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Raising the Age of Retirement to Ensure a Better Retirement

by Pierre Pestieau*

1. Introduction

For some years now, international organizations have been concerned about the viability of pensions systems and their ability to achieve their objectives. They have two principal concerns: maintaining levels of economic activity among older workers (in clearer language, raising the age of retirement), and enabling retired people to preserve their living standards (in other words, avoiding a return to poverty in old age). This paper shows that the second of these objectives is dependent on the first. With the increase in life expectancy, raising the age of retirement can assure retired persons a suitable standard of living, and also prevent social exclusion among those who have been less fortunate during their working life.

The reasoning behind this conclusion is relatively straightforward. It is applicable in those countries where pay-as-you-go (PAYG) pensions are redistributive and constitute the lion's share of the resources of the elderly, as is the case in countries of old Europe such as Germany, France and Belgium.

The ageing of the population in a number of countries will lead almost to a doubling of the dependency ratio. In the context of a PAYG system and excluding, as required by the European stability pact, recourse to borrowing or increased contributions, this will lead to almost a halving of entitlements. There are two ways of reducing these: a reduction of annual pension payments or a raising of the age of retirement, which would both reduce the period of dependence and increase the period over which contributions are paid. Now it would seem that most older people would continue to work longer were they not induced to cease working by a range of benefits which, though at first sight attractive, prove, on closer inspection, to be very costly to society. Once they have understood what is truly at stake, most of them would prefer to work longer to make sure of a still long and comfortable retirement.

The rest of this paper is organized as follows. First, it points out that the ageing problem is not only demographic. It shows that the low level of labour market participation among older people is directly explained by considerations arising from tax policy and social security, and indirectly by collusion between governments, employers and trade unions. It then explains why reforms are so difficult, and it argues that a well-designed policy to encourage labour force participation among the old, and to raise the age of retirement in line with rising life expectancy, is socially desirable.

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* Professor of Economics, University of Liège and Research Fellow at CORE, Delta and CEPR. This paper was originally presented at the 4th International Research Conference on Social Security "Social security in a long life society".

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2. The problem is not only demographic

In the Europe of the 15, in 1995, 20.6 per cent of the population were over 60; this figure will rise to 33.9 per cent in 2050. The proportion of those over 80 will rise from 3.9 per cent to 10.1 per cent in the same period.[1] These are average figures, and in some countries the proportion will rise even further. A pay-as-you-go (PAYG) pension system does not offer many options to deal with the problems arising from this trend: annual pension payments can be cut, the age of retirement can be raised, contributions can be increased, or the bill can be sent for payment by future generations.[2] At the present time, when Europe is constrained by the stability pact, and competition for government resources is extremely severe, it is no longer possible to continue using the last two solutions.

It is interesting to note that during the last four decades there has already been an increase in the dependency ratio. In France, for example, as shown in Table 1, over a period of some 40 years, the period of retirement has grown from an average of 3.2 years to 15 years for men, and from 8.6 years to 23.7 for women. But this growth, and the length, and therefore cost, of retirement are due as much to the decline in work among older workers as to the increase in their longevity.

This paper uses the terms “lowering of effective age of retirement” and “reduction of economic activity among older workers” interchangeably. They are different, but nonetheless kindred concepts. Figure 1 shows that there is a strong correlation between the average age of withdrawal from the labour force and employment rates among the 55–64-year-olds.

3. Why so soon?

There is a fairly wide gap between the statutory and the effective retirement age, explained by a variety of provisions, which allow individuals to stop working well before the standard age. To begin with, the retirement system itself allows people to bring their retirement forward in advance of the standard age, possibly at the price of a reduction in benefits. Then there are professions, mostly in the public sector, where the official retirement age is lower than the standard age – professions such as mining, teaching, the police, the armed forces and so on. In addition, there are early retirement programmes, usually targeted at sectors experiencing economic difficulties. Finally, unemployment insurance and disability insurance are used in some countries to allow older workers to take retirement well ahead of the standard age, even though they are not necessarily incapable of finding work, nor suffering from a serious disability.

