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The macroeconomics of early retirement

J. Ignacio Conde-Ruiz[a,*], Vincenzo Galasso[b,c]

[a] FEDEA, Calle Jorge Juan 46, 28001 Madrid, Spain
[b] IGIER, Università Bocconi, Milan, Italy
[c] CEPR, London, UK

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Abstract

Early retirement was introduced after the appearance of redundant middle-aged workers, not entitled to pensions. This distortionary policy reduces human capital accumulation and economic growth, but shifts part of the tax burden on future generations. Why was it adopted? Alternative policies, which do not introduce long-term distortions, but impose a larger cost on the current generation of workers, were blocked by a coalition of high income workers, who did not plan to retire early, but sought to reduce the current tax burden, and low income workers, who expected to retire early and to benefit from the early retirement pension.
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1. Introduction

Since their adoption between the late 1960s and the 1970s, early retirement provisions[1] have been so widely used to become a distinctive feature of the social security system in all industrialized countries. Early retirement is not innocuous, tough. Gruber and Wise (1999, 2004); Blöndal and Scarpetta (1998) have shown that this provision is, in fact, responsible for the dramatic decrease of the labor force participation of the last few

* Corresponding author. Tel.: +34-91-435-9020; fax: +34-91-577-9575.
E-mail address: conde-ruiz@fedea.es (J.I. Conde-Ruiz).

[1] As Gruber and Wise (1999), we label as early retirement provision different pathways out of the labor market, such as disability pensions (e.g. in Denmark, Germany, the Netherlands and Norway) and unemployment benefits for the elderly (e.g. in Austria, Finland and Germany).

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decades among middle-aged workers[2]. In virtually all OECD countries, but Iceland and Japan, the average labor force participation of males aged between 60 and 64 has dropped by at least 25%. Two striking cases are the Netherlands, from 84.7% in 1960 to only 19.1% in 2000, and France, from 68.7% in 1960 to only 17.8% in 2000. Ahituv and Zeira (2000) have complemented this view by suggesting that, in the presence of technologic progress, workers with lower human capital, or with more technology-specific human capital, are induced to take advantage of this provision, and to retire early. In a demographic context of aging population, this retirement behavior contributes to increase the dependency ratio, and therefore, exacerbates the financial unbalance of the pay as you go (PAYG) social security systems. Furthermore, Herbertsson and Orszag (2001) have calculated that early retirement can be held responsible for a reduction in the order of 5–7% of potential annual GDP in OECD countries, with even higher figures for EU countries.

Early retirement provisions were initially introduced[3] in the late 1960s and the 1970s, after large shocks to the labor market, which led to the appearance of a mass of redundant middle-aged workers, who were not entitled to a pension transfer in their old-age. Early retirement awarded them a pension. In this paper, we provide a political economy explanation for the adoption of these distortionary early retirement provisions, rather than alternative non-distortionary policy measures. Early retirement introduces long-term distortions in the economy. In fact, the generous incentives to retire early induce workers to accumulate less human capital, hence reducing the growth rate of the economy. Alternative, non-distortionary policies could instead have been introduced to accommodate the labor market shocks.

We concentrate on one-time "bundled" policies, which award an old-age transfer to the elderly with incomplete working history, do not touch the entitlement of the elderly with complete working history, and may generate some income redistribution among the young. In our political environment, any feasible policy response to the negative labor market shock has to defeat the status quo—consisting of a simple unfounded social security system that provides an old-age pension only to those agents who contributed to the system in their youth—in a pairwise majoritarian voting game. All feasible policies are then evaluated in a pairwise voting game.

When we compare a feasible bundled policy to the early retirement provision, a clear trade-off emerges. Bundled policies do not create long-term distortions, but impose a large cost on the current young generation of workers—since they need to generate enough income redistribution among the young to be preferred to the status quo. Early retirement—on the other hand—has negative, long-lasting effects on the growth of the economy, but induces a lower tax burden on the current young, although the tax bill of all future workers increases. In a pairwise comparison, early retirement enjoys the support of a coalition of the extreme: high income workers, who do not plan to retire early, but sought

[2] Actuarially fair early retirement provisions were available in some countries already in the late 1950s. Their introduction has a simple economic explanation, since they were designed to provide an early pathway from the labor market to unhealthy people or workers in hazardous sectors. Notice, however, that they did not give an incentive to leave the labor force to every worker. Our analysis applies to generous—or non actuarially fair—early retirement provisions.

[3] See Conde-Ruiz and Galasso (2003a) for a descriptive analysis of the introduction of these provisions.

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