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The interplay of retirement systems, social security, labour market policies and taxation in shaping retirement patterns

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Summary

Many countries are faced with major challenges related to population ageing. Pension reform is part of the answer but the need is for broad and comprehensive strategies addressing the broader issue of retirement reform. Based on case studies from seven countries and other available sources the article discusses social security reform initiatives covering public old-age pensions, early retirement, disability pensions and unemployment insurance schemes, sickness insurance schemes, private pensions, tax policies and labour market policies etc.

It is shown that successfully changing actual retirement patterns calls for comprehensive multi-dimensional strategies in order to effectively increase labour market participation among older workers and avoid unintended substitution of early retirement by one form of social security with another. Parallel reforms in the field of private pensions and the tax treatment of pensions may be called for in order to avoid unintended substitution of early retirement facilitated by social security with private arrangements.

Introduction

Many countries around the world - especially developed countries - are in the midst of a process of population ageing. Populations age and consequently economies are faced with major challenges and calls for reform.

Population ageing is the aggregate result of different processes. Baby boom generations enter retirement while smaller cohorts enter the labour market. Longevity rates are increasing. Fertility rates are low - in some countries extremely low - and have been so for several decades.

Population ageing affects a wide range of political and economic aspects of society as it is bound to increase public expenditure and create significant pressures on social security. More elderly people does not only mean increasing pension costs, it also means increasing demands for health services, home care services, housing for frail elderly, nursing homes, etc.

Demographic change threatens welfare policy priorities in general and it carries the potential of intergenerational conflict as it may hamper welfare development in other areas and for other generations. Some countries will be faced with difficult dilemmas of how to handle tasks that have not hitherto been dealt with by the public sector.

The challenges posed to economies and labour markets are severe and complex. Reforms targeting these predicaments have ranked high on political agendas for more than a decade - especially in the European Union (EU) and in other developed economies of the Organization for Economic Co-operation and Development (OECD).

Pension reform is a very important issue in this context, and much of the international debate on population ageing has focused on pension reform reflecting the fact that growing numbers of older people and longevity increases leads to increases in pension expenditure and hence the need to secure long term financial sustainability.

The task at hand however, is not only about pension systems. Indeed, it is a broader one focusing on the retirement reform and the interplay on pension system design, social security, taxation and labour market policies.

These issues are discussed in this article and it is shown that successfully changing actual retirement patterns calls for comprehensive multi-dimensional strategies in order to effectively increase labour market participation among older workers.[1]

Factors influencing retirement patterns

The literature and research concerning retirement decisions is quite extensive. Traditionally, theory on individuals' decisions concerning work and retirement focus on two sets of factors either pushing or pulling workers out of the labour market.

Probably the most important reason as to why workers retire is simply that it is possible. The availability of pension benefits or other means of support in retirement is crucial as it opens the pathway into retirement as such. They may be "pulled" out of the labour market. It might not only be the financial capacity which counts in the retirement decision but the preference for early retirement as well.

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But early retirement is not only about the availability and generosity of retirement options. Across countries a great number of different dynamics and forces meet in the same nexus of early retirement: Health problems - often employment related - negative employer attitudes, age discrimination, age limits in employment contracts, rigid wage structures, absence of part time employment opportunities and the structural design of labour markets are just some of these forces. Workers may be "pushed" out of the labour market. Caring for family members can be another push factor.

Retirement decisions are not taken in a vacuum. On the contrary, retirement decisions involve wider considerations of the individual life course, personal relations and overall household economy. Relations and dynamics related to these dimensions do not readily fall under the

[1] A major OECD report along similar lines was issued in 2006 (OECD, 2006).

categories of push and pull factors as they do not address incentives as such but rather the contexts within which they work.

This report focuses primarily on pulling effects. The focus is on pensions, social security, labour market policies and taxation in seven selected countries: Canada, Chile, Czech Republic, Denmark, Germany, Poland and Tunisia.

Most of these countries are faced with great challenges due to population ageing. But the challenge varies considerably and in some countries population ageing is of no or only marginal importance. Thus, among the seven countries in this study Tunisia and Chile will experience a growing labour force for many years to come.

