The Role of the State in Society – Government vs. Citizen Responsibility

Giuseppe Bertola
Professor of Economics, Edhec Business School

The title of this panel may be a little misleading if it gives the impression that citizens should deal with social issues as individuals, rather than through collective institutions. Human beings, unlike some other animals, do not hunt alone or in small packs, and do not just squirrel away stocks of food to shelter future welfare from bad luck and old age. In history protection from life risks has always led to the same increasingly complex social interactions that, through markets or governments, enable mankind to enjoy a better standard of living.

Human societies establish chains of command, organize information flows and enforce property rights for the purpose, not only of organizing production efficiently but also of distributing it across individuals and over each individual's lifetime. So while the issues discussed in this panel are very topical, as there is no doubt that recent and likely future developments pose very serious challenges to the role of governments in social protection, they are also very old.

Income sharing and the nation

To identify the sources and possible solutions of current challenges it may be insightful to recall why and how governments came to play an important social protection role.[1] Historically, the largest step away from traditional sharing of income within extended families or tribes occurred with the industrial revolution. Organization of production in large firms eased division of labor and made it possible to exploit economies of scale, but also severed the blood relation and personal acquaintance ties that bound village-sized societies together. A society of city-dwelling workers required a new social texture, based on disciplined execution of simple tasks as well as on self-interested market participation. And it needed to organize transfers of resources over time and across individuals through collective schemes, as well as through the increasingly sophisticated contracts made possible by the development of stock markets, banks and insurance companies.

The same advances in communication and transport that increased the scale of production and trade also made it possible to develop cultural traits that would allow resources to be shared more broadly. Contracts that entail more than a spot exchange need to rely on legal enforcement when they extend beyond the range of personal reputation and trust. The new nations established in the last few centuries were based on more or less artificial ethnic ties, but especially on the development of cultural features common to all social classes in large geographical areas. This was a new development, as the cultural basis of previous large-scale political entities was too shallow to even establish a common language outside of the elite classes, and made it possible for industrial production to support, over the same relatively short span of history, unprecedentedly fast and broad economic growth.[2]

The socio-political infrastructure of nations not only provided a suitable legal framework for large-scale operation of markets, but also extended the scope of solidarity beyond each individual's immediate circle of family and acquaintances, making it possible to fund and administer the formal social insurance schemes needed to replace the family- or village-level safety nets destroyed by urbanization. As regards pensions, the mostly public and unfunded pension schemes of European countries reproduce at the national level the old-age support that used to be supplied across generations within families or villages. The pay-as-you-go relationship between contributions and pensions reduces capital accumulation below what would be implied if each individual had

[1] See e.g. Bertola (2007) on the origins of national social protection schemes; Foucault (1975) or Seabright (2010) on more general socio-economic features of industrial societies.

[2] Maddison (2007) estimates that world per capita income has grown by more than 600 percent since 1820, only by 20 percent between 1500 and 1820.

to provide through savings for old age: but the same would have been true in villages where adult children cared for their aging parents instead of accumulating resources for their own old age. In modern societies with looser personal ties, public schemes can in fact be more efficient than financial market contracts if individuals do not have accurate information about their future needs and current investment opportunities, and the government's ability to enforce mandatory participation can prevent individuals from free-riding on the social assistance that the government is bound to provide if they do not save enough (or do not have enough children) to provide for themselves in old age.

Europe and finance

As recent events have made clear, and as the Panel is meant to discuss as regards old-age pension schemes specifically, no solution is perfect. New problems arise from the solution offered by nations to the problem of adapting market and social infrastructure to the transition beyond agriculture and villages. In order to foster solidarity within their boundaries, nation-states cultivate not only their citizens' common cultural roots, but also the fear and hostility towards strangers that make war politically acceptable. Changes over time of the environment in which nations operate are also problematic, as the socio-economic scale that was suitable for the early mass-production stages of industrialization need not remain efficient forever: further fast progress of communication and transportation technologies, and the spread of nationalism to less developed regions of the world, undermined the socio-economic foundations of closed and imperialistic nations.

Over the last few decades, solutions to such new problems have emerged. On the one hand, in the form of a European process of supranational economic and monetary unification that was explicitly motivated by the desire to prevent further war through economic and cultural convergence. On the other hand, in the shape of increasingly sophisticated and broad financial markets that are potentially capable of engineering the transfers of resources that once took place in families and villages, and that national schemes may find it increasingly difficult to organize in an environment where trade and factor mobility undermine governments' ability to enforce mandatory contributions and taxes.

