Demographic pressures for change in political-institutional arrangements governing intergenerational transfers in affluent societies

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The development of the modern welfare state and its resulting present-day institutional structures bear the stamp of the particular historical circumstances of the 20th century.

Although the sustainability as well as the optimality of existing arrangements governing intergenerational transfers is often questioned, long-term projections tend to take some basic features of these institutional structures as immutable.

In the political economy of intergenerational transfers three seldom discussed aspects of that implicitly assumed continuity should be singled out as of particular interest: each calls for critical examination.

One takes as given the basic features of the political decision-making process setting the terms of intergenerational transfers—in particular those organized by the state to provide pensions and health services to the elderly population.

A second has to do with the assumed constancy of spatial frames, especially state borders, within which decisions on such transfers take place.

A third envisages the longer-term future role of the state as performing a bundle of functions closely resembling, or perhaps modestly further extending or else trimming, those observable in today's most advanced welfare states: collecting one third or more of the national income in the form of taxes and returning it to the population in the form of state-organized services.

I will argue that demographic changes, in combination with the expected economic dynamics of modern affluent societies, will tend to undermine the acceptability and viability of existing institutions along each of these three dimensions.

I will also try to outline the resulting likely directions of political-institutional reforms and even radical transformations that may ensue in the course of the coming decades.

On the first score, I consider the bias represented by the increasingly disproportionate weight of the older component in the general electorate.

Even with generous allowance for altruism or at least detached consideration of the common good, the shorter-term time horizon of voters (that may be proxied by voters' expectation of life) tends to lead to legislative decisions that favor the elderly population to the detriment of younger generations.

I will suggest possible modalities of political reforms counteracting this bias.

On the second score, I will note the increasingly dysfunctional role represented by state borders, best exemplified in the case of the European Union.

Although the dominant role of EU member states in setting the terms of intergenerational income redistribution country-by-country is justified on the principle of subsidiarity, maintenance of freedom of international population movements and especially of labor migration within the EU will logically require coordinated decisions over such arrangements by supranational institutions.

On the third score, I intend to argues that increasing affluence (such as in the EU or US contexts a continuing substantial gain in terms of average real incomes, replicating the economic growth performance of the past half century) will undermine the rationale for and popular acceptance of the dominant role of state-organized collective arrangements.

These now widely accepted arrangements override micro-level autonomy in shaping fundamental demographic-economic decisions on having and educating children and making arrangements for health care and for economic support in old age.

The most likely variant of a gradually receding welfare state under such optimistic assumptions concerning economic growth is one in which the state limits its main social policy role to adjustments of the income distribution only, thus leaving individuals to acquire formerly state-provided services, notably in the domains of education, old age pensions, and health care primarily from private markets.

I now turn to a brief discussion of these themes, as allowed by the vey limited time available.

I hope that my written paper, not yet presented in the Seminar`s web site will provide a more satisfactory and persuasive elaboration.

First: Aging electorates

In affluent societies the basic rules for state-organized intergenerational transfers are typically set by democratically elected parliaments.

Voters are assumed to be well-informed about public affairs and able to recognize that their personal fortunes are affected by the common good of the political entity of which they are part; that recognition is expected to be reflected in their voting behavior.

At the same time, consideration of voters' particular personal interests, especially in the economic domain, is accepted as a legitimate factor that influences their choice of political representatives.

Competing for votes, political parties and individual candidates for office are keenly conscious of these individual economic interests, hence present platforms and make promises that appeal to voters.

But individual economic interests tend to be strongly age-related, reflecting the strong differences in time horizons, both in the short term and in the longer term.

Not surprisingly, the age composition of the electorate tends to influence party platforms and promises.

That influence is not straightforward. The beginnings of the modern welfare state, signaled by its assuming commitments to provide basic economic security to persons in their old age, go back to a time when the age distribution of voters was still relatively young.

Industrialization, geographic mobility, and changes in social attitudes weakened the traditional family-based support system for the economically dependent elderly population.

The numbers of the old relative to the working population were small: this could permit political commitments for income transfers from the working and tax-paying population to the economically inactive old at relatively modest economic costs.

Over time, with population aging, along with generous provisions for an early retirement age that qualifies for a public pension, as well as owing to the upgrading of pension levels so as to guarantee pensioners a standard of living closely comparable to what they have experienced before retirement, these modest early commitments eventually translated into the single largest public income transfer program of the modern welfare state.