The seven countries represent very different social security systems and welfare policy approaches. While the inclusion of countries representing very different systems and approaches is an objective in itself the intention is not for the specific selection to be representative in a formal sense.

Table 1. ***Main features of retirement systems in seven countries***

	PAYG financed public pension	Eligibility criteria	Voluntary early retirement possible	Public benefits related to previous earnings	Coverage of private pensions*	Un-employment benefit period
Canada	Yes	Age and residence record for OAS basic pension and age and income-test for the income-tested benefit	Yes	Yes	Medium	Short
Chile	No	Age and contribution record	Yes	Yes	Medium	Short
Czech Republic	Yes	Age and contribution record	Yes	Yes	Small	Long
Denmark	Yes	Age and residence record	Yes - contributory benefit provided by unemployment insurance	No	Large	Long
Germany	Yes	Age and contribution record	Yes	Yes	Large	Medium
Poland	Yes	Age and contribution record	Yes	Yes	Small	Medium
Tunisia	Yes	Age and contribution record	Yes	Yes	Very small	Short

*Large, medium, etc. refers to the proportion of the employed work force actually covered by such arrangements.
Source: Jacobsen et al., 2006.

Reforms of social security systems and pathways to early retirement

Below, different aspects of reforms to pension systems and other social security systems offering pathways to early retirement - meaning retiring earlier than the standard statutory retirement age - are discussed based on experiences from the seven countries.

Old-age pensions

Internationally, the norm with respect to the retirement age of public pension systems is 65 years of age. This is also the case among the countries covered by the present analysis. However some countries - Czech Republic, Poland and Tunisia - divert from this general norm.

Table 2. Pension ages and early retirement ages in seven countries

Statutory pension age and voluntary early retirement age, 2006	Men		Women	
	Statutory	Voluntary	Statutory	Voluntary
Canada	65	60	65	60
Chile	65	55	60	50
Czech Republic	62	n.a	57-61	n.a.
Denmark	65	60	65	60
Germany	65	60	65	60
Poland	65	61	60	56
Tunisia	60	50	60	50

Source: Jacobsen et al., 2006.

The development of policies in the seven countries reflects a general international tendency since the early 1990s to increase the statutory retirement age. This tendency is remarkable in a historical perspective as statutory pension ages are only rarely changed. Thus, a recent study shows that statutory pension ages remained unchanged in most countries for many decades up until the early 1990s where a remarkable process of increasing pension ages commenced (Turner, 2007).

Some countries offer deferred retirement on actuarially neutral terms, that is by rewarding deferred retirement with an actuarially neutral increase of future pension benefits. This is particularly the case in earnings-related pension plans. Denmark has adopted a similar practice to its non-contributory flat rate basic pension. However intuitively justified such measures may seem, their effectiveness in terms of increasing the labour market participation in old-age is debatable.

On the one hand, clear incentives for continued employment is desirable, but on the other hand, such measures may carry a significant dead weight cost as such premiums are likely in particular to benefit people who would have continued working anyway, and as the decision

of older workers on whether to stay on or whether to exit the labour market involves a large number of issues other than that of compensating premiums.
Furthermore, continued employment may simply be inaccessible for many workers due to old-age barriers in legislation, in collective agreements or in labour contracts.

Whereas the effects of such measures in terms of labour market participation may be questionable they may arguably be justified in terms of social justice - taking a certain viewpoint, it may seem fair to compensate those who actually refrain from taking out public benefits otherwise accessible.

Increasing the statutory retirement age and adopting incentives - regardless of their efficiency - for deferred retirement in the actual old-age pension system delays entry into the most basic of all pathways to retirement. As such and evaluated in itself, such measures might contribute to overall strategies of increasing the possibilities for prolonged labour market participation for older workers. On the other hand Canadian studies have shown that increasing the eligibility age for pensions could result in increasing the number of people using other pathways to retire.

Early retirement schemes

Old-age pension is the pathway for those who actually stay on the labour market - which in most cases only pertain to a relatively small minority.

