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R. D. Erb, Acting Chairman

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L. Van Houtven, Secretary
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Also Present

European Department: S. F. D. Powell. Exchange and Trade Relations Department: G. Belanger. External Relations Department: I. S. McDonald. Fiscal Affairs Department: V. Tanzi, Director; P. Alonso-Gamo, G. Blöndal, P. S. Heller, R. Hemming, A. H. Mansour, D. C. McDonald. Western Hemisphere Department: P. Kohnert. Advisor to Executive Director: G. D. Hodgson. Assistants to Executive Directors: A. Bertuch-Samuels, W. N. Engert, H. Kobayashi, D. Saha.

1. LONG-TERM TRENDS IN SOCIAL EXPENDITURES IN THE GROUP OF SEVEN MAJOR INDUSTRIAL COUNTRIES, 1980-2025

The Executive Directors continued from the previous meeting (EB/Seminar/86/5, 5/2/86) their consideration of a paper on long-term trends in social expenditures in the seven major industrial countries through the year 2025 (SM/85/327, 12/13/85).

Mr. Templeman recalled that Mr. Massé had earlier touched upon an issue not well developed in the staff paper, namely, an increased demand for services--such as adult education--by an aging population, an increase that was already being seen in some countries. An increase in demand for services would naturally raise questions about their supply, and he could imagine that, even within the group classified as older people, those at the beginning of the range would be supplying services for those toward the end of the range.

Mr. Goos indicated that Mr. Templeman's point seemed to be based on the supposition that the retirement age would be extended. If people continued to retire at 60 or 65, the only measurable result of, say, increased adult education would be an increase in expenditures on such programs without a concomitant increase in GDP.

A number of interesting thoughts on how to deal with the problem of an aging population had been put forward by Mr. Massé in the morning session, Mr. Goos continued. The idea of looking beyond an individual economy and exploring the possibility of investing savings in other countries where higher investment returns could be expected was interesting, although the model for such investment was based on serious uncertainties. Assuming a continuation of flexible exchange rates, one might invest at one rate and later on be forced to divest at a rate that was far less favorable.

Mr. Fujino, recalling earlier references to Mr. Sengupta's proposal for making use of savings in Japan, noted that the current high savings ratio in his country would not be a permanent feature of the society. Indeed, the time was quickly approaching when the savings ratio would be reduced to a level barely sufficient to cover Japan's own investment and other needs. While for some time the higher ratio might be reflected in a current account surplus, nearly all the surplus would be absorbed, either by official development assistance or by direct investment. Official development assistance was projected to nearly double in seven years, which meant that some US$6-7 billion of the surplus could easily be absorbed. Similarly, expected direct investment could absorb some US$10-20 billion of the surplus, with additional amounts channeled to commercial lending. In that respect, while he appreciated Mr. Sengupta's proposal, he found it a rather unorthodox approach to the problem.

Mr. Templeman, responding to a point raised by Mr. Goos, said that he had been suggesting that the participation rate of the elderly might change, irrespective of whether the legal retirement age was increased.

Evidence suggested that people were collecting a full pension and working full time as well. It was particularly easy for military retirees with, say, 20 years of service to be classified as retirees while going on to second or even third careers. Presumably, such individuals would be counted both as pensioners and as members of the labor force.

The Director of the Fiscal Affairs Department reiterated that the study before Directors did no more than provide projections for demographic changes and their implications in the seven major industrial countries. Those projections suggested that, barring any changes in current policy, the tax burden in many of those countries must grow to pay for the expected increase in social expenditures; the level of deficits created by the projected increase in social expenditure must also increase; and/or the level of real expenditure on items other than social expenditure must decline. To some extent, those projections were already being realized in the 1980s. He had been surprised to note, for example, that expenditure for capital accumulation in the countries in question had fallen in the 1970s and early 1980s, which suggested some crowding out of capital expenditure.

The staff believed that the countries studied would not allow the projections to materialize, which raised the question of how adjustment would take place, the Director continued. It was likely that part of the adjustment would be achieved by a reduction in benefits, by limitations on eligibility for social programs and pensions, and possibly by some change in the retirement age. At present, the distinction between a working and a retired population was an artificial one, useful only in the legal sense. To the extent that people lived longer and the proportion of the elderly in the total population increased, individuals might well decide that it was better to work than to retire. At that point, as Mr. Templeman had mentioned, it would be relevant to ask whether those individuals would provide the supply of, as well as the demand for, various social benefits.

