

COMMENTS ON SESSION 1 PENSION REFORM AND THE LABOUR MARKET

*Walpurga Köhler-Töglhofer**

1 Introduction

OECD countries, in particular the European countries within the OECD, will face major demographic challenges in the not-too-distant future: Age-related public expenditures will increase dramatically due to (a) the strong inflow into retirement when the large baby-boom cohorts reach pension age, (b) the steadily growing life expectancy, and (c) the well-documented decline in the age at which people exit from the labour force. Together with the observed trend towards delayed entry into the labour market, this implies a sharp decline in the length of working life and in its duration relative to the retirement period. Together with declining and now comparatively low fertility rates,¹ this leads to a shrinking active labour population (in absolute terms as well as relative to the number of retirees) which cannot be fully compensated by migration.

The process of population ageing per se is the result of a great progress in human history – the so-called demographic transition. “Before the start of the demographic transition life was short, births were many, growth was slow and the population was young. During the transition, first mortality and then fertility declined, causing population growth rates first to accelerate and then to slow again, moving toward low fertility, long life and old population” (Lee, 2003). People not only live longer these days, they also stay in relatively good health until later in their lives. However, the combination of declining fertility rates, longer life expectancies, low effective retirement ages and the large inflows into retirement of the large baby-boom cohorts transforms the benefits of demographic transition for individuals into a challenge both for the sustainability of public finances and for labour market policy. In many countries, the numbers of workers retiring each year will increase sharply and will eventually exceed the number of new labour market entrants. Without changes in the participation patterns and in productivity, this will result in declining GDP-per-capita growth and thus in lower living standards.

According to the most recent report of the Ageing Working Group of the European Commission’s Economic Policy Committee, the reduction in the population aged 15-64 and the increase in persons aged 65+ will cause the old-age dependency ratio in the EU to almost double from 28 to 53 per cent over the next 50 years; at the same time, the total dependency ratio will increase on average by 30 percentage points to nearly 80 per cent.² According to the OECD (2006), the ratio of older inactive persons per worker in the OECD area will almost double from around 38 per cent at the beginning of this decade to just over 70 per cent in 2050, if work and retirement patterns remain unchanged.³

Given these prospects, raising labour force participation will be one of the most critical measures, since changes in the ratio of retirees will be driven both by changes in the size of older relative to younger groups and by the proportion of older people who participate in the labour market. Thus, increasing participation and employment rates of older workers or – more generally – extending working life is essential for ensuring sustainable public pay-as-you-go pension systems

* Österreichische Nationalbank.

The views expressed in this comment are those of the author and not necessarily those of the OeNB.

¹ Fertility rates have decreased over the last decades and remain substantially below the demographic reproduction rate of 2.1. See Stiglbauer (2006).

² See European Commission (2009).

³ In Europe, this ratio could rise to almost one older inactive person for every worker over the same period. See OECD, 2006, p. 9.

and for safeguarding high living standards. Moreover, this would also be a logical step in the light of increasing life expectancy. As part of the Lisbon Agenda, the European Union aims at increasing the employment rate of older workers to 50 per cent by 2010 (“Stockholm target”). A complementary target is raising the average exit age into retirement by five years (“Barcelona target”).⁴

Over the last decade, Europe in fact already witnessed a significant rise in the overall participation and employment rates, with women and older workers being the most dynamic components.⁵ However, labour force statistics show that there are significant cross-country differences in the labour force participation of older workers that range from about 30 per cent to more than 70 per cent. Hungary, for example, to which one paper of this session was devoted, exhibits a comparatively low participation rate of about 35 per cent and rather problematic prospects with respect to the development of the old age dependency ratio (an increase of 34 percentage points compared to 28 percentage points for the EU-27) and the total dependency ratio (an increase of 35 percentage points to 80 per cent).

A higher labour force participation of older workers would mean a better mobilisation of the labour supply of older people; this would yield a triple dividend (OECD, 2006). Firstly, it would boost labour force growth and help offset the negative impact of population ageing on economic growth; secondly, it would improve public finances (comparatively fewer expenditures but more contributions) and finally it would help employers by smoothing the pace at which they have to replace retiring workers with new entrants.

2 Decline in the labour force participation of older workers was mirrored by a steady reduction of average retirement age

Labour force withdrawal of older workers was one of the most dramatic demographic trends in the post-war period. In the early 1960s, the participation rate of people aged 60+ was above 70 per cent in most European countries, in some it was around 80 per cent. By the mid-1990s, this rate had fallen to below 20 per cent in many countries, such as BE, IT, NL, FR or AT; in addition, cross-national differences in participation had widened. The downward trend in the labour force participation of older workers lasted until the mid-1990s, when it was eventually reversed in many countries. Despite this trend reversal, the labour force participation of males aged 55+ is still lower now than it was just a few decades ago. Female labour participation has been on the rise in general, as has been the participation of the group aged 55+; however, their respective participation levels are still much lower than those of men.

The trend of falling labour participation of older workers was mirrored by a decrease in the average effective retirement age of workers. In the 1960s and early 1970s, men retired from the labour market when they reached the age of 65. Since then, the average age of retirement has declined dramatically. The average age of female retirement, while historically lower than that of men, has followed a similar pattern from the 1960s.

Gruber and Wise (2002) point out that, to understand these trends, we have to consider the social security systems and their evolution over time, among other things. Pension policies are an important determinant of labour force participation. The extent to which social security systems

⁴ Over and above these goals, it is reasonable to think of ways to shorten education periods and years of study, since otherwise rising numbers of labour markets entrants with tertiary education (which are another explicit goal of economic policy) will tend to shorten working lives further.

