Grey New World: Europe on the Road to Gerontocracy?

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Abstract

Higher life expectancy and feminization of work have changed the life course. These developments require changes in the way society organizes work and accumulates and maintains human capital over the life cycle. This paper describes various reforms aimed at preventing Europe from becoming a gerontocracy. It also discusses the political challenges associated with reforms aimed at lengthening the working life and protecting fertility. (JEL code: J1)

Keywords: aging, fertility, longevity, feminization of work, life course, human capital, political economy.

1 Introduction

Aging of the population demands major adjustments in the way society organizes work and public income support over the life course. These reforms may be difficult to implement in a democracy, however, because also voters age (Sinn and Uebelmesser 2002; Galasso and Profeta 2004). After documenting aging and its causes in Section 1 and discussing the required institutional reforms in Section 3, this article describes the challenges to the political system raised by aging in Section 4. Section 5 focuses on how to address increased longevity while Section 6 explores how reasonably high fertility rates may be maintained. Section 7 concludes by discussing the political economy of pension and labour-market reform. This article focuses on pension and labour-market reforms and does not explicitly deal with the challenges of aging for health care. Nevertheless, the labour-market reforms described in this article helps to address some of these challenges.

2 Aging: its causes

The median age in the EU has increased from 31 years in 1950 to 39 now, and is projected to rise further to 48 by 2050 (Figure 1). In Germany, the median age of potential voters will increase from 47 now to 53 in 2030.

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This article was prepared for the 6th Munich Economic Summit on 21 and 22 June 2007. The author would like to thank Gerardo Soto y Koelemeijer for research assistance.
Other European countries will experience similar increases in the median age of the electorate. The median age of actual voters will rise to even higher levels as older voters tend to actually use their voting power more. In many countries, the old-age dependency ratio (i.e. the ratio of people older than 65 to those between ages of 15 and 65) is projected to double by 2050 to around 0.5, which implies that about one-third of the potential voters will be older than 65 (Figure 2). The two main causes of aging are increased longevity and lower fertility, which we examine below.

2.1 Higher life expectancy raises return on human capital

Average life expectancy at birth has increased by more than 2 years per decennium since 1950 in the G-7 countries and the EU (Figure 3). Life expectancy at age 65, which is more relevant for the costs of pensions, rose by about 1 year per decennium (Figure 4). From an economic perspective, increased longevity is in fact good news since morbidity appears to decline in line with mortality. Increased longevity thus implies that many more people can enjoy healthy and productive lives up to old age. They can accumulate experience and exploit their abilities longer. In other words, the return on investing in people rises.

Figure 1 Average and median age in EU-25

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2.2 Feminization of work implies better use of female human capital

As regards to the second fundamental demographic trend behind aging, fertility rates have fallen below replacement levels in all developed countries since the 1960s (Figure 5). Moreover, women bear children later in life (Figure 6). Lower and delayed fertility is the result of better schooling of women and the feminization of work. The latter development is due mainly to technological changes raising the demand for communication and creative skills in growing service sectors at the expense of raw muscle power in the industrial sector. The increased value of female human capital has raised the opportunity costs that women face when bearing children. Just as increased longevity, the increased use of female human capital on the labour market is good news. Moreover, whereas it may erode the premium base for financing pay-as-you-go (PAYG) pensions, lower fertility initially frees time and resources for working-age adults by reducing the burden of supporting young dependents (Weil 2006).

2.3 Moderate seasons in the modern life course

Increased longevity and the feminization of work are changing the life course. In the modern longer life course, adults spend considerable time in households without young children, as a result of lower fertility and delays in both parenthood and morbidity (and mortality). Indeed, in the “spring” of the modern life course (alternatively termed “early adulthood phase” or “playtime of life”), young adults first invest in their own human

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Figure 2 Dependency ratio 1950–2050 (65+/15–64)
capital through extensive education. In this period of extended social adolescence, they also experiment with relationships and jobs before they take on the responsibility for raising children during the “summer”: the family season when parents bear the responsibility for bringing up children.

