Early retirement in Europe: A call for action

Alain Jousten*

In most developed countries, major demographic changes are challenging some of the fundamental pillars of today's social protection systems, such as the public retirement income systems. This observation is particularly true for the countries of continental Europe as they are facing a much more severe and rapid aging process than for example the US or Canada. This demographic aging process is the combined result of two mutually reinforcing trends, namely a strong decrease of fertility rates coupled with a secular decline in mortality rates at any given age.[1] However, the strong exposure of continental European countries to the risk of demographic change is also due to the way the social protection systems are organized. The retirement income systems of most European countries rely heavily on a pay-as-you-go (PAYG) philosophy, which means that the benefits paid out to the current old are essentially financed through (earmarked) contributions or general taxes on the young.[2] This type of system has to be contrasted with a fully funded system, where any single generation pays for its own retirement benefits. Contributions are capitalized and the principal and return then serve as the source of financing for their own retirement benefits in the future. This state of looming financial crisis seems to be well known, all across the different layers of society. On the other hand, the strong tendency towards earlier retirement, be it compulsory or voluntary, is often erroneously considered as a totally separate issue. As I will illustrate below, it is partly the structure of the European retirement systems and their close ties with other social insurance programs that gives rise to strong financial incentives for early retirement.

European retirement systems and close ties to other social schemes provide incentives for early retirement

Aging and PAYG

The largest part of European PAYG systems dates back to the period immediately after the second world war. During the start-up phase of the systems, the first generations enjoyed a "free lunch", as they received benefits from a system they only contributed to in a very modest way. It is important to acknowledge that today we are no longer in this start-up phase, and that the systems have reached a stage of relative maturity.

Hence, keeping the age of retirement constant, it should be obvious to the reader that with the number of entrants into the young generation decreasing as a result of the lower fertility rates, and the size of the generation of the old swelling as a consequence of higher life expectancy, the only response possible in a mature balanced-budget PAYG system is to decrease the relative level of benefits with respect to contributions. This is the key observation that is at the heart of the pension reform literature focusing on the financial viability of the existing social insurance systems. The key recommendations of this literature can easily be summarized in the form of two policy options. Either benefit levels have to be cut in an explicit or implicit way. The latter can for example be achieved by increasing the number of years needed for qualifying for a full-career retirement benefit. Or revenues to the systems need to be raised, be it through increased contributions, higher labor force participation among the young, stronger productivity growth or higher transfers from general tax revenue.

Age of retirement

Against the backdrop of these demographic trends and their budgetary implications, some have sug-

* University of Liège and CEPR, London.
[1] For the present purpose, we do not have to distinguish between increases in physical life expectancy and additional years spent in good health. This is different for topics such as long-term care insurance.
[2] The only exception is the Netherlands where a large fraction of retirement benefits come from a funded private component.

gested that an increase in the age of retirement would be a very efficient tool contributing to a solution of the financial problems of the retirement income systems. Indeed, increasing the retirement age both increases the pool of the working and contributing population while shrinking the pool of the elderly people receiving benefits from the system. This observation, though strikingly simple, does however not seem to go well with political decision makers and the social partners in most developed countries. Indeed, when casually looking at data from Belgium, it becomes obvious that trends in this key variable have been in the opposite direction, namely a steady decrease of the average age of retirement, hence aggravating the problems caused by the increase in life expectancy rather than contributing to its solution. Similar tendencies can be observed for most other OECD countries, though Belgium is the country with the lowest average retirement age of all countries considered (Table 1).

These average retirement ages are in the case of some countries noticeably lower than the earliest entrance age into the official retirement programs (ER), such as for example in Belgium where the earliest age of retirement under the regular systems is 60. This finding is due to the fact that Table 1 is based on an economic definition of retirement and not a narrow administrative one, and hence defines retirement as the departure from the working population into inactivity. Doing so, it explicitly recognizes that stopping to work and first claiming benefits from the official retirement systems are two distinct steps, that can also take place at very different ages. The period between the departure from paid employment and the entrance into the normal retirement system is bridged in a country-specific way by a multitude of public, private or mixed early-retirement benefit arrangements, such as for example unemployment insurance, disability insurance, or some form of severance pay, just to name a few.[3] For example, a person leaving the labor force through some employer-sponsored early-retirement scheme at age 55 and claiming benefits in the official system at age 65 is counted as retiring at age 55, even though administratively speaking he only enters the official retirement system at 65. Hence, the economic approach to retirement and early-retirement implies that a study of the public retirement systems in too narrow a sense does not suffice. Hence, when thinking about the problem of a dropping average age of retirement, we have to take into account the multitude of routes that individuals can use as an exit into retirement.

