

Early retirement

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Abstract

Generous early retirement provisions account for a large proportion of the drop in the labor force participation of elderly workers. The aim of this paper is to provide a positive theory of early retirement. We suggest that the political support for generous early retirement provisions relies on: (i) the existence of a significant group of elderly workers with incomplete working history, who are not entitled to an old age pension; and (ii) the intragenerational redistribution built in this provision via the utility from leisure that induces low-ability workers to retire early. The majority which supports early retirement in a bidimensional voting game is composed of elderly with incomplete working history and low-ability workers; social security is supported by retirees and low-ability workers.

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1. Introduction

Generous early retirement provisions are largely responsible for the dramatic drop in the labor force participation among middle-aged and elderly workers of the last thirty years (see Gruber and Wise, 1999; Blöndal and Scarpetta, 1998). The generosity of

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these provisions—measured by the implicit tax on continuing to work (Gruber and Wise, 1999) or by the replacement rate (Blöndal and Scarpetta, 1998)—has induced workers, in particular, low-educated ones, to retire early. Early retirement has thus complemented the aging process in increasing the ratio of retirees per worker—the dependency ratio. As argued in many studies (see Gruber and Wise, 1999; Blöndal and Scarpetta, 1998; Boldrin et al., 1999, among others), this phenomenon has rapidly become the crucial—endogenous—problem for the financial sustainability of the unfunded pension systems. Due to early retirement, in fact, fewer workers are required to finance the (generous) pensions of more retirees.

The aim of this paper is to provide a positive theory of early retirement. We propose a politico-economic explanation of the adoption of generous early retirement provisions. Why did a majority of voters, in most industrialized countries, decide to award large pensions to middle aged workers with incomplete working history? We suggest that the political support in favor of early retirement hinges on two crucial conditions. First, the appearance of a large group of redundant or unemployed elderly workers with incomplete working history, who are not entitled to an old-age pension. The introduction of early retirement awards them a pension transfer. Second, the existence in the early retirement provision of an element of intragenerational redistribution via the utility from leisure. In fact, while leisure is equally valued across ability types, the foregone labor income is lower for less productive types, who therefore find more convenient to retire early. This retirement behavior gives rise to an endogenous group of workers with incomplete working history, which guarantees the future constituency for this provision.¹

The main contribution of the paper is to demonstrate that under these two conditions, a social security system with early retirement arises and is sustained as a politico-economic equilibrium outcome of a dynamic majoritarian voting game. The voting majority which supports early retirement is composed of elderly with incomplete working history and low-ability young, who expect to retire early. The size of the social security system is determined by a voting majority of all retirees and low-ability young. Although several studies have analyzed the economic determinants of the early retirement decisions (see among others, Feldstein, 1974; Boskin and Hurd, 1978; Diamond and Mirrless, 1978; Lazear, 1979; Crawford and Lilien, 1981), to our knowledge this is the first attempt to provide a theoretical explanation of the introduction of (generous) early retirement provisions.

Our analysis is motivated by two observations. First, in most European countries, between 1961 and 1977, generous early pathways from the labor market were made available to redundant or unemployed elderly workers under a wide array of early retirement schemes. These included special pensions to unemployed elderly workers (in Austria, Finland, and Germany), special contracted pensions for redundant workers (in Austria, Belgium, France, and Germany) and disability benefits awarded on the basis of

¹ This result is closely related to the recent literature on policy persistence. As in Coate and Morris (1999) and in Hassler et al. (2001), in our politico-economic equilibrium, the introduction of a policy, i.e., the institution of early retirement, induces the (low-ability young) agents to undertake certain actions in order to benefit from this policy. These actions, namely the use of the early retirement provision, are crucial to create a new (endogenous) group of elderly with incomplete working history, and thus to guarantee the future sustainability of the policy.

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