After their children have grown up, parents typically spend considerable time in good health in the “autumn” season of their life course (or alternatively “the active senior phase”). Tomorrow’s elderly can be

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**Figure 3** Trends in life expectancy at birth
expected to be healthier, wealthier and better educated than ever before. They thus enter later into the “winter season”: the last phase of life in which people suffer from serious health problems and require care.

The summer season in the modern life course is quite hot. During this so-called “rush-hour of life”, people may experience “combination stress”.

Figure 4 Life expectancy at age 65
The costs of living are high while time is scarce, as parents invest not only in their children but also in their careers. Compared to other European household types, families with co-residing children are least satisfied with living conditions, including their work or other main activity, income, housing and leisure time (Avramov 2002). In the spring and especially the autumn, in contrast, the climate is more moderate. Adults thus do not have to care for young children and enjoy relatively high purchasing power.
3 Institutional innovation
Both a longer life and the feminization of work require changes in the way society organizes work and maintains the talents of people over the life course.

3.1 Treasure human capital
The first priority for institutional innovation is safeguarding the production and maintenance of human capital. In a modern knowledge-intensive society, human capital is the key to personal fulfillment and social inclusion. At the same time, knowledge and specific skills age faster on account of creative destruction associated with fierce competition and rapid innovation. The combination of a longer life and faster obsolescence of skills demands maintenance of human capital through continuous learning. Adaptability, the ability to learn and key non-cognitive skills (such as social and communication skills, self-discipline, emotional resilience, self-control) are shaped early in life during early childhood. These personal traits undergird the social legitimacy of a competitive, innovative economy associated with creative destruction. Moreover, an adaptable labour force can embrace risk, thereby raising the supply of risk-taking capital and entrepreneurship.

Human capital is produced not only in schools but also in families and firms. Reconciliation of work (including workplace learning in firms) and family (including informal care for young children) is therefore essential. It allows parents to form and maintain supportive family relationships in which they build the future workforce’s capacity to learn, adapt and relate, while cherishing their own human capital by remaining durably attached to the labour force. Through better maintenance of their human capital, people can exploit their longer life to combine the pursuit of a fulfilling career in paid work with the vital task of raising the next generation of workers. By adjusting the allocation of work over the life cycle to the biological clock of women (so that leisure is not concentrated only at the end of life), the reconciliation of work and family thus involves the way the entire life course is organized.

3.2 More flexibility in work and careers
More flexibility in how various activities are combined over the life course is the second priority for institutional innovation in order to contain the main opportunity costs of becoming a parent—namely, foregone career possibilities. The feminization of work is thus reconciled with fertility rates that are large enough to sustain the population. More flexibility in allocating working time can prevent stress and excessive time squeeze when workers bear substantial family responsibilities in the summer.
season of the life course. Moreover, it helps women, who still carry most of the family obligations, to remain attached to the labour force. Their human capital is thus maintained better, so that their working lives can be extended and become more fulfilling. More flexibility can also allow older workers with changing private needs to keep working.

The challenge for institutional innovation is to create more flexible workplace cultures that reconcile the needs of employees who balance work with family and other obligations with the needs of employers to respond flexibly to fluctuations in demand, in increasingly competitive markets. By finding new ways to attune work conditions and career paths to the needs of employees who want to remain employable despite substantial family obligations, changes in their personal lives and creative destruction associated with rapid innovation, firms can promote themselves as good places to work. In this way, they can remain competitive on an aging labour market in which labour is becoming increasingly scarce. For example, firms can offer part-time work to parents with young children. At the same time, they can help these parents to maintain their skills during this period, e.g. by offering training when returning to full-time work. In this way, periods of part-time work do not have to seriously harm careers. This helps to contain the costs of raising children in terms of the lost human capital of the parents.

3.3 Support parents in the summer season

The key institutional challenge is to exploit the spring and especially the autumn of the life course to support young parents who are in the summer season of their lives. In addition to more flexible career paths that decompress the working life, public support should thus be gradually shifted away from the fall and winter seasons of life towards the spring and summer seasons when human capital is produced. In this way, proactive social policies that help people to build up and manage human talents replace reactive social policies that provide passive income support to those who have depreciated their human capital. Among other things, facilities that allow parents to raise young children while maintaining their own employability should substitute for privileges for full-time male breadwinners (who do not necessarily have young children in their households). In other words, public support should be tied to children rather than breadwinners. Moreover, early retirement benefits provided in the fall season should be gradually replaced by public benefits to young parents.

