

Borg, Anders; Boersch-Supan, Axel; Visco, Ignazio; Wikstroem, Solveig; Wise, David A.

## Conference Paper

# Tackling the ageing syndrome

Session Handouts, Global Economic Symposium 2008 (GES), 4-5 September 2008, Plön Castle, Schleswig-Holstein, Germany

## Provided in Cooperation with:

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Borg, Anders; Boersch-Supan, Axel; Visco, Ignazio; Wikstroem, Solveig; Wise, David A. (2008) : Tackling the ageing syndrome, Session Handouts, Global Economic Symposium 2008 (GES), 4-5 September 2008, Plön Castle, Schleswig-Holstein, Germany, Kiel Institute for the World Economy (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/79094>

## Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

## Terms of use:

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

## Social Insurance: Promoting Health and Welfare

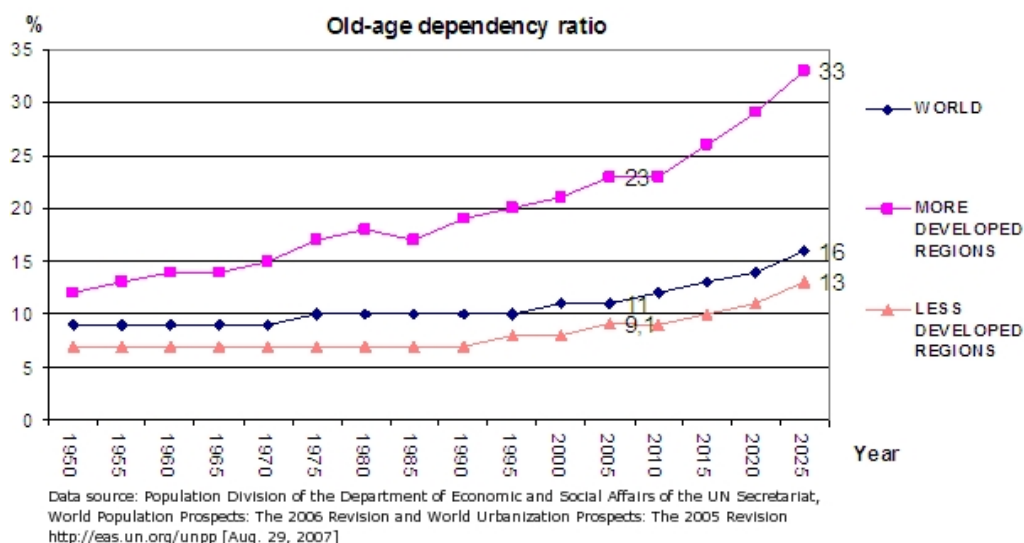
# Tackling the Ageing Syndrome

### Summary

As populations age in many countries all over the world, fewer prime-aged people will be there to care for more of the elderly. Increasing pension and medical care expenditures will raise governments' (or families') financial burden. Higher taxation on earned income to cope with the increased financial burden runs the risk of impairing incentives to work and the willingness to learn and qualify for life.

Thus policy makers must tackle a three-pronged syndrome: pension systems, health care and employment for all. We cannot design a pension system without reference to the health care costs and to the overall employment conditions; nor can we design a health care system or regulations on labor markets without taking their influence on financing pensions into account.

What joint reforms of pension, health and employment systems would enable ageing societies to maintain (or even increase) the living standards of all? How is the effectiveness of these systems interconnected? Should these systems encourage the elderly to prolong their working lives and how should they do it? How can they also motivate the working-age population to work and acquire skills? What organizational and management innovations can help integrate elderly workers in employment? What are the means to encourage life-long learning?





## Proposed Solutions

### Expert Opinion

Population ageing becomes a pervasive phenomenon not only in the developed world but also in most of the developing societies. UN expects that the old-age dependency ratio would roughly double to 33 percent from 2005 to 2025 in the more developed regions and amount to 13 percent in the less developed regions. The long-lasting developing trend of longevity is expected to have strong impacts on the economic growth in a basically unchanged institutional environment.

Under current pension systems and with no changes in present work and retirement patterns, population ageing would increase the pressure on public finance. This, in turn, may impose heavier financial burden on the young workers due to rising payroll contributions and therefore substantially weaken their work incentives, severely aggravating the financial problems of the current pension systems and amplifying the looming societal instability.

Many countries seem to embark on policies to raise fertility or to encourage immigration to mitigate the labour shortage. However, a comprehensive institutional reform package is highly warranted in order to bring individual incentives in line with the requirements for effectively and efficiently tackling the ageing syndrome. Such a policy package should include the following points:

- **Eliminating early retirement arrangements** designed for tackling severe unemployment problems in several countries decades ago. These arrangements have not solved the unemployment problems anyway, but just substituted young labour for aged workers, adding to the strain of financing old-age pensions.
- **Raising the standard retirement ages** so that the speed of rising old-age dependency ratio can be moderated.
- **Redesigning old-age pension schemes in an actuarially neutral way**; this is fundamental for strengthening the incentives of aged workers to stay on working for a longer period.
- **Increasing prime-age female labour-force participation** by improving childcare facilities and by removing discriminations of joint taxation against female participation.
- **Enhancing the role of part-time work** so that labour-force can be employed more flexibly to better match labour demand..
- **Making the school-to-work transition more effective** to prevent unnecessary waste of working power and working time, facilitating the transformation of labour potential to labour-force deployed.

