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**Article**

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CESifo DICE Report

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*Suggested Citation:* Galasso, Vincenzo (2012) : The Political Feasibility of Postponing Retirement, CESifo DICE Report, ISSN 1613-6373, ifo Institut - Leibniz-Institut für Wirtschaftsforschung an der Universität München, München, Vol. 10, Iss. 4, pp. 27-31

This Version is available at:

<http://hdl.handle.net/10419/167095>

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## THE POLITICAL FEASIBILITY OF POSTPONING RETIREMENT

VINCENZO GALASSO\*

### Retirement trends

Most developed countries have experienced a dramatic drop in the labor force participation of their middle-aged and elderly male workers over the last fifty years. The average retirement age for males, or the average age of transition to inactivity, since exits from the labor market do not necessarily coincide with formal retirement, has dropped in the OECD countries from 67.9 years in 1950 to 61.7 years in 1990.

Indeed, this phenomenon dates back to a far earlier period in time. In 1880 over 75 percent of US males over the age of 65 were active in the labor market. By 1990 less than 20 percent of US elderly males were part of the workforce, despite the contemporaneous, impressive gains in life expectancy. This trend is hardly unique to the US: France, Germany and the UK are just a few of the countries that display similar long run patterns (Costa 1998). Indeed, this phenomenon has become even stronger in the last few decades. In virtually all OECD countries, with the notable exceptions of Iceland and Japan, the average labor force participation of males aged between 60 and 64 has dropped by at least 25 percent. Two striking cases are the Netherlands, which saw a drop from 84.7 percent in 1960 to a mere 19.1 percent in 2000; and France, where the figure plunged from 68.7 percent in 1960 to just 17.8 percent in 2000. However, this phenomenon has also been particularly strong in Belgium, Finland and Italy. These trends have a clear impact on the retirement age. For instance, in 1950 French male workers tended to retire at the age of 66.1 years on average, while in 1995 this transition occurred at the age of 59.2 years. The average age of transition for Japanese

workers, on the other hand, remained virtually unchanged from 66.7 years in 1950 to 66.5 years in 1995 (Blöndal and Scarpetta 1999). Moreover, the participation rate among elderly males (aged 65+ years) has even dropped in developing countries: from 67 percent to 52 percent in Mexico between 1970 and 1999, from 62 percent to 41 percent in Peru and from 68 percent to 39 percent in Turkey (Kopecky 2011).

These retirement trends are all the more striking since longevity has constantly increased during the last few decades, at a pace of almost three years every ten years. The increase in old age leisure achieved by retiring early has often been associated with the process of economic growth, which allowed individuals to enjoy higher income (and wealth) and thus more leisure, and with a reduction in the price of the leisure goods (Becker 1965; Costa 1998). In fact, several studies (Gustman and Steinmeier 2002; Coronado and Perozek 2003) have found evidence of a strong income effect in retirement decisions: unexpected positive shocks to wealth, such as the stock market boom of the nineties, have led to early retirement. In particular, elderly workers who held corporate equity immediately prior to the bull market of the 1990s retired an average of 7 months earlier than individuals with similar characteristics, but different portfolio holdings. Similar results are obtained for Switzerland (Bütler, Huguenin and Teppa 2005): credit constrained individuals tend to leave the work force earlier the higher their accumulated pension capital. Interestingly, this mechanism also seems to work in the opposite direction: a Dutch reform in the early 1990s, which reduced pension generosity and increased the actuarial fairness of the scheme, induced workers to postpone retirement (Euwals, Vuuren and Wolthoff 2006).

Retirement decisions are also largely driven by incentives, such as the level of the income guarantee provided by the pension system and the implicit tax on earnings (Feldstein 1974; Boskin and Hurd 1978). Indeed, the adoption of generous early retirement provisions in the social security systems of most industrialized countries between the late 1960s and the 1970s has been largely responsible for the dra-



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matic decrease in labor force participation among middle-aged male workers in recent decades. Two features of these early retirement provisions have been identified (Gruber and Wise 1999 and 2004; Blöndal and Scarpetta 1999), which display a strong correlation with the departure of elderly workers from the labor force: the early (and normal) retirement age and the tax burden, which is imposed on the labor income of those individuals who continue to work after reaching an early retirement age. In fact, in most OECD countries the conditional probability of male workers exiting the labor force (the hazard rate) peaks at the early (and at the normal) retirement age, suggesting that most individuals leave the labor market as soon as they are entitled to collect a pension benefit. The strong incentive is due to the existence of a large implicit tax imposed on continuing to work after early retirement age, to which individuals respond optimally by anticipating retirement.

