Life-course Perspective and Social Policies

Institutional Failures and the Life Course

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Introduction

In the modern longer life course, adults spend considerable time in households without young children as a result of delays in family formation and parenthood as well as death. Indeed, in the "spring" of the modern life course (i.e., early adulthood), young adults first experiment with relationships and jobs before they take on responsibility for raising children during the "summer:" the family season of life when adults raise minors. After their children have grown up, adults typically spend considerable time in good health in the "fall" season of their life course (i.e., the active senior phase) before they enter "winter": the last phase of life in which people suffer from serious health problems. The modern life course is most apparent in Northern Europe. In this region, many people in the age brackets between 20 and 30 and above 55 live as singles or as couples without children. In Southern Europe, in contrast, the extended family is still very much present in these age groups.

During the summer season in the modern life course, the costs of living are high while time is scarce, as parents invest not only in their children but also in their careers. During this so-called "rush-hour of life", people may experience "combination stress". Compared to other European household types, families with coresiding children are least satisfied with living conditions, including their work (or main activity), income, housing, and leisure time (Avramov 2002). This contribution explores institutional failures that damage human capital accumulation and hamper flexibility and adaptability over the life cycle. These institutional failures lead to inefficiencies in the allocation of time and other resources over the life course, thereby contributing to more pressure on the summer season of the life course.

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Incentives to retire early

Various schemes encouraging early retirement have resulted in workplace cultures that fail to maintain human capital. These schemes have thus set in motion a vicious circle: workers retire early because their skills are obsolete, while human capital is not maintained because people can retire early. The result is a short working-time horizon and a low utilization rate of human capital. Indeed, cross-country data show a strongly positive correlation between spending on training and the effective retirement age (OECD 2006).

The waste of human capital as a result of early retirement originates in the erroneous belief that early retirement reduces unemployment because the amount of work is fixed: the so-called "lump-of-labor fallacy". In fact, early retirement has contributed to unemployment by putting a heavy financial burden on companies and families with young children. Indeed, countries with the lowest participation rates (and thus labor supply) feature the highest unemployment rates (OECD 2006).

Moreover, early retirement has nurtured working place cultures in which careers must be made during the time when people bear family responsibilities for young children, thereby creating time pressures in the family season of life in the age range between 30 and 45. By thus preventing men from taking on more household duties and caring for children, these cultures have fostered gender inequalities in employment and earnings patterns. Indeed, fathers often cite workplace cultures as the key reason why they are not more involved with their families (European Foundation for the Improvement of Living and Working Conditions 2003). This explains why the European countries with the lowest effective retirement age also feature the lowest female participation and fertility rates. In this connection, early retirement has also worsened liquidity constraints in early adulthood by transferring resources away from this early phase in the adult life cycle to the active senior phase of the life course.

Lack of wage flexibility for older workers

An important factor explaining the low effective retirement age in Europe is the lack of wage flexibility for elderly workers, which reduces labor demand and thus results in a weak labor-market position for these workers. Since many social benefits (provided by unemployment and disability insurance, for example) are directly linked to previously earned wages through fixed replacement rates, elderly workers who have experienced a decline in their earning potential are hard pressed to find a job that is acceptable to them, and therefore reduce their search intensities.

Wage rigidity explains the increase in structural, long-term inactivity in Europe following adverse macroeconomic shocks and in the face of more idiosyncratic shocks to the earning potential of individual workers due to more creative destruction. Whereas European displaced workers experience smaller income losses than their American colleagues, they face smaller reemployment probabilities, resulting in further rapid depreciation of their human capital (Ljungvist and Sargent 1998).

Another factor weakening the demand for older workers is the implicit labor contract according to which workers are underpaid when young and overpaid later on. This contract can encourage young workers to invest in firm-specific human capital and promote workers' effort and cooperation. At the same time, however, it ties older workers with golden chains to their employer. Moreover, it makes older workers dependent on the survival of the firm they work for and discourages entrepreneurship. These workers thus experience a lack of security associated with "fear of falling" in a dynamic economy in which creative destruction causes companies to exhibit shorter lifespans. Indeed, the implicit contract creates a gap between the insiders who are lucky enough to work for a surviving firm and the outsiders whose firms have not survived.

