Living Older and Stronger: Need to Work Longer

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Asia's Dependency Transition: Intergenerational Transfers, Economic Growth, and Public Policy

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1

The Issue

- Persons are living longer and disability is declining in many countries. This is a great achievement. So what is the problem?

2

The problem

- Declining birth rates and fewer young people, together with longer lives, means that the proportion of old to young is increasing.
  - As the number of older persons increases, health care costs will rise
    - Not only because of the increase in the number of older people
    - But also because advancing technology will create better and likely more expensive health care treatments

3

The problem-continued

- And the cost of public pension (social security) programs will increase.
- But there are fewer persons in the labor force to pay increasing social security and health care costs. <u>This is the problem</u>.

4

What to do?

- Social and economic choices in societies must adjust as the age structure of the population changes. What adjustments might be made as the population ages?
  - One answer is to take advantage of the gains that have been achieved in longevity to increase the labor force participation of older workers.
  - This would increase the workforce and reduce the number of retirees that those in the workforce must support.
  - But in fact, however, the labor force participation of older persons has been declining, making if more difficult for those who are working to support those who are retired.

5

Living longer, retiring younger

- In the U.S., for example, the number of years in retirement increased from about 13 years in 1965 to over 18 years in 2003.
- In other industrialized countries, the trend is more extreme—two trends: (1) the percent increase in the life expectancy of men **at 65** since 1960 and (2) the percent reduction in the labor force participation of men 60 to 64 in industrialized countries

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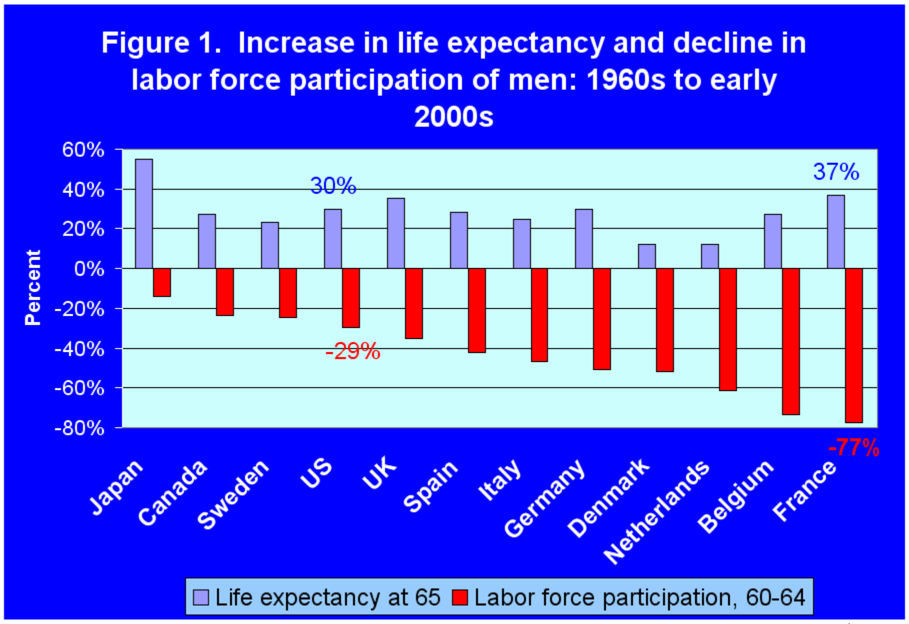

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Need to reverse trend

- The decline in labor force participation <u>will have to be reversed</u> to reduce the burden on the young that increasing social security and health care costs would otherwise impose.
- That is, some of the <u>bounty of longer lives</u> will have to be allocated to prolonging the labor force participation of older workers.
- It will <u>not be feasible</u> to use all of the increase in longevity to increase years in retirement

8

Put another way

- Or, to pay for rising social security and health care costs people will have to stay in the labor force longer.
  - The increase in the labor force will increase the production of societies
  - The increase in production will increase tax revenues
  - The increase in tax revenues will increase the funds available for social security and health care programs
  - More individual saving in some countries—e.g. U.S.

9

More on four issues

- Living longer and healthier
- Working less
- Health care cost likely to continue to rise
- Social security provisions must be adopted to accommodate the need to work longer

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Living longer and healthier

But large disability roles in many countries

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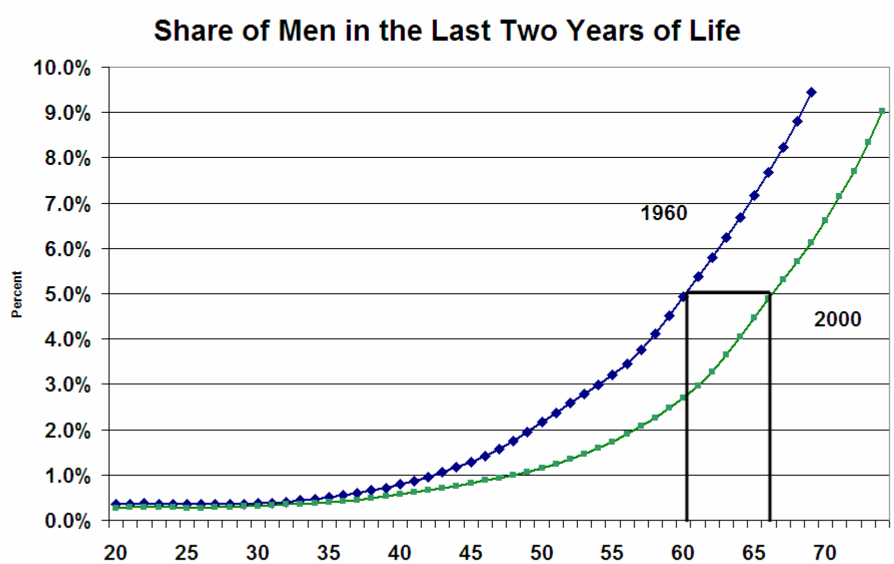

Source: Cutler and Liebman (2006) Life tables from the National Center for Health Statistics.