#### Introduction of early retirement provisions

Despite their relevance for these labor market trends, less research has been devoted to identifying the determinants of the widespread adoption of these early retirement provisions. A few explanations, however, have emerged. Some authors (Gruber and Wise 1999) have hinted at the fact that such provisions have been adopted to accommodate a secular pattern of decreasing labor force participation. The introduction of early retirement schemes may instead have represented an instrument used in the late 1960s, when Europe experienced a period of tensions and strikes, to increase the share of production appropriated by the labor factor (Caballero and Hammour 1998).

Alternatively, the adoption of early retirement provisions might have been due to the emergence of a large group of redundant or unemployed elderly workers, who were not yet entitled to an old age pension. The introduction of formal early retirement provisions, the weakening of the eligibility criterion for disability pensions, whose eligibility was often made contingent to labor market conditions, and the institution of “unemployment pensions” to be awarded to unemployed elderly workers were indeed aimed at enabling this mass of redundant or unemployed elderly persons to withdraw from the labor market<sup>1</sup> on a pension transfer (Conde-Ruiz and Galasso 2003 and 2004). Indeed, data provided

in 1986 by the Economic Commission for Europe at the United Nations on the institutional details of the first early retirement provisions in fifteen OECD countries support this argument. Almost everywhere in Europe in the 1970s and 1980s, i.e., during a period of industrial restructuring, generous early pathways from the labor market were offered to redundant or unemployed elderly workers, who were allowed to collect benefits under a wide array of welfare schemes, such as (i) special pensions to unemployed elderly workers (in Austria, Finland, and Germany); (ii) disability benefits awarded on the basis of labor market considerations (in Denmark, Germany, Netherlands, Norway, Spain, and Sweden), and (iii) special contracted pensions for redundant workers (in Austria, Belgium, France, and Germany). General early retirement provisions were also made available in Canada, Japan, and the USA; whereas Italy had already had a general early retirement provision in place since 1965, although most early exits from the labor market draw on the more generous disability benefits.

According to this argument (Conde-Ruiz and Galasso 2003 and 2004), political support in favor of early retirement hinged on two crucial conditions. Firstly, the emergence of a large group of redundant or unemployed elderly workers with an incomplete working history, who were not otherwise entitled to an old-age pension, but benefited from an early retirement pension transfer. Secondly, there exists an element of intra-generational redistribution in the early retirement provision generated by the utility from leisure. In fact, to the extent that leisure is similarly valued across ability types, but foregone labor income is lower for less productive types, lower income workers found it more convenient to retire early. This retirement behaviour gave rise to an endogenous group of low-educated workers with an incomplete working history, which guarantees future constituency for this provision. Indeed, the vast majority of the workers who, over the years, have taken advantage of these early retirement provisions are workers in low and intermediate educational groups (Blöndal and Scarpetta 1999). Moreover, early retirement has proven more common in manufacturing, where the number of retirees among males

<sup>1</sup> The proportion of men receiving disability or unemployment benefits at age 59, hence typically below early retirement age, was 21 percent in France, 22 percent in Belgium, 24 percent in Sweden, 27 percent in the Netherlands, 33 percent in the UK, and 37 percent in Germany, as opposed to only about 12 percent in Japan and the USA (Gruber and Wise 1999).

aged 55 to 64 exceeded the number of workers in every OECD country in 1995.

An interesting body of literature has also emerged along these lines that analyses the political determinants of early retirement (Fenge and Pestieau 2005; Casamatta, Cremer and Pestieau 2005; Cremer and Pestieau 2000; Cremer, Lozacheur and Pestieau 2004). These works endogenize the political determination of some of the characteristic features of early retirement systems.