Adequate education and health policies may help enhance the willingness of companies to keep workers when they are getting older. However, these public policies will only be successful, if they are supported by enterprises: The productivity of older workers may be further increased by offering firm-internal health care schemes that keep them physically fit and mentally motivated. In addition, encouraging life-long learning and updating of technological and managerial capabilities of workers may help increase the productivity of older workers and their employability. Finally, companies may foster the private savings of their employees by providing adequate investment alternatives integrated within the business pension systems.

Because of the significant and long-lasting impacts of population ageing on the economic growth and societal stability, there is urgent need for political leadership to forge a common consensus between (local) governments, companies and individuals across generations to keep potential for conflict at bay.



## Strategy Perspectives

### *Reconstructing the Swedish Model*

Anders Borg

*Minister of Finance, Sweden*

#### **The Scandinavian Model**

##### *Is there a Scandinavian Model?*

International comparisons of political and economic conditions provide important information about the institutional conditions that create the best opportunities for achieving economic policy goals. But such comparisons are understandably a sensitive matter, given differences in goals and values as well as historical conditions.

The values and the social goals manifested in how the Scandinavian countries – perhaps Sweden in particular – have chosen to organise society and weigh income distribution policy goals against the need for efficiency and flexibility have elicited considerable reactions and interest. There is often talk of a special “Scandinavian model” as a middle road between the Anglo-Saxon and Continental European countries’ ways of organising their economies and social systems. However, there is no single definition of what is meant by the Scandinavian model. Instead what the individual observer discerns to be distinctive features and experiences will generally determine how the model is defined.

One reasonable starting point when trying to distinguish between different countries or “models” is to start with the Scandinavian countries’ distinctive institutional features, rather than similarities and differences in economic and social outcomes (for example, the percentage of the working-age population that is employed or the size of the wage spread among various groups). The European Economic Advisory Group (EEAG) in its latest report surveys the advantages and disadvantages of the Scandinavian model. The report highlights the institutional features characteristic of the Scandinavian model:

- a large public sector,
- generous social insurance systems,
- a high tax ratio,
- an emphasis on active labour market policy,
- a high degree of unionisation and
- highly coordinated wage bargaining.

The EEAG’s definition is to a large extent based on the way in which the labour market is organised in Scandinavian countries as well as on the extent to which the public sector typically encroaches on citizens’ (economic) lives. Other analysts endorse this perspective in substance.

However, Lindbeck, who has principally considered Swedish conditions, is of the opinion that the degree of coordinated wage bargaining is not a distinctive institutional feature in the Swedish economy. Rather bargaining at the industry level is characteristic of the Swedish economy, while the high degree of coordinated wage bargaining is a reasonable description of the Austrian labour market. Lindbeck also points out some other distinctive features of the Swedish model, which in some respects can apply to the other Scandinavian countries. Sweden has had a strongly interventionist stabilisation policy (all though with an active labour market policy playing a central role); state intervention in capital formation aimed at increasing the total level of savings, credit supply and investment, especially in the housing

sector; an explicit (organised labour and political) goal of a compressed wage structure to compel a structural rationalisation in the private sector – “the solidarity wage policy”; a pronounced centralisation in the private sector where large companies dominate production and equally large institutions dominate holdings of financial assets; a strong corporate element in which representatives of the social partners populate the boards of public authorities and a strong free-trade policy.

### *Why the Swedish Model Worked*

Is there something to be learned from the Swedish model? It is not possible here and now to make a fully adequate evaluation of the Scandinavian model, but nevertheless a number of points can be made that, in my opinion, are important in understanding why the Scandinavian model has been relatively successful and also why it has in some respects stopped working. I will, however, base most of my observations on conditions in Sweden since I am most familiar with them. Nevertheless, several of our experiences are valid for our Scandinavian neighbours too.

A first observation is that the foundations for several of the institutional requirements for good growth and high employment in Sweden were laid before there was any talk of a specific Swedish (or Scandinavian) model. The modern economic growth literature stresses the importance of having good institutions in the form of free enterprise, a well-functioning legal system, well-defined property rights, public authorities that are free of corruption, free trade, etc. These basic conditions had been largely met in Sweden as early as the middle of the 1800s. Sweden, like other Scandinavian countries, is among those countries considered to have the best legal systems for promoting growth.

