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# Structural Changes in the Labor Market and the Rise of Early Retirement in France and Germany

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**Abstract.** *The rise of early retirement in Europe is typically attributed to the European system of taxes and transfers. A model with an imperfectly competitive labor market allows us to consider also the effects of bargaining power and of matching efficiency on pre-retirement. We find that lower bargaining power of workers and declining matching efficiency have been important determinants of early retirement in France and Germany. These structural changes, combined with early retirement transfers and population aging, are also consistent with the employment and unemployment rates, labor share and seniority premia.*

**JEL classification:** E24, H55, J26, J64.

**Keywords:** Overlapping generations; search unemployment; labor force participation; aging; labor market policy and institutions.

## 1. INTRODUCTION

Many European countries have been concerned about low labor force participation rates of older workers. While population aging is raising crucial questions about the sustainability of the current generous social security systems (Ludwig and Reiter, 2010; OECD, 2014b), low participation rates make it more difficult to provide for the retired and pre-retired. In two largest European economies that are the focus of this study, France and Germany, the participation rate of 45–64 years old men has declined from 86% to 72% and from 87% to 84% since the end of the 1960s. In 2013, the labor force participation rates of those aged 55–64 were as low as 52% in France and 74% in Germany<sup>1</sup> (OECD, 2013a). Traditionally, this has been attributed to the European welfare system which, by providing generous retirement and early retirement transfers and by taxing labor income too much, discourages older workers from remaining in the labor market. Although increasing longevity is expected to induce people to work longer as they must save for longer future (Bloom *et al.*, 2014), generous retirement

1. We find similar evolutions in most continental European countries as Belgium, Luxembourg or the Netherlands.

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transfers combined with low retirement and pre-retirement age encourage early exit from the labor force (Gruber and Wise, 1998). Models featuring competitive labor markets succeed well enough in justifying this hypothesis. For example, in Heijdra and Romp (2009), early retirement benefits provide a powerful incentive for workers to retire before the normal retirement age. With labor supply varying both at the intensive and extensive margin, Kindermann *et al.* (2013) show that pension design has important labor supply consequences. Buyse *et al.* (2013) link hours worked to pension reforms in 13 OECD countries. Hairault *et al.* (2008) study the French Social Security and assess the impact of incentive schemes on retirement. They find strong effects of actuarially fair adjustments to Social Security on retirement decisions.

In this paper, we allow for labor market imperfections and investigate whether changes in employment prospects may have further contributed to the rise of early retirement. More specifically, we investigate a possible contribution coming from the decreases in matching efficiency and bargaining power observed in France and Germany since 1970s. By resulting in downward pressure on wages and discouragement to search, they may have induced older workers out of the labor market. Yet, the importance of these channels remains largely unexplored.

The literature rarely points to the bargaining power and matching efficiency as potential determinants of incentives for workers to retire early. Gautié and Schmitt (2010) discuss the impact of institutions on the supply of the low-wage labor, including the elderly. They contrast the Danish approach that provides both human capital and out-of-work income, thus fostering worker's bargaining power, with the more liberal one of the United States, United Kingdom and Germany following the Hartz reforms, where unemployed workers are pressured to accept low-wage work and thus may be discouraged from searching for jobs in the first place. Schmitt and Jones (2012) study the rise of bad jobs in the United States since 1970s. They argue that the decline in the economy's ability to create good jobs is related to the deterioration in the bargaining power of workers, and has effectively pulled out of the labor market the workers in the middle and bottom of the pay scale. A theoretical work viewing the bargaining power as determinant of early retirement is Khaskhoussi (2009). In a partial equilibrium model with Nash wage bargaining, he emphasizes the effect of incentives to delay retirement when the bargaining power of workers is positive. The literature linking matching efficiency to early retirement is even scarcer. Dickens and Triest (2012) suggest that a potential effect of the lower matching efficiency due to the Great Recession in the United States puts older displaced workers at a relatively high risk of prolonged spells of unemployment and premature retirement. The only theoretical work that links retirement age to both the bargaining arrangements and matching process is Hairault *et al.* (2015). In a partial equilibrium matching model with Nash wage bargaining, it shows that labor market frictions give rise to asymmetries in the retirement decisions of unemployed and employed workers.