Thus, pension reform and the introduction of higher pension ages and incentives for prolonged employment may be highly inefficient measures if they are not followed by other measures addressing the - often numerous - pathways allowing workers to exit the labour market well before the retirement age. General early retirement schemes are available in many countries - the seven countries of this study included.

In most cases, the establishment of early retirement schemes has been based on labour market policy considerations - i.e. that of redistributing employment from older to younger generations.

Based on European experience it is highly questionable as to whether such strategies actually produce the intended results. There is no fixed number of jobs and retiring older workers are not necessarily replaced by younger workers. Frequently jobs left open by older workers are closed by rationalizations or by the adoption of more updated technology. Thus in reality, early retirement schemes often come to resemble downward (in terms of age) extensions of public old-age pension systems, and it is usually difficult to discern a specific social risk targeted by early retirement schemes that are not already the scope of other social security schemes.

Arguably, it seems more appropriate to interpret early retirement as general welfare benefit than a targeted social security measure in the traditional sense of the term.

Consistent with these observations, quite a number of countries have had to acknowledge that, while early retirement is readily embraced when introduced, it is a particularly painful political ordeal to dismantle it let alone to tighten its accessibility in times of labour shortage or financial predicament.

Early retirement schemes vary considerably, amongst others, in terms of the number of years prior to the statutory retirement age the benefit can be taken out, and in terms of scheme design. And the early retirement schemes of the seven countries differ with respect to their generosity. The more generous the early retirement benefit the higher the likelihood that older workers choose early retirement over continued work.

Furthermore, it should be mentioned, that in several countries special arrangements pertaining to specific groups exist, allowing these groups to retire early - usually on particularly attractive terms. Such measures may be motivated by considerations relating to the occupation of the group in question or it may reflect particular status related features. More often than not the justification for supplying such vehicles as part of public schemes seems debatable.

Given their great importance to the labour market participation - or lack thereof - of older workers, significant challenges remain in most of the countries with respect to targeting and reforming early retirement schemes in order to promote prolonged employment.

Countries running separate early retirement schemes not linked to the general retirement system - like in the case of Denmark - may be faced with special challenges in coordinating early retirement and retirement benefits and in creating an efficient overall incentive work/retirement structure.

In relation to a situation marked by increasing labour demand and actual or anticipated labour shortages the rationale of upholding unconditional access to public early retirement seems debatable. Other political motives may warrant upholding such early retirement arrangements but it seems crucial that system designs and interplays are carefully designed in order to appropriately balance different considerations and secure effective work incentives.

Partial retirement

Some countries offer partial early retirement by allowing the combination of part time work and reception of early retirement benefits. However, the rationale of offering part time work for older workers without health impairments may be an issue of some debate.

Scandinavian experiences suggest that partial retirement may indeed promote early retirement and constitute pathways to retirement for mid- and high income groups that would otherwise have stayed on the labour market working full time a bit longer.

Put squarely, the key question at stake in this context is whether part time work is mainly a device to retire earlier or later.

On the other hand, it may be desirable to provide opportunities of some continued employment in order to secure greater individual flexibility. In that event, experience calls the need for careful consideration of system design to attention.

Disability pensions

Disability and sickness incidences increase by age and a significant minority leave the labour market well before the statutory retirement age due to impaired working capacities and health. All countries in this study run disability pension schemes - i.e. they offer early retirement arrangements targeted to these groups.
The welfare policy objective underlying these schemes embraces disability as a social risk. Presumably the volume of this form of early retirement will decrease in the longer term due to improved safety at work, better working environments, technologies ridding hazardous work and monotonous work, generally increased health standards, generally increased living standards, etc.

In the short and middle term however, other measures are needed in order to secure that these schemes uphold a clear and strict foundation in the social risks they were designed to address. Prevention and rehabilitation measures play an important role in this respect.

However, in terms of early retirement the key objective is to insure that such benefits are only available to persons who actually suffer work capacity impairment.