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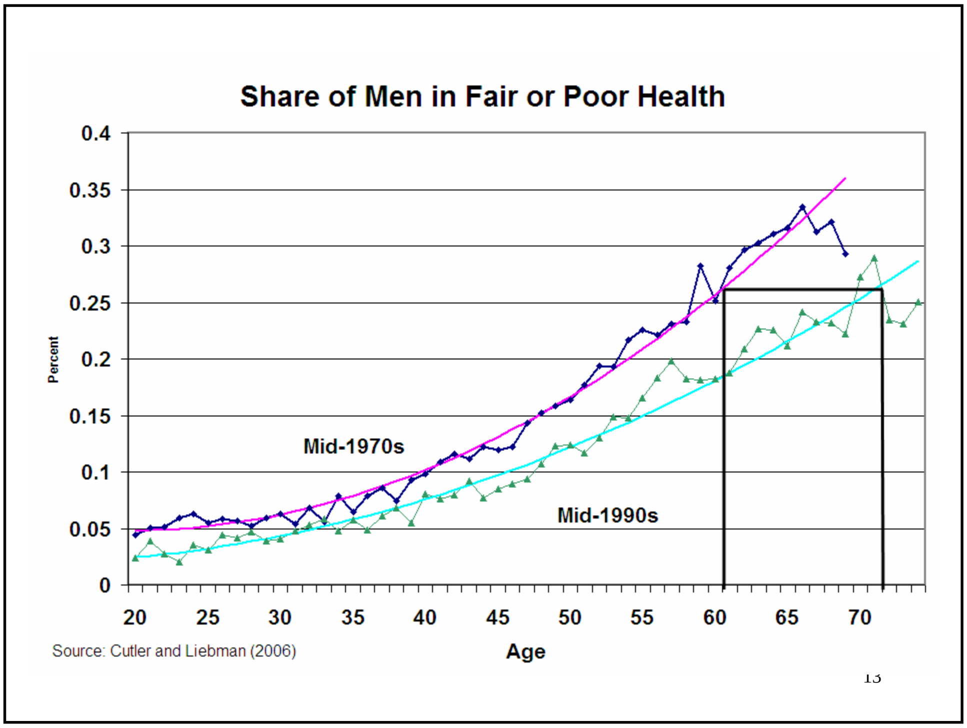
Share of Men in Fair or Poor Health
Percent
Mid-1970s
Mid-1990s
Age
Source: Cutler and Liebman (2006)
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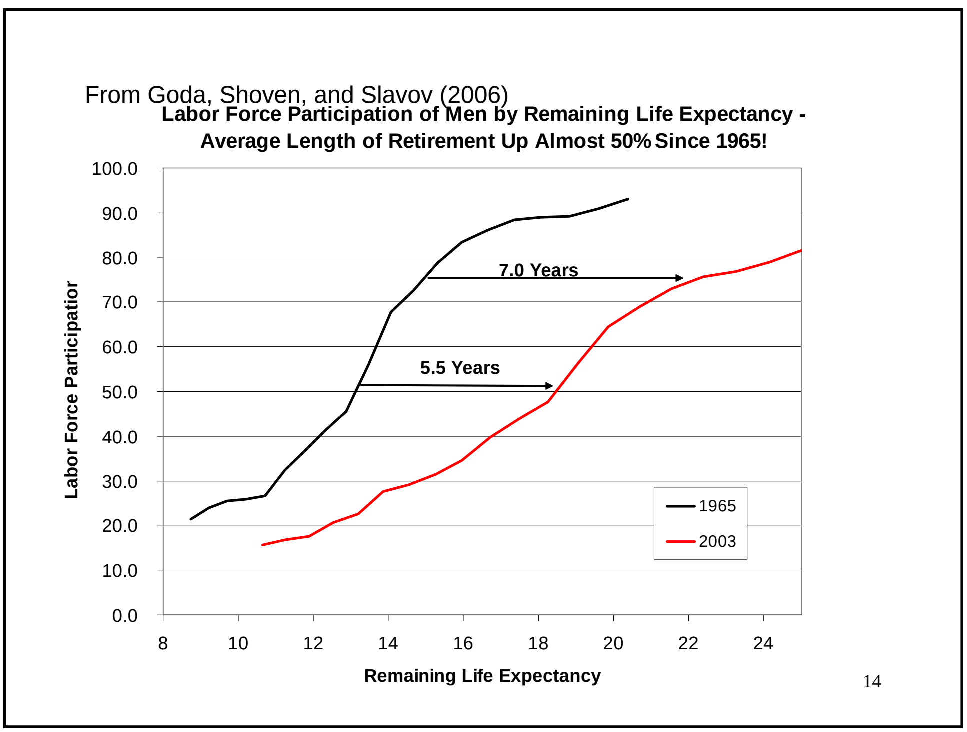
From Goda, Shoven, and Slavov (2006)
Labor Force Participation of Men by Remaining Life Expectancy -
Average Length of Retirement Up Almost 50% Since 1965!
Labor Force Participatior
7.0 Years
5.5 Years
1965
2003
Remaining Life Expectancy
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Large disability roles in some countries

- Collecting DI benefits, not "disabled"
- Determined by program provisions (return to)