In some countries, older workers have a window of opportunity to retire between 55 and 65, even between 50 and 65, and can do so with quite generous benefits, which are far greater than they would be under strict actuarial criteria. In these countries, workers who continue working are in fact penalized by having to pay further taxes and social security dues while they continue working, yet without the prospect of receiving the correspondingly higher benefits to

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[1] Calot and Sardon (1999).

[2] In France, the implication of each of these four approaches has been estimated for the year 2040:
implicit debt: annual deficit of 4 per cent of GDP;
payroll taxes increase of 58 per cent;
replacement ratio reduced from 78 to 42 per cent;
retirement age increases of nine years.
(Conseil d’Orientation des Retraites, *Premier Rapport*, Paris, 2001).

Table 1:
Age of effective retirement and life expectancy

	Men				Women			
	Life expectancy		**Retirement age**		**Life expectancy**		**Retirement age**	
	1960–65	**95–2000**	**1960**	**1995**	**1960–65**	**95–2000**	**1960**	**1995**
Belgium	67.9	73.8	63.3	57.6	73.9	80.6	60.8	54.1
France	67.6	74.2	64.5	59.2	74.5	82.0	65.8	58.3
Germany	67.4	73.9	65.2	60.5	72.9	80.2	62.3	58.4
Ireland	68.4	73.6	68.1	63.4	72.3	79.2	70.8	60.1
Italy	67.4	75.0	64.5	60.6	72.6	81.2	62.0	57.2
Spain	67.9	74.5	67.9	61.4	72.7	81.5	68.0	58.9
Sweden	71.6	76.3	66.0	63.3	75.6	80.8	63.4	62.1
U.K.	67.9	74.5	66.2	62.7	73.8	79.8	62.7	59.7

Source: United Nations Population Division, *World Population Prospects*, 1998. Blondal and Scarpetta (1998a).

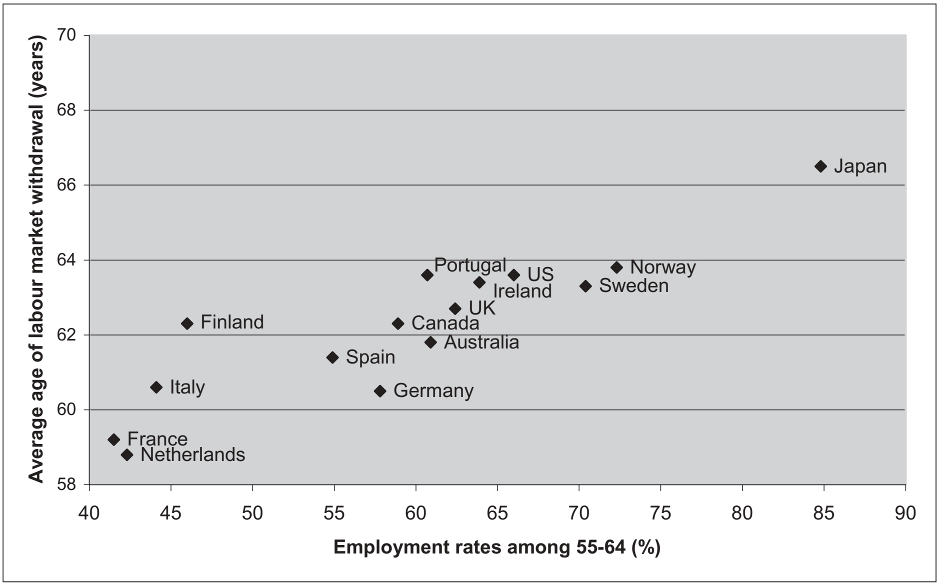

Figure 1: Employment rates among 55–64 year-olds and average age of labour market withdrawal in OECD countries, 1995
Source: Blondal and Scarpetta (1998b).

which they are thereby entitled. The concept of an implicit tax has been developed to encompass these different types of incentive to cease working. The implicit tax represents taxes and social security contributions as well as the foregone benefits from each extra working year. Figure 2 shows the relationship between the implicit tax and inactivity rates among the 55–64 age group in ten countries.