Close behind it, and exhibiting even higher rates of growth in public expenditure, were allowances for state-financed health care, an entitlement disproportionately devoted to the old-age population.

The changes in the underlying demographic factors fueling this rapid growth in the scale of intergenerational public transfers—fertility falling to levels near-replacement and life expectancy rising—were eminently desirable social developments, as were the improved income security and health care at older ages generated by these transfers.

Yet under the prevailing political arrangements these same demographic developments have led or are leading to a situation in affluent countries that are economically unsustainable and socially inequitable.

A privileged treatment of the state-pensioned population relative to the allocations benefiting the young generations (both supported by an increasingly heavy tax burden on the working-age population) reflects the disproportionately strong voting power of the part of the electorate that is either of retirement age or is fairly close to retirement hence also directly interested in the levels of pension and health care transfers and in the particular rules under which such transfers are granted.

Amplified by fertility trends that have remained well below replacement level in many of the affected countries now for several decades, as well as by the relatively high proportions of those actually exercising their voting rights among older persons, modern welfare states have witnessed the emergence of an old-age voting bloc whose size now typically represents a near-majority, and prospectively even the majority, of the electorate.

Given the pay-as-you-go financing of old age support and the decreasing ratio of the size of the working population to the size of the retired population, the redeeming of promises made under demographically more favorable conditions requires increases in tax rates or, as resistance to further tax increases grows, government borrowing that transfers a share of current support to the next generation of taxpayers.

When deficit financing approaches its feasible limits (set by the decreasing willingness of the domestic population and/or of foreign lenders to buy government bonds even at high interest premiums when the debt to GDP ratio reaches a level signaling potential insolvency of the state) a reform of the government budget, and especially of its social transfer component becomes inevitable.

But cutting back of entitlements once granted as a right is strongly resisted by the beneficiaries, hence reform of the transfer system aimed at economizing budget expenditures requires painful political decisions and generates acute intergenerational conflicts.

The main potential tools for reestablishing budgetary balance involve some combination of an increase in the retirement age, cutting the absolute level of pension benefits and health care expenditures, imposing income tests to the right to state pensions (thus implicitly transforming part of what has been formerly granted and perceived as an earned right into something closer to a welfare payment) and, not the least, cutting allocations directed to the younger population and restricting other non-social state expenditures such as for national defense and investments in infrastructure.

Given the relative political strength of what may be referred to as the old-age lobby, there is a strong probability that the resulting solution will be least injurious to the interests of the old-age population—an outcome unlikely to be optimal from the point of view of overall national welfare.

My paper describes the demographically-dependent political dynamics of the emergence and prospective outcome of the intergenerational conflict situation over the size and division of national budgets.

It presents key quantitative features (for a representative group of modern welfare states) of the relevant underlying demographic trends and the shifting relative material fortunes of the old versus the young, as well as of the age groups between the old and the young, with special attention to the younger components of the working age population.

It also considers political-institutional reforms that could attenuate intergenerational conflicts and lead to compromises that may be considered more equitable than could be otherwise reached.

Specifically, it discusses a proposal that was first bruited by me a quarter-century ago: to give voting rights to a now disenfranchised group—those under the legally set age that makes them unqualified to participate in the democratic political process and thus renders them unable to stand up for their own interests.[1]

The group without voting rights most commonly consists of those aged 0 to 17, although the age boundary sometimes is set slightly lower or somewhat higher. (In Japan, for example, voting rights are granted to those 20 or older.)

[1] Demeny, Paul. 1986. "Pronatalist policies in low-fertility countries: Patterns, performance, and prospects," pp. 335-358 in Kingsley Davis, Mikhail S. Bernstam, and Rita Ricardo Campbell, eds., *Below-Replacement Fertility in Industrial Societies: Causes, Consequences, Policies,* Cambridge: Cambridge University Press.

According to my proposal, voting on behalf of the young would be exercised by custodial parents. (For girls, for example, their mothers could vote, for boys, their father.)

This was in 1986 an outlandish proposal, eliciting numerous valid objections; it remains such today.

Nevertheless the idea surfaced in an interview given in the mid-1990s by Lee Kuan Yew, then Prime Minister of Singapore and in a 2002 pamphlet published in Germany.

