



***Old-age security in a free society:
A proposal for pension reform***

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Introduction

In the coming decades, public pension systems around the developed world will be facing hard questions. Current levels of funding are becoming inadequate as a result of rapid population aging. Declining labor force participation rates among older workers and low fertility rates are contributing to the pensions bankruptcy.

This paper makes the case for a radical shift from government-sponsored pensions to old-age security provided by families, markets and charity. The argument is not based on economic benefits alone. The real case for pension reform lies in the moral and cultural benefits of pensions policies that promote both private and collective responsibility, cultivate prudence and long-term planning, fortify families and other primary communities, and re-establish forms and sources of solidarity among generations.

Is Old-Age Security Possible without the State?

The problems with existing public pension systems are widely acknowledged. Less widely accepted is the possibility that may the state should simply keep its hands off. There are a number of ways to argue against state intervention, but one of the most fruitful ones is the *principle of subsidiarity*. This principle, which is rooted in the dignity of the human person, requires that the state should not intervene when matters can be resolved on more local

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levels and through voluntary methods. As Pope John Paul II put it:

By intervening directly and depriving society of its responsibility, the Social Assistance State leads to a loss of human energies and an inordinate increase of public agencies, which are dominated more by bureaucratic ways of thinking than by concern for serving their clients, and which are accompanied by an enormous increase in spending. In fact, it would appear that needs are best understood and satisfied by people who are closest to them and who act as neighbours to those in need. It should be added that certain kinds of demands often call for a response which is not simply material but which is capable of perceiving the deeper human need. One thinks of the condition of refugees, immigrants, the elderly, the sick, and all those in circumstances which call for assistance, such as drug abusers: all these people can be helped effectively only by those who offer them genuine fraternal support, in addition to the necessary care.¹

When it comes to old-age security, most people tend to assume that the state is strictly necessary; the market might provide pension products for richer individuals, but it is inconceivable that most people should rely on cold market forces alone. This way of thinking is understandable, because the envisioning the alternatives may take a bit of imagination. But it is understandable only in the same way as it may have been so in communist countries to assume that without the state there would be no food, housing or other basic necessities.

What might old-age security look like without the state? Let there be ordinary laws and necessary regulations but no public pensions policy. What would happen? Would people starve and freeze to death? The most probably answer is, of course, no. In less-developed countries (LDCs), where the state plays a limited role in old-age security, the government does not appear to be strictly necessary: family members and relatives look after the elderly as a matter of course. This was also the case in the affluent world just one hundred years ago. It is true that living standards in old age were meager for most people, but they were equally so during their entire lifespan.

The central point is this: even if there is no public pension policy, it is not mean that

1 Pope John Paul II, Encyclical Letter *Centesimus Annus* (1991), at no. 48.

everyone depends on the market. The market and the state are not the exhaustive arenas of interaction in any healthy society.

In the absence of state intervention, there are at least three principal sources of old-age security: the extended family, the market, and other civil society institutions such as charities and mutual-help societies. Each of these has its strengths and weaknesses, and considered alone, each institution has its limits. However, it turns out that these institutions are not rivals but complement each other.

Extended Family: A Private Pay-As-You-Go System

Governmental pension systems in the developed world are usually designed on a 'pay-as-you-go pensions' (PAYGO) basis. This means that all workers contribute a certain proportion of their wage to a public pension fund (or funds), which is then used to finance the pensions of the present generation of retirees. However, there is a much older pay-as-you-go mechanism: it is called the family.

In traditional societies families function as an informal insurance mechanism: parents look after their children, and, in return, children care for their parents in sickness and old age. This also happens to a surprisingly large extent in many affluent countries, especially when formal arrangements fail to give adequate support. Some people of course cannot have children of their own, or their children may fall ill and die. One solution to such localized contingencies is the *extended family*. When there is a larger group of individuals and couples, bound together by a common history, regular dealings, and mutual support, each of them is guaranteed better care in old-age and other periods of low income.

