New perspectives on the economics and politics of ageing

EDITORIAL: NEW PERSPECTIVES ON THE ECONOMICS AND POLITICS OF AGEING

Philip Booth and Nick Silver

For the last two years or so the IEA has been undertaking and commissioning research looking at the economic problems and dilemmas in political economy that are arising as a result of ageing. The project has been sponsored by the Templeton Foundation. Even countries that now have young populations, including many very poor countries, are likely to experience population ageing at some stage in their development. The project therefore examined policy options in the developed, the developing and in the less-developed world. Of course, policy in the field of pensions and savings is intimately linked with the problem of population ageing and this was the main focus of our work. In this regard, the consideration of less-developed countries was especially important as pensions policy has very long-term implications: thus less-developed countries have the opportunity to avoid the mistakes that today's developed countries made many years ago.

Ageing, of course, is not just linked to pensions and savings. It has implications for labour market policies too (highly regulated labour markets might exclude the old, for example). Ageing also has implications for policy towards education and training: a shrinking, ageing labour force will change the returns to capital, including returns to human capital. And there are the questions of whether policies that encourage early retirement are not just financially unsustainable but also damage the health and well-being of early retirees themselves. All of these issues are being considered in our research.

Some of the output of the project has already been published in earlier editions of *Economic Affairs* (for example, see Niemietz, 2007; Silver *et al.*, 2007). Further research will be published in an IEA monograph in 2008 and in future editions of *Economic Affairs.* This edition brings together six articles on specific aspects of the problem of ageing, demographics and pension provision which, in the traditional style of this journal, are mainly focused on important technical economic issues but are written to communicate to a wider audience that includes non-economists.

The first article deals with the political economy of ageing. Philip Booth shows how the economic problem of ageing is greatly exacerbated by the political problem of ageing. In a private pension system, individual decisions determine the allocation of resources. Individuals can, in turn, respond to economic signals to work more, save more, retire later and so on as wages and returns to capital change in an ageing population. In a state pension system resources are allocated by a mechanism underpinned by voting. Large blocks of voters with aligned interests are emerging who may support the expansion or resist the contraction of the state pension system. Booth quantifies this effect and the results do not make comfortable reading. Where pension reform has happened it has been through a process of 'buying off' older interest groups.

Juurikkala, in one of two articles in this edition, looks at the problems of means-testing. The provision of means-tested benefits has often been intended to *reduce* the size of state pension systems and target help on the poor. However, Juurikkala suggests that means-testing systems have strong disincentives to work and to save. Misoulis examines more technical economic aspects of the process of ageing and develops policy ideas based on the analysis. As an economy burdened with a pay-as-you-go pensions system ages saving declines and this can lead to a fall in economic growth. Unfortunately returns to physical capital can fall too. This can happen because of the combination of the fall in human capital (as a baby-boom generation retires) which raises the proportion of physical capital and because the amount of labour falls more rapidly than the amount of capital. This, combined with other effects, may well lead to a fall in the birth rate – not what is needed in an ageing population.

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Misoulis suggests various policy responses, including a move away from state pension provision, compulsory private saving or a reduction in means-tested provision in old age, and a reduction in government borrowing. Interestingly, he also suggests that returns to housing wealth should be treated, for taxation purposes, in the same way as returns to other forms of capital.

Jorgensen and Taylor take up some of these themes in a slightly more interventionist way. They look at the problem of under-employment of older workers. Jorgensen and Taylor suggest that active labour market policy has had little success in keeping older workers at work. They also point out that, in an era of globalisation, jobs are less secure and older workers will tend to find it more difficult to find employment than younger workers – and the incentives to work are dulled by various forms of retirement provision too. The authors do not suggest 'heavy intervention', and argue that much interventionist policy to date has failed or created adverse incentives but they do suggest that policy should do more to facilitate education and training to increase the 'resilience' of older people who lose their job.

Gabriel Stein looks at how the effect of the ageing population might interact with international financial flows. Indeed, the movement of people and/or capital might well mitigate some of the problems described by Misoulis. Stein shows how the process of ageing is likely to raise saving in the USA – and in pretty short order according to the author. The rise in saving should lead to a lower current account deficit or a current account surplus. Of course, when a 'baby-boomer' cohort is in the midst of retirement, dissaving can then happen. Overall, in globalised capital markets, we would expect demographic changes to be reflected less in changes in within-country rates of return and more in changes in capital flows which, themselves, will be reflected in balance of payments surpluses and deficits.

The collection finishes with a second article by Juurikkala. This is one of a series of country studies that forms part of the project. Juurikkala finds that there is an urgent need for market-based solutions to problems of retirement income provision in India. However, he warns against the large-scale 'blueprint' Chilean-style reforms that are currently being promoted. The Chilean model has many advantages over state pension provision – and it has achieved its objectives in Chile. But, when starting from a position of very little formal pension provision, argues the author, we should support the nurturing of those forms of provision for old age that people naturally use themselves – for example, saving, the establishment of small businesses and the extended family system. This is much less exciting for policy-makers than imposing a blueprint for pension reform. The government's role is to do properly those things that governments are supposed to do, such as protect property rights, ensure that the value of money remains stable, and ensure that the appropriate institutional framework exists so that people can have confidence in long-term saving: it is not to design pensions systems. Specifically, Juurikkala points to draconian regulation and distorting tax rules that prevent the development of proper private markets and that have discouraged saving in India.

Thus the articles in *Economic Affairs* range widely; there are several important messages; and not all the authors agree on everything. Nevertheless, three conclusions stand out. Firstly, public choice is making meaningful pension reform very difficult in democracies. Secondly, we should not put responses to an ageing population in a special box marked 'pensions': responses to ageing require flexible labour markets, high quality education and a good institutional framework to ensure that individuals can respond in the best possible way to the circumstances they face. Finally, there are important micro- and macroeconomic consequences of an ageing population. Some would argue that these require an activist policy response but the balance of argument is in favour of leaving economic agents free to respond to price signals so as to minimise the frictional and structural costs of an ageing society.

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