Particularly those countries with extensive PAYG pension and PAYG health insurance systems should support households with young children. In these PAYG systems, children who have been reared by others support
the elderly without children. By bearing children, parents thus generate positive external effects for the childless (Sinn 2005; Cigno and Werding 2007). Public support for parents of young children should increase with the social benefits of investing in the non-cognitive skills of young children and the PAYG benefits provided to the elderly.

3.4 More inclusive labour and housing markets

Rather than shielding insiders through employment protection, labour-market institutions should enable parents of young children, secondary workers and young adults to easily enter and remain in the labour market and to adjust their working conditions to changes in family conditions. Condensing the period of full-time education and spreading learning more evenly over the life cycle by integrating it better with work could also be helpful in shortening the period of social adolescence, decompressing the working life and bringing forward parenthood. Also, a well-functioning housing market can reduce the stress that young adults experience in the early reproductive stage of their lives. Among other things, tax facilities for home ownership may have to be targeted better at new entrants into the housing market.

4 Political challenges

As noted above, longevity and feminization of work are good news from an economic point of view. The required adjustments in the way society organizes work and public support over the life course, however, constitute a major challenge to the political system. The danger facing aging societies is that older voters block the needed reforms. In that case, a conflict arises between the political power of older generations (who depend on public transfers and are risk averse) and the economic power of the younger, working generations (who control the major scarce resource that fuels the modern knowledge-intensive economy—namely, human capital and entrepreneurship). In other words, politics collides with economics. With politically strong older generations favouring generous passive spending on pensions and health care at the expense of investments in the human capital of younger generations, aging societies risk becoming entangled in a vicious circle of early retirement, rapid depreciation of human capital, low fertility, slow innovation and political instability (Boeri et al. 2006).

In such a self-sustaining equilibrium, workers retire early because their skills are obsolete, while human capital is not maintained because people retire early and thus feature only a short time horizon. As working lives are being compressed (Figure 7), careers must be made during the
reproductive stage of the life cycle. This raises the opportunity costs of bearing children—especially for highly educated women. Low fertility rates of these high-skilled women damage the quality of human capital, because the skill level of children is closely related to that of their parents. As a result of a less employable and adaptable labour force, open competitive markets and the associated creative destruction lose their social legitimacy. Moreover, as workers lack the resilience to embrace risk, pension funds shed risk and prefer to invest mainly in low-risk assets and government bonds. This weakens fiscal discipline, crowds out productive investments and harms long-term growth.

The presence of only a small middle-aged generation in the summer of their life course caring for the old and the young constitutes a threat to the intergenerational contract according to which each generation invests in the human capital of the next and is taken care of at the end of its life by the generations in which it has invested. Indeed, with retirement becoming a lengthy period of state-supported leisure for a surging able-bodied population of retirees (Figure 8), the elderly are increasingly viewed as a liability rather than a vital resource. A heavy tax burden on a small active labour force puts at serious risk solidarity with vulnerable elderly, children and disadvantaged adults of working age. Last but not least, civic trust in a stable social order in which the government upholds its promises is shattered, thereby risking political upheaval.

Figure 7 Learning, working, leisure (1975–2001)
After exploring the required pension and labour-market reforms to address increased longevity and lower fertility in the next two sections, we return in Section 7 to the political economy of reform: how can the required reforms gain sufficient popular support in a democracy with aging voters?

5 Linking retirement ages to longevity
5.1 Measuring older age appropriately
In order to prevent the emergence of a large inactive class of older politically powerful citizens depending on public transfers, government should link the age at which public retirement benefits are first paid to
life expectancy.\textsuperscript{1} One sensible rule, which prevents contribution rates for PAYG\textsuperscript{2} retirement systems from increasing in the face of higher life expectancy,\textsuperscript{3} keeps the proportions of adult life spent working and in retirement a constant (Turner 2006).\textsuperscript{4} By encouraging young agents to maintain their human capital better, such a rule capitalizes the benefits of increased longevity in terms of more durable human capital and the associated ability to absorb aggregate risks so that pension funds can continue to invest in risk-bearing assets, thereby fostering entrepreneurship, innovation and growth. In this way, increased longevity is turned into an economic opportunity rather than a financial threat. In fact, one can argue that all ages that are used to measure old age should be linked to longevity so that one actually computes old age from the end of life rather than from the beginning. In this way, societies ensure that social and biological aging do not diverge further. Most importantly, this prevents the emergence of a large class of inactive older able-bodied people is thus prevented.