Reviewing the seven countries, significant differences in the practices applied appear. Some countries offer relatively easy access to disability pensions while other countries have tightened eligibility criteria and reduced access through reforms of their respective schemes.

Some countries have designed schemes targeted at providing appropriate employment for disability pensioners, e.g. Denmark has run a so-called "flex-job" scheme since the mid 1990s - a form of subsidized employment.

The general message from this Danish case is interesting. If an attractive scheme addressing a specific group on the labour market is set up it is difficult to avoid that other groups of clients are attracted to this scheme. Taking a regulatory perspective it seems that the more detailed the targeting to the needs of specific groups, the more careful system design needs to be considered and the greater the demands with respect to awarding benefits and controlling eligibility.

Early retirement through other social security schemes

Taking the public policy considerations behind various welfare schemes as a vantage point there are no other publicly financed schemes openly facilitating early retirement. However, other social security schemes may serve as *de facto* vehicles for early retirement.

Thus, several of the seven countries apply special rules to older workers in different social security schemes designed to offer temporary income replacement - i.e. sickness benefits and unemployment benefits.

Table 3. ***Main features of unemployment schemes in seven countries***

	Canada	Czech Republic	Chile	Denmark	Germany	Poland	Tunisia
Does the public sector provide income replacement to the unemployed?	Yes, UI* is administered by the public sector, but is financed by contributions	Yes, through compulsory unemployment insurance	Yes, UI is administered by the public sector, but is financed by contributions	Yes	Yes, UI is administered by the public sector, but is financed by contributions	Yes	Yes, through the social security system
Is the level of unemployment income replacement higher for the elderly than for other population groups?	No	No	No	No	No	Yes	No
Are the requirements for receiving unemployment income replacement less strict for elderly than for other population groups?	No	Yes, the benefit period is extended for persons older than 50	No	No	Yes	No	No
Does the public sector actively support the efforts of the individual unemployed in finding a job?	Yes	Yes	N.A.	Yes	Yes	Yes	No
Are activation demands less strict on the elderly than on other population groups?	No	No, active labour market measures are voluntary	N.A.	Yes	Yes	Yes	No

*UI = Unemployment insurance.
Source: Jacobsen et al., 2006.

Poland offers older unemployed workers a higher benefit. Germany and the Czech Republic apply less strict eligibility requirements to older unemployed workers and Poland, Germany and Denmark exempt older unemployed workers from activation measures and activation demands. Evaluations undertaken in Denmark argue that one result of such policies is a lesser employment rate for the involved age segment of workers.

Other social security schemes frequently serve as informal pathways to early retirement. In order to protect these systems in their own right and in order to secure increased labour market participation among older workers there is a need to secure the strict commitment of such systems to the risks defining them.

Taking a labour market perspective as a vantage point it seems clear that permanent income support should only be given to people with no or very little remaining working capacity, that temporary income support should not in effect turn permanent and that temporary income support needs to be backed up by activation measures - even in the case of older workers.

At a more general level the key point is that social security programmes - unemployment insurance, sickness insurance and disability pension - needs to be designed with the view of bringing clients closer to ordinary employment - not further away from it.

Early and continuous follow up can be of particular importance. Experience points to the great importance of early intervention in avoiding sickness turning into long-term sickness, turning into disability.

Private pensions

The essence of the previous sections has been to point out the need for reform - and most notably well coordinated multi-dimensional reform - of public social security schemes in order to promote labour market participation among older workers.

Similar suggestions have been advocated in relation to the pension reform debate focusing on strategies to secure the sustainability of public pension systems facing population ageing.

Across a very large number of countries a key part of the strategy to secure sustainability has been the creation or acceleration of private pensions. Not all countries have embraced such strategies with the same enthusiasm. Chile with its early 1980s reform gradually replacing the old public pension system with private pensions stands out as one of the countries that have gone the furthest in that direction.

Other countries have assigned great importance to privately - by collective agreement or by individual contract - organized supplementary pensions. Among the seven countries Canada and Denmark stand out in this respect. But even in other countries private pensions will be playing a still more important role over the coming decades.