In April 2004 it prompted a lengthy discussion among representatives in the German *Bundestag.*

More recently, dubbed as "Demeny voting," it was discussed in a flurry of newspaper articles in Japan and New Zealand.

And in a couple of months ago it surfaced in an article in The Economist, that presented it as an interesting novel idea by the prominent Dutch economist

Should the obvious constitutional barriers to its adoption be removable, the ensuing reform would substantially shift the mean age of the electorate downward, although, given the evolving overall population age distribution in most low-fertility countries, by no means radically so.

Analogous but farther-reaching changes could also be envisaged. For example, as I proposed at a Un conference on demographic aging a decade ago, in a bicameral legislative system votes cast for electing members to the upper chamber could be weighted by voters' average remaining life expectancy: a procedure that could be supported by persuasive ethical arguments and one that with electronic voting would be technically both feasible and simple.

But the value of introducing such a proposal in the public discourse on the interplay between political power and economic interests, and keeping such discourses alive at public forums, is not to be measured by the evidently minimal chances of it being actually adopted.

Rather the chief function of advocating such a reform, analogously to the 19th and early 20th century debates about women's right to vote, would be to sensitize public opinion about the very different time horizons that are of interest to differing generations and about the nefarious neglect of such differences in the political decision-making process.

According to expert forecasts, the majority of those under age 10 today will be still alive at the beginning of the 22nd century.

The large majority of today's voters, in contrast, will be dead by the middle of the 21st century.

The attitude of après nous le déluge that influences many bargaining positions and outcomes in intergenerational distributional politics should be fought against.

Second: Disfunctional state borders

Modern welfare states as they evolved toward maturity during the second half of the last century have been sovereign in formulating their monetary and fiscal policies.

Arrangements for domestic income distribution in general and for intergenerational transfers in particular were shaped, as it were, in quasi-closed national entities that had demographic attributes dictated primarily, even if not exclusively, by within-country fertility and mortality dynamics.

As the balance between the economically active population and the economically dependent population shifted toward increasingly higher dependency rates, state policies could counter the deleterious effects of this tendency by stimulating labor force participation rates, raising the age of retirement, raising taxes, and being less generous with redistributive transfers to dependents, especially the elderly.

State policies could also try, albeit the need for such attempts may fully emerge only in the coming decades, to stimulate fertility so as to raise a larger future labor force without recourse of mass immigration.

When under existing institutional arrangement the size of the new generations born falls distinctly below what would be required for maintaining a minimum desirable balance between the economically active population and those economically dependent, aiming for a higher birth rate hence for a longer-term sustainable social and economic equilibrium becomes a public good, and therefore a legitimate policy objective, although one constrained by the strict observance of individuals' right to choose the number of children they want.

The desultory attempts of welfare states toward raising birth rates have thus far met with little success.

There is, fortunately, a reasonably good chance that in most instances effective pronatalist policies will not be needed.

Spontaneous behavioral adjustments, combined with the currently familiar types of pro-family policies that make women's labor force participation and childbearing more compatible, may nudge fertility rates sufficiently close to replacement levels so as to obviate the need for more effective measures that could enhance aggregate national fertility.

But this benign outcome cannot be taken for granted.

As the longer-term unsustainability of current public promises for old-age pensions and for non-rationed provision of old-age health care services seeps into the public's consciousness, would-be parents will increasingly calculate that their old age economic security requires accumulation of private assets that could complement their now diminished expectations for post-retirement public provisions.

But saving during the economically active years will be far more difficult when couples also bear the individual costs of raising children.

Those assuming that extra burden are bound to find themselves at a very substantial disadvantage compared to individuals and families with no children or only one child.

The now increasingly perceived and prospectively also all-too-real weakening of the state's capacity adequately to secure a post-retirement standard of living on an acceptably adequate level is likely to emerge as a potent novel factor depressing birth rates.

More effective pronatalist policy measures than those presently applied, whether they are called as such or labeled simply as pro-family polices, may then be needed.

The most plausible form of such a policy would break away from the exclusive focus of the commonly pursued pro-family policy package that aims at improving the current or near-term economic status of families with children.

Its objective, instead, would be to reestablish the direct relationship that existed between individual fertility behavior and individual prospects for old-age economic security before modern economic advances and concomitant cultural changes decisively weakened that linkage.