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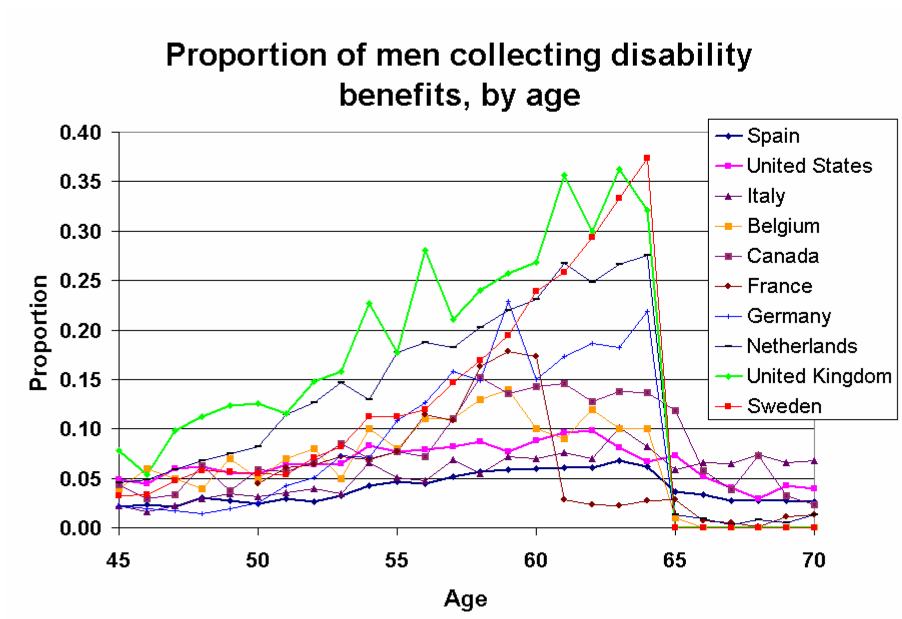

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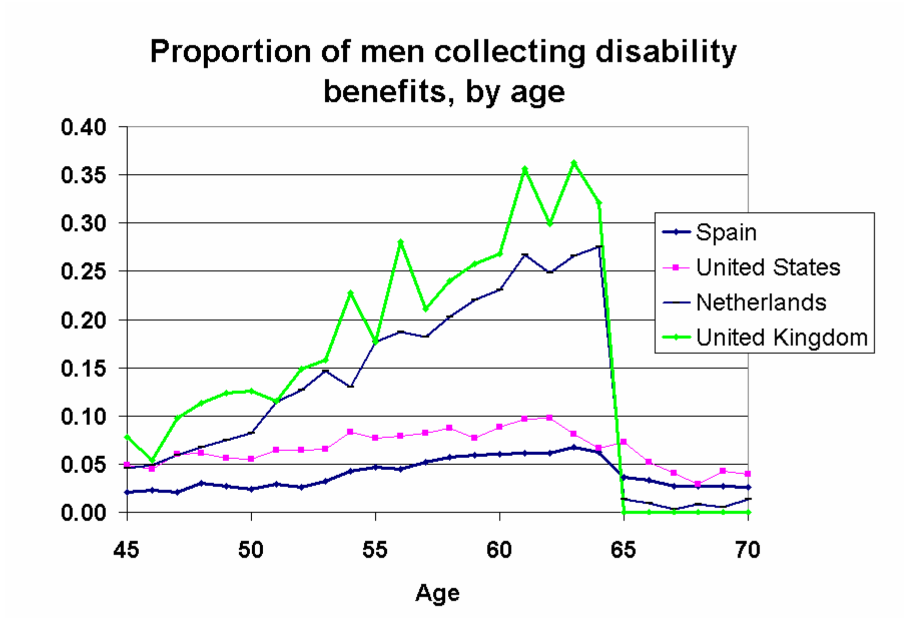

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Working less

Decline over time

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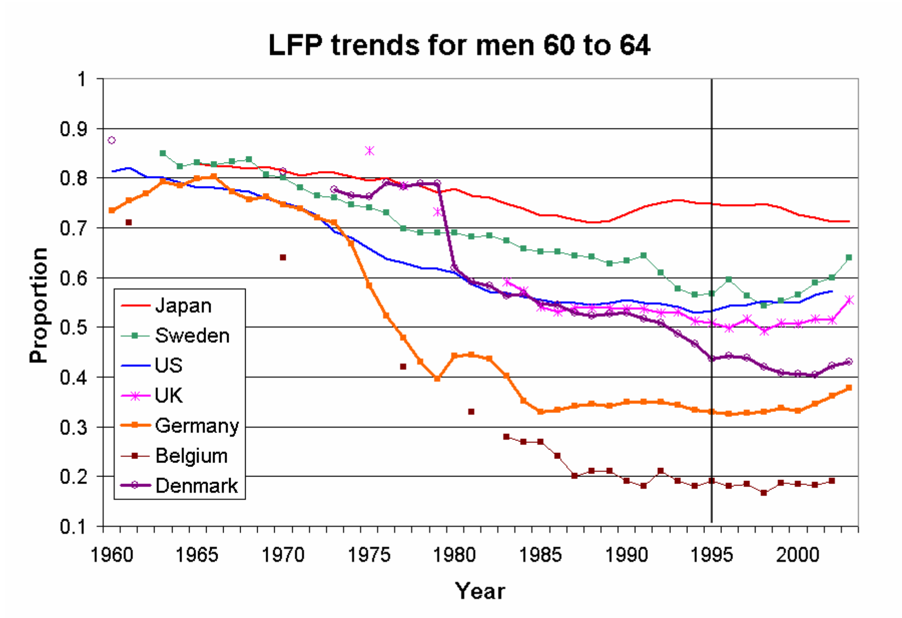
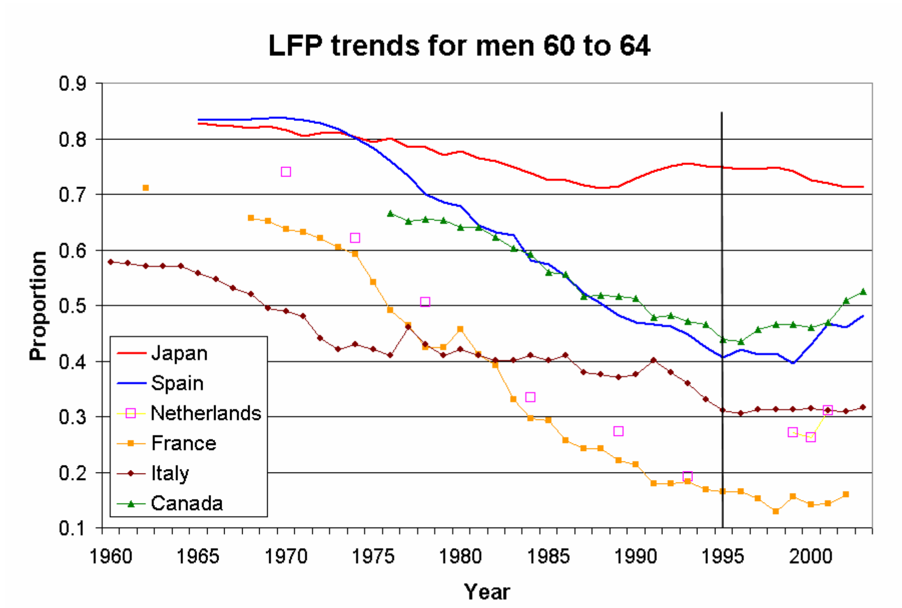

