SOCIAL SECURITY ADVISORY BOARD FORUM ON

"Policies to Extend the Working Life of Older Americans",

Washington, D.C., 18th January 2008

Some Suggestions for Reforms Based on OECD Countries' Experiences

by

John P. Martin*

Director for Employment, Labour and Social Affairs, Organisation for Economic Co-operation and Development (OECD), Paris, France

---

* I am very grateful to my colleague Ed Whitehouse for his assistance in preparing this paper. The opinions expressed here are my own and cannot be held to represent those of the OECD or its member governments.

Introduction

The SSAB has invited me to put forward some proposals, based on evidence from OECD countries, which could help older Americans to carry on working. We did indeed publish in 2005 a specific report on this very topic for the United States as part of a project entitled Ageing and Employment Policies. This project produced 21 country reports over a four-year period; a separate synthesis volume was published in 2006 entitled *Live Longer, Work Longer*.

In my presentation to this Forum, I do not intend to reproduce the many detailed recommendations which were put forward in our U.S. report. Instead, I will highlight two areas for reform which I believe are particularly pertinent for the US situation. The first concerns pension reform, more specifically establishing a direct link between future pensions and changes in life expectancy. The second concerns the possible role of wage insurance in providing stronger financial incentives for older jobseekers to find a new job as opposed to remaining unemployed or dropping out of the labour force.

1. LINKING PENSIONS TO LIFE EXPECTANCY

Continuous growth in life expectancy, often at a more rapid rate than forecast, creates obvious financial challenges for retirement-income systems. In response to these concerns about financial sustainability, many OECD governments have instituted pension reforms to contain rising pension costs. As a recent OECD overview of pension reforms over the past two decades has highlighted, 16 OECD countries had a major pension reform since 1990, but not the United States[1].

1 For details, see OECD (2007).

Changes in pension eligibility age were the most common feature of pension-reform packages (see OECD, 2007, Part II.1). The rationale for such changes is clear: in the 1960s, life expectancy was growing rapidly, but many countries cut their retirement ages. The average age at which full-career male workers can first draw their pension in OECD countries fell from 64.5 years in 1958 to 62.2 years in 1993 and for women from 61.8 to 60.7 years. Recent reforms have reversed the trend to lower pension ages, with seven countries introducing gradual increases in pension ages for both men and women and a further five countries increasing pension ages for women alone.

However, many OECD countries have gone further, and introduced measures that will automatically link future pensions to changes in life expectancy. This means that the financial costs of longer lives will be shared between generations subject to a rule, rather than sharing the burden through potentially divisive political battles.

What did countries do?

Nearly half of OECD countries – 13 out of the 30 member countries, but not including the United States – now have an automatic link between pensions and life expectancy in the mandatory part of their retirement-income systems (Table 1). A decade ago, only one country had such a link. The spread of this reform has a strong claim as <u>the</u> major innovation in pension policy in recent years.

Table 1. Four ways to link pensions to life expectancy

	Defined contribution	Notional accounts	Benefit levels	Qualifying conditions
Australia	●			
Denmark	●			●
Finland			●	
France				●
Germany			●	
Hungary	●			
Italy		●		
Mexico	●			
Norway	●			
Poland	●	●		
Portugal			●	
Slovak Republic	●			
Sweden	●	●		

Note: Covers the 13 OECD countries with a link to life expectancy in the pension system.

Source: Whitehouse (2007).

The link to life expectancy can be introduced in a variety of ways, some more transparent to voters than others. Our overview of the recent reform process has highlighted four different routes to establishing this link:

- First, Hungary, Poland, Mexico, the Slovak Republic and Sweden introduced *defined-contribution* plans as a substitute for all or part of their public pensions in the late 1990s. Australia and Norway added mandatory contributions to private pensions on top of existing public provision. Denmark has long had defined-contribution plans covering nearly all workers.