But why then are there such differences between these countries? Why does the state, in some countries, adopt these programmes to encourage people to take early retirement? It certainly cannot be because countries have different preferences, some choosing shorter working lives than others. Nor can it be because of the drudgery of work: there is no reason to think that work is harder in France or Germany than in the United States or Sweden. Instead, the explanation for these differences lies in features of the labour market itself. It is well known that the lifecycle fluctuations in wages do not correspond to fluctuations in productivity. At the start of a person's working life productivity will tend to exceed wages, whereas at the end the opposite is the case. This gap seems to be wider in some countries than in others.[3] Figure 3 shows that in Belgium and France wages follow a clear rising trend through the lifecycle, whereas in Sweden the curve is flat and in Japan it is bell-shaped.

It can be clearly seen that in the former two countries employers have to encourage early retirement programmes to rid themselves of expensive labour – costly, above all, in relation to productivity. Furthermore, in some countries there is a widespread belief in political and trade

3 See Lazear (1979), Crepon *et al.* (2002).

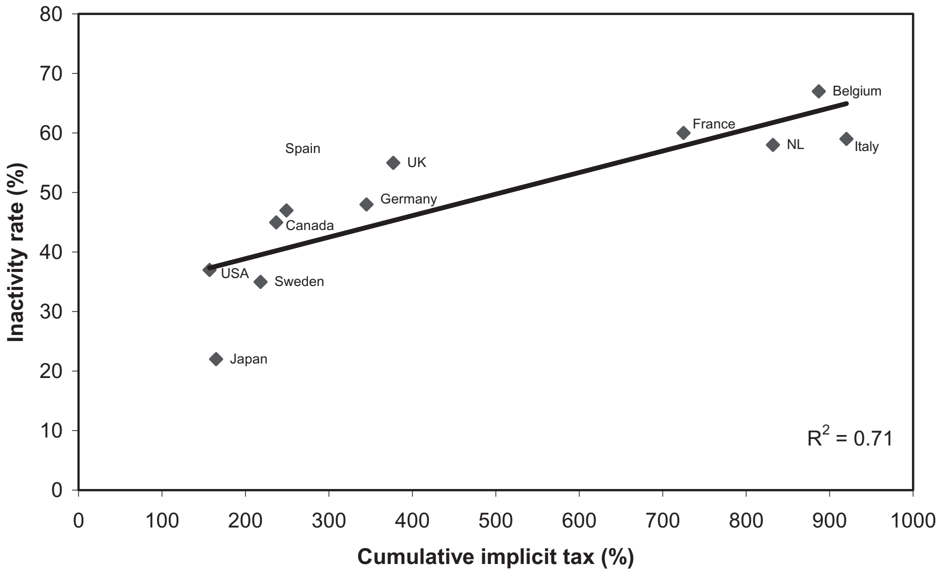

Figure 2: Inactivity rate (%) and cumulative implicit tax (%) – logarithmic scale
Source: Gruber and Wise (1999).

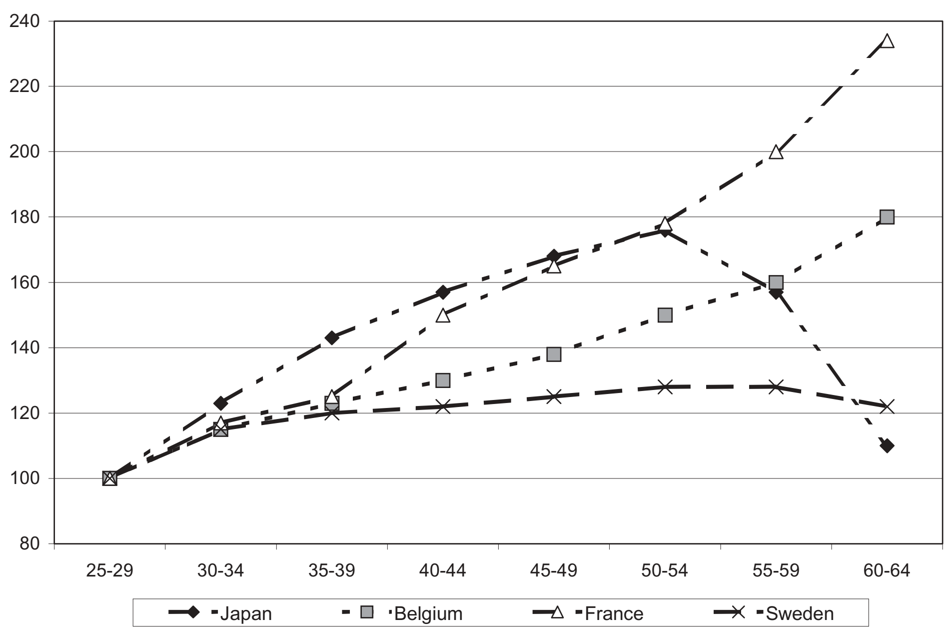

Figure 3: Male wages by age (age 25−29 = 100)
Source: *Ageing and Employment Policies: Belgium*, OECD, 2003.