LFP trends for men 60 to 64
Proportion
Year
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
1960
1965
1970
1975
1980
1985
1990
1995
2000
Japan
Sweden
US
UK
Germany
Belgium
Denmark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0.4
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0.2
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1960
1965
1970
1975
1980
1985
1990
1995
2000
Japan
Spain
Netherlands
France
Italy
Canada

Health care costs will continue to rise

The role of technology

21

Increasing cost at given age

- More older persons means more care, but the bulk of cost increases come from greater expenditure over time for persons of the same age.
- In the United States, health care costs for persons of a given age—70, or 75, or 80--are growing rapidly.
- The increase in cost at a given age is the most important reason for cost increases.
- It is largely due to improving medical technology

22

Technology costs more

- Will improve health care in the future.
- Like computers that do more per dollar of cost, medical care will also do more per dollar of cost.
- Even persons spending their own money would be willing to allocate more to health care because they get more for their money.

23

But health care differs from computation

- Unlike computers individuals don't pay their own money for a given episode of health care.
- Care is paid for through public or private insurance.
- Even countries who limit health care expenditures through restrictions on supply, will, I believe, face increasing pressure to provide more care at higher cost.

24

The key issue

- Thus the key issue, I believe, is not population aging or longevity, but how to prepare for spending more on health care.

25

"Good" and "bad" money

- Government programs need to provide health care
- But policies must also be designed to control cost
- "Good money" is money that people would spend on health care even if they were spending their own money—because, like computers, a dollar for health care buys more than it used to.

26

“Bad money”

- But advanced technology is likely to be used more than it should be.
- When people buy computers they are paying with their own money and they won’t pay unless what the computer does for them is worth the cost of the computer.
- But this is not typically true for health care.

27

- Most health care is provided on a “first-dollar” basis.
- When care is provided, the cost to the recipient is zero.
- A person will accept the care as long as it does more good than harm—it is worth more than zero.
- Unlike computers, the worth of the care to the recipient does not have to be worth the actual cost of the care.
- Thus a lot of “bad money” can be spent on health care.

28

Hard to provide care efficiently

- Medical systems, unlike the market for computers, don’t have good ways to provide care “efficiently.”

29

A test for the success of future health care systems is this:

- How does the system accommodate better technology, the increased demand for health care because it is better than it used to be?
- What reimbursement rules encourage high-tech procedures when they are effective and discourage their use when they are not?
- Or, what changes in health care system provisions would create a more “efficient” system?

30

The Challenge

- To the extent this can be done, health care systems will be successful in addressing one of the most important social issues that will face most countries.

31

Social security provisions must be adopted to facilitate the need to work longer

The changes that are needed

32

Change provisions

- To accommodate the need for longer labor force participation, care must be taken in adopting the provisions of social security systems
  - The social security systems in most developed countries are now not sustainable
  - The provisions of the systems themselves have contributed to their financial woes by penalizing work and encouraging early retirement

33

Cross-country comparison

- To understand the importance of social security provisions, we can learn from comparisons across countries—Gruber-Wise project
- Provisions in many developed countries penalize work and provide a strong incentive to retire early
- It is important that social security systems eliminate incentives to retire early

34

The social security problem

- Under pay-as-you-go systems governments around the world have made promises they can't keep
- Systems are not sustainable
- Why?
  - Population aging
  - Persons living longer
  - Retiring younger

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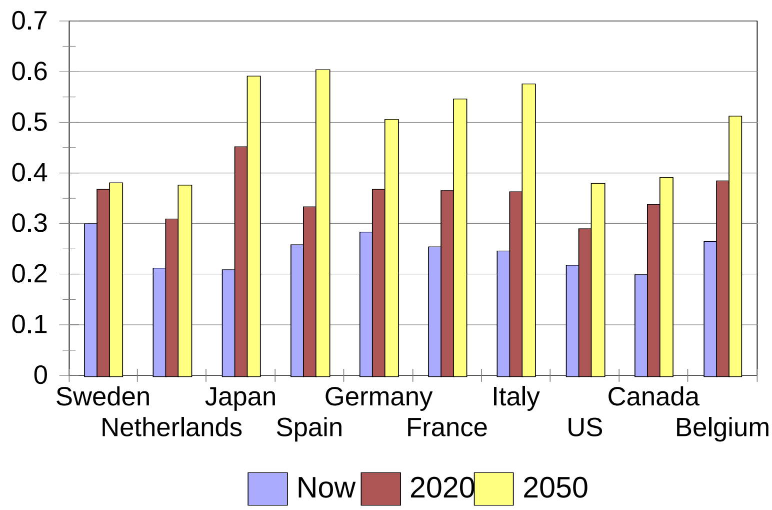
Figure 1. Population 65+ to 20-64



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Why retiring younger?

