effect induced by aging, which reduces the profitability of the existing social security system, and thus the individuals' net social security wealth.

1. Introduction

The aim of this paper is to assess the political feasibility of the most commonly suggested retrenchment measure of the social security system: postponing retirement. Conventional economic wisdom suggests that – due to population aging – social security systems will have to be largely modified in order to maintain their financial sustainability. Because of the increasing share of retirees to workers, these systems will soon be unable to finance the pension benefits — as calculated under the current rules. Hence, either contribution rates will have to be raised or per-capita pension benefits reduced. Among the latter retrenching measures, postponing retirement has typically been proposed by experts and policy-makers. This policy has been strongly advocated in those countries, such as Belgium, France, and Italy, where the effective retirement age is particularly low, because of the existence of large incentives to retire early built in the social security systems (see Blöndal and Scarpetta, 1998; Gruber and Wise, 1999 and 2004). The beauty of this measure is that it allows to keep a sufficient level of old age consumption by combining a longer working carrier – and thus more labor income – with relatively generous pension benefits, albeit at the cost of enjoying less old age leisure.

Will future voters be willing to support such a policy? A recent political-economy literature (see Fenge and Pestieau, 2005; Lacomba and Lagos, 2006; Casamatta et al., 2005; Cremer and Pestieau 2000; Cremer et al., 2004; Conde-Ruiz and Galasso, 2003, 2004) that has examined the introduction of these early retirement provision in the 70s and 80s and their further developments has emphasized the crucial role of the policy persistency (see also Coate and Morris, 1999) in the political success of these

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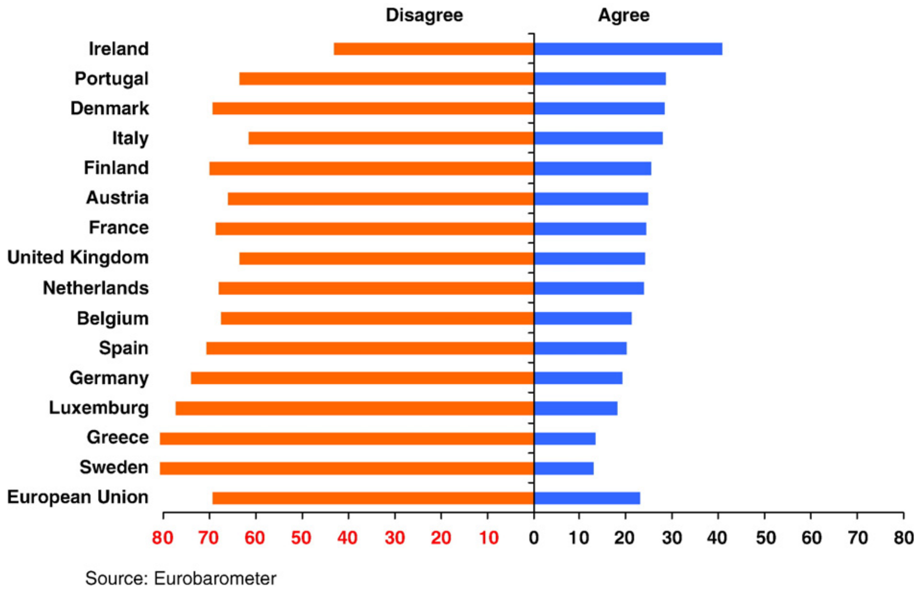

Fig. 1. Retirement age should be increased: individuals work more and enjoy less retirement period.

measures. In fact, the introduction of these early exit paths from the labor market was welcome also by some young workers who expected to benefit from these provisions. Moreover, recent Eurobarometer (2001) surveys suggest that current workers are unwilling to accept an increase in their retirement age (see Fig. 1). And indeed, most recent reforms featuring an increase in the retirement age allow for long transition periods (see fRdB report, 2000; Galasso, 2006, for a detailed description of the reform process in six countries).

Unlike the previous literature, this paper suggests that postponing retirement may become feasible in the future because of the political push of aging. In countries with large social security systems, such as most developed economies, which also feature generous early retirement schemes, aging may provoke a major negative income effect by reducing the individuals' pension net wealth. In fact, the increase in the dependency ratio reduces the profitability of systems for all future generations, who hence obtain a worse deal from the social security. Furthermore, if the reduction in the social security return takes the form of lower pension benefits, a substitution effect also arises, since the pecuniary incentive to retire decreases, which push toward postponing retirement.

This paper builds on the politico-economic model introduced by Galasso and Profeta (2004) to provide a quantitative assessment of the political sustainability of social security in six greying societies (France, Germany, Italy, Spain, the UK and the US). Their theoretical framework is enriched to allow for the endogenous political determination of the retirement age. The bi-dimensional preferences of the individuals – over social security contribution rate and retirement age – are aggregated through simple majority voting.[2] Because of the multi-dimensionality of the policy space, Nash equilibria of this voting game may fail to exit. Hence, I resort to the concept of structured induced equilibrium (see Shepsle, 1979), which allows for issue-by-issue voting, where contribution rate and retirement age are voted contemporaneously, yet separately. This issue-by-issue voting is effectively equivalent to obtain two reaction functions, which correspond to the median vote of the electors over one issue for a given vote on the other. The intersection of these two reaction functions gives rise to an issue-by-issue voting equilibrium of the game.

The quantitative evaluation of how political constraints may shape social security systems under population aging operates in two stages. First, the theoretical political-economy model is calibrated to match the main economic, demographic and political characteristics and the crucial features of the social security system in each country around the year 2000, which is taken to be the initial steady state. Since all economies are dynamically efficient, social security systems are not Pareto efficient and need to be supported by a political majority. In every country, individuals take economic and political decisions, and the social security contribution rate determined in the political process is calibrated to correspond to the actual average equilibrium contribution rate during the nineties, while the resulting economic aggregates have to be consistent with the long term features of each economy. The simulations of the impact of the electoral constraints on the political determination of social security and retirement age under aging are obtained by feeding this calibrated model with the forecasted values of demographic, economic and political variables for the year 2050, which is assumed to be the new steady state, in which the demographic process has stabilized and the social security systems have been modified to copy with these new demographic and economic elements. The social security contribution rate and the retirement age chosen by the year 2050 median voters, as estimated by the model, represent the political equilibrium outcomes of the voting game in 2050.

[2] Since individuals preferences over the retirement age are non-single-peaked, Germany and Spain are dropped from the analysis.