Table 1
Life expectancy and age of retirement in Belgium

	Male	Female
• Increasing life expactancy		
1950	63.2	68.4
1998	74.6	81.1
2050	82.1	88.1
• Decline in average age of retirememt		
1950	64.8	62.9
1995	57.6	54.1
2050	?	?

Source: Lannoy F. and B. Lipszyc (2000), Blöndal and Scarpetta (1998).

Why then do we observe this strong decrease in the average retirement age at a time of financial trouble caused by demographic aging? The answer to this question is essentially twofold. First, many European governments have been using compulsory early retirement policies in their quest for a lower rate of unemployment. Doing so, they have tried to resolve an unemployment problem by reducing the number of workers competing for any given job, essentially by getting older more expensive people off the labor market. These policies have also facilitated the structural change in the economy as older workers may simply lack the skills for some new careers. However, they also imply tremendous costs for government budgets through increased benefit payments and missed contributions. But even leaving these budgetary implications aside, many economists think that these programs have failed in opening up jobs for young people and in reducing the rate of unemployment. Second, financial incentives built into the social insurance programs – but also private early retirement options – induce many people to leave the labor force early on a purely voluntary basis.

Compulsory policies and financial incentives have raised early retirement

The trend towards earlier retirement and lower activity rates for older workers is reflected in some key data from the 1990's that are summarized in Table 2 for males belonging to different age brackets. Youth unemployment does not seem to have

[3] In the present article, a program is considered to be an early retirement program if it effectively allows workers to quit the labor force at an earlier age than the earliest retirement age defined in the official old-age retirement system.

Table 2
Unemployment rate (UR) and Activity rate (AR) for different age groups, Percentages for Males

		1990	1996	1997	1998	1999
Belgium	UR 15–24	10.1	17.3	17.6	18.3	22.7
	AR 25–54	92.2	92.4	92.1	91.7	91.8
	AR 55–64	35.4	33.8	33.9	33.9	36.8
Canada	UR 15–24	13.6	16.9	17.1	16.6	15.3
	AR 25–54	93.1	90.8	90.9	91	91.1
	AR 55–64	64.3	58.4	59.6	58.8	60.7
France	UR 15–24	15.3	22.1	24.6	21.9	24.2
	AR 25–54	94.5	95.2	94.8	94.5	94.1
	AR 55–64	45.8	42.3	42	41.3	42.6
Germany	UR 15–24	5.3	9.6	10.7	9.7	9.1
	AR 25–54	91.2	93.1	93.4	93.6	93.9
	AR 55–64	57.7	55	55.7	55.2	55.1
Italy	UR 15–24	23.4	30	28.7	30.2	28.6
	AR 25–54	94	89.7	89.9	90.5	90.5
	AR 55–64	51.7	44	43.5	43.5	42.8
Netherlands	UR 15–24	10.3	11.3	9.2	8.3	6.6
	AR 25–54	93.4	92.7	93.5	93.5	93.4
	AR 55–64	45.8	42.2	44.4	47	49.8
United Kingdom	UR 15–24	11.1	17.8	15.6	13.8	14.1
	AR 25–54	94.8	91.9	91.6	91.4	91.6
	AR 55–64	68.1	62.9	63.6	62.6	63.5
USA	UR 15–24	11.6	12.6	11.8	11.1	10.3
	AR 25–54	93.4	91.8	91.8	91.8	91.7
	AR 55–64	67.8	67	67.6	68.1	67.9
European Union	UR 15–24	13.6	19.6	18.8	17.6	16.1
	AR 25–54	93.7	92.6	92.5	92.6	92.6
	AR 55–64	56.6	52.4	52.6	52.4	52.7

Source: OECD (2000).

Activity rates of people 55–64 have tended to fall

been reduced on a large scale by compulsory early retirement schemes. However, the time trend of economic activity rates for people in the age bracket 55 to 64 is tending to a lower level than before, a finding that becomes even more striking when looking further back into the past.