Some twenty-odd years ago I outlined a proposal that could accomplish that objective.[2]

The proposal received little attention, but it may acquire new relevance as public pension schemes and health care provisions for old age are forced to undertake a painful retrenchments.

The central facet of the proposed reform would be to earmark a socially agreed-upon fraction of the compulsory contribution from earnings that flows into the common pool from which pay-as-you-go national pension schemes are now financed and transfer that fraction to individual contributors' live parents as an additional entitlement.

The rules governing the distribution of receipts from the remaining common pool need not be affected by such a transfer.

Obviously, reestablishment of the fertility/old-age security linkage would be politically acceptable only if children's financial support for elderly parents would not affect children's material circumstances, and, conversely, if parents' receiving such support would not create in them a sense of obligation toward their adult offspring.

Using the well-established distributional transfer mechanism of current pension and health care institutions operated by all modern welfare states can fully satisfy these requirements.

The expected positive fertility effect of such an institutional restructuring of old-age support arrangements would of course be strongly dependent on the fraction of the individual contribution earmarked for direct transfer to living parents.

High effectiveness would require a generous provision, resulting in a substantial differential entitlement between retired persons with and without children and, among the former, between parents with differing numbers of children they successfully raised to productive adulthood.

[2] Demeny, Paul. 1987. "Re-linking fertility behavior and economic security in old age: A pronatalist reform," *Population and Development Review.* Vol. 13. No. 1, pp. 128-132.

This promising reform of intergenerational transfers, potentially capable of reestablishing sustainable patterns of fertility behavior, is, however, rendered unfeasible when the conditions of quasi-closedness of national economies and possession of national autonomy in matters of monetary and fiscal policies no longer hold.

And beyond that, the long-standing basic intergenerational transfer schemes of the traditional welfare state, too, would become increasingly untenable.

This is likely to be the situation in which the economically weaker members of the European Union are likely to find themselves in the coming years.

The most notable accomplishment of the EU is the creation of a common economic space within which the movement not only of goods, services, and capital but also of people and, in particular of labor, is unimpeded.

Under normal conditions of economic development, that is, in the non-recessionary phases of the business cycle, open borders will generate substantial migratory flows in the direction of the more dynamic and higher wage-level centers of economic growth.

Migrants will be taxed where they work and the home state will not be able to claim and redistribute such revenues.

Since EU rules relegate intergenerational transfer arrangements to the constituting national units, member states experiencing outmigration of labor will find their tax revenues shrinking and their ability to maintain promised transfers to the relatively increasingly larger dependent populations correspondingly curtailed.

The policy response to this will leave no alternative to the states so affected except to raising taxes on their diminished economically active population and cutting redistributive allowances to dependents.

Both elements of such a policy will only accelerate the process that induced the need for those policy moves in the first place, hence resulting in a potentially disastrous cumulative downward spiral.

Voluntary remittances by migrants to their home countries would attenuate this problem but are unlikely to reestablish equilibrium.

The vulnerability to these effects of economically weaker countries that successfully gain admittance to the Euro zone would be especially great since they would no longer have recourse to an independent monetary policy that through exchange rate adjustments could create more attractive conditions for non-speculative capital inflows and impart export advantages to their domestic industries.

There is only one effective remedy for the problem just outlined: the creation of what is sometimes called social Europe, that is elevation of intergenerational transfer arrangement to the all-EU level.

Given the existing very great differences of average incomes between the countries of the EU27, the near- and medium-term prospects for such a change are remote.

Third: State paternalism undermined?

The Great Recession that hit the global economy toward the end of the first decade of the new century was poorly predicted by experts. That major macro-economic setback followed an extraordinarily successful six decades of rapid economic growth, characterized by relatively modest up and down deviations from the upward trend in much of the developing world and virtually everywhere among the developed countries. Ignoring the years of recovery that followed the end of World War II, between 1960 and 2009 real GDP per person in the United States, measured in 2005 prices, grew from some 15,700 dollars to 42,200 dollars. During the same period, average real disposable income has fully tripled. Corresponding growth was even more rapid in most of Europe, and still more spectacular in several East Asian countries that, as a result, have joined the rich countries' club. In these countries economic growth has permitted a build-up of modern welfare systems that, beyond mitigating poverty, provide economic security and vast array of state-organized social services and assorted subsidies to the population at large or to selected segments within it.