Another drawback of the implicit contract is that it requires a mandatory retirement age at which workers are laid off. Hence, the speed and extent of phased retirement cannot act as a buffer for absorbing aggregate financial market and aggregate longevity risks. In an actuarially neutral pension system, working one year longer (and thus receiving annuities one year later) tends to raise their pension by about eight percent. The speed and timing of retirement is thus a powerful instrument for absorbing risks.

Employment protection

Social insurance systems in various European countries protect breadwinners against income shocks through employment protection legislation and social insurance linked to previous earnings. These systems shielded families against poverty at a time when the earning potential of women was low and men could look forward to a continuously increasing wage profile in a single-track, full-time career. In modern economies that rely on creative destruction and feature a large potential labor supply of female skilled workers who aim for careers in paid work, these systems protecting insiders are increasingly costly in terms of wasting human capital of outsiders, tying older incumbents to the fortunes of their employer and discouraging these insiders from moving into new jobs that better fit their life season. Paradoxically, workers feel more secure in those European countries in which employment protection is lowest. One reason is that employment protection discourages not only firing but also hiring, thereby reducing the turnover in the labor market, and thus the jobs that are opening up for new entrants to the labor market, and for those who want to get out of their current jobs. Rather than the difficulty of being laid off from the current job, the ease with which a worker can find a new job is becoming increasingly important in determining the sentiment of security in a transitional labor market.

In addition to preserving the status quo when innovation requires new work practices, employment protection discriminates against outsiders by slowing down turnover in the labor market. The lower probability of finding a good job in a dual labor market depresses the labor supply of secondary workers and raises the opportunity costs of bearing children for young, highly educated women. In countries with strict employment legislation in which workers hold permanent highly protected jobs, women face both higher unemployment risk and the prospect of lower future wage growth (through foregone experience and delayed wage growth) if they temporarily (or on a part-time basis) exit the labor market during the childbearing years. Indeed, worsened future career prospects, rather than foregone earnings during the relatively short period spent with the baby, account for the bulk of the opportunity costs (in terms of lower lifetime income) of becoming a mother (or of sharing household work and caring for a child as a father). Thus, whereas the literature has traditionally focused on maternity benefits and childcare as the key towards reconciling work and family life, an inclusive labor market is at least as important because in such labor markets young workers do not have to engage in costly rent seeking to acquire highly protected jobs when they build a family.

On the basis of a panel of OECD countries for the last 35 years, Adsera (2004) shows that countries with labor market institutions facilitating women's exit and entry in the labor market combine high fertility rates with high female labor supply. This third factor of rigid labor markets protecting insiders at the expense of younger workers explains why the cross-country correlation between fertility and female labor-force participation, which has traditionally been negative (conforming to the theoretical predictions), became positive in the mid-1980s. In particular, fertility dropped in southern European countries (with traditionally low female participation rates) when structural unemployment rose.

By discouraging employment of young adults and the elderly, employment protection and wage compression contribute to the compression of the working life. Moreover, young adults stay in full-time education longer than would be optimal. As a direct consequence, social adulthood and the responsibility for supporting oneself is increasingly postponed beyond the age of biological maturation. Bertola, Blau and Kahn (2002) find that employment protection and wage compression price women as well as young and elderly men out of employment and into other states (the informal economy, home making, education and retirement). OECD (2006) shows a significant negative relationship between employment protection and the employment rate of the population aged 50–64 across OECD countries.

Housing market: insiders versus outsiders

Young households often face difficulties entering not only the labor market but also the housing market. To illustrate, rent control protecting incumbent renters typically reduces the rental housing supply for new entrants and results in the rationing of rental properties. As a direct consequence, workers find it difficult to move around. This hurts their job prospects and, more generally, the flexibility of the labor market.

Tax incentives that are not targeted at new entrants may drive up house prices. High house prices reallocate resources from young households who have not entered the housing market towards older incumbents. Imperfect capital markets that prevent young households with insecure jobs from taking out mortgages add to the strain experienced by youngsters. The difficulty of entering the labor and housing markets discourages young people from starting a family. This lengthens the period of social adolescence, thereby postponing the establishment of a durable relationship and parenthood.