⁵ Between 2000 and 2008, the employment rates of female and older workers increased by about 5.5 and 9 percentage points respectively.

affect the pattern of labour force participation depends on the generosity of the system, such as replacement and coverage ratios. These two ratios were on the rise in European countries until the mid-1990s.

However, economic incentives built into the social security system were not the only reason why more and more people retired early. Above all, this development was caused by deliberate policy measures to reduce labour supply. Especially at the end of the 1970s and in the mid-1980s, governments, firms and trade unions often created “incentive schemes” for older workers to leave the labour market. Economic policymakers took action to “relieve” the labour market in times of low demand (recessions) or high supply (immigration) or in the face of structural unemployment problems caused by declining sectors – also in Austria. Various “soft landing” plans were implemented to reduce the labour supply (early retirement schemes, specific long-term unemployment benefits for older workers in declining sectors or a generous handling of invalidity pensions); these measures were characterised by less stringent eligibility rules, which were later even extended to all employees. Such bridging pensions were introduced also in FI, IT, DE and NL.⁶ Most of these soft landing plans have become permanent institutions which have come to shape people’s attitude towards retirement and thus to influence individual retirement decisions.

When investigating, *inter alia*, the reasons for cross-country differences in the labour force participation of older workers, Börsch-Supan *et al.* (2008) find, not surprisingly, that early retirement regulations in particular are an important determinant of labour force participation decisions in older age. In addition, they find that over and above the general institutional or other differences specific to a country, it is the generosity of the pension systems itself that matters a great deal in making individuals retire or keep on working.

Apart from the retirement rules and the monetary incentives built into the social security systems, also other aspects determine the labour force participation of older people, such as the trend of increasing real earnings, the existence of non-pension alternatives for old age (availability of different sources of income in old age), health-related factors, within-household decision-making (retirement decisions of couples) and care responsibilities, labour demand factors and social norms and traditions.⁷

3 Reversing the falling labour participation trend – an important target of pension reforms...

Labour force participation as well as employment rates of older workers have been raised significantly in several European countries in recent years. Pension reforms introduced since the 1990s primarily aimed at improving the sustainability of the public pay-as-you-go pension systems; they did so *inter alia* with the help of measures that intended to increase the labour force participation of older workers and to delay their exit from the labour market. The paper by Arpaia, Dybczak and Pierini, which was presented in this session, focuses on whether pension reforms enacted in the EU-27 over the past two decades have been successful in raising the labour force participation of those aged 50+ in the short term. It points to a difference in the short-term impact of pension reforms on the participation rate of men and women. The policy conclusion that can be

⁶ The political intention behind these measures was to replace ageing high-wage workers by young low-wage workers or to encourage older workers to retire in order to give their jobs to younger, possibly unemployed, workers. However, this hypothesis could not be verified empirically for the past decades. Still, in the face of the strong rise in unemployment of young male workers in the wake of the global economic crisis, this argument has again become politically attractive.

⁷ The importance of the latter should not be underestimated, in particular in those countries where people tend to retire at the first opportunity offered, even if their pensions are low and would be higher if they delayed retirement. Longer retirement becomes an acceptable, even a highly desired part of a typical worker’s life.

drawn from their study is that at least reforms of early-retirement options seem to have had a significant positive impact on the labour force participation of older women.⁸ However, we have to bear in mind that this reform category, as defined in the study, includes very heterogeneous reform measures. Thus, from a policy perspective it would be of greater interest to check for the labour supply impact of specific measures or elements. The authors do not find any clear-cut short-term impact from fundamental or non-fundamental reforms. However, people make plans and do not change them quickly when a system changes – and this is particularly true for older people. Therefore, asking about the short-term impact of different pension reforms may just not be the most relevant question. With respect to reforms aimed at enhancing the long-term sustainability of the pension systems, the medium- to long-term effects on participation are probably more important. Above all fundamental reforms – but also early-retirement reforms – may have long phasing-in periods. For instance, Austrian's early-retirement schemes will be phased out slowly until 2017. Moreover, the breakdown of reforms into “early retirement”, “fundamental” and “non-fundamental” reforms does not allow any statement or inference about the time horizon, *i.e.* whether the political intentions were geared primarily towards the long term or also to the short term. Finally, as labour supply and labour force participation of older workers are not independent from the cycle, adequately controlling for the economic conditions is indispensable.

4 ... but efforts to increase labour force participation have to be transformed into successful structural reforms

If the labour supply of older workers could be more fully mobilised, this would reduce economic dependency ratios and would improve public finances as well as increase potential growth (both in the short and long term). However, in order to transform pension reform-related efforts to increase labour force participation into successful structural reforms, they will have to be complemented with measures improving the employability of older workers in the future; the latter is far from assured. Increasing the employment rates of older workers has to be part of a more comprehensive strategy to cope with population ageing. This requires a broader reform perspective: Attention needs to be given to strengthening the skills and improving the training of individuals to reduce the gap between marginal productivity and total compensation of older people; to combating discrimination against older workers and people with disabilities; and to fostering changes in employer behaviour that inhibits employment of older workers (and people with family and care responsibilities). Moreover, the very low hiring rates of older workers have to be increased.

⁸ As mentioned by the authors, the increase in female labour force participation following pension reforms might be related to the fact that women tend to have shorter working lives due to career interruptions (maternity leaves and other family reasons).

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