To evaluate the contribution of the bargaining power of labor and matching efficiency in the labor market to early retirement, we introduce the imperfect labor markets as in Pissarides (2000) into the standard overlapping generations (OLG) framework (de la Croix and Michel, 2002) with a two-tier pension system, and explicitly model the labor force participation of older workers at the extensive margin. Our model is unique in the sense that it brings together life-cycle

consumption and saving and labor market frictions, along with a realistic representation of the demographic process of aging, in order to study the determinants of early retirement in Europe. Compared to models with perfect labor market, this set-up allows us to consider the impact of labor market institutions such as retirement benefits and bargaining arrangements, as well as labor market mismatch, not only on the labor force participation of older workers but also on other labor market outcomes such as employment, labor share and seniority premium.

Thus, we do not study senior labor force participation in isolation, and our setup allows us to gauge asymmetric responses to shocks for different age groups and countries. Moreover, the incorporation of saving and capital accumulation into a frictional labor market model with early retirement serves two purposes. First, the effects of aging are better understood when saving and capital accumulation are accounted for because, confronted with increased life expectancy, workers react by saving more and working longer. Second, as shown in de la Croix *et al.* (2013) who extend our simple framework to 15 generations to study population aging and pension reforms in France, having the capital market equilibrium results in crucial interactions between capital accumulation, interest rates and vacancy creation. This further influences workers' labor force participation choices. Unlike de la Croix *et al.* (2013), we investigate alternative determinants of early retirement, beyond pension schemes. We focus on the declining bargaining power of labor and falling matching efficiency, and ask whether and to what extent they have affected the willingness of older workers to participate in the labor market.

Specifically, we consider an economy populated by three generations of agents – junior, senior and retired – who allocate resources between consumption, saving and bequest. Each generation forms a household that ensures perfect risk sharing across individuals of that generation, in line with most literature. Firms and workers engage in costly search for partners in the labor market and, when matched, bargain over wages. All workers are perfect substitutes but their productivity varies with age. Firms do not discriminate between workers of different age and decide on the number of vacancies that can be filled either by the young or old. Job destruction is kept exogenous. While all young are active searchers, central to our analysis is the labor force participation choice of senior workers who face a trade-off between looking for jobs and pre-retiring. Being search active involves a cost in the form of disutility of search but it carries an expected gain from potential employment. Inactivity allows to enjoy full leisure and pre-retirement income from social programs. As a result, we find that lower bargaining power of workers largely contributed to early retirement in France and Germany. However, we find that lower matching efficiency in the labor market had an opposite effect on senior workers' labor force participation. Finally, we need to combine the two structural shocks with old-age transfers and population aging to reproduce the joint evolutions of other labor market variables for senior and junior workers.

We take on the bargaining power of workers because it is now widely accepted that the bargaining power of labor *vis-a-vis* capital has declined substantially (OECD, 2012a). The most direct factor leading to lower bargaining power of

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workers has been the changing nature of bargaining arrangements. In France and Germany, the index of union density<sup>2</sup> fell from 20% to 8% and 32% to 19%, respectively, between 1968 and 2008. In the same period, the collective bargaining coverage<sup>3</sup> increased in France from 70% to 90% and declined in Germany from 85% to 64% (Quinteros-Rojas and Langot, 2016). The numbers for Germany certainly point to a large decline in workers' bargaining power. OECD (2012a) suggests that the union coverage in Germany was especially reduced due to a large share of employees coming under non-standard contracts, such as mini-jobs, throughout 2000s. Germany has also seen a rise of wage decentralization via derogation clauses that allow firms facing economic difficulties to deviate from previous agreements.

On the other hand, given that the union coverage increased in France, the decline in the bargaining power of labor in France seems less intuitive. However, an increase in the union coverage does not necessarily reflect a larger union clout. In the case of France, high coverage reflects the sectoral bargaining obligations, in the context of declining union power. Sectoral agreements define sector-specific wage scales and minimum wage levels, but the effective wages are fixed at the firm level. In fact, since 1982, French government has encouraged decentralized wage setting by making wage bargaining compulsory at the firm level. As a result, over the years, wage bargaining in France has become more decentralized and the role of firm-level bargaining has increased. According to Castel *et al.* (2013), in 31% of firms representing 25% of wage earners in France in 2004–05, there was little impact of sectoral wage agreements. Overall, the changing nature of the globalized economy, demanding larger flexibility in local markets, has put a growing pressure on the bargaining processes both in Germany and in France. The rise in domestic and international competition, offshoring, foreign direct investment and the privatization of industries and services are believed to lie behind the deterioration of workers' bargaining position. They not only affect the size of rents but also extent to which workers share in them (Rodrik, 1997).

