

Coping with low labour-force participation

Contents

[Labour-force participation:](#)

Enhancing labour-force participation of female workers, p.2

Obstacles to continued work faced by older workers, p.3

Policy options to raise labour force participation, p.5

Recent Working Papers, p. 6

Recent and forthcoming releases, p. 8

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How to deal appropriately with ageing has been a major concern of modern societies. The greying of the baby boomer cohorts has heightened concern about growth prospects and the long-term sustainability of public finances.

Not enough attention has been given, however, to the fact that we are living healthier and longer lives, a process that may be superficially seen as ageing but could be more accurately described as "living younger later". From this standpoint it may look paradoxical that steady increases in life expectancy without incapacity have not translated, in many countries, into longer working lives with their associated benefits in terms of growth, public finances and global welfare.

One partial explanation to this puzzle may lie in the presence of public policies that aim at shortening the working life through various subsidies and regulatory impediments, often with a view to reduce unemployment in the short-run. The same sort of policies may also act to reduce female labour supply in many OECD countries. Anecdotal evidence provides many examples where it is financially punitive for women and the so-called "ageing workers" to stay in the workforce.

At the OECD we have explored these links further and in this Newsletter we offer an overview of recent empirical work from the Economics Department on the relationship between low labour utilisation and public policies. In particular, it summarises work on the factors hindering female labour force participation; the interaction and impact of pension, tax and social policies on the decision to continue to work beyond the age of 55; and reports on simulations of various policy reforms to assess the potential scope to boost the supply of labour offered by females and older workers.



*Jean-Philippe Cotis,
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Enhancing labour-force participation of female workers

The participation of women in the labour force has been rising over past decades, but large differences prevail across countries. These differences in part reflect cultural and social norms. Financial incentives and work practices also play an important part and in this respect government policies influence the decision of women to enter the labour force. Recent OECD empirical research has evaluated the contribution from lowering the obstacles to female labour supply manifest in taxation systems, rigid work-time arrangements and costly child care facilities. The study concludes that there is considerable scope in some OECD countries to raise female labour supply.

Female labour force participation varies widely...

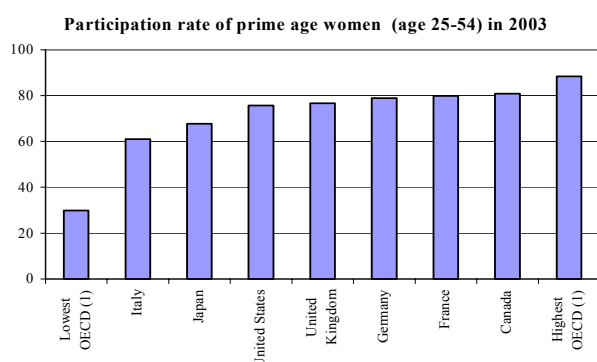
In most OECD countries preferences for female participation in the labour force are much higher than actual participation rates (see figure). The obstacles to higher female participation are both social and economic. Focussing on the latter, OECD research has identified and quantified the contribution from economic distortions, especially those embedded in tax and social policies.

Largely reflecting distortions in taxation systems and

In most OECD countries households with second earners - typically women - are taxed more heavily than single men and women. On average the tax rate on the income of second earners in OECD households is about 20 per cent higher than on single individuals earning the same income. Taxation is heavier because the combined family income is taxed at a higher marginal rate and spouse allowances, which exist in most separate income tax systems, are foregone when both spouses work. This distortion discourages female participation, especially in looking for full-time employment.

Rigid working-time arrangements

Survey evidence finds that part time participation is the most frequently preferred working arrangement for women. Such work makes it easier to combine family care commitments with a professional life. But even when part time work opportunities are plentiful, inflexible working hours represent a sizeable obstacle to female labour force participation, since those women who want to work substantially fewer hours, but cannot, have a high propensity to leave the labour market.



1. Highest OECD refers to Iceland, lowest to Turkey. Data for Iceland refer to 2002.
Source: OECD Labour Force Statistics

Female participation may also be affected by other policies, albeit indirectly in some cases. For instance, excessive regulation of the services sector, the predominant employer of women, may hinder its development and thus job opportunities.

Countering the disincentives to female participation is a variety of government policies to support families with young children. These include, paid parental leaves, childcare subsidies and child benefits. Another example is in-work-benefit schemes, which tend to increase the participation rate of low income individuals in general and single mothers in particular.