Informal insurance can seem inefficient in comparison with sophisticated formal insurance schemes. To some extent this is true. However, there are also advantages. For one, an informal system such as the extended family is more effective in solving informational and monitoring problems because all members have constant dealings with each other. Emotional ties also give stronger internal incentives to act for the common good. This results in less moral hazard and fewer free-rides—problems that are common in formal insurance markets and pension schemes.

The benefits of family go far beyond economics. The family is the most local level after the individual person, and it is the most basic and fundamental social institution.

Growing old has consequences unrelated to material needs, and the evidence on elderly loneliness and depression testifies that often the emotional needs are even more urgent. The provision of income security in old age is inextricably linked with nonfinancial care, and governmental pension programs and elderly homes have failed to provide what old people need most: care and attention from their loved ones.

Markets for Savings and Insurance

In addition to families, there is the market for savings and insurance. The market should not be seen as the only source of old-age security, but, in developed economies, it would play a major role. Indeed, private retirement savings and insurance already constitute an important part of retirement incomes in more market-orientated countries such as the United States and the United Kingdom. Savings schemes are likely to have indirect benefits such as better incentives to work and higher productivity due to capital accumulation and efficient resource allocation. Moreover, emphasis on savings would promote beneficial cultural values, including prudence, a long-term view on life, and greater personal responsibility.

This is not to say that everyone should save all they can for retirement. Savings and formal insurance could play a complementary role, along with an informal PAYGO within the family. Moreover, people could choose how and when to retire, if at all. There is generally a need to deinstitutionalize retirement patterns because, given the choice, many older workers might choose part-time work instead of once-and-for-all retirement. Currently, the rules and complexities of formal pension schemes make partial retirement difficult or impossible. Having a variety of old-age income sources would facilitate different retirement patterns and modes.

It could even happen that the very concept of retirement would disappear. That would not be a bad thing if people consciously chose that way. Historically, retirement is an invention of the government. Just 75 years ago, when public pension schemes were not significant, more than one half of all men over sixty-five were still working. In those days, some people had to quit working for health reasons, as happens now, but general health outcomes have greatly improved since then. Today, an increasing number of people are realizing that they might want to work longer, and the system of old-age security should facilitate and encourage that. A combination of savings and familial support would most

certainly do so.

Civil Society: Charities and Mutual Aid

Old-age security in a free society would not be limited to families and markets. An equally important factor is other civil society institutions, such as charities and mutual aid organizations. Charities would provide support for the poorest members of the society, those who are unable to look after themselves and may also lack a family that cares for them. In developed countries, private charities have taken an increasingly important role in solving needs not looked after by markets or governments.

In addition to traditional charities, there would be mutual-aid societies, which are a kind of middle way between the extended family and formal insurance.² Popular especially in the eighteenth and nineteenth centuries, mutual-aid societies came in various sizes and shapes, such as trade unions, friendly societies, credit unions, self-help groups, and fraternal organizations. They were often based on some common religious or ideological convictions that help to establish loyalty and commitment. Like families, charities and mutual-help societies are the principle of subsidiarity in action. They possess numerous advantages such as voluntary support, local knowledge, local action, commitment, and ability to innovate.

Members and beneficiaries would not depend on their families and private savings alone but would receive additional security from this third sector. Before welfare states were created, mutual aid societies were extensive and efficient. Fraternal societies provided practically every kind of welfare service: orphanages, hospitals, job exchanges, homes for the elderly, scholarship programs, and so forth. They also supplied health insurance at much lower rates than the present-day formal schemes. They were able to do so because their members knew each other and supported each other, so there was less opportunity (and less desire) for moral hazards and free-rides. Today, mutual-help societies could combine their informality with the benefits of sophisticated financial markets so as to pool their risks better than in the past.