Just like other national solidarity-based programs, public unfunded pension schemes can be undermined by trade and factor mobility opportunities that, at least to some extent, effectively make it possible for income earners to opt out of supposedly mandatory taxes and contributions, by producing abroad, and for poor individuals to seek subsidies in more generous systems. A more imminent challenge to public pay-as-you-go pension schemes arises from demographic trends that, in most developed countries, call a shrinking number of working-age individuals to provide for ever larger cohorts of retirees.

Ageing is also a problem for funded pension schemes, however. In modern economies, private savings increase the stock of productive capital, rather than a hoard of accumulated consumption goods. To the extent that a smaller labor force decreases returns to investment, it also reduces the viability of funded pension schemes. From this perspective, it is unsurprising to see that defined-benefits pensions disappear even faster in the private sector than in public-sector pension reforms. Regardless of whether they are funded or unfunded, private or public, pension schemes can react to demographic trends in two ways only: by delaying retirement, and by adapting old-age benefits to longer survival probabilities.

Ageing internationally

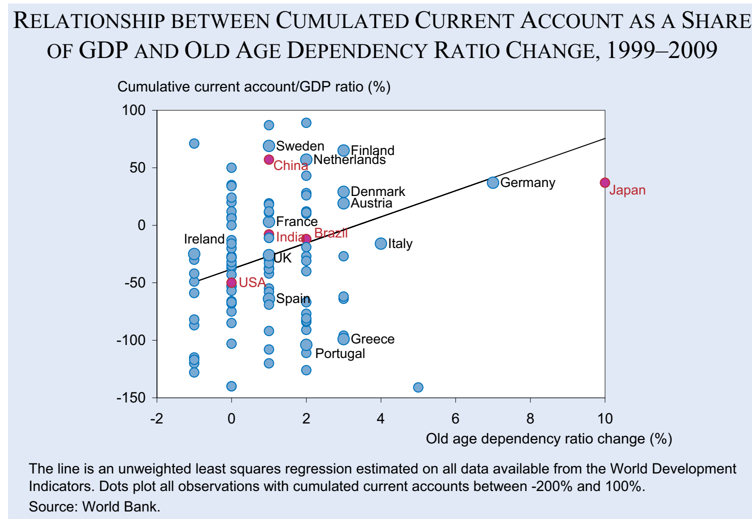
Life expectancy does not only vary across generations within the political and cultural boundaries of nation-states. It varies with socio-economic conditions within generations, and within countries and cities.[3] And its generational dynamics are rather different across countries, making it at least potentially possible to seek international solutions to national pension problems. Just like in early industrial societies old-age support could not be provided by families, nations where a shrinking labor force challenges both public and private retirement schemes may need to rely on globalized economic interactions.

Figure 1 reveals two interesting and relevant facts. Between 1999 and 2009, Germany has been getting older faster than any other country but Japan, and has accumulated one of the largest current account surpluses among industrialized countries. This country-specific observation lines up neatly in the figure

[3] For example, life expectancy decreases by roughly one year per Tube stop along lines than run from Central London to the East End: see http://eurohealthnet.eu/research/health-inequalities/health-differences-europe.

Figure 1

RELATIONSHIP BETWEEN CUMULATED CURRENT ACCOUNT AS A SHARE OF GDP AND OLD AGE DEPENDENCY RATIO CHANGE, 1999–2009



The line is an unweighted least squares regression estimated on all data available from the World Development Indicators. Dots plot all observations with cumulated current accounts between -200% and 100%.
Source: World Bank.

with the strong and statistically significant relationship, across all countries with available data, between cumulated current accounts and changes in old age dependency ratios over the last ten years. For countries that need to provide for their ageing citizens, it is very sensible to consume relatively less, and to invest their savings in countries where young workers will remain relatively abundant over the relevant time horizon.

