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Correction 1

April 21, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: Long-Term Trends in Social Expenditure in the Group of Seven
Major Industrial Countries, 1980-2025

The following corrections have been made in SM/85/327 (12/13/85):

Page 52, 1st full para., 4th line from bottom: for "between 2000 and 2022,"
read "between 2000 and 2027,"

Page 54, 2nd full para., lines 1 and 2: for "but their proponents...on
saving,"
read "but the proponents of funding
highlight its positive
impact on saving,"

Page 67, 2nd full para., lines 1-5: for "In Germany, the government...
medical services."
read "In Germany, since the mid-1970s,...
medical services."

Page 107, Appendix II, paragraphs on Germany: Revised

Page 108, Appendix II, paragraph on Japan, line 7: for "65 for men and 60
for women"
read "60 for men and 55
for women"

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

indicates the effect of combining the "greater aging" demographic scenario with the baseline economic scenario (see also Appendix Table 14). In all countries, final expenditure ratios are higher, although in some countries there is either no difference before 2000 or the expenditure ratios are initially lower (France). In no country is the "greater aging" scenario so much more unfavorable than the baseline scenario that the final expenditure ratio increases markedly. However, the differences reflect 1 percentage point or more as found in France (2.6), Italy (2.4), Japan (1.9), the United Kingdom (1.2), and the United States (1.0).

The pessimistic economic scenarios differ from the baseline scenarios by assuming lower productivity growth and, in most cases, higher unemployment. Where pensions are increased in line with earnings (or in effect productivity growth), an assumption of slower growth in productivity does not affect the results of the projections. However, higher unemployment does affect them, since the expenditure ratio is inversely proportional to the employment rate. Where pensions are held constant in real terms during retirement, as in Canada and the United States, an assumption of lower productivity growth will imply a higher expenditure ratio. Where pensions are increased in line with net earnings, as in Germany, the outcome is indeterminate. In the case of the United Kingdom, the pessimistic economic scenario is characterized by a lower GDP growth rate than in the baseline scenario, but by the same unemployment rate. Since pensions are assumed to increase with GDP per capita, the projections remain unaffected. Chart 11 also shows the impact of combining the "greater aging" demographic scenario with the productivity growth rates and unemployment rates that characterize the pessimistic economic scenarios in Tables 2 and 3. Because the pessimistic scenario's unemployment rates differ only slightly from those in the baseline scenario, the pessimistic economic scenario shows little impact on the expenditure ratios in France, Italy, and Japan. And even in Canada and the United States, the combination of more pessimistic unemployment rates and productivity growth rates does not have an enormous impact on expenditure ratios. In Germany, the combination of reduced productivity growth and increased unemployment causes the final expenditure ratio to fall slightly.

4. Policy issues

What are the policy implications of these projections? The answers to this question are mixed and are not at all obvious from the numbers appearing in the tables. Certainly, the prospect of the growing and ultimately large share of national income that some countries will have to spend in order to provide the pensions now being promised has been a source of concern. This has been a major issue in Germany, Japan, the United Kingdom, and the United States, but it has been less of an issue elsewhere. For example, in Canada, an official report, although recognizing that an aging population would create some additional fiscal pressure, concluded that the high incidence of poverty among

pensioners called for an increase in the real level of pensions and that Canada would have the capacity to provide it. ^{1/} And in France, the financial pressures created by population aging are recognized, although recent concern has been with short-term rather than long-term financial imbalances. This concern is reflected in the sort of policy responses being discussed, which revolve around making some attempt to increase the fertility, savings, and participation rates, rather than to reform the pension system. Population aging does not yet seem to be viewed as a pressing issue. In Italy, there is more widespread recognition of the need to reform the pension system, but little immediate progress seems likely, even though a pension reform bill is currently before the Italian Parliament. This bill has been motivated more by a desire to rationalize the existing system than by the need to respond to an impending fiscal crisis.

Even in the United States, pension reform is no longer a dominant issue because a number of measures have already been introduced to counteract the demographic factors that would otherwise force up pension expenditure. The projections in Table 6 take account of these measures, which include: the 1977 Social Security Amendment, changing the method of calculation of pensions for those reaching 62 after 1982 so that replacement rates would fall from their 1981 peak until they stabilize in 1990; ^{2/} and the 1983 Social Security Amendment, which legislated an increase in the retirement age from 65 to 67 between 2000 and 2027, introduced changes in early retirement benefits and delayed the retirement credit to be phased in from the beginning of 1986, and subjected to tax half of the pensions of people with high incomes.