The potential to increase female participation is large

Government policies thus tend to both discourage and encourage female participation. To appreciate their net impact and the effectiveness of specific policies to boost female labour force participation, recent OECD research, based on multivariate analysis has quantified the impact of these key policy and non-policy factors affecting female participation.

The empirical results can then be used to simulate the impact of various policy reforms. Such exercises indicate a substantial potential to boost female participation. For example, if equal tax treatment of second earners were introduced, or if childcare support were increased to equal that in Denmark, the most generous of OECD countries, female participation could in each case rise on average by about 4 percentage points.

Such policy changes have a budgetary cost, even though they may be partially self-financing. How these costs are financed has not been taken into account in the simulations. The cost effectiveness of policies to boost female participation depends on the policy instrument used. For example, regarding childcare policies our work finds that paid parental leaves boost female participation most, provided their duration is not too long. In contrast, child benefits tend to depress female labour force participation, because they raise the income of families and thus lower the financial need to look for paid work. ■

For further reading on this topic:

OECD Economic Studies No. 37, "Labour-force participation of women: empirical evidence on the role of policy and other determinants in OECD countries", by Florence Jaumotte.

Obstacles to continued work faced by older workers

Workers usually retire voluntarily only when they can afford to. This typically means waiting until they reach the age or situation in which they can begin to draw retirement benefits. However, even on reaching minimum retirement age, workers may choose to continue in activity if the cost of doing so in terms of foregone pensions and additional contributions is offset by the increase in future pension benefits. Recent OECD work, however, finds that pension and social systems are not actuarially neutral in this way. Rather, older workers effectively face punitive implicit tax rates that distort the decision in favour of withdrawing from the workforce. Moving to an actuarially neutral incentive structure would have a significant impact on older-worker labour-force participation, particularly in continental European countries. This would help to support living standards in a context of ageing populations.

Determinants of older worker participation

For a long period the effective age of retirement in OECD countries declined. In recent years, participation in the labour force of those aged between 55 to 64 years old has stabilised, and in some cases slightly increased. However, cross country differences in older worker participation is large and has widened (see figure). The disparities are particularly large for older male workers, with participation rates ranging from around 30 per cent in Italy to over 80 per cent in Japan.

These trends may be accounted for by a broad range of factors. Some of these directly reduce labour supply, such as wealth effects associated with rising living standards and increased demand for leisure. Other factors affect employment via reduced labour demand, such as slow wage adjustment in times of rapid technological change or high minimum wages.

But these determinants cannot plausibly account for all the cross-country variation in the labour supply of older workers. Also of empirical significance, and the focus of recent OECD research, are features embedded in pension and social policy systems that directly reduce labour supply by encouraging early retirement.

The retirement decision depends on the design of pension systems

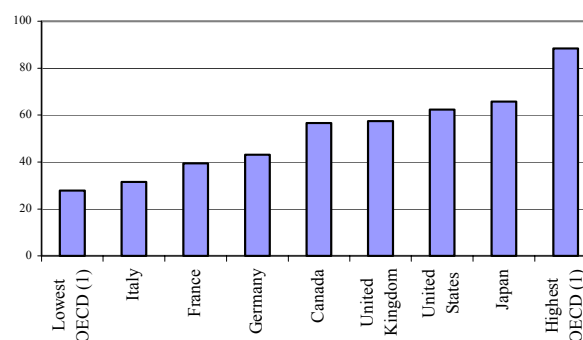
There are three pension parameters that are found to be especially important in influencing labour supply.

The first is the standard age of entitlement to pension benefits. This acts as a social norm and in some countries people are not permitted to work after the standard retirement age, even if so desired. In the OECD, the standard age of eligibility to a full pension varies between 60 in a few countries (e.g. France) and 67 (e.g. Norway).

The second important parameter is the level of pension benefits. These also vary widely among OECD countries. For instance, at age 60, expected gross replacement rates, calculated over a five year period, range from 0, because the earliest age of eligibility is 65, to 70 per cent in the most generous countries.

The third factor is the expected net gain from continuing to work instead of retiring. This depends on several other financial considerations including *inter alia*: the cumulative pension income lost when retiring later; the supplementary contributions paid and, on the other hand, the higher pension benefit gained from staying longer in the labour force.