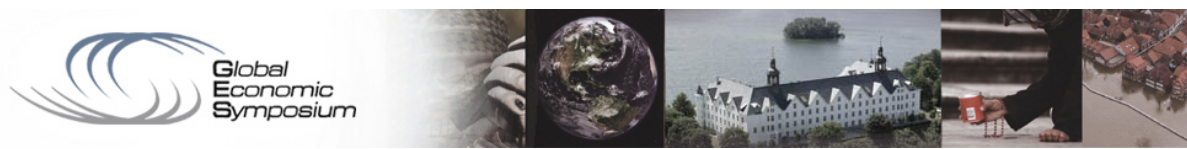
A second observation is that the Swedish economy was comparatively unregulated until the beginning of the 1970s, even though certain regulations had survived from the time of the Second World War. Even at the end of the 1950s, public expenditure as a percentage of GDP was lower in the Scandinavian countries than in most other European countries and also lower than in the United States. In the middle of the 1950s the tax burden in Sweden was on a level with other OECD countries, but by 1970 it was the highest in the industrialised world.

Even in the area of labour legislation, the Swedish labour market seemed comparatively liberal; Swedish employers had – and still have – a far-reaching right to direct and distribute work. Sweden’s current labour legislation, which is relatively strict according to the index produced by the OECD, is to a great extent a product of the changes to labour legislation implemented in the 1970s.

A third observation is that several of the distinctive institutional characteristics usually attributed to the Swedish welfare system are favourable for economic development. Economic research also provides good support for the contribution to increasing labour force participation, especially of women, made by access to childcare and care for the elderly, a well-functioning basic education, and the absence of individual taxation of spouses. Correspondingly, a high-quality education system and infrastructure improvements contribute to higher productivity.

Even in labour market policy and social insurance, especially in the 1950s and 1960s, there was an emphasis on the work-first principle, which meant that access to benefit systems assumed for the most part that one first had had a job of reasonably long duration and that the individual was actively seeking work in order to continue receiving benefits. The level of benefits was in addition considerably lower than compensation from gainful employment. Sweden has had a large public sector, but it has also had in major respects a growth-oriented public sector.





It is also likely that the stable relations between the social partners with a collective agreement based contract model for wages and other working conditions, combined with a relatively high degree of centralisation, at least in the 1950s and 1960s, helped keep unemployment lower and create good conditions for the business sector. However, the importance of central wage bargaining must not be exaggerated, which Lindbeck (1997), among others, has pointed out, but considering that large parts of the business sector in the 1930s had been crippled by innumerable strikes, the postwar Swedish labour market's relative peace and display of responsibility were an important factor in enabling the Swedish model to function well.

A fourth aspect of the Swedish model which merits attention is that Sweden, like other Scandinavian countries, has adopted an open attitude to international competition and a positive approach to free trade and the kind of structural change that international specialisation involves. Even though the connection between the degree of international openness and the rate of growth in the long term is complicated, economic research indicates that open countries experience higher growth than less open countries. The openness of Sweden and the other Scandinavian countries has consequently contributed to the strong economic development these countries experienced during the postwar period.

It is absolutely clear that the Swedish economy grew very rapidly in the 1950s and 1960s and in this respect the Swedish model worked well. From 1950 to 1973, annual GDP was 3.7 per cent, which was over one per cent higher than it was from 1918 to 1950 (2.74 per cent a year on average). Unemployment varied between 1.5 and 2.0 per cent, which was lower than the European average and much lower than in the United States. As a result of good and stable economic development in Sweden in the 1950s and 1960s – indeed a period of good growth in several other OECD countries – at the beginning of the 1970s, Sweden had the fourth highest GDP per capita measured in purchasing power parity.

However, in my opinion, the success of the Swedish model is not founded on any economic miracle but on a number of basic economic principles that are still valid today, namely:

- a labour market and labour market legislation in which there is mutual understanding between the social partners and which ensures a reasonable balance between employees' legitimate demands for job security and employers' need to be able to adjust the work force and organisation of production to changed terms of competition;
- a social insurance system that provides security in the event of change but at the same time strongly emphasises the importance of getting a job;
- publicly financed welfare services available to all, but designed to support high labour force participation and high productivity growth; and
- a business sector that is open to international competition and experiences few interventions in free price formation.

Correspondingly, it is my view that the problems associated with low growth and increasing macroeconomic imbalances in the 1970s and 1980s, as well as the employment problems that were exposed in the wake of the crisis in the early 1990s, were to a considerable extent a result of abandoning fundamentals in the Swedish model. Economic policy, particularly in the 1970s, created institutions and structures that owing to their rigidity and one-sided focus on security and evening out social and economic differences were not capable of coping with new economic realities, such as growing international economic integration, and paid less attention to the negative effects on the economy as a whole that occurred as a consequence of neglecting the need for flexibility, dynamics and economic incentives.



### *Why Did the Model Stop Working? Economic Development in Sweden in the 1970s and 1980s*

What then were the factors that made the Swedish model stop working? The economic downturn that followed the two oil crises of course had a negative impact on Sweden. But these shocks also affected other industrial countries and it is difficult to argue that Sweden would be so particularly vulnerable to the international business cycle that it would explain why Sweden fell from fourth place in the OECD's ranking of member countries by GDP per capita around 1970 to ninth place in 1990 and eighteenth in 1997.