This development is best exemplified by the success of the European social model, widely heralded as an example to follow in state-directed striving for economic security, social solidarity, narrower differences between social strata with respect to levels of income, and social cohesion. Pursuing these goals entailed a corresponding downscaling of personal services formerly performed by the family, a massive expansion of the share of national income captured by and distributed through state programs, a large increase in the share of public-sector employment and of persons whose main income source is a social transfer payment, and a greatly augmented influence of special interest groups and of politics in general over the modes and directions of the distribution of state-provided benefits.

The future of this model, and of the economic prospects of rich countries at large, are now clouded. Forecasts differ widely, but pessimism tends to predominate. An expected secular slow-down in economic growth coincides with predictable demographic trends characterized by low or negative rates of natural increase combined with rapid expansion of the inactive old-age population, hence increasingly high rates of old-age dependency. While existing commitments concerning future pensions, health care, and welfare benefits call for increased future expenditures, hence higher taxes, shifts in the global economy impose increasing competitive pressures on high-wage countries, prompting reductions in tax rates and lowering wages and related benefits.

If the pessimistic economic scenario is validated, changes in welfare state policies and in particular in intergenerational transfer arrangements are likely to be essentially incremental and defensive: taking the form of adjustments that seek maximally to preserve the status quo. Such incremental changes, however, can cumulate to major cutbacks in transfers and social services compared to those earlier promised. In pension schemes retirement for disability will be made more difficult, normal retirement age will be increased, benefits, if at all indexed, may be tied to price increases only and not also to increases in productivity, and their real value may be reduced outright by fiat. In health services co-payments may be introduced or augmented and de facto rationing through longer waiting times is likely to become more prevalent. Blunting the severity of such measures will be higher tax rates on the working population. Bargaining over balancing cutbacks and higher taxes will be the likely source of sharpening political conflicts. The resulting welfare losses under any solution will increase the role of the family and interpersonal networks in providing fall back options for social security.

A more benign economic scenario, however, cannot be ruled out. The extraordinary pace of technological innovations may well sustain continuing increases in productivity and many of the net benefits of economic globalization may yet to be exploited. The rise of China, India, and Brazil, and parallel development elsewhere in the developing world need not result in a zero-sum economic interaction between the newly better-off and the already affluent but could lend more dynamism also to the latter. Energy and environmental problems may find technical solutions and generate new markets. Market incentives will increase employment rates among older persons, alleviating the deleterious economic effects of population aging.

With resumed growth of incomes per capita, the prospects for changes in the welfare state are likely to be of a very different character that those under the pessimistic economic scenario. Basic features of the service-providing function of the state will be more and more perceived as inconsistent with the preferences of an increasingly affluent population. Dissatisfaction with the status quo is not likely to manifest itself as demand for further expansion of the existing service portfolio offered by the state but in a renewal of criticism of the basic structure of welfare state arrangements and its undesirable social and cultural byproducts, hence in pressures for fundamental reform.

Social democratic principles that dominantly animated and directed the development of modern welfare states once called for taking possession of the commanding heights of the economy by nationalizing key industries and setting the base for welfare-enhancing centralized rational planning. That attempt was a failure. Efficiency dictated that today the productive sectors of the economy in all welfare states are essentially in private ownership, sometimes after having been denationalized as a result of state initiative. Markets, albeit regulated, rule and provide the essential economic base on which the edifice of the welfare state is erected. Ironically, what did get nationalized are the components of the social economy formerly provided by the family or obtained by individuals through voluntary interaction with private providers. At an early stage, the gradual take-over of these functions by the state was justified by the need to help and uplift the poorest segment of society. That need still exists even in rich countries but providing a remedy for the poverty problem, and more broadly, making adjustments in the income distribution demanded by a democratic political process, hardly calls for a state that is often the largest employer in a country and collects and redistributes in the form of services and subsidies one-third or more of the national income. Above a certain, not excessively high, income level the citizenry would be arguably better served if the state gradually gave up its current near-monopoly in providing education and health services, and allowed them to be acquired in private markets by a corresponding reduction of taxes. Alternatively, and more congenially to the spirit of current practices, states could redistribute existing revenue to the citizenry according to politically approved rules and thus become financers of demand rather than providers of services in kind.

Elaboration of this controversial point must await the completed paper.