The paper had highlighted the fact that the expected demographic changes would create problems in varying degrees in all the countries studied, and the hope was that the projections would stimulate discussion about possible solutions to the problem long before it got out of hand, the Director remarked. In that respect, there were indications in the study that the search for solutions should begin soon. For example, it was clear that there had been very little increase in public spending since the beginning of the twentieth century in categories other than social expenditure, and if the growth of social spending continued, taxes would have to be increased beyond their current levels and inefficiencies could arise. Disincentive effects were connected with high rates of taxation, and those effects could become more serious to the extent that tax rates become even higher.

In some of the economies studied, other problems had arisen because of developments in social legislation, the Director observed. In certain countries, for example, qualification for social benefits by one person

in a family qualified all others in the family for the same benefits. In that respect, it might be convenient for the head of the family to hold a regular job entitling the rest of the family to various social benefits, while other members of the family became engaged in underground activities in which they were not required to contribute to the resources financing the social benefits. Furthermore, evidence existed of waste in the use of certain benefits. For example, where no cost was involved, individuals were known to have visited doctors and received several prescriptions for medicine that was not needed or used. Unfortunately, such waste led to a deterioration in the quality of the benefits. In the area of public education, for example, the scarcity of funds to finance education programs had forced a number of people to look for private provision of such services. The areas he had mentioned were only a few in which inefficiencies had arisen, either on the tax side or on the expenditure side, in connection with high rates of social spending. Obviously, each country must decide on the extent to which it wanted to provide social programs, but it was important to recognize that there were costs in terms of efficiency and in terms of the growth of the economy.

A number of speakers had queried the impact on the economies of individual countries of the demographic changes described, the Director recalled. Clearly, the staff had not explored all the possible effects, although many of the likely ones had been mentioned. An older population, for example, could be expected to use more of certain types of output than others. The demand for services might increase, while the demand for food might fall, a development that had obvious implications for production. Moreover, if the manufacturing sector of an economy was more efficient than the services sector, productivity would be affected. Older people could be expected to increase the demand for health and other services; at the same time, because they had more free time to travel, they might also increase the demand for, say, transportation.

The Director of the Fiscal Affairs Department commented that he shared Mr. Massé's skepticism as to whether countries could accumulate reserves to meet future needs. At least in the United States, the share of capital income in total national income had remained unchanged for nearly a hundred years, and it seemed unlikely that the Government would be able to bring about the much higher capital share that would be needed in the future. In the circumstances, more savings would probably lead to a decline in the rate of return on those savings, at least within a closed economy. Obviously, with an open economy some of the savings would spill out and seek higher rates of return. It should perhaps be noted that the United States had made an effort, by the introduction of individual retirement accounts, to substantially increase the savings rate; thus far, however, the results were not encouraging.

A staff representative from the Fiscal Affairs Department agreed with Mr. Foot that the paper could be enhanced by an amplification of the section on the sectoral policies that had been adopted or were being considered for adoption in response to projections for change of the sort outlined in the paper. In initially drafting the paper, the staff had

debated how much detail could be incorporated in terms of sectoral policy analyses. It had been found in the preliminary review of pension and medical policies that the issues in each of those sectors were complex, and the early efforts to write about them had pointed toward a paper that could have been unwieldly. In the event, the staff had attempted to provide some policy detail, particularly where important policy changes were taking place in individual countries, and to focus on what key issues would face the authorities in reviewing the growth of benefits and costs.

Some Directors had queried whether the staff had in its study perhaps underestimated GDP growth rates, the staff representative recalled. Mr. Goos, in particular, had pointed out the possibility of a higher rate of labor force participation by women, higher capital intensity of production, and correspondingly higher rates of productivity. In some countries, the staff had clearly attempted to make those corrections; indeed, it had projected for Germany a decline in the unemployment rate based on the evidence that labor market pressures would be tight. In making projections for GDP, the staff had looked at the demographic projections and had made some assumptions about labor force participation rates, unemployment rates, and the rate of productivity growth that seemed reasonable in light of past experience and that did not imply too sharp a difference in the pattern across countries. It would have been odd, for example, to observe wide differences in the experience with unemployment rates or productivity growth within, say, the European Community. Still, a number of points should perhaps be highlighted with regard to the staff's GDP assumptions. First, unless policies were adopted explicitly to break the link between the rate of growth of productivity and the rate of growth of benefits and costs in the social service sectors, the expenditure ratio was likely to be fairly independent of the rate of productivity growth. The link did not appear so strong in the discussion of unemployment rates and labor force participation, because, clearly, a reduction in unemployment or labor employment rates would lead to an adjustment in the total output level, which would reduce the ratio of expenditures to GDP. The effect would be measurable but by no means dramatic. What was really important was the link between productivity and the rate of growth of benefits.