Instead, I would argue that the explanation lies with the economic policy of the 1970s and 1980s. Five factors stand out as especially significant:

- Budget deficits and high inflation undermined macroeconomic stability,
- the tax and benefit systems created incentive problems and lock-in effects,
- a weak competition policy and ignorance of the importance of entrepreneurship and capacity for innovation in the business sector,
- an uncertain investment environment in the wake of macroeconomic imbalances, and
- a fragmented political system combined with a weak institutional environment made a long-term economic policy more difficult.

### *Changes in Economic Policy in the 1990s*

#### Structural Reforms

The structural reforms implemented in the economy in the 1990s were aimed at improving efficiency through more competition and better incentives to work. While the focus of economic policy in the 1970s had been primarily selective industrial policy and attempts to bridge over recessions with various forms of support for investment and stockbuilding, policy in the 1990s instead focused more and more on the factors of production by putting the emphasis on promoting education and stimulating capital formation. By doing so, better conditions were created for companies to compete internationally.

The tax reform of 1991 involved reduced marginal taxes, simplified rules and a broader tax base. At the same time taxes on capital were relatively low. The corporation tax was lowered to 28 per cent. Housing policy was changed to reduce interest rate subsidies. There was a shift in the aim of the policy over time from providing support for production to giving financial support to the residents. The main feature of this policy shift was that both the producer and consumer now have to bear a larger part of both capital and production costs.

In 1993 a stricter competition law was introduced. Several product and service markets were deregulated in the 1990s, for example, the transport, telecommunications and electricity markets. Sweden was given full access to the internal market in 1994 under the Agreement on the European Economic Area and a year later became a member of the EU. In the 1990s labour legislation was also amended to meet the demands for greater flexibility. One of the changes, agreed fixed-term employment, made it easier to hire on a temporary basis.

A broad policy agreement was reached on a new pension system with closer links between contributions and future benefits. The pension system was introduced in 1994. In social insurance the crisis in the early 1990s and the subsequent budget consolidation led to the introduction of a qualifying day. As well employers pay for sickness benefits for the first two weeks, the sick pay period. At the same time replacement ratios in, respectively, the unemployment and sickness insurance benefit systems were reduced from 90 to 80 per cent of previous earnings.



## Fiscal and monetary policy reform

The crisis during the early 1990s made it necessary to reverse the trend towards growing budget deficits. The crisis also helped increase understanding of deficiencies in economic policy and its framework and the problems for the Swedish economy that ensued. A consensus developed on the need to improve the regulatory framework and review the goals of economic policy. The result was a number of reforms made to economic policy aimed at greater stability and increased predictability. Under the reforms, both monetary and fiscal policy were assigned clear goals in the form of targets for inflation and the public finances.

After the crisis in the early 1990s, the public finances were consolidated. Under the non-socialist government of 1991 to 1994, work was begun on a long series of measures, including reduced benefit levels in unemployment and sickness insurance, a reform of work injury insurance and cuts to subsidies in the housing sector. In total, measures consolidating the budget came to 7.5 per cent of GDP according to IMF estimates. The Social Democratic government that followed completed the consolidation of the public finances. The total consolidation programme came to about 15 per cent of GDP and stabilised the unsustainable debt situation and public finances began to show a surplus again.

The credibility of the consolidation programme was strengthened by the reform of the budget process. Sweden went from having one of the weakest budget processes to having one of the strongest. Like monetary policy's new goal, the need for sound public finances is today firmly anchored in policy. The Riksdag's target of a surplus in general government net lending of 2 per cent of GDP over a business cycle also has the aim of lowering the debt ratio. This is warranted by the expected burden that an ageing population will entail for the public finances. Sweden, as an EU member, has agreed to follow the terms of the Growth and Stability Pact on central government net lending and indebtedness, an undertaking that also strengthens fiscal policy credibility.

### *Why Did the Model Need to Be Re-established?*

The persistently low employment level and consequent high levels of exclusion from the labour market mean that economic growth is lower than it would have been otherwise and that some people cannot fully participate in the good economic developments. The labour market is also important in meeting future economic challenges. An ageing population along with continuing internationalisation and structural change in the economy require high employment and good adaptability.

### *The Challenges Ahead*

There are a number of major challenges facing the Swedish economy. Globalisation continues to require considerable economic adjustment and flexibility. The demand for welfare services is increasing as the population ages and incomes rise. Environmental changes, not least climate change, are global and affect living conditions all over the world. Even though these challenges will have their biggest impact a little into the future, action is required now and economic policy must continue to take a long-term view.

The demand for welfare services – chiefly health care, social services and education – will increase in future. Such an increase depends both on demographic developments and on the trend to rising incomes. More elderly in the population increases the demand for health care and care for the elderly. The number of people aged 65 and older will increase rapidly in the next 30 years while a much more limited increase in the 20 to 64 age group is expected. To meet the growing demand for welfare services, the surplus target for general government net lending must be maintained as long as it is needed to ensure sustainable public finances. In addition measures have to be taken to increase efficiency in the public sector. In order to get more resources for welfare services, it is crucial to increase the number of hours worked





in the private sector as this expands the tax base and brings in more tax revenue. Reforms that increase the labour supply and durably reduce unemployment, along with sound public finances, are therefore vital to pay for the long-term financing of the welfare services. The high level of exclusion, the risk of imbalances in the economy as a consequence of labour shortages and the importance of high employment in order to finance welfare services in the future when the population will be older are factors that clearly point to the need for a better functioning labour market. To achieve a durable high employment and reduced exclusion, it is necessary to make far-reaching reforms. Sweden has successfully carried out reforms of both the product markets and the monetary and fiscal policy framework. It is now high time to reform the labour market as well.