- Social security provisions themselves induce departure from the labor force
- Further increasing the ratio of retirees to labor force participants who pay for benefits
- Magnifies the financial pressure caused by population aging and longevity

37

Social Security and LFP

- Social Security provisions often penalize work —tax on work
  - If work another year, is the increase in benefits enough to offset receipt of benefits for 1 fewer years? (Actuarial adjustment)
- Strong relationship between tax on work and % of older workers out of the labor force

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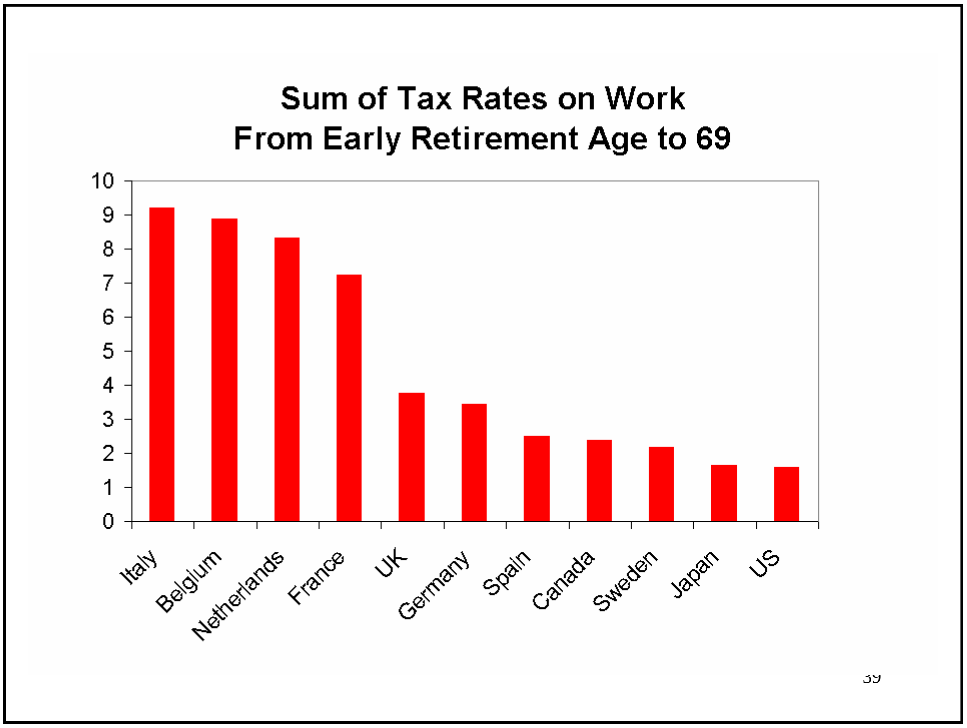
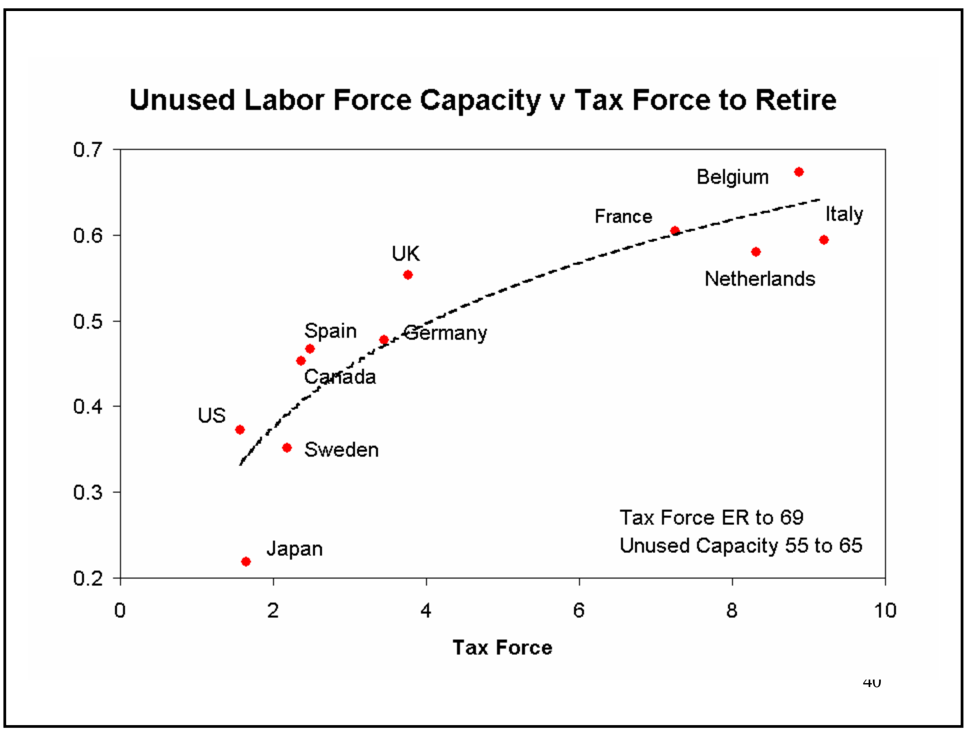

Sum of Tax Rates on Work
From Early Retirement Age to 69
10
9
8
7
6
5
4
3
2
1
0
Italy
Belgium
Netherlands
France
UK
Germany
Spain
Canada
Sweden
Japan
US
39


Unused Labor Force Capacity v Tax Force to Retire
0.7
0.6
0.5
0.4
0.3
0.2
0
2
4
6
8
10
Tax Force
Belgium
France
Italy
UK
Netherlands
Spain
Germany
Canada
US
Sweden
Japan
Tax Force ER to 69
Unused Capacity 55 to 65
40

Social Security and LFP

- Two social security provisions matter most
  - Age of first eligibility
  - "Actuarial adjustment"—reduce benefits if retire early
- Must also include disability programs and special unemployment programs

41

Changing Provisions and LFP

- For illustration, consider:
- **Three-year increment in eligibility ages:** Increase all eligibility ages by three years, including the early retirement age, the normal retirement age, and the ages of receipt of disability

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Changing Provisions and LFP

- **Actuarially fair:** reduce benefits actuarially if taken before the normal retirement age and increases benefits actuarially if taken after the normal retirement age.