If mutual aid was really so impressive, one wonders why that tradition has largely been lost. The answer seems to be simple: governmental welfare programs drove it out. Sadly, the change that took place did not replace like with like. The greatest virtue of

² See David T. Beito, *From Mutual Aid to the Welfare State: Fraternal Societies and Social Services* (Cambridge: University of North Carolina Press, 1992).

mutual-help societies was their commitment to helping individuals where they needed it most. They did not paralyze those who asked for assistance but fostered self-reliance, thrift, and self-control. Now, instead of approaching voluntary organization marked by reciprocity and a fraternal spirit, the poor and unfortunate must go to unfriendly bureaucracies dominated by legalism and collective frustration. Government welfare programs tend to make the poor passive and to penalize effort; where mutual-help societies did all they could to put people back on their feet.

Government Solutions: Potential and Risks

There are various things governments can do to shape the landscape of old-age security. Some of these may be beneficial, while others are less likely to be so. For the sake of simplicity, the following discussion considers two general types of government intervention: (1) pay-as-you-go pensions, and (2) compulsory private pensions. However, before looking at specific policies, it is worthwhile to look at some common problems with state intervention.

Problems with state intervention

There are at least three common problems with large-scale state intervention in the life of the society: insufficient information, unintended consequences, and public choice difficulties.

Firstly, the state usually has *insufficient information* to make prudent decisions on complex issues. This was the crux of Hayek's classic argument against socialism.³ It is very much applicable to the complex issues surrounding old-age security, because it is hard for individual public actors to understand well what the nature of the challenge is, what alternative solutions there might be, and how the solution can be executed most successfully. The bureaucratic nature of government also demands that programs are sufficiently formal, but this causes difficulties when predicting the relevant variables – population growth, longevity, employment, wage levels, etc. – is an inherently hard task. It is hardly surprising that public pension schemes are becoming unsustainable in the long

3 F. A. Hayek, 'The Use of Knowledge in Society', *American Economic Review* (1945), Vol. 35, No. 4, pp. 519-30. Available online at www.econlib.org/library/Essays/hykKnw1.html.

term.

Governments can also be clumsy in responding to practical challenges. This relates to the second common problem, which is that any state intervention is likely to cause *unintended consequences* that can be difficult to handle. Public pension are really a case in point. The reason for the looming crisis is not so much rising life expectancies as early retirement and low fertility rates. But according to a number of studies, it seems that the latter problems have partly been caused by the pension systems themselves.⁴

As far as incentives to work are concerned, current pension schemes tend to impose implicit penalties for working longer, which encourages early retirement. Because contribution rates are high, and later retirement is not properly awarded in most countries, people are leaving the labour force earlier and earlier. In fact, people are also entering the labour force later than before, because income taxes are high and public education is subsidised from tax revenue.

Governmental pension schemes also seems to encourage smaller families. In a public PAYGO scheme, current pensions are financed from the contributions of the current working population. In the absence of these schemes, children would repay their parents when they grow old. Now, this does not happen, because everyone is forced to support the entire body of elderly folk, regardless of how many children they have had. Thus having fewer or no children becomes relatively cheaper. Fertility rates are now below replacement levels in many countries, and this is a major reason for the insolvency of pension schemes.

Thirdly and lastly, actors in the public square can be tempted by their private interests to the detriment of the common good. According to 'public choice theory', politics is not always directed towards the good of the society as a whole, but the private interests of individuals and groups.⁵ For pension policy, this makes it especially difficult to sort out the existing pensions muddle in a sensible way. Some analysts argue that population ageing is going to make it ever more difficult to achieve good reforms, because older electorates will put pressure for an increasingly bloated pension system at the expense of

4 On pension systems and incentives to work, see Jonathan Gruber and David A. Wise (eds.), *Social Security and Retirement Around the World* (Chicago: University of Chicago Press, 1999). On pensions and fertility, see Isaac Ehrlich and Jinyoung Kim, 'Social Security and Demographic Trends: Theory and Evidence from the International Experience', *Review of Economic Dynamics* 10, no. 1 (2007): 55-77, and Michele Boldrin, Mariacristina De Nardi and Larry E. Jones, 'Fertility and Social Security', NBER Working Paper No. 11146 (2005).

