

**Strengthening growth and public finances
in an era of demographic change**

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**Keynote speaker
in the afternoon session on Thursday May 13, 2004**

What is the problem?

It is highly appropriate that the possible impact of population ageing on public finances and economic growth in the coming years is brought to the forefront of our discussions here today. Although economic projections may not always be accurate, I think we can all agree that most of us are facing some major challenges in this area. The OECD has estimated that if current retirement patterns continue, ageing will weaken growth as labour forces increase more slowly and may even decline in some countries. Furthermore, the transfer of resources from those in work to the retired population will increase. This would put pressure on the public finances' situation, calling for either higher taxes or reduced expenditures which would, in turn, lead to lower economic growth and higher unemployment.

What needs to be done?

The easy answer is that this situation – or rather these prospects – inevitably call for some action. The OECD countries simply have to tackle the challenge of ageing. I fully agree with the OECD that this calls for bold reforms which will not be popular and most certainly will not be easy to implement. But if such reforms are enacted, the future benefits will be significant and may fundamentally change the prospects as they are now assessed.

There are, however, no easy solutions to this problem. Technological progress and productivity gains will not alleviate the problem, at least not in the short term. This may even aggravate the problem as the number of people out of work may increase, not decrease. But I think this is a temporary phenomenon as productivity increases will in the end be beneficial for our economies.

I would like to use the situation in Iceland, my own country, as a reference basis for what I feel needs to be done. But let me quickly add that our case does not necessarily provide clear answers as to how structural reforms elsewhere should be implemented. It is more a successful example rather than a universal blueprint. Also, I should note that our population is still relatively young, but that is of course the stage in the demographic trend where it is wisest and easiest to prepare for the ageing problem.

The Icelandic case

First of all, let me mention that the Icelandic labour market is highly flexible compared to other countries. This applies specifically to the private sector while the public sector is still somewhat rigid. The regulatory framework facilitates both easy hiring and firing and this has been an important factor contributing to low unemployment and strong growth performance since this strengthens the adaptability and resilience of the economy to deal with both supply and demand shocks.

A flexible labour market also contributes significantly to exceptionally high labour participation rates in Iceland in all age groups, the highest in the OECD area at about 88 per cent.

Another important point is that taxes on labour costs in Iceland are very low, among the lowest in the OECD. This applies to both marginal and average taxes. Also, the average personal income tax payments are relatively low by international standards because of a comparatively high tax credit and low marginal tax rates.

In addition, the retirement age in Iceland is high compared to most other countries. The stipulated retirement age is 67 years but people can go on working until 70 in the public sector and even longer in the private sector. One of the reasons for the high retirement age is the absence of early retirement schemes. This has not necessarily been the result of a carefully planned political agenda but reflects the fact that many people simply want to work as long as they are able to. In a sense, this is a cultural thing rather than an economic phenomenon.

But this is not the only reason why the ageing issue is not as pressing in Iceland as in many other countries. Another important explanation lies in the structure of our pension fund system which is based on the principle of a fully funded system rather than a pay-as-you-go system. A private pension fund system was established already in 1970 which is now more or less fully funded. In 1997, similar changes were made to the public pension fund system.

It is mandatory by law to pay at least 10% of all wages and salaries into fully funded pension schemes that provide lifelong retirement and disability pensions. These are mostly provided by occupational pension funds set up through collective agreements between the partners on the labour market. Of the 10% minimum 4% are to be paid by the employees and 6% by the employers. Membership of occupational pension funds was made compulsory for wage earners in 1974 and for the self-employed in 1980.

Comprehensive legislation covering the operation of pension funds came into force in 1998. It lays down the general requirements for pension funds regarding size, minimum pension rights, risk, internal auditing and funding. Finally, it gives guidelines and limits for the funds' investment policies based on the risk diversification principle. Most of the funds are governed jointly by the partners on the labour market. They are regulated by the Ministry of Finance but supervised by the Financial Supervisory Authority. The partners on the labour market have assumed the

greatest responsibility for the sustainability of the pension fund system. Under the pension fund legislation payments to individual pension funds are to be increased if necessary for the respective funds to be able to fulfil their future obligations, for example as a result of higher life-expectancy.

Furthermore, I would like to mention the third pillar of the pension system which is the voluntary pension scheme introduced in 1998. This system involves specific tax incentives as employees are allowed to deduct from their taxable income a contribution to authorised individual pension schemes.

Concluding remarks

To conclude, let me repeat the possible lessons that can be learned from the Icelandic experience:

- The labour market is highly flexible which contributes to high labour force participation rates of men and women in all age groups.
- Taxes on labour are relatively low.
- The retirement age is very high.
- There are no early retirement schemes in operation.
- The pension fund system is in principle fully funded and contributions are mandatory by law. Employers and employees have a role in maintaining the sustainability of the system. A third pillar, a voluntary savings scheme, where tax incentives also play an important role, has further raised the level of pension savings.