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STRENGTHENING GROWTH AND PUBLIC FINANCES IN AN ERA OF DEMOGRAPHIC CHANGE

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The challenge

1. Most OECD countries are or will soon be strongly affected by population ageing. If current retirement patterns continue, ageing will weaken growth as labour forces increase more slowly and, in most countries, eventually decline. Furthermore, the transfer of resources (whether through public or private pensions, family support, public health-care spending, etc.) from those in work to the retired population will increase. In countries with public sector pay-as-you-go pension schemes, this could put pressure to increase taxes. If this were to occur, a spiral could develop whereby higher taxes would tend to reduce employment levels, hours worked and, hence, growth. This spiral could be exacerbated by rising expenditures on public health and long-term care and the taxes needed to support them.

2. Against this background, it is crucial that OECD economies tackle the challenge of ageing. Bold reforms are needed to prevent ageing from undermining long-term growth and the sustainability of public finances. The right policy responses will enable us to benefit fully from the major achievement of people living longer and healthier lives.

Responding to the challenge

3. There are no easy solutions to this challenge. Technological progress is a major driver of growth through gains in productivity. But public policies are poorly suited to fine-tune technological progress. Moreover, if pensions and other transfers from the working population to people outside the labour force rise in line with real wages, productivity gains will not reduce the burden of these transfers.

4. Immigration is sometimes cited as a solution for ageing populations. Indeed, in the short term, an increased number of young immigrants without dependants can boost the proportion of the workforce in the population. Ideally, these young immigrants should be well-educated and integrate relatively easily into the host society. But it is difficult to attract immigrants so selectively and, of course, even young immigrants eventually grow old and will need to be supported by those at work.

5. Reductions in public debt bring down future interest payments and thereby increase the budgetary capacity to accommodate ageing-related spending pressures. But the recent deterioration in public budgets in a number of OECD countries illustrates that sustained policy discipline is needed to reduce public debt to prepare for ageing.

6. Hence, most countries are faced with hard choices. People spend a smaller part of their lives working, largely because institutions and policies have not been adapted to increasing longevity. Statutory retirement ages and strong incentives in public pension schemes discourage working beyond 60 or 65, even though people may expect to live for 20 years or more afterwards. In addition, disability and unemployment benefit systems, and dedicated early retirement schemes continue to give healthy and work-ready persons strong incentives to retire well before they qualify for an old-age pension. OECD research suggests that if incentives for retirement were neutralised, labour-force participation of persons in the age-group 55-65 could rise by up to 20 percentage points. Indeed, an argument could be made that incentives in public schemes should be tilted towards staying in the labour force, at least until a certain age, because people who do so contribute to public budgets through their taxes, as well as promote economic growth.

7. The necessity of change is now well recognised. There is, for instance, widespread political acknowledgement that incentives for early retirement need to be unwound and many countries are moving in this direction. But more rapid and ambitious reforms are needed.

8. Reforms have to go beyond eliminating the financial incentives to withdraw from the labour force. Attitudes of employers and older workers towards working longer also have to change, and evidence

suggests this will not be easy. Policy changes may also be necessary to ensure that there is demand for the additional supply of workers.

9. Other policies that keep people away from work need to be reconsidered. Female participation remains low in some countries due to disincentives built into tax and family policies, the cost and limited availability of quality child and elderly care services, as well as inflexible working patterns. Likewise, the incentives for young people to enter the labour force could be strengthened in ways that would not undermine skill development through education. And, in some countries, sickness and disability benefit policies keep a large number of people at prime age out of work.