Participation rate of older workers (55-64) in 2003



1. Highest OECD refers to Iceland, lowest to Luxembourg. Data for Iceland and Luxembourg refer to 2002.

Source: OECD Labour Force Statistics

Government policies discourage older workers

Thus, to investigate whether older workers are financially penalised by working beyond the ages of 55 and 60, it is necessary to have information on the expected replacement rate from a pension, the parameters of early-retirement schemes, the age of eligibility to a full pension and the existence of actuarial adjustment before and after standard retirement age.

The OECD has collected these data for more than 20 member countries. This information is then used to compile a synthetic indicator labelled the implicit tax on continued work. It is defined as the change in net pension wealth (i.e. the present value of the future stream of pension payments, net of additional contributions paid) resulting from a decision to postpone retirement.

As calculated, implicit taxes on continued work generally tend to rise rapidly as individuals age. At age 55, for instance, the implicit tax in ordinary pension

schemes averages about 5 per cent, but by age 60 it is on average closer to 30 per cent (see figure).

The average OECD implicit tax disguises striking differences across countries. In systems that are close to "actuarially neutral", such as New Zealand, the implicit tax is low because the cost related to continuing to work is offset by additional benefits. In most countries, however, remaining active in the labour market is costly, because the offset is not complete. Broadly speaking, the disincentives are low in Japan, the English-speaking and Nordic countries and high in continental European countries where they could reach 40 to 50% in 2003.

Early-retirement schemes and other social benefits also influence retirement decisions

Apart from standard old-age pension schemes, older workers in many OECD countries also choose other pathways into retirement. These include special early-retirement schemes and unemployment-related and disability benefits, which enable workers to withdraw from the labour market well before the normal age of eligibility to a full pension. These schemes strongly influence retirement decisions because they typically provide high replacement rates and allow the accumulation of additional pension rights even, if, in some cases, at a reduced rate.

OECD calculations of the implicit tax rate that also take into account these "early retirement routes" (typically through a period of unemployment assistance preceding retirement) suggest that workers face even more punitive financial disincentives to remain active in the labour force. On average the implicit tax rate at age 55 is 30 per cent. Again, Continental European countries have above-average implicit tax rates, approaching 100 per cent in some cases.

Assessing the quantitative impact of various pension reforms

As one would expect there is a negative relationship between retirement incentives, as captured by the implicit tax rate on continued work at age 60 and older worker labour force participation, especially when the early retirement route is considered. Taken at face value, it suggests that a 10 percentage points increase in implicit tax rates would reduce participation rates of older workers by 3 to 4 percentage points.

Econometric analysis based on panel data regressions for older male workers, also finds a significant effect. However, the estimated participation elasticities with respect to implicit tax rates are clearly lower than those found with simple cross country regressions.

Simulating the effect of pension reforms on the participation of older workers

The next step of the analysis was to use the estimated coefficients of the older worker participation model to evaluate the impact of possible pension reforms on the labour supply of older workers.

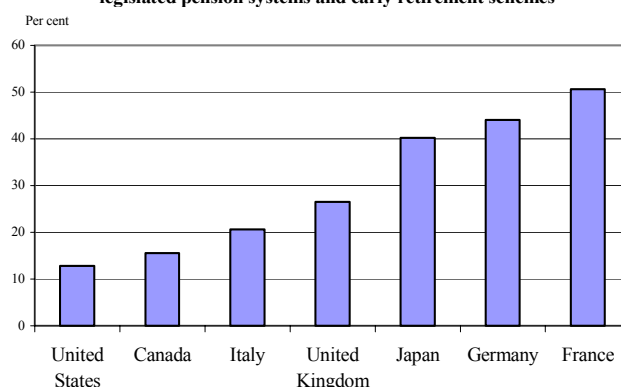
Three scenarios were examined. These were i) a removal of early retirement schemes; ii) a move towards actuarial neutrality of old-age pension systems; and iii) a convergence of standard retirement ages to 67. The three reforms are simulated cumulatively and for each scenario two estimates were produced: a low case based on the estimated parameters of the panel regression and a high case based on coefficients estimated from a simple bivariate regression.

The simulation results suggest that removing early-retirement schemes would yield sizeable participation effects on the 55-64 year old age group. In countries where such schemes are still being used extensively (e.g. Belgium, France, Germany), participation could rise by 6 to 15 percentage points.

If as well old-age pensions are made actuarially neutral, the impact on participation, particularly those aged 65 and above could on average rise by around 3 to 4½ percentage points more than otherwise would be the case.