Matching efficiency, the productivity of the process that brings workers and jobs together, has also undergone major shifts since 1970s. Larger heterogeneity of workers and jobs has led to skill and sectoral mismatch; search behavior has changed due to advances in technology; and labor market sclerosis has contributed to worker discouragement and skill loss (Petrongolo and Pissarides, 2001). Declining matching efficiency is believed to be behind some of the outward shifts of the Beveridge curve<sup>4</sup> in Europe, including in France and Germany (Jackman *et al.*, 1990; Layard *et al.*, 2005). In Germany, Entorf (1998) finds evidence of a rise in mismatch between 1972 and 1992. In particular, he attributes the growing imbalance between the supply of and demand for labor to the growing labor force, higher female labor force participation and higher share of service jobs. Fahr and Sunde (2004) estimate a matching function for West

2. Union density records union members as percentage of employees.
3. Collective bargaining coverage relates to workers covered by wage bargaining agreements as a proportion of wage and salary earners.
4. The Beveridge curve is an equilibrium relation that equates flows in with flows out of unemployment. It is downward sloping in the vacancy-unemployment space (Blanchard and Diamond, 1989; Pissarides, 2000). It shifts as a result of changes in matching efficiency, job separation and population growth.

Germany in the period 1980–97. In line with Entorf (1998), they find a negative time trend in the matches formed of roughly  $-3\%$  per annum. In particular, they find that matching efficiency is low in the regions that see a larger fraction of older workers, as well as workers with intermediate skill levels. Fahr and Sunde (2006), between 1980s and 1990s, calculate an overall 9% and 10% drop in the matching efficiency in the most and least efficient regions of West Germany, respectively. They also find that, without the German reunification, the fall in matching efficiency would have been even larger. Estimations of the matching function for France are even scarcer. Ibourk *et al.* (2004) suggest a substantial decrease in the matching efficiency in 1990s, from 0.8 to 0.53 (equivalent to 34% ) in only five years, from 1990 to 1995. Thirty per cent of the decline can be traced to changes in the composition of unemployed job seekers. Another significant factor suggested by the authors for France is a rise in vacancies for non-permanent jobs that are less appealing to the job seekers.<sup>5</sup>

Our modeling strategy is close to Chéron *et al.* (2011, 2013) who use a search and matching process similar to that of Mortensen and Pissarides (1994), adapted to include finite lifetimes. However, they do not model participation and aging. Because they do not consider demographic change, and essentially focus on the economic environment at a given moment of time with a given demographic structure, their simplifying assumption of no capital accumulation is a natural choice. The same argument also applies to Hairault *et al.* (2015) whose model combines search and matching *à la* Mortensen and Pissarides, retirement and life-cycle. As such, this model links optimal retirement age to the bargaining arrangements and the matching process, but again it foregoes saving and capital accumulation. This is different to our case, where the link between interest rate, vacancies, employment and retirement gains importance in the medium-to-long run. Finally, labor share cannot be studied in these models, as there is no capital accumulation. Saving and capital accumulation are incorporated into Mortensen and Pissarides framework by Quinteros-Rojas and Langot (2016) in order to study labor supply at the intensive and extensive margin. However, their setup ignores worker heterogeneity by age. In another paper, Hairault *et al.* (2010) incorporate stochastic aging and study early retirement decisions and job search intensities in a search model of McCall (1970) with exogenous wage distribution. However, because wages are exogenous, there is no scope here to study the effect of bargaining power on participation nor can the effect of aging be reproduced reliably as there is no saving. Khaskhoussi (2009) elaborates on the partial equilibrium model of Hairault *et al.* (2010) by introducing Nash wage bargaining and predicts that the incentive to pre-retire declines when the worker's bargaining power is positive. However, as earlier papers, he ignores capital and thus provides no way to study the labor market jointly with the saving and capital accumulation. Instead, we introduce wage setting through Nash bargaining between workers and firms, as well as capital accumulation.

5. A recent study for the EU (Arpaia *et al.*, 2014) indicates increases in efficiency starting to appear in Germany around 2008, possibly due to the Hartz Reforms (Fahr and Sunde, 2009). In France, during 2000s, one observes a relatively trend-less evolution with cyclical fluctuations. We focus on matching efficiency trends prior to the Great Recession as our exercise is concerned with the period 1968–2007 in order to avoid the conflation with anomalous macro-dynamics arising due to the crisis.

### 2. THE MODEL

Time is discrete and runs from zero to infinity. The economy starts with initial conditions bearing on the capital stock and on employment. At each date, a single numeraire good is produced from labor and capital.