- Secondly, Italy, Poland and Sweden have substituted *notional accounts* for traditional, defined-benefit public schemes. Notional accounts, like most public, defined-benefit schemes, are financed on a pay-as-you-basis, where today's contributions pay for today's retirement benefits. Defined-contribution schemes, in contrast, are "funded", with real money in individual accounts, and are usually privately rather than publicly provided. But notional accounts are designed to mimic some of the features of defined-contribution plans: in particular, pension entitlements are calculated in a similar way to annuities.

- Thirdly, some countries have retained defined-benefit public schemes while introducing a link between life expectancy and future pensions. Finland, Germany and Portugal will adjust *benefit levels* in line with trends in life expectancy.

- Finally, two countries will link *qualifying conditions* for pensions to life expectancy: the pension age in Denmark and the number of years of contributions needed for a full pension in France.

How should life-expectancy risk be shared?

It is hard to see why people approaching retirement should not bear at least some of the cost of their generation living longer than previous generations. After all, living longer is desirable. A longer life and a larger lifetime pension payout due to increased life expectancy confer a double advantage on individuals.

The optimum amount of life-expectancy risk that individual retirees should bear is therefore not zero. The obvious next question is, should 100% of the risk be shifted onto the pensions of new retirees? The issue is complex because each individual has a lifecycle that includes periods as a contributor and as a beneficiary. There is a trade-off: greater certainty over retirement benefits *versus* greater certainty over the amount of contributions or taxes paid when working.

Moreover, life-expectancy risk is but one of many risks involved in pension systems. With defined-contribution pensions, the value of retirement income is also subject to investment risk. Also, other objectives of the retirement-income system – such as ensuring low earners have an adequate standard of living in retirement – may conflict. Reducing already small pensions to reflect increases in life expectancy might risk a resurgence of old-age poverty.

Also important is the balance between mandatory and voluntary retirement-income provision. In countries such as Canada, Ireland, Japan, the United Kingdom and the United States, voluntary, private provision for old-age is widespread. The shift from defined-benefit to defined-contribution occupational schemes has already moved much life-expectancy risk from pension providers to individual retirees. In these countries, the mandate to provide for retirement is relatively small. Thus, the risks borne by taxpayers and contributors are also commensurately smaller and so are the gains from sharing the risk between generations.

The Office of the Chief Actuary of the Social Security Administration has projected the financial impact of 26 proposals for reform of the public pension scheme in the United States. Around a quarter of these — seven to be exact — involve automatic links to life expectancy. These proposals were made between 2001 and 2006. All of them would link benefit levels to changes in life expectancy. It is natural to ask whether a link between the pension eligibility age and life expectancy would be a simpler, clearer way of achieving the same objective.

Two-thirds of OECD countries that have had major retirement-income reforms since 1990 have introduced a link between pensions and life expectancy. A social-security reform package for the United States that was to include a link to life expectancy might deliver a fairer allocation of pension-system risks across generations. But, perhaps more significant for policymakers, it might provide a rationale for cuts in benefits that voters find both credible and reasonable. There is, of course, the big political economy question of selling such a reform to voters. But the evidence from OECD countries' experiences over the past two decades suggests two lessons: (i) it is possible to sell such a reform to electorates; and (ii) such a reform would provide a significant incentive for older Americans to participate in the labour market longer.

2. INCREASING INCENTIVES FOR OLDER JOBSEEKERS TO FIND WORK

While it is very important to reform pension and other social protection systems (e.g. long-term sickness and disability benefits) in ways that encourage older workers to want to continue working, they have to be convinced that they will be able to find suitable jobs with good earnings if, by any chance, they should become unemployed or seek to re-enter the labour market following a spell of inactivity. This raises the question of what kinds of reforms should be envisaged to assist older jobless persons to find work.