5.2 Intergenerational sharing of longevity risk

Normal retirement ages should be based on the life expectancy of a cohort as measured at the normal age of retirement. In this way, younger, active cohorts (who exhibit a longer horizon and more flexibility to adapt) absorb longevity risks, while older generations who have retired and thus have depreciated their human capital are shielded from these risks. The government can further enhance the efficiency of intergenerational sharing of longevity risk by issuing longevity bonds,\textsuperscript{5} thereby allowing private pension funds and insurance companies to protect retired generations from longevity risk. Linking the age at which citizens first receive their public pension to life expectancy makes it in fact more attractive for the government to issue longevity bonds because this link reduces the exposure of the government’s balance sheet to longevity risk.

\textsuperscript{1} Agents can be allowed to collect retirement benefits earlier if annual retirement benefits are cut in an actuarially neutral way.

\textsuperscript{2} At fixed retirement ages, increased longevity puts financial stress on not only PAYG schemes but also funded pension schemes. Indeed, funded pension schemes may be particularly vulnerable to increased longevity. The reason for this is that the longer life spent in retirement calls for more financial saving, which depresses the return on capital and thus hurts funded pension schemes.

\textsuperscript{3} The rule is thus closely rated to so-called notional defined contribution (NDC) systems, which keep contribution rates fixed when longevity rises.

\textsuperscript{4} Denmark has implemented a rule that keeps constant the absolute length of the expected retirement period so that the statutory retirement age in the public pension system rises on a one-to-one basis with longevity.

\textsuperscript{5} These bonds pay coupons that are proportional to the survival rate of a given population.
5.3 Automatic link mitigates political risks

Automatically linking public pensions to life expectancy as part of a transparent risk-sharing contract avoids the political costs of discretionary decisions limiting eligibility to public pensions. Agreeing on a risk-sharing rule *ex ante* also reduces the political risks associated with collective discretionary decision-making (Section 7). Moreover, the government does not offer unrealistic guarantees but is transparent about how it distributes risk over the stakeholders of the public pension. Linking retirement ages to life expectancy is also fair: younger generations work longer but still enjoy a longer expected period of retirement. Moreover, in the face of gradually increasing life expectancy and retirement ages, workers and firms can adapt gradually to a longer working life by better maintaining human capital and adjusting the organization of work to the needs of older workers. An increase in spending on disability pensions and unemployment benefits is thus avoided.6

5.4 Flexible labour markets extend working lives and stimulate entrepreneurship, risk taking and informal care

Linking retirement ages to longevity is credible and politically legitimate only if a well-functioning labour market for elderly workers ensures that additional demand for older workers matches additional supply. Together with better-maintained human capital, a flexible labour market also allows the speed and extent of phased retirement to act as a buffer for absorbing aggregate risk. This requires adjusting the implicit labour contract according to which workers are underpaid when young and overpaid later on. Indeed, increasing the retirement age at which the employer lays off the employee must not put undue strain on the employer. Employees should thus accept more wage flexibility over the life course (so that they are paid according to their productivity) as well as flexible working practices (so that labour productivity is maintained at higher ages).

