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Taxation of early retirement windows and delaying retirement: The French experience

P.J. Messe

GAINS-TEPP-PRES UNAM, Université du Maine, UFR Droit et Sciences, Economiques, Avenue Olivier Messiaen, 72085 Le Mans Cedex 9, France

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ABSTRACT

This paper investigates the effect of the 2003 French pension reform on hiring, firing and employment rates among older workers. This reform increased the mandatory retirement age and simultaneously it set a tax levied on early retirement windows paid by firms to their older workers, to encourage them to leave their job early. We use a matching model with endogenous job destruction extended to account for a mandatory retirement age and we calibrate the model with data drawn from the French Labor Force Surveys for the years 2002 and 2003. We show that in the case of a high tax rate, delaying retirement raises job separation rates, which partially offsets its positive effect on job finding rates. Consequently, the combination of an increase in the retirement age and a taxation on early retirement windows may have negative effects on the employment rate among older workers.

1. Introduction

Effective retirement ages had fallen significantly over the last 30 years in most OECD countries. This pattern may lead to fiscal sustainability problems, especially for countries with Pay-As-You Go pension schemes, in which pensions of retired individuals are financed through contributions of workers. The creation of early retirement schemes in the 1970s may be an explanation of the decline in employment among elderly people observed in Europe during the same period. Zaidmann et al. (2000) has shown that in France these schemes led to a consensus between older workers, firms and government. This phenomenon may be due to two main reasons. First, early retirement schemes were partly financed by the government so they could be treated by firms as a layoff subsidy (Hakola and Uusitalo, 2005; Hutchens, 1999). Second, the government encouraged early retirement to make more room for young workers in the labor market in a setting of high youth unemployment (Zaidmann et al., 2000).

Since the employment rate among workers aged more than 55 in France was in the early 2000s one of the lowest in the European Union (29.9% in France with respect to a European average of 37.8%[1]), the French government implemented important changes to constrain early retirement. These changes aimed simultaneously at restricting the access conditions to publicly subsidized early retirement schemes for workers and firms and at increasing the share of early retirement expenses charged to employers. However, in spite of the increase of early retirement costs for firms, employers continue to encourage their older workers to leave early their job, offering them generous financial incentives called “early retirement windows”.

We can discuss the motivations that lead employers to offer early retirement windows to their older workers rather than firing them. One potential explanation suggested by Amauger-Lattes and Desbarats (2006) is that the legislation regarding separations among older workers implies a cumbersome and often costly procedure for employers. Studying more than 300 court rulings of the Court of Cassation during the period 1994–2004 regarding job separations for older workers, they highlight that in most cases, employers strike a mutual agreement with their older workers, offering them generous early retirement windows and reporting a “dismissal for serious misconduct”, although it is not the case.

In the face of this widespread phenomenon, especially in the case of big firms, the French government set in 2003 a tax levied on the amount of early retirement windows paid by firms. The tax rate amounted to 23.85% in August 2003 and in August 2007 it raised to 50%. In addition, to deter firms from pushing their older workers into retirement too early, the 2003 reform also led to an increase in the mandatory retirement age. Initially, this age was 60, which means that when a worker reached 60 and if her insurance period was sufficient to allow her to draw a full pension, an employer could push her into retirement paying her a low retirement allowance. In 2003, this age has been increased to 65 and since 2008 it is 70.

The goal of this paper is to investigate the effect of the combination of these two reforms on the hiring rate, the job destruction rate and

E-mail address: pierre-jean.messe@univ-lemans.fr.

[1] Source: Eurostat.

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the employment rate among older workers. Let us first define what job destruction means in this paper. As we allow employers to offer early retirement windows to their older workers to encourage them to leave their job and to avoid a layoff, the definition of a separation (or job destruction) differs across the age group of workers. On the one hand, for middle-age workers, a separation results from a layoff and the employer has to pay to the worker a severance pay, as defined in the French Employment Protection Legislation. On the other hand, for older workers close to retirement, a separation has not the same nature. Indeed, for this age group of workers, job destruction means that the employer encourages a worker to leave her job, before she reaches the mandatory retirement age, offering her early retirement windows.

In this setting, the tax set in 2003 and levied on the amount of early retirement windows paid by firms is a sort of age-dependent employment protection, given that it concerns separations for one specific age group of workers. In this paper, we put forward the idea that in the case of a high tax rate on early retirement windows, delaying retirement may raise the separation rate among the group of workers concerned by the tax. We refer to this effect as the "impatience effect". The idea is the following: as shown in the previous literature on age-dependent employment protection, especially on the Contribution Delalande in the French case[2] (Behaghel, 2007; Behaghel et al., 2008; Chéron et al., 2007, 2008), a high tax rate deters employers from laying their older workers off after a shock, even though their filled jobs imply negative profits for firms. Indeed, as long as their firing cost exceeds the expected losses, employers prefer waiting until their older workers reach the mandatory retirement age. This is the well-known labor-hoarding effect of the tax. In this paper, we point out that in this setting, delaying retirement leads to an increase in expected losses incurred by firms, making them more impatient to get rid of their older workers. Consequently, an increase in the retirement age may encourage firms to offer generous early retirement windows to their older workers to force them to leave, rather than waiting until they reach the new mandatory retirement age.