In most OECD countries, but not the United States, one obvious answer to this would be to expand spending on so-called active labour market policies (ALMPs) to assist the older unemployed to find jobs and/or increase the degree of targeting of existing ALMPs on older job seekers. The problem with such a recommendation in the U. S. context is that the U.S. spends relatively little on ALMPs. In 2005-2006, spending on ALMPs as a per cent of GDP in the United States amounted to 0.13% compared with an OECD average of 0.7%. In addition, there is almost no targeting of ALMP spending in the U.S. on older workers. Indeed as OECD (2005a) points out, the sole major federal ALMP in the U.S. which is targeted to older workers is the Senior Community Service Employment Program (SCSEP)[2].

[2] SCSEP is funded and operates under the Older Americans Act, but is run by the Department of Labor. It serves low-income persons who are aged 55 and older and who have poor employment prospects (their incomes cannot exceed 125% of the official poverty line). It places them in subsidized part-time community service positions and helps them to get unsubsidized jobs. SCSEP gives priority to persons aged 60 or over. In 2003-2004, 106 000 individuals participated in the programme: this was equivalent to less than 4 per cent of all participants on all ALMPs in that period.

Evidence reviewed in OECD(2005a) showed that older jobseekers are underrepresented among the participants in ALMPs in the United States; the counterpart is a strong overrepresentation of young (aged less than 25) jobseekers on ALMPs[3]. There is also a question concerning the outcomes of ALMP participation for older jobseekers compared with those for other participants. Here, the evidence summarised in OECD (2005a) for outcome measures concerning the Adult and Dislocated Worker programmes seems rather clearcut: older exiters from these two ALMPs, especially those aged 55 and over, reported lower re-employment probabilities, one to 3 quarters after exiting the programme compared with younger exiters. They also experienced less favourable earnings outcomes.

Thus, it is hard to avoid the conclusion that older jobless Americans are not well served by the existing volume or mix of ALMPs in the United States. One possible solution might be to expand the volume of spending on ALMPs towards the OECD average and/or increase the degree of targeting of existing on older job-seekers. But this begs the question as to whether a significant increase in public spending on labour market policies to assist older workers to find re-employment would be effective or not.

Obviously, we would like to increase spending on those ALMPs that "work" for older workers in the sense that <u>rigorous</u> evaluations of them show positive benefit-cost ratios for the economy, as well as significant employment and earnings gains for programme participants. However, it is not so easy to draw up a list of programmes which pass this rigorous evaluation test. Indeed, one of the leading

3 Part of the overrepresentation of youth among ALMP participants reflects the fact that a number of ALMPs are targeted specifically at this age group.

experts in this field, Nobel Prize winner Jim Heckman, has expressed strongly the view that it is not cost-effective for society to invest much in ALMPs for the older jobless[4].

Now the U.S. is blessed compared with many other OECD countries by having a relatively flexible labour market. One result of this compared with some of the larger continental European countries is that the older unemployed tend to find it easier to get a new job in the United States, but they often suffer large wage losses once re-employed[5]. One possible reform to overcome these potential large earnings losses and thereby to offer greater incentives to older unemployed workers to accept job offers would be to institute a system of wage insurance targeted to unemployed workers aged 50 and over.

Now such a reform has been much debated in the United States recently in connection with the issue of compensating either trade-displaced workers or all displaced workers for possible large earnings losses. Lalonde (2007) is an excellent summary of this literature and his proposal for wage (or what he calls "displacement") insurance is very close to the one advocated here. One main difference is that he proposes to target the scheme to long-tenured displaced workers, whereas the proposal presented here would use an age criterion. However, given the high correlation between long job tenures and age, the practical differences between the two proposals may not be too great.

Wage insurance may be a useful addition to the policy tool kit

A system of wage insurance would pay an older unemployed worker who accepts a new job at a lower wage within a specified period of time an earnings subsidy that replaces a fraction of the difference

[4] See Lalone (2007) for a similar scepticism concerning the cost-effectiveness of retraining programmes.

