Discussion

*Sheryl Kennedy**

Charles Beach's paper is a comprehensive and clear exposition on the implications of Canada's aging workforce for living standards. This well-balanced study integrates a considerable body of theory and empirical results, while underscoring areas of uncertainty. Beach reaches sensible conclusions and offers sound policy prescriptions. His paper provides a fitting tribute to David Dodge and his approach to policy making. In my comments, I will expand further on the implications of an aging society more broadly, and suggest avenues where I believe there is a need for some changes in public policy.

To assess the impact of the aging workforce on living standards, Beach explores what aging means for employment/participation rates and productivity. This is a difficult challenge, since we have been surprised by the higher-than-expected trend labour input—and the dismal trend in labour productivity—for some time now!

The turnaround in the participation rate of older workers since the mid-1990s is not unique to Canada. Beach mentions many possible explanations, but I would like to highlight work by Barillas and Schleicher (2003) that links the increase in participation rates of older workers to education. I also believe that the rising participation rate of women in the workforce since the 1970s (and, unfortunately, the recent higher divorce rates among older men and women) is a significant factor. Of course, rising education levels probably contributed to the substantial female entry into the labour market over the past several decades.

And we should not forget the influence of an economy operating at full capacity but with inflation under control over this period.

As for productivity, Beach touches on a point that David Dodge and I have been raising for some time, one that is, in David's words, *extraordinarily important*: it's not just the investment in technology and the capacity to learn new skills that are necessary for significant productivity gains, but also the reorganization of work and the ability to function in teams encompassing diverse skills and viewpoints.

As Beach notes, *ceteris paribus* won't hold when analyzing the impact of an aging workforce. Tight labour markets will lead to higher wages and induce various types of adjustment (including higher investment), which will provide a partial offset to the expected negative hit on productivity. Theoretical work, including research at the Bank of Canada by Lavoie and Mendes, suggests that slower labour force growth will raise the capital/

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output ratio temporarily, depressing the return to capital, and boosting the return to labour. The interest rate will tend to fall and the wage rate to increase to an extent that depends partly on the degree of intertemporal substitutability. For a while, this could stimulate labour productivity growth via capital deepening. On the empirical side, the relative price of capital to labour has been found to significantly influence capital intensity in Canada. Thus, in addition to the potential impact from such channels as greater innovation and the development of new labour-saving modes of production, capital deepening is likely to mitigate the impact of aging on productivity and potential output growth.

For policy prescriptions, the following three areas are important, but I will pay particular attention to the third issue:

- Implement phase-in and dual-track retirement options.
- Promote flexibility, adjustment, and structural reforms to avert a trend decline in potential output growth.
- Encourage learning and skills upgrading for older workers—and for youth, as well.

Beach emphasizes the importance of learning, training, and skills upgrading for older workers to enhance their productivity as they continue in the workforce, but as a mother of a teenage boy, I want to draw your attention to a paper by Fortin and Lemieux (2005). They expect only a small labour supply response to the large increase in the university wage premium forecasted for men. Rather than relying on labour supply effects through this price channel, they conclude that educational policies should increase the number of available positions for university students and, therefore, enable a larger percentage of youths to receive a higher education. We need to enhance learning for young males as well as for older workers!

Macroeconomic Implications

As Beach notes, the degree of expected aging varies considerably across advanced countries. It seems to me that we have to start thinking about the macroeconomic implications for open economies of these different rates of aging beyond the obvious observation that they will affect the gaps in GDP per capita relative to the United States.

In a September 2007 speech, Jean-Claude Trichet (Trichet 2007) concluded that, owing to aging, there would be a faster fall in investment rates than savings rates in industrialized economies. This would be partially mitigated by current account surpluses in many aging economies which, in turn, would contribute to a minor reduction in equilibrium real interest rates over the next decades.

From an open economy perspective, the variable pace at which economies age and the resulting wage differentials can lead to sizable migration between countries (from young, developing economies to older, advanced economies). But, conversely, older savers in aging economies may look for higher returns in countries with younger populations and lower capital-labour ratios. From a policy perspective, therefore, since we don't know what is optimal here, I would think that we should focus on enabling a freer flow of both people and capital globally.

Beach rightly recommends looking at the effects of aging in formal, general-equilibrium models. It seems particularly useful to improve the modelling of endogenous labour supply and innovation in growth models, since they probably hold the key to how serious the effect of aging will be in the end. Moreover, this is an area where model uncertainty is particularly great. We have a pretty good idea of the forces, but a difficult time quantifying them.

According to the life-cycle theory, individuals accumulate financial wealth during their working lives to finance consumption during retirement. So, if a population's average age is closer to retirement, one can expect higher wealth-to-income ratios and greater sensitivity of consumption to asset prices. Policy-makers need to take this change into account.

Financial Sector Implications

It is important to consider more sophisticated measures of rising living standards and welfare. If, for example, the increase in older worker participation results from a desire to avoid poverty, it's not clear that this is a real improvement. In fact, Beach mentions that one reason for people to postpone retirement is the increased retirement-income risk owing to the move to defined contribution (DC) pensions. But right now, defined benefit (DB) pensions are seriously under water, as well, and as we head into a cyclical downturn, the idea of linking one's total retirement fortune to the survival of a single firm might appear somewhat reckless. And many pensions are filled with incentives to retire as one ages rather than incentives to continue to work. Pension policy reform, therefore, is an urgent priority.

Aging populations are supposed to mean a change in portfolio strategy toward less demand for risky assets. Does the recent reach for yield contradict this? Or did investors just buy a pig in a poke, believing that they had found essentially risk-free products with a better return?

There has been a lot of research on the effect of demographics on housing prices. There clearly needs to be a supply adjustment, but recent studies suggest that it may take longer to materialize than initial work suggested: leading-edge boomers are likely to stay in their homes longer. But, as we are painfully realizing, many aspects of housing policy and housing finance have been misguided. Efforts to enhance home ownership and aid affordability more often tend to inflate bubbles, reduce affordability, and leave marginal homeowners broke and homeless when the bubble eventually bursts. One hopes that we can get the economics right as we revise housing policy with an eye on changing demographics.

Fiscal Implications

And then there are all the fiscal worries. How will we afford income-support programs, pensions, and health care?

During my time at university, I never quite understood the "pay as you go" concept for retirement income, and health care for that matter. There was an expectation that rising productivity and living standards would work their magic. Policies will need to address intergenerational transfers of wealth in program design, and "insurance" programs (e.g., health) should be reworked to be actuarially sound. Insurance programs need to be just that—yet all of us know that it is easier said than done. I believe that there will be a lot more focus on insurance-type products and concepts in public policy as our society ages. In the 1980s, we merged banking and securities; looking ahead, in my view, it will be insurance that becomes more integrated.

Good Policy Making

I would like to conclude with some general lessons to guide policy decisions. It was when I met David Dodge in 1985 and we were arguing about the oil-price assumption for the Budget, that I learned that good policy making actually involves getting the economics right—making sure you have a coherent story. David always emphasized the analysis part of good policy making, organized in such a way that you provide the fodder for reasoned debate and sound decision making.

So as I lifted my head this past weekend out of monetary policy and the financial crisis to think about the aging society and what that means for public policy, I realized that my approach embodied several David Dodge maxims that I have learned over the 25 years of our association, championing a host of policy initiatives:

- Public policies need to be forward looking, cognizant of long-term structural changes and behavioural dynamics. The earlier you "fix it," the less it will cost.
- The effects of structural changes are generally smaller than initially expected and take longer to materialize but, like death and taxes, they do happen.
- Small changes each year add up to something meaningful over a decade or two.

References

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