As usual, there is no perfect solution: international opportunities come with international pitfalls. The savings that German society entrusted to its banks were invested in the liabilities of countries that had less severe ageing problems and were also growing fast, such as the United States of 1990s productivity miracles, and the EU peripheral countries that had been catching up since their accession in the 1990s. Past performance, as usual, does not guarantee future returns. Hopes of reliable repayment waned as the recent crisis made it doubtful that the United States could rejoin its past growth path, and made it certain that Greece will be unable to replicate the 30-percent real per capita GDP growth it experienced between 2000 and 2007.

While disappointing international investment returns may lead some to advocate a return to earlier nation-centered configurations of socio-economic relationships, more likely developments can be identified analyzing the problems that emerged during the crisis for the European Union and financial development solutions to the problems of nation-based systems. Unification of markets, and then of monies, has been meant since the 1950 in order to prevent further wars between European nations. The process was enlarged in the 1980s to countries burdened by a history of colonial or imperial rule and fascism, and then to Central and Eastern European countries that had experienced Soviet domination, aiming to foster their cultural and economic convergence by adoption of *acquis communautaire* good government practices and of a market-based economic framework. The acceleration of financial development was also meant to address the real problem of matching, in better ways than those of families and governments, the diverse investment and savings of individuals and countries interacting in increasingly complex and open economies.

Just like those who invested in innovative financial products expressed faith in the power of diversification, those who bought Greek debts purchased a stake in that supranational European project. The financial and economic crisis of 2008–09 showed that diversification is powerless in the face of aggregate shocks; that macroeconomic shocks can undermine confidence in private and public debt repayment by slowing down prospective growth of incomes and tax revenues; and that default can occur and spread as loss of confidence drives unsustainable default premia into debt service ratios. It did not show that that development of financial markets and supranational institutions caused any of these age-old problems: rather, it indicated how further evolution of those welcome developments may make future crises less severe.

Beyond the crisis

Financial markets will need to be better regulated internationally, within Europe as well globally. And Europe will need to move further beyond its past national configuration, because it would be poorly equipped to compete with such multi-ethnic continent-sized entities as China and the United States if social cohesion and political consensus still needed to rely on recent and sometimes artificial feelings of national solidarity.

The European economic integration process was always meant to extend solidarity beyond the borders

of previously belligerent nations. This is not easy, of course, and fiscal and social policies have so far remained assigned to national governments. Just like renouncing monetary sovereignty was necessary to ensure that European market would be stable and large enough to allow the large-scale investment and production of modern technologies, however, social policy and income transfers will ultimately need to transcend the boundaries of the nations that existed in Europe over the last few centuries. The scope of collective policies cannot be very different from that of economic interactions made possible by the progress of communication and transportation technologies. Every society needs a system of income transfers and public debt service, while part of that system in a closed economy, needs to rely on tax revenues that in an open economy can quickly disappear as economic activity moves elsewhere.

It is for this reason that in the United States most states are legally bound by balanced-budget rules,[4] and the Federal government backed public debt since the very beginning: as George Washington wrote in 1793 to the House of Representatives, *"no pecuniary consideration is more urgent than the regular redemption and discharge of the public debt: on none can delay be more injurious, or an economy of the time more valuable"*.

In Europe, the Maastricht Treaty's debt and deficit constraints aimed at addressing much the same problem as state-level balanced budgets in the United States but could not be enforced while national governments retained all fiscal policy powers and all political legitimacy. Unfettered economic integration, however, is logically inconsistent with subsidiary fiscal powers. If factors and goods can move freely across the boundaries of fiscal constituencies, tax bases will ultimately be too elastic to support income redistribution and issuance of public debt for tax-smoothing purposes.

Just as in the United States and other large Federal countries, fiscal union will be the solution to the problems made evident by the current crisis. Not a perfect solution, of course, and fraught with new pitfalls. But certainly a better development than a return to closed national economies unable to support economic progress, and a feasible one if elements of fiscal and social union will be accompanied by the development of that common political culture which would support restraints on national government powers, and complete the process which, in the aftermath of World Wars, envisioned economic union as a means to a cultural union end.