In the area of pensions, the question was how large a disparity one could envision in relative income positions between retirees and the working population at various points in future, the staff representative from the African Department remarked. Clearly, if real pension benefits could be held at their present level, the expenditure problem would not exist on the pension side. In the areas of medical care and education, the relationships were far more complicated, and the staff had felt somewhat uneasy about making its projections. For example, the determinants of the rate of growth of medical costs were particularly complex and related to the role of technological change and supply and demand interactions. In labor markets, they related to the institutional mechanisms by which services were provided and financed. All the staff had to guide it was the history of a rapid rate of growth in relative prices and costs in the medical sector and, in that respect, one might argue that for some

countries the staff's assumptions were rather optimistic. In any event, the staff was well aware that the projections were sensitive to the assumptions made about certain economic parameters and projected rates of growth of costs and benefits. If it was agreed to publish the paper, it might be useful to highlight that sensitivity in a covering note, with an indication that the results could vary greatly on the basis of slight changes in the assumptions.

Mr. Goos observed that the staff had seemed to begin with the assumption that the current ratio of social expenditure to GDP was more or less the maximum acceptable to governments and that it could not be increased further without unfortunate consequences, such as a weakening of incentives to work. He was not certain whether the assumption was appropriate, especially given the history of an increasing ratio since the 1950s. His own view was that with a strong increase in productivity, the ratio could be increased; and if the living standard of the population could be increased, he would assume that the working population would be prepared to pay an increased share of the costs.

The staff representative from the Fiscal Affairs Department said that while he could accept the point made by Mr. Goos, his own view was that the increases in taxes that would be necessary to pay for the costs being projected would not be acceptable, at least not without much higher levels of income.

On other matters, the staff representative agreed with those Directors who felt that cross-country comparisons would be made despite the caveats mentioned by the staff. All the staff could do was ensure that its caveats were made as explicit as possible.

One speaker had asked about the possibility of producing a scenario based on holding demographic parameters at their present level, the staff representative recalled. The staff had, in fact, begun its study with three scenarios but had dropped the middle one to avoid presenting too many figures. The remaining two were the baseline scenario, which assumed higher fertility rates and no improvement in life expectancy, and a second "greater aging" scenario in which fertility rates were maintained at their present levels while life expectancy was improved along the lines observed over the past 10-15 years. The scenario of holding demographic parameters at their present level would fall between the two employed by the staff.

A number of uncertainties lay at the heart of the staff's projections, the staff representative from the Fiscal Affairs Department concluded. The present pattern of medical advances and technology seemed to suggest a lengthening of life expectancy; however, that did not necessarily mean that people would be working longer or making less use of medical services. All that could be said was that the group of people over the age of, say, 75 would become more important in future, which raised the question about whether it would be possible to achieve significant improvements in the quality of life at that age and older. It was also unclear what pressures

would be put on people in the age group 65-70 to respond to pension policy changes or to return to or remain in the labor market. In any event, there were many factors that could easily change the staff projections, and all readers should be aware of those factors.

Another staff representative from the Fiscal Affairs Department, remarking on the financial implications of private sector involvement in social security financing, noted that a number of factors influenced the choice between the two forms of financing--the pay-as-you-go system and actuarial funding--mentioned by Directors in the course of the discussion. It should be noted that the choice did not affect the resources actually transferred to the elderly; indeed, as long as the total resources available were the same, a funded program faced the same demographic pressures as a pay-as-you-go program. However, if contributions to a funded program financed investment with a real rate of return that exceeded the rate of return implicit in the various demographic parameters, additional resources might be available to meet the pensions bill. In other words, the funded program might be associated with a higher overall savings and investment rate in the economy as a whole. It was also interesting to note that the same would be true if the real rate of return were negative and the demographic parameters implied a rate of return that was more negative. Savings and investment would continue because one could not escape the need to finance retirement.

One point often forgotten in comparisons between funding and pay-as-you-go systems was that private pension plans experienced a multitude of problems, the staff representative remarked. For example, in the absence of indexed assets, it was difficult to guarantee protection against inflation, and there was some evidence that private pension programs had an adverse impact on job mobility. Moreover, many questions had been raised about the security of pension rights in private funded schemes. In light of these problems, private pension schemes tended to be subject to wide-ranging regulation.