Finally, the additional impact of raising the standard retirement age of entitlement to a pension to 67 adds a further couple of percentage points, but considerably more in those countries where the standard retirement age is currently low (e.g. France and Korea)■

Implicit tax on continued work at age 60 in currently legislated pension systems and early retirement schemes



Source: OECD Economic Studies No. 37.

For further reading on this topic:

OECD Economic Studies No. 37, "Retirement behaviour in OECD countries: impact of old-age pension schemes and other social transfer programmes", by Romain Duval.

Policy options to raise labour force participation

In the face of substantial expected population ageing, policies that boost labour-force participation have attracted considerable interest in OECD countries. Since the cross-country divergence in participation rates is mostly accounted for by differences in participation of prime-age women, older workers and youth, reforms targeting these groups are of special interest. Recent OECD work has quantified the impact of various reforms on aggregate participation. The main outcome of this analysis is that the combined effect of possible reforms targeting prime-age women, older workers and youth might suffice to stabilise the average participation rate in OECD countries over the next 25 years, but will be insufficient to offset the additional reduction of participation likely to be caused by demographic changes beyond 2025.

Labour forces are projected to decline

Over the next five decades, as populations age labour supply in OECD countries is expected to decline substantially, with negative effects on output growth, material living standards and public budgets. Projections by the OECD made on the basis of current policies anticipate that:

- The share of people aged 15 and over that remain active could decline by some 10 percentage points between year 2000 and 2050, reflecting the withdrawal from the labour force of prime-age workers, and despite a projected increase in women's labour force participation.
- The labour force in the OECD area is, as a result, expected to fall by around 4 percentage points over the same period. Large cross-country differences are embedded in these trends. Broadly speaking, the labour force is expected to increase steadily in the United States, stagnate or decline moderately in Europe and fall more precipitously in Japan.
- The proportion of inactive adults to the total labour force is expected to increase on average by close to 30 percentage points by 2050. The upward trend is particularly marked in Europe and Asia.

Policies to enhance labour force participation...

Recent pension reforms are built into the baseline projection outlined above, but they have little impact in most OECD countries over the period considered. However, further policy reforms that tackle the disincentive to continue working and the specific obstacles that some female workers face could mitigate or reverse these prospective developments. To assess their quantitative impact, model simulations have been undertaken, using the econometric estimates summarised in the previous two articles in this Newsletter.

Specifically, as well as the policy reforms mentioned in the previous article, three policies to enhance female labour-force participation were simulated. These were: i) an equalisation of the tax treatment of second earners and single individuals; ii) an increase in child care provision; and iii) a removal of disincentives to work part-time. A final scenario simulated the impact of shortening the school-to-work transition on youth participation.

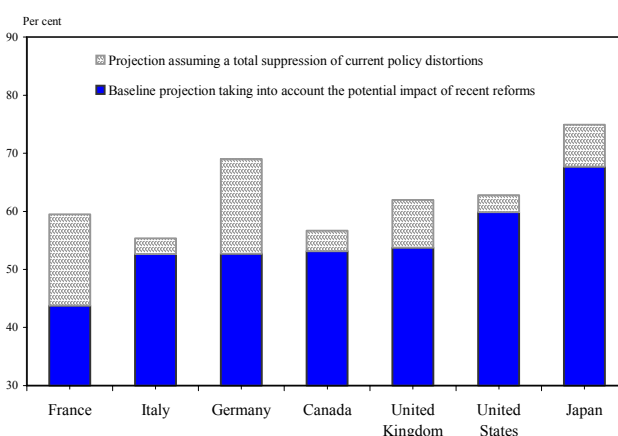
...could raise aggregate participation considerably

The results of the simulations illustrate that these policy reforms combined as a package could considerably boost aggregate participation over the coming decades (see figure). The aggregate participation rate could rise by nearly 5 percentage points over the period to 2025, sufficient to offset the decline that would otherwise occur. In fact, among the EU countries, such comprehensive reforms could boost participation by more than the targets laid down in the Lisbon Agenda, although not by the ambitious 2010 deadline set in March 2000.

Among the policies, reforms of pension schemes, particularly those achieving actuarial neutrality, offer the largest impact on participation in these scenarios. Sharper work incentives for women are also influential in many of the English-speaking countries.