With a more flexible labour market, older workers bear less unemployment risk and thus depend less on political intervention in the form of public income transfers. In fact, a well-functioning labour market with plenty of jobs for older workers protects these workers against firm-specific shocks and is thus an efficient insurance device, which relieves

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6 At the same time, the eligibility criteria for passive unemployment and disability benefits facilitating early retirement and rapid depreciation of human capital should be tight. By discouraging employers and employees from using these schemes as early retirement schemes, governments encourage firms and social partners to invest more in older workers and to adapt work, wages and workplace cultures to the needs and talents of elderly workers.
pressure from the welfare state. In particular, it narrows the differences between the insiders who are lucky enough to work for a surviving firm and the outsiders whose firms have not survived intense competition. Moreover, golden chains no longer tie older workers to their employer. Indeed, workers can more easily transfer between different states in the labour market (e.g. entrepreneurship, full-time employee, part-time worker, part-time retirement, etc). The flexibility to change one’s working conditions to better suit changing needs and to find new challenges stimulates entrepreneurship and can help to extend the duration of fulfilling working lives. The positive effect on labour-market attachment of enhanced flexibility to adjust working conditions to one’s private circumstances holds true also for women between the ages of 50 and 70, who often provide informal care to aging, fragile relatives and friends. This informal care is likely to remain important in the future, due to shrinking family sizes and budgetary pressures on formal care provided by the public sector.

5.5 Individual human-capital risks call for disability insurance
A longer working life may expose workers to more idiosyncratic human-capital risk because old workers are especially vulnerable to adverse shocks in health, in general, and in cognitive and physical abilities in particular. In other words, the distribution of abilities is more heterogeneous at older ages. Accordingly, robust disability insurance is essential to make longer working lives legitimate. Moreover, in occupational pensions, retirement ages can be attuned to the longevity and morbidity of the insured group of workers. Indeed, low-skilled blue-collar workers tend to feature substantially higher mortality and morbidity than high-skilled workers do.

6 Protecting fertility
6.1 Voting rights for parents of young children
One radical measure aimed at increasing the political support for families and more inclusive labour and housing markets is to give parents with minors an additional voting right for each child. Indeed, the political process is often biased in favour of protecting the interests of insiders at the expense of the outsiders and new entrants.

6.2 Link PAYG retirement benefits and child benefits to fertility
Whereas both funded and PAYG pension systems are vulnerable to increased longevity, PAYG pension schemes are especially vulnerable to lower fertility because they rely on the human capital of the young to
finance the pensions of older generations. This calls for automatic and transparent risk-sharing rules which stipulate that retirement ages (pension incomes) in public PAYG systems should increase (decrease) more proportionally with longevity if fertility declines or remains at a low level.\(^7\) Indeed, if generations invest less in the human capital of the next generations by reducing fertility, they should invest more in financial capital by saving for their retirement or in their own human capital so that they can work longer.\(^8\) Indeed, lower fertility may call for gradually shifting from PAYG financing to funded pension schemes (Sinn 2000).\(^9\) Lower public spending on pensions also creates budgetary room for more public support for households with young children. By thus redistributing from people without children to those with children, society avoids becoming entangled in a vicious circle of low fertility, early retirement and a dearth of human capital.

In the face of low and falling fertility rates, countries with large PAYG systems should thus consider focusing the public scheme on poverty alleviation\(^10\) by gradually reducing earnings-related PAYG benefits for those earning higher incomes.\(^11\) This would yield a better balanced portfolio between funded and PAYG schemes, as workers with middle- and higher incomes substitute private, funded pensions for public PAYG benefits (OECD 2001). Workers thus would become more dependent on capital markets rather than public transfers for their retirement. This strengthens political support for private property and reduces the scope for potential conflicts between labour and capital. Moreover, the fact that

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\(^7\) Notional defined contribution systems, which adjust the indexation of pension benefits so that contributions remain fixed, provide examples of such rules (Lindbeck and Persson 2003).

\(^8\) Investment in human capital rather than financial saving is called for if human capital and physical capital are poor substitutes and other countries are aging as well or international trade in financial capital, labour and/or goods is limited.

\(^9\) These private savings plans do not have to be individual defined-contribution schemes, but can also be low-cost stand-alone collective pension plans with restricted individual choice (Bovenberg 2007). Indeed, the government may compel workers to save part of their labour income in order to protect households from myopia or to prevent households from counting on the government to bail them out from old-age poverty.

\(^10\) Public transfers for old-age unskilled workers may be in order if low-income individuals are not able to save or work longer in the face of raising differences in life expectancy and health between low-skilled and high-skilled individuals. A flat public pension may be preferred over means-tested public pensions because means-tested benefits may be stigmatizing. These latter benefits may also discourage saving and undercut the political support of the middle class for public pensions: targeted programs for the poor may result in poor benefits.