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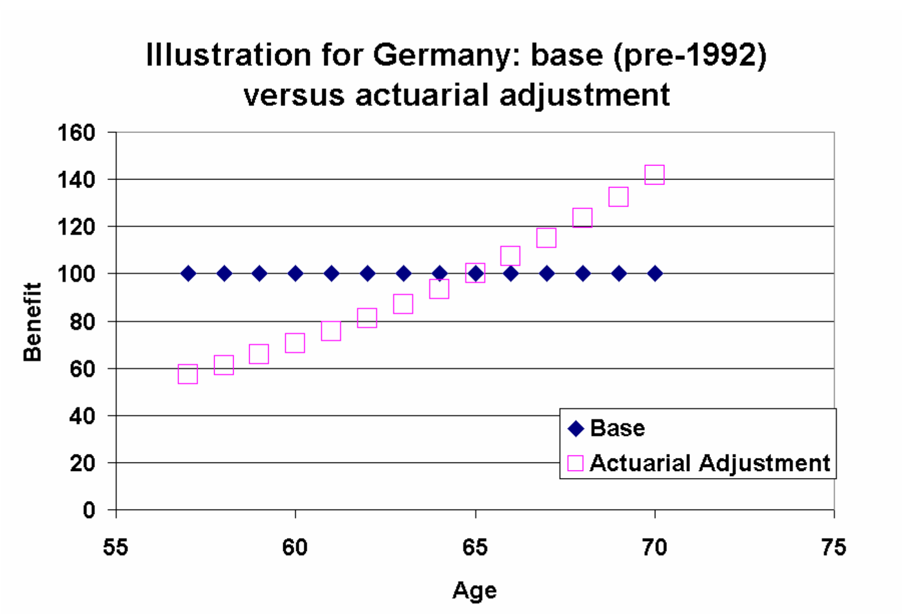

44

Changing Provisions and LFP

- **Common reform:** the same reform in each country:
  - the ERA is 60; the NRA is 65
  - benefits taken before age 65 are reduced "actuarially" by 6% each year and increased by 6% each year if taken after 65
  - replacement rate at age 65 is 60 % of age 60 earnings.

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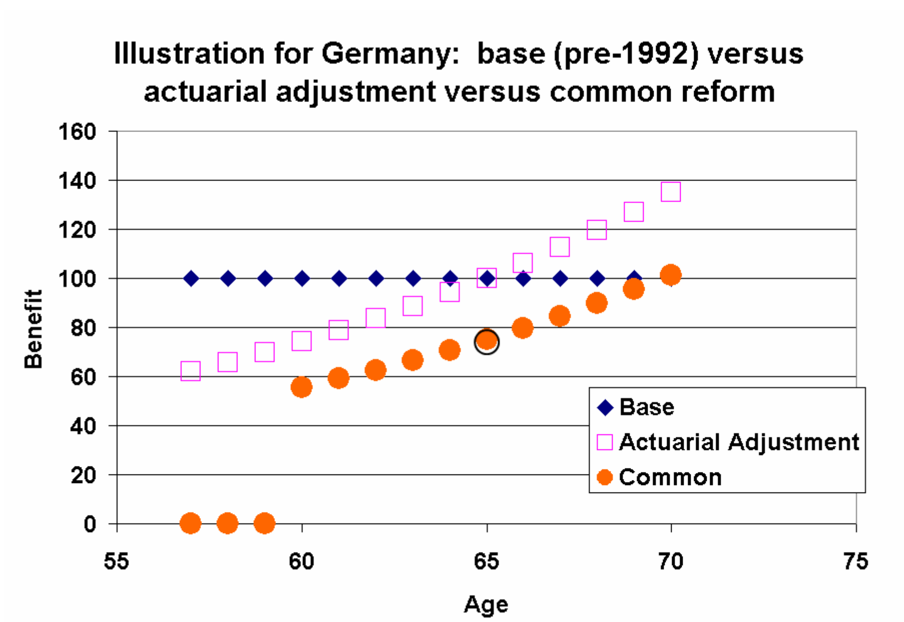

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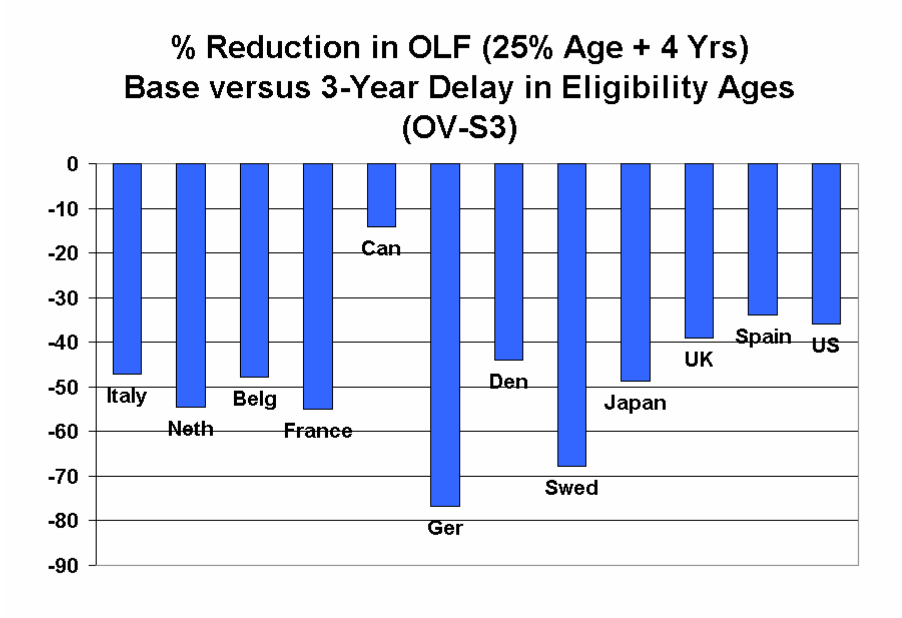