### *The Reform Strategy for the Labour Market*

The structure of the labour market is complex, and the way it functions is shaped by the behaviour of different actors, by the political system, by business, by employees and by the world around. It is therefore impossible to give a brief and at the same time exhaustive description of all the factors that influence labour supply and employment. In addition, different analysts attach different weights to the various explanatory factors. Nevertheless, there is a substantial agreement among the views on how economic policy can influence labour supply and the equilibrium rate of unemployment and thus employment.

Labour market reforms must be designed to target those groups most likely to change their behaviour. The labour supply is dependent on how worthwhile working is relative to not working. The labour supply is more sensitive in groups having a weak position in the labour market, who cannot expect a salaried career, have repetitive and heavy tasks and work in hierarchical organisations. Women's labour supply is more sensitive than men's. For these groups, threshold affects appear to be more critical to the labour supply than do the marginal effects. Replacement levels in the social insurance systems appear to be more critical for the labour supply than do taxes. The combination of high taxes on low incomes, means-tested income support and high benefits in the event of unemployment, absence due to illness and early retirement create serious poverty traps. When various social security schemes are combined, benefit levels tending to lead to permanent exclusion are created.

The wage structure in the economy affects the demand for various types of labour. In Sweden, the wage structure is relatively compressed and this contributes to a comparatively weak demand for labour with relatively low productivity. Some individuals' productivity is – or is felt to be – too low in relation to the cost of labour.

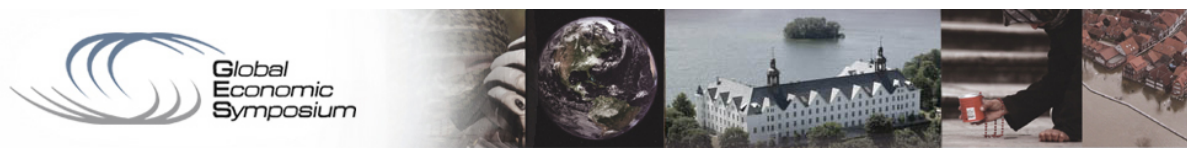
To boost the labour supply, increase employment and lower equilibrium unemployment, a reform strategy must contain both measures that help increase the labour supply and measures that increase the demand for labour.

### *Concluding Remarks*

In 2006 the Government went to the voters with an ambitious reform programme to increase employment and reduce exclusion. The reform programme substantially preserves and builds on the strengths of the Swedish model. With the reforms being carried out, it will become more worthwhile to work and easier and more profitable to hire.

Even though many strong measures are being implemented, it is difficult at this point in time to judge how effective the reforms will be and how long it will take before they have an impact. However, additional measures will likely be needed later on.

The focus of the reform measures must be on more jobs, higher employment and lower unemployment. Less unemployment and less exclusion are of major importance to smooth income differences and thereby achieve the goals of income distribution policy. In addition to



the income distribution effects, increased employment will lead to increased welfare and to greater means with which to finance important welfare services in the long term. The latter is of considerable importance since access to welfare services of good quality is a present-day way of smoothing consumption between individuals and helping those who, for various reasons, end up outside the labour market or who have low incomes.

The Government's employment policy is ultimately based on the understanding that the opportunity to work has a value in a broader sense. By offering more people the opportunity to move from exclusion to employment, there will also be more people who can provide a livelihood for themselves and their families. Having a job affects one's well-being. In the workplace one is part of a larger social community and is capable of achievement, development and a sense of participation. Without a job, the risk of financial, social and health problems increases. For the individual and for welfare at large, the value of work is fundamental. A policy for increased employment and less exclusion is thus a moral imperative and not just a financial necessity.

### ***Myth and Misconceptions About Aging in Old Europe***

Axel Boersch-Supan

*Director, the Mannheim Research Institute for the Economics of Aging*

The extent of the demographic changes in Europe is dramatic and will deeply affect future labor, financial and goods markets. The expected strain on public budgets and especially social security has already received prominent attention, but aging poses many other economic challenges that threaten growth and living standards if they remain unaddressed.

There is no shortage of "solutions". Almost every reputable economist with interest in actual policy has published reform proposals to address population aging, most of those focused on pension and labor market reform. Some academics have actively participated in reform commissions, such as the various unsuccessful US Social Security Reform Commissions, the very successful Swedish NDC-Pension Reform Commission, or the German Sustainability Commission which was successful in reforming pensions but miserably failed in health care. Most proposals include a mix of solutions, including most prominently measures to increase employment and to shift financing of future pensions from the next to the current generation. Almost all economists agree on this general line.