\(^11\) The currently retired generation has not been able to anticipate lower public PAYG benefits. Accordingly, a strong case can be made for changing the rules of the game (i.e. reducing PAYG benefits and increasing taxes on the elderly) only gradually. Relative PAYG benefits can be reduced gradually by indexing benefits more to prices rather than wages or by raising the retirement age for younger cohorts.
the elderly rely less on public transfers averts political conflicts between the generations about the level of public transfers. Indeed, solidarity between older generations and younger generations raising young dependents becomes more symmetric as the state supports not only the old (especially the poorer old) but also young families in raising children.

7 Political economy of reform

We have argued in favour of state-contingent rules for sharing demographic risks. At the same time, we must acknowledge that such legal rules suffer from limitations. First of all, in designing state-contingent rules, governments face a trade-off between commitment (rules) and flexibility (discretion). In particular, governments may want to create clarity *ex ante* in complete contracts with regard to how risks are shared in order to limit political risks. At the same time, however, they may want to leave some discretionary powers so that they can respond to unforeseen contingencies.

A second limitation of legal rules is that commitment in a democracy is always limited. Even though rules are the default if laws are not changed, and defaults can be powerful also in politics, voters can always change the rules. Giving rules a constitutional status can enhance commitment to rules because a larger majority is required to change these rules. Even in that case, rules must retain sufficient popular support in order to be credible. Hence, implicit rules embedded in the culture are ultimately more important than legal rules.

Politics, economics and culture (i.e. individual preferences and social values) are mutually dependent. The political structure obviously affects economic policy. At the same time, however, by affecting the income sources of future voters, current economic policy impacts which policies will gather sufficient political support in the future. Moreover, by inducing people to work longer, governments may change future preferences and social norms (Lindbeck, Nyberg and Weibull 1999). These insights point to the importance of implementing soon the institutional reforms described in this article. In this way, we prevent Europe from becoming a gerontocracy: a large future constituency is built that is economically active, endowed with sufficient human capital to embrace the risks associated with a dynamic, innovative society, holds a stake in flexible labour and capital markets, and exhibits a strong work and entrepreneurial ethos supporting the dynamics of open markets. Indeed, to enhance confidence and trust in a stable social contract while at the same time facilitating timely adjustments, governments should announce as early as possible any prospective changes in the social contract. This would
allow the large baby-boom generations to anticipate reduced public transfers in retirement by saving more and investing in human capital.

In addition to arriving at new, transparent risk-sharing arrangements, the key challenges of aging for institutional innovation are twofold. In the face of scarce human capital, the first challenge is to stimulate the maintenance of human capital and the flexibility of the labour market. In this way, human capital of youngsters, women and elderly workers is exploited better, the working life is extended, the major opportunity costs facing parents when investing in children (i.e. lost career opportunities) are contained and people can embrace risks. Indeed, a large entrepreneurial workforce empowered with sufficient skills safeguards the legitimacy of a dynamic market, thereby boosting productivity growth.

The second challenge for institutional innovation is to better diversify the income sources of the elderly. This politically powerful group thus becomes less dependent on public transfers and relies more on labour and capital income, thereby creating more budgetary room for support of young parents. Replacing passive public spending on able-bodied elderly by public spending on young children aimed at enhancing their ability to learn prevents large one-sided resource flows between generations, which may be the source of divisive political conflicts.

Two major economic securities of citizens should be, first of all, their employability and the associated capability to adjust to shocks in labour and financial markets and, second, secure claims on pension and financial assets that help agents diversify risks. Schools, employers and unions can play an important role in helping people acquire the necessary financial competences and life and work skills. Better education may also make voters more aware of the fundamental trade-offs in social policy, thereby enhancing the quality of the political debate and ultimately improving policymaking (Boeri, Borsch-Supan and Tabellini 2002; and Boeri and Tabellini 2005). For example, better educated older voters may understand that investing in the human capital of younger generations is also in their interests because pension benefits are often linked to wages. Moreover, higher labour productivity on account of higher quality human capital can contain the costs of health care and other services provided to the elderly.

References


