How to sustain our European economic and social model in a context of an ageing population?[*][♦]

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Official projections (Eurostat 2009) maintain that in the next forty years European population will moderately decrease and become considerably older: while the large baby boomer cohorts approach retirement, fertility rates will remain largely below their natural replacement rate and longevity will continue to improve, triggering a major increase in the old age dependency ratios. This demographic scenario calls for structural reforms in the welfare systems as well as in the labour and financial markets in order to increase participation rates (of both the elderly and women) and to promote investment in human capital and technological progress, so as to offset the expected negative impact on growth caused by the rising needs of an increasingly elderly population. Indeed, this reform process started in the Nineties and is still in progress.

While many issues are involved, the following stand out as crucial:

i. work prospects for the elderly;
ii. education and training programs to enhance their employability, as well as their capacity to participate, when retired, in socially productive activities;
iii. women's financial security;
iv. adequacy of provisions for retirement income, including long term care.

Although these issues extend far beyond pension systems, these account for the largest share in social protection expenditure, and their reform has occupied and will continue to occupy a very important place in policy agenda. Provisions for retirement are thus the main perspective around which the following observations are organized.

i. *Extending working life*. Increasing the elderly employment rate and the average retirement age is perhaps the most effective way to prevent old age poverty and to promote the adequacy of pension systems, without jeopardizing financial sustainability. It should thus represent the natural response to population ageing. On the contrary, pension provisions in Western Europe effectively encouraged early retirement, through lenient eligibility requirements and pervasive distortions in the pension formulae. This trend was reversed only in the last decade of the XX Century, when demographic pressures forced governments to introduce reforms.

These set out to correct the myopic but widely held '*lump of labor fallacy*' (conducive to '*work less, work all*' kind of policies) and to reduce the implicit tax on the continuation of work embedded in the generous earning-based pension formulae. Both endeavors appear essential to strengthen older workers' willingness to work, while granting them a greater freedom as to the age of withdrawal. *Flexible retirement* (not to

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be confused with the pre-reform early retirement provisions) requires an *age-related incentive structure*. Research has demonstrated that workers respond to financial incentives: if they are taxed, they leave as soon as possible; if they are rewarded for staying longer in their job, they stay (provided other factors, such as health or family considerations, do not prevent them from doing so).

This is the main rationale at the basis of the stronger correlation that has been established between contributions and benefits in the determination of pension benefits, largely coincident with the passage from earnings-based (or Defined Benefits, DB) to contribution-based (or Defined Contribution, DC) pension formulae.

In this more neutral scenario, a *minimum age*, usually complemented with an income eligibility test, is typically established in order to prevent people from making short-sighted decisions and to prevent the growing of future claims on public transfers. Beyond the minimum and up to a maximum age, an actuarial mechanism often links pension benefits to life expectancy. In some cases, an automatic adjustment of the minimum age with respect to increases in life expectancy is included, so as to ensure the financial equilibrium of the system and a more balanced allocation of the demographic risk across generations. To encourage forms of *gradual* retirement, provisions also increasingly separate the actual cashing of the pension benefit from effective withdrawal from the labor force.

These changes, implemented with diverse speed and features in the different European Countries, put the correct management of demographic and economic risks at the heart of pension systems and reduce the scope for discretionary political interventions, responsible in the past for distortion, undue redistribution, and burdens to future generations.

ii. Education, training, and compensation. If a comprehensive array of measures have been set up, on the supply side, to ensure that workers will be induced to stay longer in their employment, the weaker part is still how to induce firms to keep their elderly labor force, i.e the demand side.

Empirical evidence suggests that age discrimination practices are still persistent and that firms are doing little to adapt to the drastic change in the age composition of their workforce; direct surveys of firms' attitudes show negative stereotypes of older workers, particularly with respect to their capacity to adapt to new technologies or organizational models. Empirical evidence, on the other end, suggest a positive correlation between the educational levels of the elderly and their participation in the labor market; it also suggest that the health individuals with less human capital deteriorate faster with respect to individuals with more human capital.

Targeted education and (on the job) training programs to enhance workers' employability and productivity and more flexible working arrangements that better suit older workers and slow down their withdrawal from the labor force (*gradual* retirement) will thus be very important. The effectiveness of these programs depends on how long older workers will stay employed, implying a trade off with early retirement provisions or pre-retirement schemes that simply transfer money to laid off workers.