There are two reasons why I do not want to indulge in a detailed discussion of the solutions' mix. First, there is no "one size fits all" reform for all aging countries, not even within Europe. Demography varies remarkably even within Europe, and so does labor force participation. History has shaped very different pension, health care and social assistance schemes. Attitudes towards risk and saving, and towards intergenerational support vary dramatically between the North and the South of Europe. Countries with an already high labor force participation rate will have difficulties to increase it even further: for Italy, increased female labor force participation and a higher retirement age offsets much of the employment effect of aging; in Denmark, there is little to gain because employment levels are already high. More saving for retirement, the another prominent solution, works in countries with a low saving rate but will fail in countries where the saving rate is high and much of it is already spent on old-age provision. I would argue, for instance, that Germany has no room for additional funded pensions once everybody is enrolled in "Riester pensions" or an equally sizable company pension plan.

The second reason for shifting the discussions' focus is more important. Citizens in those countries which have the largest pay-as-you-go pension systems and the most vulnerable labor markets (notably the "Old Europe" dominated by France, Germany, and Italy) show re-



markable resistance against pension and labor market reform. Little is known about how to overcome straightforward opposition to reform, and even less is known about long-term negative behavioral reactions to originally successful reforms. While the economists' profession may know the "solutions", societies appear not to know how to successfully implement them.

This is not a brand new insight. But little is done to overcome it. My earlier work with Boeri and Tabellini has shown that resistance to reform is largest among those who know little about the system that should be reformed. This is my point of departure. I claim that economists do not do good enough a job in explaining what is going on.

Let me follow this through in four examples which appear to be quite suitable for a panel discussion. Let me frame them as "myths and misconceptions" which we need to explain away. Of course, this will not resolve conflicts of interest between the young and the old, nor between the rich and the poor, nor between the insiders who profit from the current system and the outsiders who have nothing to lose in a reform. Not all conflicts, however, fit into these categories. I claim that quite many "conflicts" are artifacts generated by the following myths and misconceptions.

First, there are misconceptions about the force of demography. They reach from disbelief to total gloom. One set of misconceived beliefs stresses that aging has been going on since the turn of the 20th century with the rapid decline in birth rates after the European industrialization. Europe has been growing since, hence there is nothing to be afraid of. If at all, demographic change is used as a pretense to redistribute from the poor to the rich.

Another set of misconceived beliefs, also prominent in this country, Germany, ends on the note that demography is our destiny and nothing can be done about it.

Both are wrong. My attached paper with Alexander Ludwig ("Old Europe Ages: Reforms and Reform Backlashes") shows that the force of population aging suffices to significantly reduce living standards in Old Europe vis-à-vis the rest of the developed world. The paper also shows that the combination of pension and labor market reform can more or less fully compensate for the effects of population aging. The lesson is: first, there is something to be worried about, actually quite much is at stake, and second, it is well worth going through the trouble of reforms.

Second, there are misconceptions about who profits and who loses from reform. The worst enemy of labor market reforms encouraging more work, particularly among older individuals, such as an increase in the statutory retirement age, is the misconceived belief that the old take jobs away from the young. My attached paper with Reinhold Schnabel ("Early Retirement and Employment of the Young in Germany") is part of a large international enterprise led by David Wise and shows that large decreases in employment of the old have not concurred with increases in the employment of the young, and that increases in the effective retirement age have not concurred with rising unemployment rates of the young. If there is a correlation at all in the data, it suggests that higher employment of the old has also helped to employ more young people. The most likely reason is not difficult to communicate: Later retirement reduces pension contributions and payroll taxes in the pay-as-you-go systems of Old Europe which are actuarially unfair. Lower pension contributions and payroll taxes reduce total labor compensation. Lower labor costs encourage companies to hire more workers.

Third, there are misconceptions about older workers. Another enemy of later retirement age is the misconceived belief that older workers are less productive than younger workers. There is not much literature on this topic. One set of studies compares entire companies with slightly different age structures. Such studies are difficult to interpret because of selection and aggregation effects: output of apples and oranges has to be made comparable, and new



quickly growing companies tend to have young employees. Another set of studies uses qualitative data such as supervisors' evaluations. They tend to perpetuate misconceptions. Then there are of course the many studies on cognitive and physical abilities. They tend to decline from about age 30 on. They may, however, be of little relevance in a service and knowledge-oriented modern society. Studies on top performers (Nobel laureates and top athletes) ignore that day-to-day business for most employees is about a steady average performance. Few studies have a clear experiment with comparable output and a relevant measure of productivity. Our own study may help in this respect, see the attached paper with Düzgün and Weiss ("Productivity and the Age Composition of Work Teams: Evidence from the Assembly Line"). It shows no signs of declining productivity until the mandatory retirement age of 65, even after controlling for a possible selection of less productive workers through selective early retirement policies.

Fourth and finally, there are misconceptions about the health of older workers. Bad health is indeed a good predictor of early retirement, but it is far from being the only one. In fact, health is a very bad predictor for international variations in retirement. My paper on "Work Disability: The Effects of Demography, Health, and Disability Insurance" makes the point using the new SHARE data, a unique source for interactions between health and employment in Europe. It takes disability insurance as an example. One should think that disability insurance is most closely linked to health and least closely to tastes for early retirement. This is not true. The paper shows that even in disability insurance, health is a much worse predictor for enrolment than institutional features such as the coverage, the minimum disability level required, and the benefit generosity of the disability insurance system.