Extraordinary changes are needed, and possible in the aftermath of a crisis that brought about unprecedented coordination of macroeconomic policies not only at the global level, averting the danger of a new Great Depression; but also at the intergovernmental level in Europe, averting the danger of sovereign insolvency and financial meltdown. Recent institutional developments in Europe combine the relevant ingredients (extended solidarity as regards public debt management, and shared responsibility through policy monitoring and coordination as regards old-age and social policies) with political concerns that still make it difficult for countries to help each other financially, and to accept supranational coordination. The Franco-German proposal to enforce by intergovernmental methods a coordinated increase of retirement age and harmonization of corporate tax bases in the euro area was met with considerable skepticism in Spring 2011. Only a rather loose 'Euro Plus Pact' was annexed to the March 2011 European Council Conclusions, whereby common objectives should be 'politically monitored' by Heads of State or Government and the European Commission should agree with EU member countries the sustainability gap indicators for pensions, health care, and social benefits. The regulatory framework that would make it possible for private financial markets reliably to fill citizens' old-age protection needs is also hard to implement and enforce supra-nationally.[5]

The future and the past

While the shortcomings of financial markets and of economic union without political union have been very apparent in the current crisis, socio-economic institutions will certainly evolve further. It would not be constructive to lament the demise of national system or advocate a return to those or other obsolete organizations. Rather, it may be useful to remember that nation building processes went through much the same difficult steps as Europe is called to climb.

The boundaries of the German Empire and of other national entities were established by wars, by 'blood

[4] See e.g. Bassetto and McGranahan (2011) for institutional information, theoretical considerations, and empirical evidence.

[5] The European Commission's 2010 Green Paper on pensions COM(2010)3765 notes that there are substantial gaps in EU-wide regulatory aspects and advocates a EU role in 'surveillance, coordination, and mutual learning'.

and iron' in the words of Bismarck, who quickly proceeded to cement national solidarity through provision of social protection. The process that is leading to Europe's further unification is peaceful instead, indeed rooted in the desire to prevent further wars among Europe's peoples. Its steps, however, do resemble closely those of the process that over some 50 years in the nineteenth century led Germany to economic before political unification,[6] and certainly fostered doubts similar to those that many now express about Europe's integration process. Political consensus can no longer be based on national identities when economic and social interactions take place either at sub-national levels, or globally on the internet. Abandoning the euro would make no more sense than re-adoption in German regions of pre-Deutsche Mark currencies, as might yet happen if Landesbank losses caused by an unlikely (but still possible) collapse of the single European currency proved difficult to manage within Germany's federal fiscal system.

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Panel

Panel Chair **Robert Thomson,** Managing Editor of *The Wall Street Journal* and Editor-in-Chief of Dow Jones, had an optimistic and a pessimistic view on ageing. The optimistic view is that most of the people attending this Summit will grow much older than at any previous time in history; the pessimistic view is that they will be unaffordable. Actuaries, he quipped, have therefore become very fashionable. To put a figure to the pessimistic view, he quoted a couple of statistics: by 2035, two-thirds of every federal tax dollar in the United States will go to state health care and pensions. In New Zealand, the number of people over the age of 85 has trebled over the past 30 years. The challenge, then, is sizable – and growing.

The first panel speaker was Bavarian Economics Minister **Martin Zeil**, who started by quoting Ludwig Erhard, the father of the social market economy and of Germany's 'economic miracle': *a good economic policy is the best social policy.* And that is exactly what Mr Zeil believes every country needs in order "to put [its] social system on a firm foundation for the future". The main task of an effective social policy, he said, must be to strengthen the performance of the economy in the face of global competition by supporting innovation, education, efficient infrastructure, transparent regulations and a sound energy policy. But at the same time the state must continue to be the guarantor of social security. People in need should continue to be entitled to transfers through the basic allowance scheme, which in Germany is "in principle a sensible combination of due solidarity and the incentives necessary to re-enter the labour market". It has contributed to an increase in employment by providing more incentives to take up a job and reducing calls for a minimum wage. "We are building on more personal responsibility and more self-reliance, for it is definitely not the task of the state to guarantee all-round insurance". This has also brought Germany one step further along the road to adapting the social security systems to demographic change.