Recently, the policy debate has been most active in Germany, Japan, and the United Kingdom. Indeed, in Germany there has just been a significant change in the pension system, switching the basis of pension increases from gross to net earnings, with the intention that demographically induced increases in social security contribution rates would feed back into smaller pension increases. This switch has been incorporated into the study's projections. Without it, the projected 2025 expenditure ratio would increase to more than double the 1980 ratio of 13.3 percent of GDP as compared with the 20.5 percent now projected.

In Japan, the ratio of pension expenditure to GDP is projected to grow to the level currently found in Germany. But that is more than

^{1/} See Economic Council of Canada (1979). Official projections assume that pensions will increase with earnings; although this is not the current practice, such an assumption provides for an increase in real pension levels. In the baseline economic scenario for Canada, the 2025 expenditure ratio would rise from 4.3 percent to 6.5 percent.

^{2/} This compensates for a rapid rise in the replacement rate through the mid-1970s because of a flaw in the indexation mechanism introduced in the 1972 Social Security Amendment.

three times the 1980 level, and would have been substantially higher were it not for the 1985 Pension Reform Act, which reduced the benefit level by up to 37 percent by lowering the replacement rate and eliminating multiple benefits. The reform was motivated by the concern over the long-term viability of the pension scheme: while the large funds now accumulated in the system would have allowed higher pension payments with the current contribution rate to be maintained until the end of this century, the contribution rate would ultimately have had to rise almost fourfold when the accumulated funds ran out. The reform lowered the replacement rate after 40 years of employment from 89 percent to 69 percent, which effectively freezes the replacement rate at the average level for current new recipients, who have about 32 years of enrollment in the system. Thus, the reform did not have to involve lowering the benefit of current recipients, which helped alleviate controversy over benefit reduction. The reform also unified the Kosei, Kokumin, and Seamen's pension schemes, and pension provisions for spouses have been unified and extended. These measures will rule out the possibility of individuals or households receiving excessive pensions through eligibility under multiple pensions. The expenditure ratio anticipated under the revised system is still believed by the authorities to be too high, and raising the standard eligibility age from 60 to 65 is under consideration. This could reduce the ratio by about 3 percentage points of GDP.

The United Kingdom has perhaps been taking the most radical look at its pension system in light of the long-term cost implications of SERPS. Its reform strategy has recently been outlined in a discussion document.^{1/} It involves the phased discontinuation of SERPS. To replace it, membership in a private pension scheme will be made compulsory. Basic pensions would not be affected. Estimates of the cost savings implied by these reforms have not been published, and it is difficult to infer them from cost estimates of SERPS. All men aged 50 and over and women aged 45 and over are to remain in the scheme; however, few of them will be receiving pensions by 2025. But some pensions will still be paid on the basis of coverage between 1978 and 1988 (if the reforms are enacted in 1985) since there will be a three-year phasing-out period for younger age groups. If these pensions are small, the ratio of pension expenditure to GDP in 2025 could be up to 3.4 percentage points lower in the baseline scenario, although this may not lead to a corresponding reduction in government expenditure. Increased membership in private pension schemes will, under present arrangements, lead to increased tax expenditure in the form of reliefs and exemptions currently accorded to such schemes.

The nature of the trade-off currently facing, or which faced policy-makers in each of the seven countries is clear. If projected contribution rates rise too quickly or to unacceptable levels, then future

^{1/} United Kingdom, Reform of Social Security: Programme for Change (1985).

pension expenditure has to be reduced (relative to the projected total), either through a reduction in pension benefits (again relative to their projected level), an increase in pension age, or a combination of both. The United States has emphasized a phased increase in pension and retirement age while Germany, by linking pensions to net earnings rather than gross earnings, will systematically reduce the growth rate of pension expenditure as demographic pressures build up, although contribution rates will remain relatively high. In the United Kingdom, the principal source of increasing pension expenditure, i.e., earnings-related pensions, may be phased out altogether. Japan will freeze replacement rates, but this will only partly offset a marked increase in contribution rates. However, because the pension program is small, there is scope for the contribution rate to increase more than in other countries. Ultimately, France and Italy will respond to demographic pressures, and Germany may have to take further measures to control the growth in pension expenditure.