Other aspects of the labor market will have to be redesigned. For example, seniority-based earning schemes may contribute to a mismatch between compensation and workers' productivity and have extensive undesirable consequences. More generally, *labor market rigidities* tend to create suboptimal age-based coalition of interests. In flexible labor markets, wages track productivity: they typically increase up to middle age and then fall as workers approach retirement. Firms have no particular incentive to prefer younger to older workers and employees tend to work longer, because their labor demand is stable over time; there is no need for unemployment rates to differ across age classes. Conversely, in more rigid labor markets, wage and productivity tend to be less correlated to workers' age; older workers cost too much and generous early retirement rules represent an escape for both firms, which prefer to hire the young, and older workers, who prefer leisure to work. These arrangements have detrimental consequences: apart from redistribution of resources from future to current generations and from high to low skilled workers, they favor under-investment in education, as people invest when the expected benefits make up for the lost earnings.

If more flexible job markets are consistent with higher employment of the elderly, they need of course to rely on adequate provisions for temporary layoffs and spells of unemployment.

iv. *Women's pensions.* Women's position is passing from a model of paternalistic welfare, based on the combination of both state and family support – perhaps generous in terms of results, but not so in terms of opportunities – to a new one, where they will enjoy more independence but face greater risks. Women will probably suffer most from reforms, because the pension system restructuring is being implemented before the necessary changes (meaning *equalization of opportunities*) are realized in the labor market, and at a time when women's economic wellbeing in retirement is still very much dependent on their role as *spouses* (i.e. on their being a *dependent* member within the family). Most women of the older generations have worked less than men in the job market; have been paid lower earnings and have had more interruptions in their working careers, also because of care activities directed at both children and elderly parents. Although things are changing for the younger generations, calculating pensions on a strict contributory/actuarial basis will certainly reduce benefits. At the same time, and this is particularly valid for the young, the breakdown of the traditional family structure will require social safety nets in place of the customary solidarity within the family, but these are at odds with the predominant "insurance" role that reforms are increasingly assigning to public pensions.

Whether the new situation, apart from being more "modern", will prove more equitable to women and will reduce their dependence on family/state support greatly depends on how labor market participation and earnings will evolve in the future and on the possibility to realize a more balanced division of tasks within the family. Even though gender disparities are clearly more rooted in culture/tradition rather than in cognitive and working abilities, they have key implications for retirement wellbeing and take time to be corrected.

iv. *Adequacy of provisions*. Having enacted reforms that, in order to restore financial sustainability and reduce distortions, have cut public benefits and made retirement income more uncertain and more "self-made", policymakers need to concern themselves that other income sources will provide adequate supplements and that households will not be left with excessive risks.

Indeed, the *multi-pillars approach* is being implemented in most European countries not only as a compensation for the reduced replacement rates offered by the first pillar, but also as a better *risk sharing device*, with public pensions (and other benefits for the elderly, such as minimum pensions and survivor benefits) subject to different risks with respect to those relevant for occupational pensions and voluntary household savings. To be effective, and thus provide satisfactory old age income security in a less "paternalistic" environment, this diversification entails that workers participate in pension plans and engage in personal savings. Partly in recognition of their social importance, private pensions are not allowed to operate on a strictly *laissez faire* basis, but are typically subject to various measures of public regulation and supervision, and are also sometimes partially backed by public guarantees.

This evolution prompts important questions: are individuals prepared (preparing) for this? How can they be helped to take appropriate decisions concerning both the age of retirement and the accumulation/investment of personal savings? Empirical evidence point to widespread "inadequate" behaviour with "anomalies" such as overconfidence, lack of self-control, mental accounting, dynamically inconsistent time preferences and so on. Also, financial illiteracy is becoming a very relevant issue: people seem to lack the basic notions concerning savings and risk management and the problem seems to be particularly acute among specific demographic groups (women, low educated). Financial education programs should thus be implemented to improve the tradeoff between individual freedom and responsibility, on the one hand, and state (or firm) paternalism, on the other.

A special risks that needs to be tackled is long term care, the demand for which will inevitably increase with ageing, and it is not clear what will be the appropriate model for financing and organize the supply of care, and what the respective role of families and public provisions should be.

As a concluding note, a distinctive element of pension reform in the EU is a tension between the role of individual countries and EU-wide policies and institutions. Even though the need to increase the role played by funded pensions is driven by EU-wide economic and demographic forces, individual countries have had the autonomy to pursue reforms based on specific national circumstances, without direct influence from the European Union. At the same time, maintaining and/or creating a strongly funded second pension pillar is an important element in a broader EU policy agenda of fostering capital and labor mobility.