Mr Zeil was followed on the podium by **Aigars Štokenbergs,** a former Latvian Minister of Economics who is now Minister for Justice. Given that the economic and demographic situations differ, he said, "there are no one-size-fits-all solutions". For instance, Latvia's raise of the retirement age from the current 62 to 65 by 2021 may sound modest, but life expectancy in his country is somewhat lower than elsewhere, with 13 survival years for men and 20 for women. The country has undertaken a number of other reforms of its social security systems, including raising the number of years to qualify for a minimum pension and reducing some contributions to the disabled and to working parents. But not without hitting some snags: some measures were overturned by the Constitutional Court, forcing a repayment of the benefits that had been slashed. But his country remains ambitious: it wants to reduce its budget deficit to 2.5 percent of GDP in 2012, with a view to fulfilling all conditions to join the eurozone in January 2014. As regards the future, from a social standpoint, he mentioned a min-

[6] The pan-German Zollverein and Münzverein closely resembled the process of market and monetary unification in post-war Europe. As in Italy, monetary union occurred in Germany at the same time as political unification; in older nations, such as France, political union preceded the monetary reform process necessitated by the industrial revolution in the 19th century.

ister in the Norwegian government who had just become a father and who is taking parental leave as a result. *That* is the kind of future way Mr Štokenbergs wants for his own country as well.

The last speaker was **Kurt Biedenkopf,** a former Minister-President of Saxony. In the 1950s, he said, with the country recovering from the war, Germany defined the social function of the state as helping citizens to help themselves. If they should be unable to do so, they would be supported by the state for their basic needs, but not beyond. In other words, the state should not become a nanny to its citizenry. Now, fifty years later, a wealthy population has come to expect more expenditure by the government on social security, but we are now in a situation "where it is necessary for the people to relieve the state of some of the promises it has made, by providing more for their own future". This requires a cultural change, but that cannot be achieved by political fiat. Social systems, after all, have deep cultural foundations. Furthermore, "we have no experience with an ageing society. We have never had one in history". It is likely that people will have to work for as long as they live, or as long as they can, with 'the 70-year-old taking care of the 90-year-old', while the working population finances the younger retirees. We will need more personal solidarity, more mutual support in the community. But given that the elderly will command many votes, there is the risk of the elderly pushing laws through that will oblige the young to pay for what they decide they need. A backlash would be likely.

During the ensuing discussion, Mr Thomson asked whether there should be a distinction in the retirement age between people who do administrative work and those who do heavy manual labour. Mr Bertola settled for '60'. "Given that after 60, in some trades you cannot do the same work you did before", he stressed that what is important is that the opportunity must be open for those reaching that age to do something equally useful.

Mr Štokenbergs argued that we should think about 'integrating the elderly into work'. A simple calculation, he added, says that people spend 20 percent of their lives in their formative years, 20 percent in retirement, and 60 percent working. If they live longer, the equation should also change: it now means *we simply have to work longer.* Retraining would play a big role in keeping people in occupation.

Mr Biedenkopf pointed out that retirement age is a fairly new concept. When it was introduced in Germany in the late 19th century it was 70: "none of the workers secured ever reached this age". A better way would be to set an age, say 65, after which the government will cover your basic needs, and if you continue working beyond that age, your retirement payment increases, as if were capital-based. This would eliminate the need for the government to prescribe the retirement age. People would have an incentive to decide themselves how long they wish to work. "Retirement age will not be very stable in future", he predicts.

Mr Bertola added that the approach must be two-pronged. On the one hand, giving people who want to continue working the chance to do so, and on the other, take account of the differences in life expectancy. As an aside, he also pointed out that retirement age is handled as a nationwide issue, when in fact "moving east from central London, life expectancy decreases by one year every Tube stop". Mr Biedenkopf immediately retorted that "this is one additional reason why the government should not prescribe a particular retirement age".

Mr Thomson then threw a provocative question to his panellists: "do you think people in Portugal or Greece retire too early or have too many holidays?" Mr Bertola approached the answer from an angle: "the feeling in Germany, as I understand it, is that if you have to bail out a country for the unsustainable promises it made to its own people, then the promises must be changed". Mr Štokenbergs, in turn, said that the key issue is not how many holidays they have, "but how well prepared people are to take on the challenges of the modern world".

Mr Biedenkopf concurred. Compared to the situation of 50 years ago, he said, Germans have now 52 additional holidays just by not having to work on Saturday. "This is perfectly alright. Holidays by themselves are not an expression of whether countries are lazy or productive. If the productivity of a country is such that it can produce what we all need in four days, then the holidays would be three days per week". We would first have to look at the productivity of the countries where these holidays are earned. If the Portuguese want to have the number of holidays they have, let them have them. "But they should not pass on the cost of their holidays onto others".