[5] See OECD(2005 b, chapter 1) for evidence on the large earnings losses experienced by displaced workers in the U.S. compared with those experience by their European counterparts.

between earnings on the old and new jobs. This reform would serve as an incentive to speedy re-employment as unemployment benefits or other early retirement options become less attractive relative to accepting a new job, potentially in growth sectors. Once re-employed, the employee would have an opportunity to benefit from on-the-job training which, in turn, could raise future career prospects.

Germany and the United States have recently introduced wage insurance programmes for certain older displaced workers. These initiatives – which are briefly described in Box A – are too recent to allow any firm conclusions to be drawn concerning their effectiveness in practice. Indeed, these types of schemes raise a number of complex issues related to design details and possible distortions that have yet to receive careful scrutiny. In particular, it will be important to clarify whether subsiding re-employment at low wages could tend to blunt incentives for displaced workers to search for good job matches or to invest in on-the-job training in their new job. Similarly, the relatively high levels of labour turnover and year-to-year earnings variability in the labour force suggest that eligibility for wage insurance needs to be tightly targeted on job changers for whom wage reductions are involuntary and are likely to have a significant impact on living standards. There is also the issue of how long should the earnings top-up last, i.e. should it be temporary (e.g. two years as under ATAA) or more permanent? Finally, there is the issue of how to pay for such a proposal. Lalonde (2007) estimates the cost of his wage insurance proposal in the U.S. at $3-4 billion a year and outlines alternative ways of financing this cost ranging from slightly higher payroll taxes to reorienting existing public spending on ALMPs.

Box A. Two examples of wage insurance for older workers

Germany instituted a programme of wage insurance in 2003 (*Entgeltsicherung fûr âltere Arbeitnehmer*) which is limited to job losers aged 50 years and older. Workers becoming re-employed in a new job paying less than their previous jobs are eligible for two types of earnings supplements. First, a payment of 50% of the earnings gap between the prior and new jobs is offered. Second, pension contributions on the new job are supplemented up to 90% of the level on the prior job. One notable aspect of this scheme is that no time limit is placed on these earnings supplements.

A wage insurance scheme for older trade-displaced workers was recently introduced in the United States. Since August 2003, workers at least 50 years of age who are certified as being trade-displaced workers and meeting all of the eligibility criteria for the Trade Adjustment Assistance programme may choose Alternative Trade Adjustment Assistance (ATAA) instead. This programme offers a wage subsidy to workers who start a new full-time job within 26 weeks of separation and who are paid wages below those on the previous job. Provided that the worker does not earn more than USD 50 000 per year in the new employment, a payment of 50% of the difference between the new salary and the old salary is paid, up to a maximum of USD 10 000 over two years. This subsidy is available for a maximum period of two years following the layoff. ATAA also includes the possibility of retaining health care benefits for older trade-displaced workers which, is in theory, a major additional incentive to find a new job.

Conclusion

Reforms to encourage older Americans to continue working will have to cover several domains if they are to be successful. In this paper, I have chosen to focus on two policy innovations – linking pensions to life expectancy and wage insurance for the older unemployed -- which could help achieve this goal. Other areas which would need to be tackled include changing employer practices towards the hiring and retention of older workers, especially in small and medium-sized enterprises, and encouraging mid-career and older workers to invest more in upgrading their skills and competences. But there should be no grounds for pessimism. The trend towards earlier retirement has been halted in most OECD countries over the past two decades thanks, in part, to the political will to introduce reforms along the lines advocated here.

References

Lalonde, R.J. (2007), *The Case for Wage Insurance*, CSR No. 30, Council on Foreign Relations, New York, September.

OECD (2005a), *Ageing and Employment Policies: United States*, Paris.

OECD (2005b), *Employment Outlook*, Paris.

OECD (2006), *Live Longer, Work Longer,* Paris.

OECD (2007), *Pensions at a Glance: Public Policies in OECD Countries,* Paris.

Whitehouse, E.R. (2007), “Life-expectancy risk and pensions: who bears the burden?” Social, Employment and Migration Working Paper no. 55, OECD, Paris.