One policy issue that has not yet been mentioned, but has certainly featured in discussions of pension reform, is financing. This paper focuses on expenditure, and the method of financing cannot affect the size of the transfers to the elderly, although it can affect the resources available to meet the pension bill. Most programs are now financed on a pay-as-you-go basis, whereby pensioners are paid out of the current income of the working population. There has been some discussion, especially in the United States, of introducing an element of funding into social security financing--that is, setting aside funds in advance for a pension liability that has to be met. Only Canada and Japan fund part of their social security pension liability, and the trend appears to be toward funding even less.

Both pay-as-you-go and funding have merits, but the proponents of funding highlight its positive impact on saving, capital accumulation, and growth. 1/ In fact, research has revealed that the impact of a switch from pay-as-you-go to funding is difficult to determine, although it most likely would lead to more saving. 2/ If this in turn, leads to higher growth through increased capital accumulation, then this would make the future pension burden easier to bear. However, a number of issues arise. First, it is not all clear that social security is the most efficient policy instrument available to a government wishing to increase an economy's savings rate. Second, there is no guarantee that a higher government savings rate will lead to higher rates of capital accumulation and growth. And third, the creation of funds large enough to have any significant impact on the future burden of pensions may create problems of monetary management that far outweigh any benefits derived from funding social security.

1/ For a fuller discussion of the alternative methods of social security financing, see International Labor Office (1984).

2/ See Saunders and Klau (1985) for a review of the theoretical and empirical literature dealing with this subject.

for medical care by patients and excessive supply of services by physicians and hospitals. Other policies have attempted to shift a greater share of the cost burden to the insured population and to increase their cost consciousness.

A brief and by no means comprehensive survey will suffice to illustrate the types of policies emphasized in some of the countries. Changes in reimbursement procedures to hospitals and physicians have been introduced in several countries as a means of precluding an excessive pass-through of charges to medical insurance systems. Such changes have been associated with efforts to limit the increase in the reimbursement rate over time. The introduction by the United States in 1983 of a prospective payment system for inpatient care is one example. 1/ In Italy, changes have been made in the reimbursement procedure for general practitioners. In Japan, actions have been taken to reduce "excessive treatment" through closer monitoring of claims and periodic revisions to the reimbursement price to reflect the actual cost of medicine and medical treatment.

In Germany, since the mid-1970s, the government has followed a policy aimed at containing expenditure growth, partly through legislative changes but also through negotiations with physicians' associations, hospitals, and representatives of health insurance companies and the pharmaceutical industry. These actions have led to some restraint in the volume of services provided and in modifications in the tariff structure of medical services. In late 1984, the German Government also attempted to provide greater profit incentives to hospitals as a means of containing costs.

In France, policies were introduced in 1980 to limit physicians' fees through a uniform-fee schedule mechanism and in 1984 to set an annual ceiling for hospital expenditures, forcing hospitals to live within fixed means. 2/ This latter policy has already led to some self-restraint by hospitals (as manifested by a decline in the average length of stay). Direct authority was also given to the Ministry of Health to phase out excess bed capacity in government hospitals. Finally, in France, Germany, and the United States, reimbursement rates have not been allowed to capture the full effects of inflation.

These changes directly affect the incentive system facing suppliers of medical care and hopefully lead to more cost effective procedures. Whether these changes will actually reduce overall costs is not yet clear. 3/ For example, in the United States, the changes in the

1/ United States, Council of Economic Advisers (1985).

2/ Godt (1985) and Laurois (1984).

3/ For a fuller discussion of alternative approaches to the prospective payment system, see United States, Council of Economic Advisers (1985), pp. 149-50.

reimbursement system have led to a reduction in the average length of stay in hospitals. It is not yet clear whether this has been offset by increased admissions, a shifting of care to an outpatient basis (where a prospective payment system has not yet been introduced), or by a tendency to classify patients according to more expensive diagnostic categories.