All quoted misconceptions are enemies of reform. Ignoring demography is folly; evoking gloom discourages reform. Employing older workers helps the young to be employed, and it can profitably be done because older workers are as productive as their younger colleagues and generally of good health, thanks to better medical attention – which has increased the length of life with unexpected speed and steadiness, which is, after all, one reason for population aging.

This needs to be emphasized more. My theme for the discussion in Plön is that it does not suffice to know the solutions and to design a reform plan according to our economic insights, we also need to overcome the myths and misconceptions which stand in the way to successfully implement them. This requires more effort also among academics.

### ***Population Ageing: Longer Working Life, Higher Retirement Savings***

Ignazio Visco

*Deputy Director-General, Member of the Governing Board, Banca d'Italia*

The social and economic consequences of population ageing have emerged in several countries, where demographic trends affect public finances, social security systems, labour markets and financial systems. While reforms have been implemented, further adjustments are needed in pension systems, employment policies and health and long-term care arrangements.

A key feature of successful responses to ageing is multi-dimensionality. Actions should focus on both pension provision and labour supply and should be coordinated, in order to be effective as well as socially and financially sustainable.

I agree on the policy priorities outlined in the GES Team's introductory document, which have been acknowledged by the economic profession and policy experts for long time now.





There is little doubt that one of the most effective responses to the rise in old-age dependency ratios due to the increase in longevity is to raise the pension eligibility age. An issue which is often overlooked is that with higher longevity not only dependency ratios would rise but also the period of life spent in good health would also increase. A longer, and perhaps more varied, average working life would help to contrast the “ageing syndrome”. A longer career would also spur human capital accumulation both in school and on-the-job. It comes as no surprise that in the reforms of pension systems that have been undertaken so far later retirement is the most common measure.

I would like to emphasize a few additional issues.

Together with a significant rise in the effective retirement age, policymakers should aim at (i) increasing employment among women and older workers; (ii) supporting socially and economically sustainable immigration policies. These measures would contribute to offsetting the impact of ageing in the coming decades and to improve the financial soundness of pension systems in the long run.

As importantly, policymakers ought to stimulate current (public and private) savings, in order to pre-fund the costs of ageing. This is desirable not only on efficiency grounds but also as a means to spread the burden of ageing population across generations. In this respect, reforms aiming at stimulating retirement savings (either collectively or through individual accounts) and promoting the development of funded pension pillars remain a priority.

Insufficient information, financial illiteracy, myopic behaviour, are among the many obstacles to an increase in retirement saving. Empirical research has shown that the introduction of well designed default rules (e.g. automatic enrolment) and the framing of simple, standard retirement options may help increase pension funds participation rates. It is also necessary to raise the availability of simple and cost-effective insurance and financial products that allow workers to efficiently accumulate and de-cumulate their pension wealth.

Pension funds are the main vehicles for retirement saving. It is important to strengthen the rules concerning their governance and to promote competition both within this sector and among asset managers in general.

Special attention should also be devoted to the development of annuity markets and other instruments which help the retirees in the pay-out phase. Product characteristics should be simple and fit to the need of workers. Costs should be kept as low as possible. In particular, adverse selection costs due to asymmetric information could be reduced by providing instruments targeted to specific groups of people (e.g.: smokers). Costs due to aggregate longevity risk could be reduced by the timely release of accurate longevity projections and the issuance of longevity-linked and long-term inflation-linked bonds. Competition among financial intermediaries (to be pursued mainly through a high level of transparency and comparability across products) could keep profit margins low.

### ***Tackling the Ageing Syndrome***

Solveig Wikstroem

*Professor of Business Strategy and Consumption, Stockholm University*

How to tackle the interrelated problems of pension systems, health care and employment? To analyse this problem and to suggest policy actions, let us start with a discussion of the pension system and the health care problems from an ageing perspective.



## ***Pension System***

The problem to the pension system is largely a demographic issue; People live much longer than before, which increases the proportion of elderly in the population. But elderly people are today biologically much younger than just a few decades ago. There are studies revealing that people's biological age today in several western countries tends to be 10 years lower than earlier related to their calendar age. Hence, people should be capable of staying longer in the work force than what is stipulated by the official retiring age today.

There are alternative ways to keep elderly people productive:

- Continue to keep them in their present job, later on eventually working shorter hours, conducting less demanding activities etc.
- Engage the seniors in new jobs designed for elderly, paid jobs or voluntary jobs. Create a prestigious second carrier for elderly at flexible and individually set wages.
- Develop a system where "healthy" elderly provide services for elderly in need of personal services. By this activity the care givers collect "point" by which they later on can "buy" services for themselves from peer elderly.