Another important point was related to the transition from a pay-as-you-go system to a funded system, the staff representative remarked. Just as some generations had received windfall gains when social security had first been introduced, so some later generations would have to bear the cost of the transition to a funded system. In fact, one or more generations would have to pay not only for their own pensions under the funded arrangement but for the pensions of a preceding generation under the pay-as-you-go arrangement as well.

One way in which a funded system had a distinct advantage over the pay-as-you-go system was that the former signaled the cost implications of the pension promises being made, the staff representative from the Fiscal Affairs Department remarked. With a pay-as-you-go system, the costs simply accompanied the expenditures. If promises were made to pay larger pensions in, say, 20 years, the resources did not have to be found for 20 years. With a funded system, a pension plan was forced to make provision for payment at the time the pension rights were conferred, at least notionally.

Mr. Massé noted that, as with pension plans, it was also important to begin saving for health care services in advance so that the resources, bolstered by compounded interest, would be available later when they were actually needed. On another matter, he wondered whether the staff had reached any conclusion about whether there was an optimal level of social security expenditure for a given level of income and/or a certain shape of the population pyramid. Clearly, some social expenditures--education was a prime example--increased the rate of growth of the economy and, after a time, education became a consumption good rather than an investment good.

The staff representative from the Fiscal Affairs Department replied that the staff had not attempted to reach any conclusions of the sort mentioned by Mr. Massé and, indeed, would be reluctant to try. One could judge in the abstract what might be "important" illnesses and what might be an efficient way of organizing a health system, but it would be difficult to keep to a minimum the number of ethical judgments that would have to be made about who should or should not be eligible for health care and about whether or not expenditures on medical care for people in the last year of their lives was an efficient or sensible way of spending money.

Mr. Fujino asked, first, why the staff had excluded from the figures on social expenditure in Japan the amount for war pensions, which was equivalent to 0.7 percent of GNP. Second, it was clear that changes in the social structure of countries would have an impact on social expenditures; the extent of that impact was less clear. For example, a weakening of family ties might mean that the elderly would need to make greater use of social programs outside the family, and in countries where that weakening had not yet occurred, the impact on the cost of social expenditures to be borne by the government could be enormous in the coming years. Third, some of his colleagues had suggested that the analysis employed in the staff paper be applied to some major developing countries, and he would be interested in such an application. The results might be very different in a country like China where the social system was different from that in the seven countries studied in the staff paper and where a drastic population policy was being put into effect.

The staff representative from the Fiscal Affairs Department remarked that the staff had been made aware in the course of its study that some welfare benefits had been omitted that were equivalent to approximately 1 percent of GNP. Certainly, an effort would be made to include the appropriate amounts in any redraft of the paper. On another matter, he shared Mr. Fujino's interest in looking at the implications of the demographic changes currently taking place in some developing countries. And he agreed that China would be a particularly interesting case because of its family policy.

Mr. Templeman said that he understood that some Directors were uneasy about publishing the staff study in its present form. He hoped that bilateral talks with the staff could alleviate their concerns. The study

was an interesting one, and his colleagues should not underestimate the ability of those who would normally read the Occasional Papers series to understand the analysis and its limitations.

The Acting Chairman remarked that there appeared to be fairly broad support for publication of the paper pending further discussions between the staff and Executive Directors on particular elements of the report. If Directors could agree, he would propose the circulation of a revised version after the bilateral discussions had taken place so that Directors who might still have difficulty with the publication would have a further opportunity to make known their views.

Mr. Goos remarked that he could live with publishing the paper as it stood so long as it was accompanied by a cover note clarifying the concerns he and others had raised.

Mr. Foot said that his preference would be to change the text itself to reflect his concerns and those of others.

The Acting Chairman recalled that Directors had also commented on the degree to which the Fund should even engage in such studies and the extent to which the issues covered in the staff paper should be examined, for example, in the context of Article IV consultation discussions. Directors apparently felt that, while the issue of social expenditures and the political and ethical questions involved in them were not properly within the terms of reference of the Fund, the work of the Fund should nonetheless focus on the implications of the results of the study for macroeconomic developments and broad financial policies in member countries and the international community as a whole.

The Executive Directors, accepting the Acting Chairman's understanding of their views regarding publication of the study and the relationship of the study to the work of the Fund, then concluded their discussion.

LEO VAN HOUTVEN
Secretary