

PREPARING FOR AN ERA OF DEMOGRAPHIC CHANGES

How to adapt to population ageing is now a major challenge for most OECD countries. Ageing is a source of concern because, in the absence of further reforms, it could undermine long-term growth and the sustainability of public finances. But it is also an opportunity to contribute more to society because, with the continuous increase in longevity, we are living younger longer. Indeed, life expectancy without incapacity has increased by two and a half years per decade over the past century.

Without further reforms, ageing will undermine growth

Without changes in existing policies, ageing could cause a marked slowdown in economic growth in most OECD countries and result in a sharp deterioration of public finances. Based on current rules governing retirement and early retirement, the labour force will increase less rapidly, or even decline. Furthermore, additional resources will be needed to cover increased pension expenditure, irrespective of institutional arrangements (public or private pensions). In countries with pay-as-you-go public schemes, a vicious circle could develop. Rising public pension payments could put upward pressure on taxes, which in turn could tend to reduce the number of people at work and, hence, undermine growth. These adverse prospects might very well be exacerbated by rising public health expenditure and the associated taxes.

One way to mitigate this vicious circle would be to implement, early on, tighter fiscal policies aimed at reducing public debt. This would lower future interest payments and create “room” for increased ageing-related spending. Public debt is, however, currently increasing nearly everywhere, following the recent deterioration in public budgets throughout the OECD area. This raises questions about the political feasibility of a strategy aimed at paying off debt to prepare for the consequences of ageing.

Increased labour force participation is required

The diffusion of new technologies is certainly an important source of growth, but it is difficult to programme its effects with public policies. More importantly, the benefits of technological progress do not show up only in higher wages but also, later in life, in better pensions so that net transfers to inactive people are not reduced.

Immigration is sometimes seen as another way to meet the ageing challenge. And in the shorter term, an increased number of well-integrated young immigrants may boost the workforce. But immigrants also grow old and eventually will have to be catered for by those at work.

Raising labour market participation of older workers

The challenge is therefore to design and implement labour market and social policies that preserve the long-run sustainability of public finances and, more importantly, support economic growth. Policies encouraging higher employment rates of older workers would go a long way towards mitigating the consequences of ageing. After all, most people face longer and healthier life expectancies, which make them able to remain active longer than their parents. This positive development runs counter, however, to the numerous incentives and institutional arrangements encouraging premature withdrawals from active life. People remain active for a smaller and smaller part of their lives, in large part because institutions and policies are ill-adapted to increasing longevity. Statutory retirement ages or strong incentives built into public pension schemes mean that working beyond 60 or, *a fortiori*, 65 is discouraged, even though people live for a longer and longer period afterwards. And in many countries, invalidity, unemployment benefit and dedicated early retirement schemes give healthy and work-ready persons strong incentives to retire long before they qualify for an old-age pension.

Recent OECD research suggests that if incentives for retirement were made neutral, labour-force participation of persons in the 55-65 age-group could rise by up to 20 percentage points in the long run, or even more in a few countries. Hence, governments are considering reforming their pension schemes so as to avoid discouraging longer active lives. Such reforms would have positive effects not only on participation rates, but also on contributions to public budgets through income tax receipts. Most importantly, employers' attitudes toward older workers will also need to change, if these persons are to stay successfully in the workforce. In this context, public policies to strengthen the attractiveness of older workers may be helpful.

Higher participation of female and young workers also matters

Other policies that keep people away from work need to be reconsidered. For instance, female participation is low in some countries because tax and family policies discourage women from entering the labour market. Over-regulation also inflates the cost of services caring for children and the elderly, thus discouraging women from engaging in active lives. Likewise, people could be induced to enter the labour force at a younger age, without undermining their necessary investment in human capital. Broadly speaking, removing existing obstacles to labour market participation of all groups of workers would make important contributions to economic growth and the sustainability of public finances.

Can greater reliance on private pension schemes help?

Even if these policies to activate a higher proportion of persons were successful, they are likely to be insufficient to safeguard public budget positions in a number of countries. In such cases, less generous increases in public pensions may be necessary, even if that raises issues of inter-generational fairness. These adjustments might be facilitated by a set of measures encouraging future pensioners to accumulate private savings in order to supplement their future pension income. Positive side-effects can be expected from the accumulation of private savings, including higher investment, stronger potential growth and financial market development.

But there are several inherent difficulties with private pension schemes. Tax breaks are often provided to induce such saving, but such tax breaks may be more effective in triggering a reallocation of saving that would have taken place anyway rather than in stimulating new saving. At the same time, these tax breaks tend to benefit the well-off and the cost to public budgets is significant. OECD estimates suggest that the fiscal cost of such tax incentives ranges from 0% to 2% of gross domestic product (GDP). As well, administration costs of private schemes are often substantial. Finally, existing private pension schemes increasingly tend to be based on defined contributions, rather than pre-specified benefits. This implies that the individual saver carries the bulk of the financial risk, without necessarily being the best placed to do so.