Signs of progress

By Jean-Jacques Rosa

The debate on pensions is biased towards the immediate interests of supporters of the existing system. The transition to extensive capitalization is both desirable and possible.

The trouble with politicians is that they are slow movers. Recently, there have been signs of a changing view of economic policy – both with the Left and with the Right. But this evolution of mentalities is lagging behind the needs. By finally resolving himself to stress the necessity for a total reformation of the French pay as you go pension system in order to deal with the major demographic crisis facing us all, Jacques Chirac was only stating the obvious – known and proclaimed by experts for some fifteen years.

The pay as you go mechanism worked admirably for earlier post-war generations of pensioners, by paying them pensions whether they had contributed or not during their working lives. But over time, pensions went up faster than resources and it became necessary to constantly extend the number of contributors – by making compulsory pension schemes "universal" – in order to build up resources and continue paying substantial pensions to an ever increasing amount of retired people. Today, although the latter had paid contributions throughout their working lives, it became clear that the profitability of their "pension investment" would not be maintained at the level enjoyed by their predecessors.

In addition, the many "baby-boom" generations all started reaching retirement age – just as the number of young working people was decreasing. This resulted in the new work force having to pay increasingly high contributions to maintain the standard of living of the many existing pensioners, who incidentally are only expecting their due. However, the pay as you go system, together with the demographically-induced structural imbalance between generations and the slackening economic growth over the last fifteen years have made the burden borne by younger employees untenable. Maintaining the level of pensions for their seniors - in unchanged demographic and growth conditions – amounts to fiscal blood-letting. The fact is that these younger employees' pension will in effect never match the contributions they have made during their working lives. Their "investment" is a wasting asset, with a negative interest rate. The compulsory pay as you go system has resulted in a net loss of assets and the slogan "Solidarity between generations" has ended up meaning robbing the youngest to pay the eldest.

Everyone knows that very soon we will have to reduce the level of pensions, increase contributions and extend our working lives, that is, defer the age when we become entitled to a pension. The implementation of these various options will need to be fine-tuned in order to achieve some sort of financial equilibrium. The problem is political: how to redistribute the burden and the benefits among the various interested parties, and namely, between pensioners and young employees.

But beyond the question of shared sacrifices, the pensions crisis reveals the inadequacy of the pay as you go mechanism, despite the outright denials of the system's supporters. At best, it could be anticipated that the resources to be shared out would grow at the same rate as the national income or global payroll. A figure which can scarcely exceed 4% per annum. With demographic stability and no major hiccups, a contributor could expect a future pension representing an increase of 4% on the sums paid into such a pension scheme. A poor return "investment" indeed.

On the other hand, capitalization – building up savings and investing them for one's retirement – could mean diversified investment in firms across the world which generate profitability margins of 8% - 10% in the medium and long term, irrespective of demographic trends. The profitability differential between the two mechanisms derives from the productivity of the investment afforded by actual saving.

In the debate that is just opening up on reforming the existing system, pay as you go supporters are trying to cover up this differential and to do all they can to avoid the introduction of capitalization – simply because, allowing individuals to choose a pension scheme would threaten the near state monopoly enforced through the pay as you go system. Indeed, the state system has to be compulsory in order to function, else who in their right mind would want to join a system where future commitments are uncertain and which at best, promises a 4% return, when a diversified savings plan could generate on average 8% - 10% ?

Giving employees the option of choosing their pension plan would toll the bell for the state monopoly on social benefits provision, managed by unions of employers and employees under the aegis of the government. This explains the resistance to reform and the minimizing of the benefits of capitalization.

A smooth transition

Although the transition from pay as you go to capitalization has been successfully implemented in several countries and has produced excellent results, France continues to cling on to its essentially monopolistic system, thereby becoming increasingly isolated. There is no doubt that even a partial changeover to individual choice of pensions, and hence of savings schemes, would add yet another burden on employees' shoulders : they would then need to build up reserves for their own retirement while continuing to fund pensions for the elderly. They should therefore be helped to build up the necessary resources by reducing the burden of honoring past promises. Indeed, strong fiscal incentives for pension schemes and funds are vital.

What is more, in a system with choice, employees who wish to opt out of the pay as you go system by renouncing any future entitlements would at the same time be releasing the community from a debt, even if it is as yet unquantified. On these grounds, such people ought to benefit from a reduction in their existing payroll taxes to the system, since the future debt owed to them would also be reduced.

Simulations of the transition from a pay as you go system to a capitalized system with this type of fiscal measure, conducted in the USA by Martin Feldstein, demonstrate that it is possible to make the changeover, at the cost of a modest increase in existing pension contributions, which would raise the proportion of payroll tax contributions in the national income by just two or three percentage points over some twenty years. This is of course a substantial figure but it would represent an investment for the community, by moving from an inferior system without any prospects of future improvement to a more efficient one, which would no longer discourage those of working age or the growth of employment.

Is it too much to ask?

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