Overall, the largest scope for increasing participation is found in France, Korea, Germany, Belgium, Luxembourg, Spain and Portugal, all countries where the initial distortions to participation are sizeable. Nonetheless, when the horizon of the simulations is extended to 2050, these policy reforms in virtually every country are insufficient to offset the projected contraction in the workforce due to demographic developments.

Potential impact of pension reforms on labour force participation of older workers (projected labour force participation rates of the 55-64 age group in 2025)



Source: OECD.

For further reading on this topic:

OECD Economics Department Working Paper No. 371, "Coping with ageing: a dynamic approach of alternative policy options on future labour supply in OECD countries".

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[No.415: Structural policy reforms and external imbalances](#)

by M. Kennedy and T. Sløk

[Saving behaviour and the effectiveness of fiscal policy](#)

This paper examines the extent to which fiscal policy actions may be offset by simultaneous, anticipatory changes in private saving, as well as the determinants of that offset. The conditions under which private agents will engage in forward-looking consumption-smoothing behaviour are quite strict and unlikely to hold fully in practice. However, based on a sample of at most 21 OECD countries spanning the period 1970-2002, there is strong evidence of partial, yet substantial, offsetting movements in aggregate private and public saving. The overall offset is estimated at between about one-third and one-half, depending on model specification, and applies both to public consumption and revenue shifts. Initial conditions, as reflected in debt/GDP ratios and the operation of fiscal rules are found to influence the size of the offset. Moreover, the offset is found to increase with the size of the discretionary fiscal impulse, suggesting that fiscal action is subject to diminishing returns.

De Mello, L., P.M. Kongsrud and R. Price (July 2004), "Saving behaviour and the effectiveness of fiscal policy", Economics Department Working Paper No. 397

[Housing markets, wealth and the business cycle](#)

The paper examines the linkages between housing markets and the business cycle in OECD countries, focusing on how differences in the degree of resilience to economic shocks can be affected by the structural characteristics of housing and mortgage markets. The paper focuses specifically on: the transmission channel from housing wealth to consumption and on the factors behind house price variability, which help to determine whether the housing sector plays a stabilising role or not. Estimates of the marginal propensity to consume out of housing wealth are presented for ten OECD countries, where it is found that the strongest impact on consumption is in countries that have large, efficient and responsive mortgage markets. With regard to house price variability, the significant differences found among OECD countries appear to be connected both to macro-economic factors (such as inflation variability) and to structural ones. A tentative conclusion is that structural policy settings that are desirable for the sake of efficient resource allocation also tend to be conducive to greater macro-economic resilience to shocks.

Calte P., N. Girouard, R. Price and C. André (2004), "Housing markets, wealth and the business cycle", Economics Department Working Paper No. 394

[Long-term budgetary implications of tax-favoured retirement plans](#)

This paper provides estimates of the implicit fiscal assets as well as of the evolution over time of fiscal costs and revenues related to tax-favoured retirement saving regimes in 17 OECD countries, taking into account current and future contributions, asset accumulation and withdrawals, all of which will be strongly influenced by future demographic developments. The main results show that in the case where tax incentives are assumed to lead essentially to saving diversion rather than creation, the net budgetary cost of tax-favoured schemes would remain large, despite the sharp rise in revenues collected from withdrawals as population ages. The paper shows that this cost would significantly be reduced if tax-favoured schemes succeed in promoting additional private savings. It then explores a number of policy options to maximise the amount of additional saving.

Antolin, P., A. de Serres and C. de la Maisonneuve (2004), "Long-term budgetary implications of tax-favoured retirement plans", Economics Department Working Paper No. 393

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by A. Fuentes, E. Wurzel and M. Morgan

[Channels for narrowing the US current account deficit and implications for other economies](#)

In this paper the OECD's interlink model is used to explore several possible channels through which a narrowing of the US current account deficit could occur. The shocks considered include dollar depreciation, fiscal consolidation, and an improvement in the non-price competitiveness of US producers. A key conclusion is that shocks would have to be very large in order to materially reduce the US external deficit. In part, this is because second-round effects, including domestic policy responses, tend to offset the shocks' initial impact. The exchange rate simulations highlight the fact that more exchange rate flexibility in Asia would spread the burden of adjustment more evenly across US trading partners. Attention is also drawn to the increased risk of deflation posed by significant fiscal consolidation at a time of unusually low interest rates. Finally, higher growth rates in US trading partners are estimated to improve the US current account balance only minimally.