Financial incentives

The role of financial incentives towards early retirement has long been understudied, particularly in the face of the perception that the early retirement process is essentially a compulsory one. However, besides the pure generosity of early-retirement and retirement benefits, there is an issue of how they vary according to the age of first claiming them. Recent studies have shown that financial incentives towards earlier retirement are sometimes extraordinarily powerful and hence make continued work a prohibitively expensive option. A measure often used is Net Pension Wealth (NPW), which corresponds to the present discounted value of net benefit flows from the various retirement or early-retirement benefits a person can expect to receive over the rest of his life. Using this concept of NPW, it is possible to define the implicit tax (IT) on earnings that a person has to face when working an additional year purely on the basis of him being part of the official retirement system. The IT on continued work can sometimes approach or even exceed 100 percent, which obviously creates powerful individual incentives for a utility optimizer to leave the labor force, such as for example illustrated in Table 3. This is particularly true for countries with easily accessible and generous early retirement schemes. Indeed, the latter often lack a sufficient degree of actuarial benefit adjustment, i.e. an adjustment of monthly benefits to offset the longer period of benefit receipt. Further, the accessibility of such early retirement paths varies widely as a function of age across dif-

Table 3
Implicit tax rates in various countries (IT)

	Earliest entrance age into the official retirement programs (ER)	Implicit Tax at official early retirement age (IT in percent)
Belgium	60	82
Canada	60	8
France	60	80
Germany	60	35
Italy	55	81
Netherlands	60	141
United Kingdom	60	75
USA	62	– 1

Source: Gruber and Wise (1999).

ferent countries and different sectors. While in some countries, early retirement routes do de facto exist as early as the age of 50, in others this is not so till a much later age. For example, elderly employees of the former Belgian flag carrier Sabena that went into bankruptcy a short time ago can expect an exit route through early retirement arrangements at an age as low as 50.

The need for a reform

In my eyes, there is a clear need for a reform of the approach to early retirement. Indeed, it is difficult to imagine pursuing a deliberate early retirement policy combined with heavy subsidization of early exit from the labor force, whilst at the same time wanting to safeguard the existing retirement income system in the face of the tremendous demographic challenges. This is particularly true in the face of the rather modest effects of early retirement plans on unemployment in general, and youth unemployment in particular.

However, a reform should not be confined to the official retirement income systems, but also needs to include changes to the myriad of early retirement pathways. For example, in this line of thought, it seems obvious to me that an increase of the official normal retirement age, which is currently close to 65 in most countries, does not look like a promising route, as many people do no longer directly exit to the official retirement systems but rather pass through some early retirement program (see Table 4 for Belgium). Indeed, a tightening of the rules governing accessibility to the different early retirement systems is much more likely to be an effective policy tool. This tightening of the rules should, however, not be such that it completely prevents any access to social insurance programs, say before the age of 60, as there is a considerable degree of heterogeneity in the population making a wide window of potential retirement ages a socially desirable feature.

A reform is also more likely to be optimal if it introduces smaller financial disincentives towards continued work, mainly through a better actuarial adjustment of benefits as a function of the age they are first claimed at. By decreasing the IT on continued work, people face lower penalties or even positive incentives on continued work, and hence will tend to leave the labor force later.

Table 4
Pathways to retirement for wage-earners in Belgium
(in percent)

	Male	Female
Directly to public retirement	34.85	54.85
First early retirement	46.97	20.02
First disability	8.21	5.25
First unemployment	9.97	19.99
Total	100	100

Source: Dellis, Jousten and Perelman (2001).

References

Blöndal, S. and S. Scarpetta, (1998), *Falling participation rates among older workers in the OECD countries*, Paris.

Dellis, A., A. Jousten and S. Perelman, Micro-modelling in retirement incentives in Belgium, CEPR Discussion Paper 2795

Gruber, J. and D. Wise, ed., (1999), *Social Security and Retirement around the World*, NBER and University of Chicago Press, Chicago, IL.

Lannoy, F. and B. Lipszyc (2000), Le vieillissement en Belgique: Données démographiques et implications économiques, in P. Pestieau et al. (eds), *Réflexions sur l'avenir de nos retraites*, Garant, Leuven.