Considering the need to increase the labour market participation among older workers, an important question concerns the effect of these elements of privatization and individualization with respect to the labour market participation of older workers.

An immediate reflection suggests two directly opposed effects - it can increase as well as decrease labour market participation. Both effects can be illustrated by observations from the Chilean case.

A number of studies have shown that a significant part of the Chilean population (25-50 per cent) will receive old-age pension of less than the minimum amount and will not have access to the sum guaranteed by the State because they do not meet the minimum contribution requirements.[2] People receiving such low pensions - other things equal - are forced to continue working.

The inability of the Chilean pension system to produce adequate pensions for a significant part of the future older generations has been the subject of current political concern, and strategies to improve the system are considered.

On the other hand, the Chilean system stands out in comparison with most other systems by its incentive structure. Based as it is on a clean defined contribution approach it offers - all other things equal - a clear and definite financial benefit from deferred retirement as the retirement period to be covered by this private arrangement is shortened.

It is however, possible that the system will gradually increase the propensity to retire early - especially among more financially privileged groups.

The Chilean pensions system permits voluntary early retirement provided there are sufficient resources accumulated in the individual account. Early retirement is possible for workers within ten years of the statutory retirement age if the certain requirements with respect to previous income and accrued pension rights are met. Early retirement is possible at an even lower age but eligibility criteria have recently been tightened and they will be tightened further over the next five years.

Even though the demands to be met in order to retire early are gradually tightened, it must be assumed, that more well off citizens will be able to build up the resources necessary to retire early. This may seem worrying and quite costly since this particular segment of the population can also be assumed to be the most productive.

It is not possible to estimate whether this actually happens. However, there are data suggesting a strong preference for early retirement. Out of the 377,000 old-age pensions currently under payment from the Chilean AFPs, 61 per cent are voluntary early pensions.

[2] Superintendencia de AFP (*Administradoras de Fondos de Pensiones de Chile*) November, 2005, written by Solange Bernstein, Guillermo Larrain and Francisco Pino.

Other countries have advanced far with respect to introducing and developing private supplementary pensions. Denmark, and to a lesser extent Canada and Germany, share some of the characteristics of the Chilean system.

Thus, in the Canadian case some 60 per cent of the full time employed work force is not covered by employment related pension arrangements. The similar figure in the Danish case is some 15 per cent. These groups may in time wind up becoming a particularly disadvantaged group of pensioners. In both cases - like in Chile - a significant portion of these groups are self employed. However, due to the generosity of the basic pension provision and other social security it must be assumed that very few - if any - will be barred from retirement for want of subsistence.

The still greater importance assigned to private pensions induces clear incentives for prolonged working careers. However, given the supplementary character of private pensions these effects may be somewhat lesser than in the Chilean case.

It should be acknowledged that the assessment of work incentives related to private pensions in multi pillar systems is a rather complex matter. The simple observation is that private pensions produce incentives for deferred retirement simply by the fact that deferred retirement translates into higher benefits later. However, the real incentive structure is much more complex and is constituted not only by these dynamics but also by the role of private pensions in the overall pension package, the coordination of public and private pensions, the accessibility and generosity of age related social benefits - i.e. housing subsidies, health care, long term care etc. - the coordination of spouses income and the tax treatment of private pensions.

The Danish case offers a very instructive example as the importance of private pensions is much smaller for low and mid income workers than for high income groups. This is due to the flat rate character of the basic pension, the income test applied to the pension supplement (part of the basic pension scheme) and the existence of a wide range of rather generous age related social benefits - e.g. housing benefits. The overall result is that the efficiency of work incentives imbedded in private pensions is significantly weakened for low and mid income groups simply because these incentives are offset - partly or in full - by the features mentioned. On the other hand, the work incentives are quite efficient for high income workers.

Like in the Chilean case it can be considered whether the greater reliance on tax favoured private pension savings in Canada, Denmark and probably Germany can actually stimulate earlier retirement for some groups.

Common to the three countries is that they all offer opportunities to take out tax favoured pension savings before the statutory pension age but the details of the regulations applied vary.