Brook, A.-M., F. Sédillot and P. Ollivaud (2004) "Channels for narrowing the US current account deficit and implications for other economies", Economics Department Working Paper No. 390

[Factors driving risk premia](#)

This paper assesses the extent to which the fall in risk premia of a number of financial assets, which occurred throughout 2003, was due to improvements in factors specific to individual markets at that time or to general economic fundamentals coupled with OECD-wide abundant liquidity. Regarding the latter two factors, principal component analysis was used here to identify a common trend in risk premia in equity, corporate bond and emerging markets since early 1998. The analysis finds that both economic fundamentals and liquidity have played a statistically significant role in driving the common factor. It also finds that liquidity (measured as the GDP weighted average of M3 of the three major economies less its trend) performs better than similarly weighted short-term interest rates. By spring 2004, the common factor in different risk premia had fallen below what could be explained by economic fundamentals and liquidity.

Sløk T. and M. Kennedy (2004), "Factors driving risk premia", Economics Department Working Paper No. 385

[Differences in resilience between the euro-area and US economies](#)

This paper is concerned with how stylised differences in monetary policy transmission mechanisms and product and labour market rigidities between the US and euro-area economies affect their resilience to temporary shocks. To address this issue, a small general equilibrium model with long-run neo-classical and short-run neo-Keynesian features is calibrated to replicate the key properties of the US economy. To this model, features of the euro area's financial and then product and labour markets are added sequentially with a view to replicating what is generally agreed are aspects of the functioning of the euro-area economy. Most of the analysis is conducted assuming identical monetary policy reaction functions, although the sensitivity of the results to this assumption is tested. The results illustrate the importance of adjustment patterns in financial, product and labour markets for economies' responses to demand shocks and in determining the appropriate monetary policy reaction.

Drew A., M. Kennedy and T. Sløk (2004), "Differences in resilience between the euro-area and US economies", Economics Department Working Paper No. 382

Recent and forthcoming releases

OECD Economic Surveys (www.oecd.org/eco/country_surveys)

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Denmark	- Boosting growth through greater competition
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Japan	- Getting the most out of public sector decentralisation
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Czech Republic	- Immigration policy: addressing the needs of an ageing labour force
Finland	- Product market competition and economic performance
Turkey	- Improving the quality and cost efficiency of public expenditure; - Establishing an open and non-discriminatory business environment

Forthcoming Surveys to be released by the end of April:

Belgium	- Enhancing the economic impact of migration
Spain	- Getting the most out of public sector decentralisation

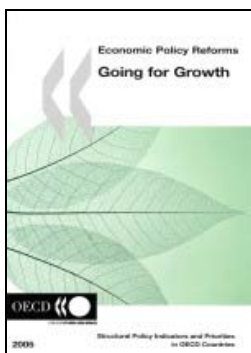
Speeches and presentations (www.oecd.org/eco/speeches)

- Getting the agenda right: strategies for spurring growth and creating jobs. Presentation to the Lisbon Council Young Leaders Congress, March 2005.
- EMU after 5 years, Conference on EMU and economic governance, September 2004.
- États des lieux des pays de l'OCDE: les outils de pilotage pour la gouvernance mondiale, conférence "Les Canadiens en Europe", September 2004.
- Alternatives for stable economic growth: increasing productivity, greater competitiveness and entrepreneurial innovation for The Economist conference on "Economic background and perspectives for 2004-2005: The track towards a dynamic economy", June 2004.

Economic Policy Reforms: Going for Growth

(www.oecd.org/eco/EconomicPolicyReforms2005)

This new publication takes stock of the progress made in implementing policy reforms and suggests priorities for the future reform agenda in each member country. It also provides a rich set of recent comparative indicators covering structural policy areas such as labour markets, education and product market regulation. These indicators enable countries to see their economic performance and structural policies in comparison with others. The publication puts together the knowledge accumulated at the OECD in these various fields and includes four analytical chapters.



Economic Studies (www.oecd.org/OecdEconomicStudies)

No. 39, 2004/2 (forthcoming)

- The U.S. fiscal gap and retirement saving
- Long-term budgetary implications of tax-favoured retirement saving plans
- Tax treatment of private pension savings in OECD countries
- Mind the gap: the effectiveness of incentives to boost retirement saving in Europe
- Effectiveness of tax incentives to boost retirement saving: theoretical motivation and empirical evidence
- Pension savings and government finance in the Netherlands