Governments have also attempted to increase the share of costs borne by the individual, both as a means of increasing the share of financing by the private sector and also as a means of discouraging wasteful consumption of medical services. In Japan, for individuals under age 70, the enrollee's copayment rate was recently increased under the Health Care Act from 0 to 10 percent (subject to certain major medical provisions); for individuals over age 70, inpatient and outpatient care, which was previously free, is now subject to a nominal charge. Recent evidence suggests that total medical payments to insurees in the three months since implementation were 10 percent below the level of the previous year (the first decline in the monthly data since 1971). ^{1/} In Italy, patients are now required to pay some part of the cost of drugs. In the United States, legislative efforts are underway to increase both the copayment rate and the contribution rate by pensioners with respect to Medicare. In France, a minimum day rate payment imposed in 1984 created an incentive for patients to reduce hospital stays. ^{2/}

Though the approaches described above may discourage wasteful consumption, particularly of ambulatory care and drugs, significant cost-sharing will prove more difficult in situations where expensive hospitalization is required, thus defeating the purpose of insurance. Also, increased cost-sharing for some services can lead to substitution in demand for other services for which the individual's copayment rates are lower.

Another issue relates to whether individuals should bear higher copayment rates according to their lifestyle or habits (e.g., smoking, excessive drinking, taking drugs, etc., which increase the risk of illness). In effect, should individuals not be encouraged to lead healthier lifestyles, rather than taxed to support the more medically costly lifestyles of others?

Finally, it should be noted that some governments have been moving toward an overall ceiling on government medical expenditure. Such a ceiling exists already in the United Kingdom, whereby approximately 80 percent of expenditures on medical care are "cash-limited" and subject to extensive efforts to minimize the limits of expenditure totals. This ceiling

^{1/} "Enrollee Health Costs Down 10 Percent," Yomiuri Shimbun (1985).

^{2/} Godt (1985), p. 165.

France (continued)Special Schemes

There are compulsory schemes for agricultural workers, seamen, railway employees, public utility and other public employees, and the self-employed. The schemes provide earnings-related retirement pensions, with the benefit formula varying between schemes. Many pensioners receive more than one pension. Pension age varies between 60 and 65, depending upon the scheme. Disability and survivor pensions are also provided. Finance is provided by employees, employers, and general revenue.

GermanyOld Age, Survivors', and
Disability Insurance

An employee becomes eligible to receive retirement pension benefits at age 65 if he or she has been in the scheme for 5 years, and at age 63 with 35 years in the scheme. Under certain conditions, women, disabled persons, and the unemployed receive a retirement pension at age 60. The retirement pension and the general disability pension are equal to 1.5 percent of "assessed" wages for each year in the scheme. The pension rate is reduced to 1 percent in the case of occupational disability pensions. "Assessed" wages have been revalued to reflect wage growth. Pensions have in the past been increased to reflect the growth in gross wages, although in recent years this link has been broken, and pensions are now in fact indexed to net wages. The scheme is financed through earnings-related employee and employer contributions, and a general government subsidy. There are minimum and maximum earnings levels for both benefit and contribution purposes.

Public Sector Employees'
Pension Scheme

Pays a retirement pension of 75 percent of pensionable income to civil servants with over 35 years of coverage. The scheme is financed by general revenue. Other public sector employees receive pensions from the social insurance scheme, but they are brought up to comparable level through additional pension schemes for public employees paid for by employers. Disability and survivor pensions are provided.

Italy

General Scheme (FPLD)

Social insurance scheme providing earnings-related pensions for employees in industry and commerce. The retirement pension is equal to 2 percent of the average of the last five years' earnings for each year of scheme membership, up to a maximum of 80 percent of earnings, which are themselves subject to a maximum. Pension age is 60 for men and 55 for women with 15 years of coverage. A means-tested old-age benefit is available to those with very low pensions. Disability and survivor pensions are paid. Pensions are increased in line with a composite index reflecting changes in the cost of living and wages. The scheme is financed through earnings-related employee and employer contributions, subject to a minimum, and a lump-sum government subsidy.

Special schemes

There is a large number (over 50) of similar schemes for those not covered by the general scheme. Multiple pensions are common.

JapanEmployees Pension
Insurance (Kosei)

Part of a dual social insurance scheme that provides earnings-related pensions for employees. The retirement pension is equal to a fixed amount for each year of coverage, up to a maximum of 35, plus 1 percent of average revalued lifetime earnings. Pension age is 60 for men and 55 for women with 20 years in the scheme. Disability and survivor pensions are provided. Pensions are automatically adjusted to reflect changes in the cost of living. The scheme is financed by earnings-related contributions charged to employees and employers, subject to a minimum and a maximum, and 20 percent of the cost of the scheme is met by the Government of Japan.