5 James Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962). Available online at www.econlib.org/library/Buchanan/buchCv3Contents.html.

the working population.⁶

Public PAYGO Pensions

If one takes a longer-term perspective and distances oneself from the existing pension muddles, one wonders whether extensive PAYGO schemes are a good idea in the first place. They have deep-seated inflexibilities and inefficiencies, which result from the way in which they impose one retirement mode on everyone.

With respect to government's role in old-age security, the provision of assistance to the needy may be justified, but comprehensive government pension schemes are more difficult to defend. Existing PAYGO schemes rarely focus aid to the poor; in fact, the opposite seems to be the case. Pension benefits under these programs are highly dependent on years and amount of contributions, which means that those who really need public assistance receive little or nothing. Public pension systems are not helping the poor by redistributing funds. In many cases, they do not even try to do that. In the United States, for example, the Social Security rules are designed in such a way that on average the system transfers resources *from the lifetime-poor to the lifetime-rich*.⁷ This is even more so in Continental Europe: benefit levels are linked not to total contributions but to final salaries, which tend to grow more for white-collar workers, and these also start their careers later and live longer after retirement. These schemes seem to favour the rich at the expense of the poor.

A potentially better option would be to have a small basic pension, available universally regardless of contributions. The overall cost of such a pension could in theory be reduced by making it means-tested, but the experience with means-testing is highly negative because it creates harmful incentives and tends to exacerbate income inequalities.⁸ The cost could also be cut in other ways, such as setting a higher eligibility age, something in the range of 70 through 75. The benefit level should also be made low, so that it is only relevant for those who really need it. The small basic pension would assist in cases where people have failed to save enough and have no family to support them and would also provide additional support for those who live unusually long.

6 Vincenzo Galasso, *The Political Future of Social Security in Aging Societies*, (Cambridge: MIT Press, 2006).

7 See for example Julia Lynn Coronado, Don Fullerton, and Thomas Glass, 'The Progressivity of Social Security', NBER Working Paper No. 7520 (2000).

8 See for example David Neumark and Elizabeth Powers, 'The Effect of Means-tested Income Support for the Elderly on Pre-retirement Saving: Evidence from the SSI Program in the U.S', *Journal of Public Economics* (1998), Vol. 68, No. 2, pp. 181-206.

Compulsory Savings Schemes

A different approach is to compel people to save some specific proportion of their earnings for retirement. If one compares compulsory savings with governmental PAYGO pensions, they certainly have numerous merits. For example, they give better incentives to work, and they offer larger pensions for a given level of contributions.

However, one must ask why there should be compulsion if one wishes to give people more freedom and responsibility. A downside of compulsion is that it forces everyone into the same pattern. In the absence of compulsory savings, it is actually not necessary for everyone to rely on their own savings. In LDCs today, most people save for retirement indirectly, not by accumulating assets, but by “investing” in a larger family.

Compulsion may also create inefficiencies in the market, because it tends to go hand in hand with heavier regulation. In Chile, for example, the government has imposed a multitude of onerous and rather senseless limits on the investment of compulsory pension assets. Investments in foreign assets have been particularly restricted, which has major implications because international diversification is one of the key methods for protecting the funds against national shocks as well as bad government policies (such as monetary inflation).

Replies to some Arguments

A number of objections may be raised to the proposal to pull government back from old-age security. The most obvious difficulties with a nongovernmental approach are the defects of market pension schemes, the inability of some people to save sufficiently, and the limits of charitable activity. These are justified worries, but their force does not appear strong.

Limits of Markets: Insolvent Companies and Crooks

There are two common worries concerning markets. One is that companies are less stable than governments, and, if they fail, some individuals will lose all their savings.

Another is that purchasing savings and insurance instruments requires knowledge that many people do not have, and this could result in ruthless exploitation of innocent people.