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Large Fiscal Implications of Reform

- 3-Year increment in eligibility ages
- Actuarial adjustment
- Common reform

- Consider: (decrease in government benefit payments) – (increase in tax revenues)

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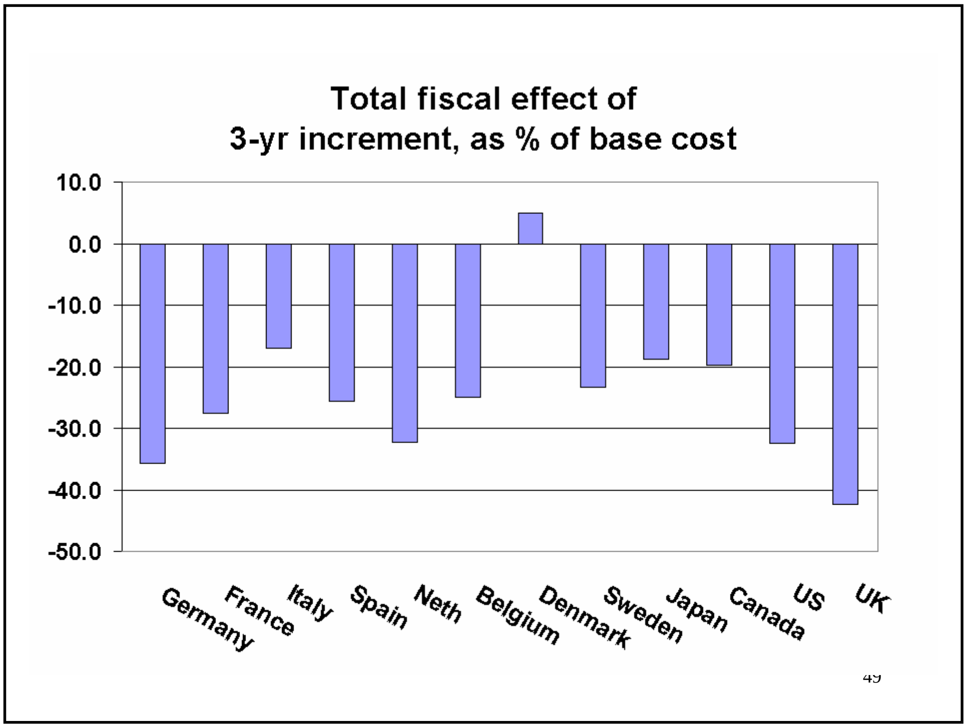
Total fiscal effect of
3-yr increment, as % of base cost
10.0
0.0
-10.0
-20.0
-30.0
-40.0
-50.0
Germany
France
Italy
Spain
Neth
Belgium
Denmark
Sweden
Japan
Canada
US
UK
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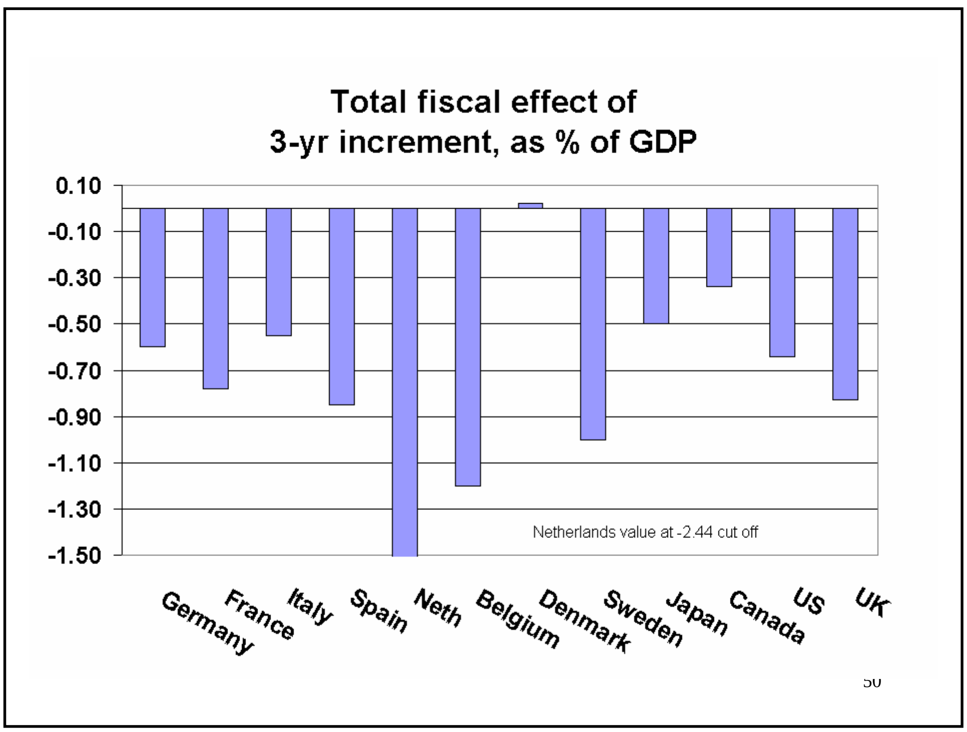
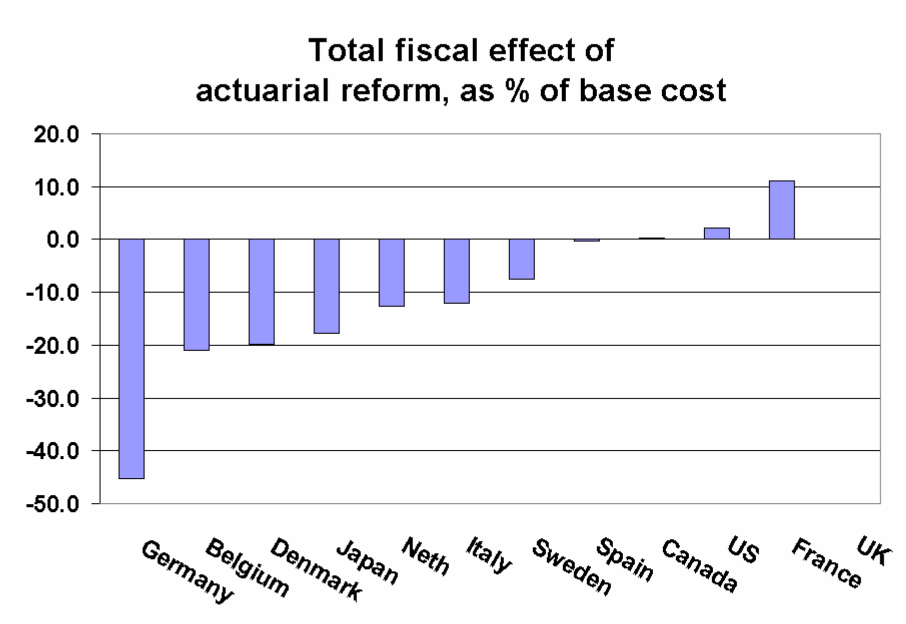
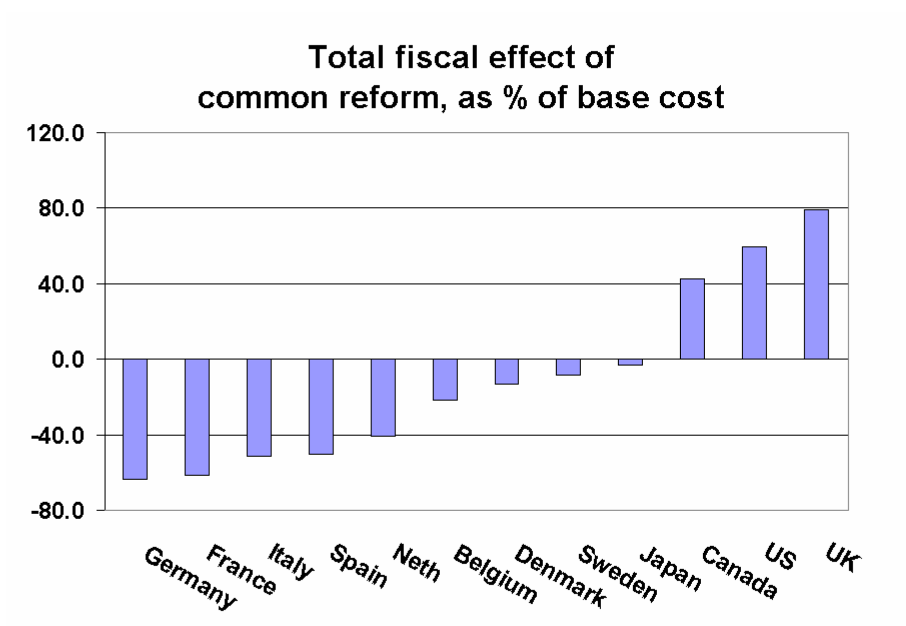