Germany and Denmark apply a specified age limit as to when tax favoured pension arrangements can be activated if the tax credits are to be preserved. In the Danish case this age limit is identical to the early retirement age - currently 60, due to increase to 62 and henceforth to be indexed to longevity. In Germany the age is also 60 years but it is independent of age limits in public retirement schemes. In the Canadian case, tax-assisted individual private savings can be withdrawn ahead of time but individuals will pay taxes on these withdrawals.

All three countries offer private, tax-favoured possibilities for early retirement. In principle tax-favoured private pension arrangements may in due course offer an alternative to publicly financed early retirement.

A forward looking strategy on this particular issue may be to apply and regulate criteria as to the type of benefits that can be derived and the age from which such benefits can be withdrawn. Such regulations may be justified by the tax favours granted and the need to increase labour market participation among older workers.

It is still too early to estimate the effects of increased reliance on private pensions on real retirement ages. On the one hand private pension saving in itself offers clear incentives but on the other hand they may also offer new possibilities and aggregate incentive structures is much more complex.

The real challenge in this respect however, may be to secure that "going private" does not mean losing out on political tools adequate to influence retirement behaviour. It will be possible to regulate the conditions for tax favoured pension arrangements. But it should be remembered that private pension arrangements are not the only private source available for retirement. Many older workers - and particularly among those best equipped in terms of private pensions, enjoy other wealth as well (i.e. private housing, other savings, etc.).

At a more general level a future conflict between society's need to control retirement and the individual's freedom to decide on the use of individual resources can be at stake.

Conclusions

Much of the international debate on the issue of population ageing has focused on pension reform and in particular reforms designed to increase long term sustainability.

The wide range of reform strategies followed in different countries reflects a basic observation. Namely, that there are no ready made "one size fits all" model for retirement reform. On the contrary welfare policy reform is a highly complex matter, and the sustainability of strategies pursued is highly dependent on broad based political support and on popular acceptance.

At the same time the problems facing the countries differ considerably as do their positions and approaches in addressing these challenges.

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There are probably no more important prerequisite in this field than the already existing models and structures. Reforms are very often shaped in some sort of continuation of the existing legacies in the relevant field.

However, the wide range of reform elements and experiences referred to above also reflects another trivial - but frequently overlooked - observation: retirement behaviour is not only about pensions. Rather, retirement behaviour and decisions are constituted and set in a context influenced by a wide range of policies and structures. It is indeed a very complex interplay of policies and structures. Frequently so-called "balloon-effects" can be observed - tightened criteria may lead to lower take up rates in one section of social security but simultaneously - and unintentionally - create increased pressure in other sections.

While much of the debate has focused on pension reform much less attention has historically been paid to labour market effects of population ageing - i.e. its consequences for labour supply. A lesser output of labour will eventually lead to reduced growth rates and thus increases the challenges associated with the catering for still larger groups of pensioners.

Therefore it seems obvious that social security reforms must be designed with the view of supporting growth by way of supporting labour market participation.

If strategies to increase the participation rates of older workers are to prove successful, the need is for comprehensive multi-dimensional strategies. Such strategies involve pension reform with the view of securing sustainability and of getting incentives right. But retirement behaviour is not just about pensions. Reform strategies also need to address other areas of social security and labour market policies - older workers should be invited to stay on the labour market and the labour market should be accessible to them.

A common trend in many countries is the attempt to make private pensions assume a greater role in the longer term. This may be an obvious step in view of the need to secure financial sustainability and to ease the long term pressure on social security and public finances. However, it should be acknowledged that greater reliance on private pensions does not necessarily translate into stronger incentives for prolonged working careers - especially not so in the case of private pensions forming part of multi pillar structures. Arguably from a labour market perspective privately financed retirement is as problematic as public financed retirement.

The real challenge in this respect may be to secure that “going private” does not mean losing out on political tools adequate to influence retirement behaviour. It will be possible to regulate the conditions for tax favoured pension arrangements. But it should be remembered that such arrangements are not the only private source available for retirement.

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