union circles that any early retirement of older workers creates vacancies for younger workers. This belief rests on the hypothesis of perfect substitutability between jobs for older and younger workers. But this hypothesis is debatable, and it is now widely recognized that sending older workers into retirement in order to stimulate employment among the young does not work and may even be counter-productive. Certain recent empirical studies do indeed show that this type of policy has usually failed.[4]

These two observations tell us that if the trend towards early retirement is to be reversed a revolution is needed in the mentality of the countries concerned. Economic agents, employers' organizations, trade unions and governments must be persuaded to adopt wage scales which more closely match productivity, and they must give up the belief that there is a direct link between early retirement and jobs for the young unemployed.

It would indeed be naïve to think that a drastic reduction of implicit taxes on postponed activity would suffice to increase the activity rate of older workers. Such a reduction should have to be accompanied by active employment policies in a number of areas: training of ageing workers, legal barriers to age discrimination, employment subsidies and, as already mentioned, a better match between wage and productivity. On these matters the successful experience of countries such as Japan, the United States, Sweden and more recently Finland could be used as guidelines for countries plagued by too early retirement.

4. It is difficult to reform a popular system

It would be tempting to applaud current trends. After all, the lowering of the age of retirement and the long-term reduction of the working week are signs of progress. But this continually growing period of inactivity has to be funded. All the projections show that without urgent reform, the ageing of the population will bring about a worrying impasse.

Another way of illustrating the cost of older people's low rate of labour market participation is to calculate what theoretically would have been gained if they had continued to work up to the age of 65. Herbeston and Orszag (2001) have performed this calculation for several countries, and found that these theoretical gains represent more than 10 per cent of GDP in Germany, France and Belgium, as illustrated in Table 2.

Table 2:
Cost of early retirement in selected countries (as a percentage of GDP)

	1980	1990	1998
Germany	7.7	9.5	10.9
Belgium	–	15.2	13.5
France	6.2	11.3	10.5
United Kingdom	–	7.5	7.6
United States	5.8	5.4	4.7

[4] Boldrin *et al*. (1999); Snessens *et al.* (2003).

Despite the need to reform the retirement system, most countries exhibit resistance to any kind of change and a strong preference for the *status quo*. Table 3 reproduces the results of surveys in which people were asked about their ideal and their expected retirement age.

These surveys show that none of the age groups have any complaint against the current situation, although both young and older workers are realistic, and expect to cease working later than they would wish. Other surveys in various countries show not only that workers are fond of their retirement system, but also that they are opposed to the slightest reform, especially if it would lead to a raising of the standard retirement age.[5]

5. The double dividend of a policy to stimulate employment of older workers and to raise the retirement age

Given these survey findings, demonstrating the need to raise the retirement age risks the criticism that one is seeking people's wellbeing against their will. This criticism is to be rejected for the following reasons.

To begin let us explain what is meant by raising the age of retirement. Firstly, such a reform would be gradual and announced well in advance. Secondly, it is not a one-off exercise, but rather would involve gradually raising the standard retirement age in line with the increase in life expectancy, supporting economic activity among older workers, defined by their closeness to the standard retirement age. Reform would leave unemployment and disability insurance untouched so that they can continue to cover those who cannot find a job and those affected by disability, but at the same time it would close those schemes to older workers who are in good health and able to find a job. For these workers, the retirement system must be made actuarially neutral, which implies for example a replacement (wage-to-pension) ratio of 70 per cent at 65, but only of 20 per cent at 50. It would also allow part-time retirement even beyond the standard retirement age.