Highlighting this so-called impatience effect, our paper gains new insights into the effect of an increase in the retirement age on job creation, job destruction and employment. The effect of an increase in the legal retirement age on employment among older workers has been already considered in the literature. Previous studies pointed out that delaying retirement may have a positive "horizon effect" on job creation, when labor is treated as a quasi-fixed factor that implies fixed costs (Oi, 1962). These costs result from either a bilateral monopoly problem (Hutchens, 1986) or from an accumulation of specific human capital through training (cf Hashimoto, 1981) and imply that firms are more reluctant to hire a worker close to the retirement age. Furthermore focussing on job destruction, Aubert et al. (2006) showed that there is an age-bias technological change, so employers are less likely to retain an older worker in the case of a shock on her job, if her employment duration is too short. Extending the model of Mortensen and Pissarides, (1994) in order to account for the life cycle of the worker with a bounded retirement age, Chéron et al. (2007) have drawn similar conclusions and argue that an increase in the retirement age may have a positive effect on hiring rates and may reduce firing rates by lengthening the employment duration of older workers.

In this respect, the impatience effect that we highlight in this paper may offset the horizon effect in the case of high age-dependent employment protection, leading therefore to a rise in separation rates among the age group concerned by the tax. While previous studies on age-dependent employment protection (Behaghel, 2007; Behaghel et al., 2008; Chéron et al., 2007, 2008) showed theoretically and empirically that an age-specific firing tax may have a strong negative effect on job creation among the protected age group and also that it may raise separation rates among the previous cohort of workers not concerned by the tax, these works did not pay any attention to the effect of delaying retirement on job creation, job destruction and employment in the case of a high age-specific separation cost.

In this paper, we determine a critical value of the rate of the tax on early retirement windows, above which the impatience effect is higher than the horizon effect. If the tax rate is higher than this critical value, an increase in the mandatory retirement age raises job destruction among older workers. In that case, the positive horizon effect of delaying retirement on job finding rates among the age group of workers concerned by the tax is attenuated. In addition, as an increase in the retirement age reduces transitions from unemployment to retirement, it exerts a negative effect on employment among older workers, if the horizon effect is not sufficiently strong. Consequently, the higher the tax rate on early retirement windows, the lower the horizon effect with respect to the impatience effect and the stronger the negative effect of postponing retirement on employment among the protected age group.

Calibrating our model using data drawn from the French Labor Force Survey for the years 2002–2003, we provide a numerical illustration of these findings. We show that the change in the job separation rate for older workers after an increase in the retirement age strongly depends on the tax rate. Consequently, the effect of delaying retirement on employment among the protected age group is sensitive to the level of taxation of early retirement windows.

The remainder of the paper is structured as follows. In the next section, using the data drawn from the French Labor Force Survey for the period 2001–2009, we provide a brief presentation of the patterns in job destruction rates among older workers between 2001 and 2009, investigating to what extent separation rates have been affected by the 2003 and 2008 reforms. Then, using data from the Survey on Health Ageing and Retirement in Europe (SHARE), we show the incidence of early retirement windows in the job destruction among older workers in France. In Section 3, we describe in detail the theoretical model, following the specification of Behaghel, (2007). In Section 4 we present our main theoretical findings on the effect of an increase in the mandatory retirement age on hiring rates and firing rates of middle-age and older workers in a setting of partial employment protection. In Section 5, we describe our quantitative analysis based on the French Labor Force Surveys for the years 2002 and 2003 and we present our results. Section 6 concludes.

2. Early retirement in France from 2001 to 2009

As mentioned in the Introduction, in France access conditions to publicly subsidize early retirement schemes have been severely restricted for workers and firms since the early 2000s. This policy has had two main effects: on the one hand, it has divided by 10 the number of yearly entries in such early retirement schemes. On the other hand, it has led to a sharp increase in the number of older unemployed without job-search requirements but who remain on unemployment benefits until they reach the retirement age (Merlier, 2010). As this so-called "unemployment tunnel" has been used by firms since the early 2000s as a new way to get rid of their older workers, unemployment spells can be treated as pre-retirement periods in the case of older workers. In addition, as stated by Amauger-Lattes and Desbarats (2006), separations result in most cases from a mutual agreement between older workers and employers, for which firms accept to pay early retirement windows to encourage their workers to benefit from the unemployment tunnel.

When investigating the effect of the 2003 reform on separation rates among older workers, we would expect that setting a tax on early retirement windows paid by firms would reduce separations,

[2] The Contribution Delalande is a tax paid by firms who fire workers aged more than 50.