**The cost of early retirement**

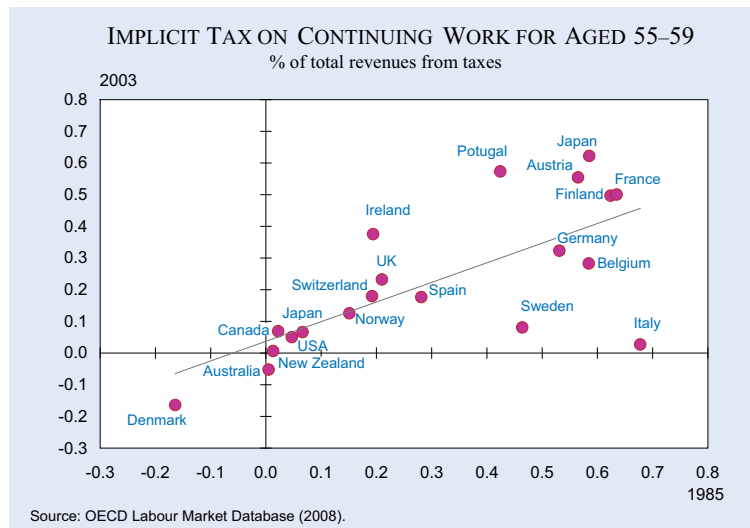
According to a justification, which has proven very popular among politicians and the media, early retirement may have been introduced in periods of high youth unemployment in order to encourage elderly people to withdraw from the labor force, and thereby to provide more job opportunities for young workers. This argument – which has become known as the “lump of labor fallacy” – has been proven flawed both theoretically<sup>2</sup> and empirically (Boldrin et al. 1999; Gruber and Wise 2010). These studies found early retirement to have no (positive) effect on youth employment. Additionally, a positive, albeit small, correlation was established between the implicit tax of earning (which is known to induce early retirement) and youth unemployment. Hence, the fiscal burden produced by the incentives built into the early retirement provisions may actually hurt the job prospects of young people.

In the context of the technological progress and globalization that immediately followed the introduction of these provisions, workers with lower human capital, or with more technology-specific human capital, are even more induced to take advantage of these provisions, and to retire early (Ahituv and Zeira 2000). Coupled with the demographic dynamics of an aging popula-

tion, these retirement trends have helped to increase the dependency ratio, and therefore, to exacerbate the financial imbalances of pay as you go (PAYG) social security systems. Due to early retirement, fewer workers are effectively available to finance the (generous) pensions of a higher number of retirees. Furthermore, calculations (Herbertsson and Orszag 2001) have shown that early retirement can be held responsible for a reduction of around five to seven percent in potential annual GDP in OECD countries, with even higher figures for EU countries.

As the costs of early retirement have become increasingly apparent, several scholars and international organizations like the European Union or the OECD have proposed raising the effective retirement age, or, analogously, increasing the activity rate among individuals aged above 55 years, as the crucial policy measure for controlling the rise in social security expenditure. Postponing the retirement age has thus become a common element in all social security reform proposals. Yet the actual implementation of these policy prescriptions has proven difficult. Figure 1 displays the incentive to retire early, as measured by the implicit tax on continuing to work for individuals aged 55 to 59, in OECD countries in 1985 and 2003. Different patterns emerge. The pension systems in Denmark and in a few other Anglo-Saxon countries, located on the lower left of Figure 1, have historically provided little incentive to retire early. In other countries, like Sweden, Italy and, to a lesser extent in Germany and Norway, incentives have recently been removed, with the implementation of pension reforms that have transformed the systems from defined benefits to notional defined contribu-

**Figure 1**



<sup>2</sup> Since the economy cannot be represented as a closed box with a fixed number of available jobs, the retirement by an elderly worker does not necessarily make room for a young worker, nor is needed for a young individual to find a job. Moreover, elderly and young workers need not to be close substitute due to differences in ability and productivity.

tion (NDC). In NDC schemes, pension benefits depend directly on lifetime contributions, and are actually linked to retirement age – thereby providing little incentive to retire early. However, these reforms, and analogous proposals, have always met with strong opposition from elderly workers, who are close to (early) retirement, and from the unions (Boeri et al. 2006). In the case of the 1995 Italian pension reform, political support was achieved by designing a long transition period in order to allow middle-aged workers to retire with the unreformed (more generous) systems.