Internal flexibility of firms

Workplace practices and cultures in many countries are still oriented towards the full-time male breadwinner who can devote all of his time and energy to his career. Senior male management and unions (often dominated by older male workers) sometimes lack leadership in introducing family-friendly workplace measures. These measures include flexible leave policies (parental leave, emergency leave to care for sick elderly relatives or children); flexible working hours (e.g., school-holiday adjusted working hours; part-time work; flexi-time); flexible working arrangements (like tele-working); support with childcare and eldercare; and provision of training during or after leave so that the allocation of work over the life cycle is better adjusted to the biological clock of women. Even if some of these facilities are present, workers sometimes fail to take advantage of them because they fear that doing so would harm their careers (Groot and Breedveld 2004). Indeed, employers may perceive women who take time off for childbirth as less committed to their career than male breadwinners, and are therefore less likely to invest in female career opportunities. This produces a vicious circle, as many women do not pursue a career in view of a limited likelihood of advancement.

Empirical evidence suggests that the career effects of taking parental leave differ substantially across countries, reflecting different workplace cultures. To illustrate, Kunze (2003) finds that taking parental leave substantially reduces future wage growth in Germany. In Sweden, in contrast, women do not experience much smaller wage growth after taking parental leave (Albrecht et al. 1999). Apparently, since taking parental leave is so common in Sweden, it does not signal anything about career commitment.

High wage floors

Welfare payments and minimum wages in many countries are based on a breadwinner having to care for a dependent adult and young children. The need to provide an income for two adults results in high minimum-wage floors and compresses the wage scale. Moreover, the limited wage flexibility at the bottom of the labor market puts the unskilled out of work, resulting in social exclusion and further loss of skills and morale. Indeed, high minimum wages act as a tax on employers who employ low-skilled labor. The absence of a low-wage sector prevents families (and also the elderly) from contracting-out household services (cleaning and housekeeping, small repairs around the house, child minding, old-age care). Women thus reduce their labor supply as households face more difficulties in reconciling work and family life.

The idea that a minimum wage should be sufficient to provide for a dependent adult and young children is increasingly inappropriate for two reasons. First of all, the potential earnings of the secondary earner have increased because of the stronger labor-market position of women. Second, in the modern longer life course, adults spend considerable time in households without young children. In the spring and fall of the modern life course, adults thus do not have to care for young children and therefore can make do with lower incomes and social protection. In any case, a higher minimum-wage floor raises the human capital requirements of those entering the labor force. If agents do not have sufficient capabilities to earn the minimum wage, they risk ending up in welfare schemes.

Equity versus efficiency

Redistribution from rich to poor and social insurance against income losses are basic functions of the welfare state. In modern welfare states, however, a large part of the taxes levied to finance social transfers merely redistributes resources from one stage in an individual's life cycle to another. Pettersson and Pettersson (2003) found that only 18 percent of the taxes levied to finance social insurance transfers and social services in Sweden can be categorized as interpersonal redistribution. For Ireland and Italy, O'Donoghue (2001) estimated a degree of interpersonal redistribution of 45 percent and 24 percent, respectively. Sørensen et al. (2006) found that the degree of interpersonal redistribution in Denmark amounts to 26 percent across all taxpayers. These studies show that a considerable part of the tax bill does not redistribute lifetime income from the lifetime rich to the lifetime poor but is essentially income that the taxpayer transfers to himself over his own life course. In the absence of an actuarial link between (social security) taxes paid and social transfers received, taxes and transfers inevitably distort labor supply. Moreover, transfer programs often create moral hazard, as taxpayers have no incentive to reduce their reliance on transfers.

Conclusions

This article has explored the institutional failures that damage human capital accumulation and hamper flexibility and adaptability over the life cycle. Together with aging, these institutional failures threaten the intergenerational contract according to which each generation invests in the human capital of the next and is taken care of at the end of its life by the generations in which it has invested. Traditional social policies, such as compressed wage scales and job protection, are becoming increasingly counterproductive in generating security. This calls for institutional innovation in developing new proactive approaches to social protection over the life cycle. Among other things, passive benefits compensating the loss of human capital should be transformed into preventive, proactive social policies that build and maintain human capital. As workers increasingly combine their work with other activities (caring, resting and learning), new social-protection institutions should facilitate various transitions and changing combinations of activities during the life course. Flexibility in wages and work practices thus becomes more important. A more adaptable labor force provides the legitimacy for competitive open markets and the creative destruction associated with rapid innovation and growth. Moreover, substantial human capital contributes to a high level of labor-force participation, which provides a strong economic basis for ensuring solidarity with the vulnerable elderly, children and disadvantaged adults of working age.

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