The latter objection is mitigated by market competition. If ordinary people were to invest more in financial instruments, there would be a market opportunity for companies to develop safe, easy-to-access products coupled with hands-on service. There already exist various kinds of old-age insurance, including products with very low or even no risk. Besides, getting poor investment returns does not mean that everything is lost. One should remember that the alternative, government schemes, normally provide a worse deal without any hope of higher returns.

There is of course the possibility of crooks operating for short-term profits. In practice, this is mitigated by longer-term market dynamics: Companies can make bigger profits if they grow in size and extension, and this in turn requires more long-term commitment to safety and quality. Moreover, there could develop nonmarket, nongovernmental organizations such as investment clubs, which could grow out of mutual-aid societies.

A more powerful criticism is that markets tend to be inefficient and waste savings in administrative fees. It is often said of the Chilean system of compulsory savings that it has created large overhead costs, and fund companies are robbing workers by making record profits without reducing their charges. However, as a starting point, one should not forget that governmental schemes have large overheads too, and generally speaking private operators have better incentives to act efficiently.

The problem in Chile seems to result from poor competition in the industry, which in turn is due to the over-regulation of the system – an important reason to be cautious of compulsory savings schemes. These companies are able to make excessive profits, because it is difficult to enter the market and challenge the established players. In addition to relaxing uncompetitive regulations, the government should allow Chilean workers to bundle together, so that they could demand better deals from the funds. Such bundling could take place through mutual-aid societies.

Limits of Human Being: Short-Termism and Undersaving

A different kind of concern is that individuals cannot be trusted: if people are left to decide for themselves, they might be tempted to make short-term decisions and

consequently save too little for retirement. Note, however, that this should not be seen an issue in principle, because there is no reason why people should provide for their own retirement through personal savings. This is why it is so crucial to include families and civil society organizations in the equation.

Moreover, the undersaving concern seems to be misguided. It is true that some individuals save systematically too little, but this is at least partly the result of welfare programs which penalize saving. In the United States and the United Kingdom, for example, the rules on means-tested retirement benefits penalize wealth accumulation, and thereby render hand-to-mouth living the economically optimal choice under the circumstances.

In the absence of perverse incentives, judgmental difficulties need not result in undersaving but could equally lead to *oversaving*—a perfectly acceptable outcome. There is no evidence of a widespread short-term bias. In contrast, most people are *risk-averse*, which means that (in the absence of public pension programs) they would be likely to save so much that they had a good retirement secured. The limited evidence there is suggests a tendency toward oversaving.⁹

Private savings could also be encouraged without introducing compulsion. In fact, companies providing old-age insurance would exploit judgmental biases so as to encourage more sales. The government could also correct behavioral anomalies by providing *default rules*, that is, rules that are followed unless one specifically demands otherwise. In general, these have been found to have a strong effect on how people behave. There could for example be an automatic investment paid from one's salary unless one explicitly chooses to opt out. Those who wish to opt out would do so conscious of the risks involved and probably would already be in contemplation of some other way in which their old-age income is secured.

Limits of Charity: Emotions and Fluctuations

Finally, there are limits to charitable activity. In general, charity can be driven more by emotions than by objective needs. Charitable behavior may be too slow to act until *after*

⁹ A recent study by the New Zealand Treasury finds that, overall, actual private savings rates are higher than people need to maintain current living standards in retirement. Slight 'oversaving' is found across different social segments. There are just two groups that are possibly saving less than enough: the really poor and the really rich. The latter do not need to save, whereas the former generally cannot and will in any case be looked after by public programs. See Grant Scobie, John Gibson and Trinh Le, *Saving for Retirement: New Evidence for New Zealand*, New Zealand Treasury Working Paper 04/12 (2004); available online at www.treasury.govt.nz/workingpapers/2004/twp04-12.pdf.

the problem has been created. In the case of elderly poverty, one would not wish to see elderly people dying of neglect before someone came to their rescue. However, there is every reason to believe charity would be more efficient than in the worst-case scenario.