### **The political feasibility of postponing retirement**

Although early retirement has recently been identified as one of the main culprits, together with aging populations, of the financial imbalances that characterise many social security systems, postponing retirement – although widely endorsed by experts and policy-makers – is not the only possible solution. Alternatively, contribution rates could be (further) increased, or per-capita pension benefits reduced. These policy measures have different economic effects, as well as different sources of political support, as the cost of these reform measures varies across generations. The beauty of postponing retirement is that it makes it possible to maintain a sufficient level of old age consumption by combining a longer working career – and thus higher labor income – with relatively generous pension benefits, albeit at the cost of less old age leisure.

But will future voters be willing to support such a policy? The recent political-economic literature (Fenge and Pestieau 2005; Lacomba and Lagos 2007; Casamatta et al. 2005; Cremer and Pestieau 2000; Cremer et al. 2004; Conde-Ruiz and Galasso 2003 and 2004) on the introduction of early retirement provisions emphasizes the crucial role of policy persistence for the political success of these measures. This suggests that the introduction of early exit paths from the labor market were also welcomed by young workers who expected to retire early. An EC survey (European Commission 2004) indicates that current workers are effectively unwilling to postpone retirement.

Yet tomorrow's potential early retirees are today's young workers, and they may be facing a different economic scenario. Recent contributions (Galasso 2008; Conde-Ruiz, Galasso and Profeta 2013)

suggest that postponing retirement may indeed become feasible in the future due to the political push of aging. In countries with large social security systems, like most developed economies, which also feature generous early retirement schemes, aging may induce a major negative income effect by reducing individuals' pension net wealth. In fact, the increase in the dependency ratio reduces pension profitability for all future generations, who hence obtain a worse deal from the social security system. Furthermore, if the reduction in the social security return takes the form of lower pension benefits, a substitution effect also arises, since the pecuniary incentive to retire decreases, which favours postponing retirement.

This mechanism rests on the existence of income effects in retirement decisions, which were already present in early contributions (Michel and Pestieau 1999; Sheshinski 1978; Lacomba and Lagos 2007). Recent empirical contributions consider the role played by income effects as derived from the consequences of higher exposure to market risks – in the US, older workers hold almost two thirds of their 401(k) balances in equities – in the decision to retire. For instance, did the recent decline in the stock market encourage older workers to postpone retirement? Indeed, participation rates among older workers have increased during the recessions of this decade (Munnell, Muldoon and Sass 2009; Munnell and Saas 2008). In particular, the collapse of the stock market might explain part of the two percentage point increase in the labor force participation rate of older workers (55–64) between early 2000 and 2002, (Eschtruth and Gemus 2002; Cahill, Giandrea and Quinn 2006), which constitutes an unprecedented effect during a recession, when labor force participation usually declines. Moreover, one out of five among the 50–70 year old respondents in an AARP survey, who had not yet retired, reported that they postponed retirement as a result of stock market losses (Munnell et al. 2009).

These phenomena have had only limited effects on the average retirement age to date, which has only increased slightly in most countries since the early 1990s. A more recent phenomenon with potential long lasting effects has, however, occurred in the labor markets of many European countries: the introduction and the massive use of temporary contracts<sup>3</sup>. These contracts are largely concentrated among the young (in 2006, respectively 52 percent, 36 percent and 32 percent of twenty-five year-old

Spanish, Italian and French workers had a temporary contract), and often do not provide the same pension rights as regular jobs. Furthermore, temporary contracts are typically associated with lower wages than permanent contracts.

The potential long-term effects on pension benefits – and thus on the future retirement behaviour – of this current phenomenon in the labor market on the younger generations is estimated to be fairly substantial. Unfortunately, in many countries, postponing retirement for future generations of workers may turn out to be politically feasible, but for the wrong reason: individuals who are now young will not have enough pension rights to retire (early) when they get older, and will need to work longer.

<sup>3</sup> According to OECD (2008) data, the share of temporary contracts among dependent workers increased from eight percent in 1980 to 14.4 percent in 2008 in the EU 15 countries, jumping from 4.7 percent (in 1985) to 13.9 percent in Italy, and from 15.5 percent (in 1987) to 29.3 percent in Spain.

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