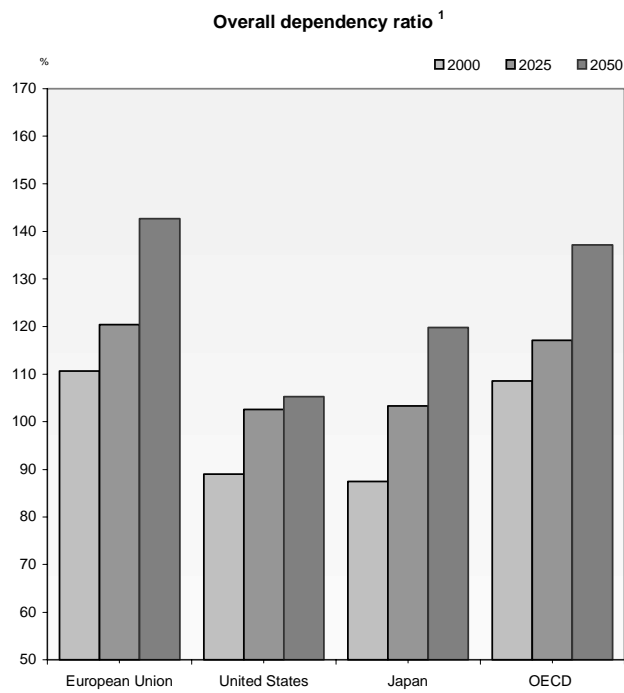
10. Even if policy reforms succeed in boosting labour supply and demand, they may not suffice to safeguard public budget positions for a number of countries. Cutbacks in public pensions may be necessary. This raises the question of the role of private pensions saving and its interplay with public pensions. On the one hand, widespread private pension saving may be a precondition for reducing the cost of public pensions. In addition, higher overall saving could stimulate potential growth, at least over the medium term, potentially making it easier to shoulder the burden of ageing.

11. On the other hand, the tax incentives associated with private pension savings may have a negative impact on public finances. Tax breaks are given to induce additional saving but may be more effective in triggering a reallocation of saving. In addition, these tax breaks tend to benefit the well-off, who are typically better placed to reallocate saving, which makes the cost of inducing new savings even higher. And administration costs of private schemes are often substantial.

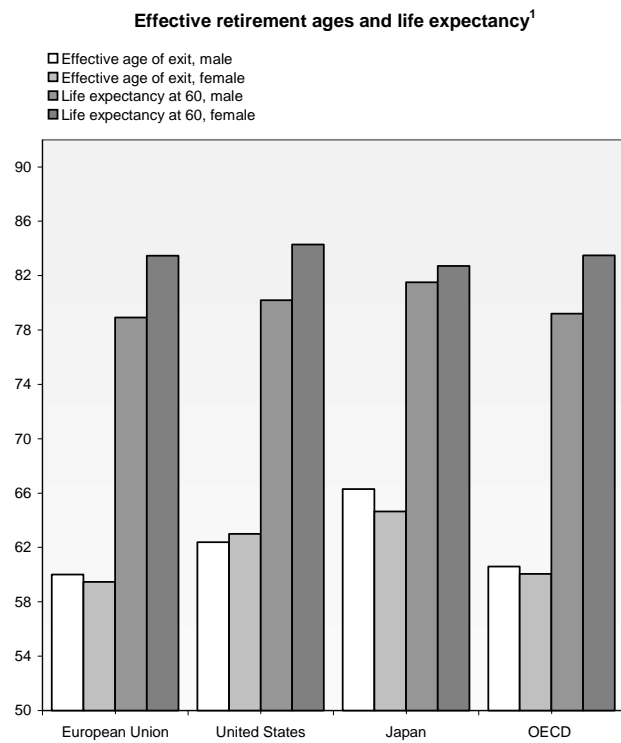
12. Addressing the challenge posed by the ageing population is not an easy task. It requires strong political leadership to undertake difficult reforms in a wide range of policy areas. But it is urgent to act now, as the cost of inaction might be very high for future generations.

Questions for discussion

- *Is it sufficient to eliminate the disincentives to work that are currently embodied in pension and other tax and benefit systems or will it be necessary to introduce positive incentives to encourage increased labour force participation among older workers, women and young people?*
- *Is there a need to balance such measures by reforms to strengthen the attractiveness of older workers to businesses? What can be done in this respect and what are the potential downsides?*
- *Under which circumstances would changes in the balance between public and private pensions help relieve future labour cost and tax pressures?*
- *Under which conditions could increased productivity reduce the financial burden on social protection systems? To boost productivity, what are the respective roles of governments and the private sector in promoting investment and the use of new technologies, and the development of human capital, including through life-long learning?*



1. Total inactive population relative to total labour force (15 years and over). OECD projection based on unchanged policies and a combination of national, Eurostat and UN demographic projections. European Union and OECD are simple average.



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