Keeping elderly longer in the work force has, of course, implications for the labour market, both positive and negative depending partly on the labour market situation. In a situation with shortage of labour this solution is beneficial. In a situation with shortage of jobs, keeping elderly in the work force may e.g. create problems for young people to enter the workforce. Hence, a streamlining of jobs suitable for elderly respectively young people may be needed; and more flexibility of relative wages are required.

## ***The Health-care Problem***

High aggregate costs for old-age care and sick care are largely related to the last few years of people's lifetime, when they are fragile and often in need of extensive personal care and medical support to survive.

Policy actions:

- There are studies documenting that investment in new technology in elderly care is quite small today. This is the case in spite of the fact that studies indicate that there is much to gain from new technology use. For instance, digital systems for monitoring elderly living alone in their homes have proven efficient. By use of such systems, people are able to live in their own homes in stead of moving to a nursing home. This extended time at home is highly appreciated by the seniors and their families, and at the same time costs are cut.

By today's advanced medical care very old and sick people who actually are dying are often kept alive in an artificial way. It may be time to question this approach in elderly care, hence to take the ethical debate on this difficult issue and then perhaps modify the practice to delay the process of dying. Such measures are important not only for economic reasons but also on humanitarian grounds.

## ***Facilitating Labor Force Participation of Older Persons***

David A. Wise

*Professor of Political Economy, John F. Kennedy School of Government, Harvard University*

I won't emphasize specific solutions, but rather emphasize a key component of economic accommodation to changing demographic trends. Older persons will have to spend longer in



the labor force and public and private policies will need to facilitate prolonged labor force participation. In this note, I set out the reasoning behind this view.

Persons are living longer and disability is declining in many countries. This is a great achievement. So what is the problem? Declining birth rates and fewer young people, together with longer lives, means that the ratio of old to young persons is increasing. As the number of older persons increases, health care costs will rise, not only because of the increase in the number of older people, but also because advancing technology will create better and likely more expensive health care treatments. And the cost of public pension (social security) programs will increase. But there are fewer persons in the labor force to pay increasing social security and health care costs. This is the problem.

What to do? Social and economic choices in societies must adjust as the age structure of the population changes. What adjustments might be made as the population ages? One answer is to take advantage of the gains that have been achieved in longevity to increase the labor force participation of older workers. This would increase the workforce and reduce the number of retirees that those in the workforce must support.

But in fact, however, the labor force participation of older persons (until recently) has been declining, making it more difficult for those who are working to support those who are retired. In the U.S., for example, people are living longer, yet retiring at younger ages. The number of years in retirement increased from about 13 years in 1965 to over 18 years in 2003. In other industrialized countries, the trend is more extreme.

The decline in labor force participation will have to be reversed to reduce the burden on the young that increasing social security and health care costs would otherwise impose. That is, some of the bounty of longer lives will have to be allocated to prolonging the labor force participation of older workers. It will not be feasible to use all of the increase in longevity to increase years in retirement.

Or, to pay for rising social security and health care costs people will have to stay in the labor force longer. The increase in the labor force will increase the production of societies. The increase in production will increase tax revenues. And, in turn, the increase in tax revenues will increase the funds available for social security and health care programs.

To accommodate the need for longer labor force participation, care must be taken in adopting the provisions of social security systems. The social security systems in most developed countries are now not sustainable. The provisions of the systems themselves have contributed to their financial woes by penalizing work and encouraging early retirement. To understand the importance of social security provisions, we can learn from comparisons across countries. Comparisons from the Gruber-Wise project show that the provisions in many developed countries penalize work and provide a strong incentive to retire early. Comparison across countries shows that as social security incentives to retire increase, the percent of older persons not working increases. Even after recent reforms, substantial incentives to retire early remain in most countries.

This is not just an issue for developed countries. The issue will also arise in developing economies such as China. In adopting new social security systems care must be taken to assure that social security provisions do not penalize work at older ages. Finally, it is important that changes begin sooner rather than later. This will help to avoid abrupt increases in taxes or declines in benefits. If individuals must increase their own saving, it will be much easier if they can begin to increase saving long before retirement.

**“Solution” 1:** It is important that social security systems eliminate incentives to retire early. Provisions of private employer-provided defined benefit pension systems also provide strong incentive to retire early and these incentives must be removed as well. Finally, to facilitate longer working lives, the organization of work within firms and the social customs will need to



change. For example, many older persons would choose to work longer if it were possible to work half time, for example.

Just to be sure: There is a misconception in many spheres that if the labor force participation of older workers were increased, as a consequence, the labor force participation of younger workers would decrease. Recent analysis in the Gruber-Wise project finds absolutely no support for this claim. Indeed if anything the reverse is true – increased labor force participation of older persons is associated with increased labor force participation of younger persons. The attached DRAFT introduction and summary of the Gruber-Wise volume on Social Security Programs and Retirement around the World: The Relationship to Youth Employment details the evidence.

What about the rising cost of health care. This is a particular problem in the United States but other countries will not be immune from advancing technology, which will likely provide better but also more expensive health care. Here I suggest one proposed direction to help to address the problem.

**“Solution” 2:** More attention must be given to comparison of the cost effectiveness of treatments. As Alan Garber has put it; menus without prices can only lead to a higher price for meals.