Although it is true that charities often do receive funds when some disastrous event takes place, there are also other kinds of charity. The Red Cross is an example of a charity that operates on a very long-term basis and continuously receives substantial donations. There could be similar charities devoted to caring for the less fortunate in old age. Most people know some elderly people, so their condition is not a marginal or unknown concern. If there was a growing problem with old-age security, this would be widely known, and responsible individuals would address it.

In practice, the funds needed might well be modest. Elderly poverty is only common when there are other kinds of poverty too, as in many LDCs. In economically developed countries, where there are plenty of resources for old-age purposes, charity would only have a limited role because the majority of people would look after themselves and their families through work, savings, and mutual aid.

Conclusion

Old-age security in the absence of public programs would come from a number of sources, including extended families, savings in financial markets, mutual-aid societies and charity. There might also be scope for a small basic pension at an older age such as 75. It is however impossible to predict exactly what old-age security would look like in the absence of government programs. Institutions and customs related to old-age security are interlinked and complex wholes that feed into each other.

For example, the imposition of compulsory, large-scale public PAYGO systems will undermine private PAYGO systems (i.e., families and extended families). Governments taking care of the poor will also undermine voluntary associations and mutual-help societies because of the crowding-out effect. Even private market solutions may undermine nonmarket institutions, although in some respects they also complement each other. Institutions do not exist in a vacuum; they are born and maintained for a purpose, and when that purpose ceases to exist, institutions can be eroded.

Having a combination of sources of income security would have the advantage of

systemic *heterogeneity*. There would be many different systems linking to each other and complementing each other, which gives rise to a totality that is more robust, more flexible, and more adaptable than any kind of formal solution. When people are left free to solve their problems, they are surprisingly responsible and creative in sorting things out.

At the end of the day, it is difficult to create a single model that works perfectly everywhere, because old-age security is interwoven with the economic, social, cultural, and political conditions of each society. This particularly calls for the virtue of *prudence*, which requires that all thinking and acting is made compatible with the objective reality. We must strive to know the truth and learn from mistakes, which at times requires true courage.

But even more important is *charity*—not just external charitable acts, but true charity, which stems from the heart and requires continuous interior conversion. It also requires being watchful of the temptation to shirk personal moral responsibility by relying solely on government policies or on the merits of competitive markets, because the virtue of charity is a characteristic of human persons, not of institutions. Transferring the requirements of charity to formal institutions—such as social security—can undermine charity on an individual level. On the other hand, pulling the state back does not necessarily lead to more a humane economy; economic liberalization alone is not enough to restore charity. Charity comes from individual men and women who, through their work, family life, and generosity toward the needy, are called to cooperate in the creative, life-giving, and redemptive action of God.

These final considerations are summed up, better than the present author could ever do, by Pope Benedict XVI in his first encyclical letter, *Deus Caritas Est*:

Love—*caritas*—will always prove necessary, even in the most just society. There is no ordering of the State so just that it can eliminate the need for a service of love. Whoever wants to eliminate love is preparing to eliminate man as such. There will always be suffering which cries out for consolation and help. There will always be loneliness. There will always be situations of material need where help in the form of concrete love of neighbor is indispensable. The State which would provide everything, absorbing everything into itself, would ultimately become a mere bureaucracy incapable of guaranteeing the very thing which the suffering person—every

person—needs: namely, loving personal concern. We do not need a state that regulates and controls everything, but a State which, in accordance with the principle of subsidiarity, generously acknowledges and supports initiatives arising from the different social forces and combines spontaneity with closeness to those in need. The Church is one of those living forces: She is alive with the love enkindled by the Spirit of Christ. This love does not simply offer people material help, but refreshment and care for their souls, something which often is even more necessary than material support. In the end, the claim that just social structures would make works of charity superfluous masks a materialist conception of man: the mistaken notion that man can live 'by bread alone' (Matt. 4:4; cf. Deut. 8:3)—a conviction that demeans man and ultimately disregards all that is specifically human.¹⁰

10 Pope Benedict XVI, Encyclical Letter *Deus Caritas Est* (2005), no. 28(b).