Such a reform is socially desirable and would obtain the support of the majority once it was fully understood. Of course, when citizens are asked to choose in a vote or a survey between the *status quo* and a reform which would bring about an increase in the retirement age, it is not surprising that they choose the *status quo*. As a comparison, take the 35-hour week with an unchanged weekly wage. The choice between a 40-hour week and a 35-hour week with the same weekly wage is a "no-brainer". In contrast, offered a choice between a

Table 3:
Ideal and expected retirement age

France			Belgium		
Age	**Ideal age**	**Expected age**	**Age**	**Ideal age**	**Expected age**
18–34	54.3	62.2	<25	55	60
50–64	56.4	60.3	>50	59	60

Sources: Assous (2001); De Vits (2002).

[5] Boeri *et al.* (2000); Boeri *et al*. (2001); Ferrera (1993); Schokkaert *et al.* (2000).

40-hour week and a 35-hour week with an unchanged hourly wage, it would not be surprising if the majority chose the 40-hour week.

When workers are asked at what age they would like to retire, they assume that, whatever the retirement age, their pension would be more or less the same. But suppose they were told that in order to keep the current standard retirement age they would have to suffer a 30 per cent reduction in their pensions, or that if they agree to work a few more years their pensions would remain at their present level: it is likely in that case that those who are in good health and have a job would choose the latter option.

One can show theoretically that if the implicit tax is very high and the social security systems (pensions, disability, unemployment) are redistributive (that is, not fully contributory), a reform which aims to encourage economic activity among older workers is socially desirable. It is certainly preferable to a reduction in benefits and it happens to be particularly effective in the fight against social exclusion.[6]

To show this we used the results of a micro-simulation of the retirement decision among Belgian workers. Three scenarios were considered. Scenario 0 is the naïve *status quo* decision, under which none of the key parameters – age of retirement, size of contributions, wage-to-pension ratio – are changed, and the implicit hypothesis is that the expected increase in the dependency ratio is taken care of by future generations. Scenario 1 raises the age of retirement and leaves everything else constant. In this scenario various eligibility ages are raised by three years, namely the age at which the pension entitlement begins, the age at which early retirement can begin, and the age of leaving the workforce. On average, this reform produces an effective increase of less than three years in the retirement age. Finally, scenario 2 is that of the *status quo* with additional constraints: existing benefits are reduced by a proportion equivalent to the increase in resources obtained in scenario 1.

We believe that the valid comparison is between scenarios 1 and 2, whereas public debate usually centres on that between the naïve *status quo* and its reform, that is between scenarios 0 and 1. It emerges that as compared to the *status quo* with additional constraints, the more thorough reform represented by scenario 1 would enable pensioners at the bottom of the income scale to avoid social exclusion and experience a decent retirement.

6. Conclusion

The time has come to reach a conclusion. This article began with the claim that if there is a problem in financing pensions, it arises not only from the ageing of the population, but also from the progressive reduction of the retirement age. We then argued that to resolve this financial problem, priority must be given to reversing the paradox of declining retirement age combined with increasing life expectancy. We explained why reform encounters political obstacles even though it would bring about a double dividend of increasing resources for the system and greater equity.

It would of course be naïve to think that the reform proposed would be enough: it would certainly have to go together with changes in other parameters of the system, especially those governing the redistribution of retirement benefits. It would also have to be supported by the harmonious development of the second and third pillars of retirement, namely supplementary collective and individual funded schemes.

[6] Cremer and Pestieau (2003).

It should be noted that our conclusions are valid only under the twin assumptions of a severe distortion and a redistributive pensions system. Let us suppose we have a Bismarckian (contributive) system, but with a strong incentive to retirement.[7] Any relaxation of this constraint would lead workers to prolong their working life. Their incomes will increase, but at the cost of an unbearable increase in effort for those workers with lower productivity or who suffer from poor health. Under a redistributive system, increased benefits could compensate for this loss of utility. Therefore, in the absence of a redistributive element, the reform proposed could be undesirable from the point of view of these categories of worker. Should this be taken to mean that the age of retirement should not be raised? Certainly not. It simply means that a reform should be adopted which extends the working life of those who want to work longer, but still contains an element of redistribution.

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[7] See on this Henin and Weitzerblum (2002).

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