Total fiscal effect of
3-yr increment, as % of GDP
0.10
-0.10
-0.30
-0.50
-0.70
-0.90
-1.10
-1.30
-1.50
Netherlands value at -2.44 cut off
Germany
France
Italy
Spain
Neth
Belgium
Denmark
Sweden
Japan
Canada
US
UK
50


Total fiscal effect of
actuarial reform, as % of base cost
20.0
10.0
0.0
-10.0
-20.0
-30.0
-40.0
-50.0
Germany
Belgium
Denmark
Japan
Neth
Italy
Sweden
Spain
Canada
US
France
UK


Total fiscal effect of
common reform, as % of base cost
120.0
80.0
40.0
0.0
-40.0
-80.0
Germany
France
Italy
Spain
Neth
Belgium
Denmark
Sweden
Japan
Canada
US
UK

LFP Increases Since 1995

- The reversal can be traced to changes in social security provisions in many countries

53

Taking stock

- LFP and social security provisions strongly related—eligibility age and tax on work
- Changing provisions would increase LFP
- Increases in LFP would have large fiscal effects
- Allocating some of longer and healthier lives to labor force participation will depend on changes in provisions of social security systems

54

LFP of old and employment of the young

- Will retiring the old employ the young?
- For sure will increase the cost of social security.
- Means higher taxes on the young
- Likely increase labor costs and may reduce demand for young workers
- Can't make work for the young by raising the costs of social security
- Economies grow, they are not "boxed"

55

Personal accounts and retirement

- In the US about 85% of contributions to private pensions plans are now to personal accounts, not Defined Benefit plans
- Personal retirement accounts do not incorporate the early retirement incentives of DB plans
- Persons will work longer and save more

56

Working longer and saving more

- I conclude:
- In all countries people will have to work longer to pay for “social security” and increasing health care costs
- Working longer means GDP will be greater and thus help to pay for more older people and greater health care costs

57

Facilitate working longer

- Assure that pension plan provisions don’t penalize work—with incentives to retire early

58

All countries

- This is <u>not just an issue for developed countries</u>
  - The issue will also arise in developing economies such as China
  - In adopting new social security systems care must be taken to assure that social security provisions do not penalize work at older ages

59

Problem for the young

- Rising health care and social security costs increases are primarily problems for the current young, not the current old.
- Rising cost means that the young will have to save more than would otherwise be possible.
- The young need to spend more on health care than their parents now spend, and save for their own retirement, and at the same time pay for the retirement of current retirees.

60

Guiding principle

- In my view, in adopting policies to address these problems, the guiding principle should be this: while repairing the financial imbalances caused by social security over-promises, and while preparing for greater health care expenditures that better medical technology will "require," what policies minimize the cost to the young?

Now

- Finally, it is <u>important that changes begin sooner</u> rather than later
  - This will help to avoid abrupt increases in taxes or declines in benefits.
  - If individuals must increase their own saving, it will be much easier if they can begin to increase saving long before retirement