#### 2.1. Demographics

We consider an OLG model. Each cohort lives for three periods (junior, senior and old, respectively, indexed  $j, s, o$ ). The size of a cohort born at time  $t$  is equal to 1. In each period of life, agents make different participation decisions:

- all juniors participate in the labor market and search for jobs; they may be employed or unemployed:

$$1 = N_t^j + U_t^j; \quad (1)$$

- the seniors choose to participate or not in the labor market; those who withdraw enter early retirement schemes; total senior population is thus split into three groups – employed, unemployed and inactive:

$$1 = N_t^s + U_t^s + I_t^s; \quad (2)$$

- only a fraction  $\sigma$  of a cohort reaches old age; all old people are inactive ('retired'):

$$\sigma = I_t^o. \quad (3)$$

#### 2.2. Labor market flows

We use a Mortensen–Pissarides representation of search frictions. We assume an exogenous job destruction rate  $\chi$  and a constant returns to scale matching function. The total number of job seekers at time is equal to:

$$\Omega_t = 1 + (1 - I_t^s) \left\{ 1 - (1 - \chi) N_{t-1}^j \right\}. \quad (4)$$

The pool of job seekers at a time  $t$  equals to the new population of junior workers normalized to 1 plus the currently active unemployed senior workers (i.e. those who separated from jobs in the previous period but continue to participate in the labor market in the current period). It is assumed implicitly that the initial employment status of the seniors does not affect their early retirement choice. Given the matching function:<sup>6</sup>

6. Although firms may prefer specific workers (young vs. old), they never turn down an application as long the asset value of a job is positive. Therefore imposing exogenously a segmented labor market (two matching functions) would be unrealistic because the firm would have no incentive to refuse a worker from the other segment. It is worth noting that these results would not hold with another kind of production function (workers not being substitutes) and/or with no free entry condition for the firms (see also Pissarides, 2000 for a related discussion).

$$M_t = M(V_t, \Omega_t), \quad (5)$$

the probabilities of finding a job and filling a vacancy will be, respectively, given by:

$$p_t = \frac{M_t}{\Omega_t} \quad \text{and} \quad q_t = \frac{M_t}{V_t}. \quad (6)$$

The probabilities that a vacancy is filled by a junior and a senior worker are:

$$q_t^j = \frac{1}{\Omega_t} q_t \quad \text{and} \quad q_t^s = \frac{\Omega_t - 1}{\Omega_t} q_t. \quad (7)$$

The number of employed junior workers is then equal to:

$$N_t^j = q_t^j V_t, \quad (8)$$

$$= p_t. \quad (9)$$

From the firm's and the worker's point of view, respectively, the number of employed seniors is:

$$N_t^s = q_t^s V_t + (1 - \chi) N_{t-1}^j (1 - I_t^s); \quad (10)$$

$$N_t^s = \left[ (1 - \chi) N_{t-1}^j + p_t \left\{ 1 - (1 - \chi) N_{t-1}^j \right\} \right] (1 - I_t^s). \quad (11)$$

These two equations mean that senior employment is the sum of the remaining junior employment from the previous period and the newly created jobs with senior job-seekers.

### 2.3. Households

Each generation forms a household equipped with perfect foresight. Let  $c_t$ ,  $d_{t+1}$ ,  $e_{t+2}$  denote consumption per household member in each period of life of a generation born at time  $t$ . We allow for bequest  $b_{t+2}$ , also defined per household member. By this, we assume the joy of giving, rather than dynastic altruism. The agents have a probability  $\sigma$  of surviving into the last period. The objective function of a representative household is then:

$$W_t^H = \max_{c_t, d_{t+1}, e_{t+2}, b_{t+2}, I_{t+1}^s} \left\{ P(c_t) + \beta \left[ P(d_{t+1}) - D(N_{t+1}^s) - D(U_{t+1}^s) \right] + \sigma \beta^2 \left[ P(e_{t+2}) + V(b_{t+2}) \right] \right\} \quad (12)$$

where  $P(\cdot)$  is the utility of consumption, and  $D(N)$  and  $D(U)$  are disutilities associated with work and search unemployment.<sup>7</sup> Disutility of inactivity is nil. Our

7. For simplicity, we assume the disutilities of work and search only for the seniors since the participation decision concerns only them. What in fact matters is the difference between disutilities of work and search when old and young, so we do as if the disutilities for the young were normalized to zero. We represent the utility of consumption by  $P(\cdot)$ , instead of  $U(\cdot)$ , to avoid confusion with unemployment.

objective function is not only similar to Michel and Pestieau (2013) but it also includes the disutility of job search when unemployed. It is also similar to Docquier *et al.* (2007) although their labor supply decision is determined by investment in human capital and there are no bequests. The household maximizes its objective function subject to (2) and the following employment flow (13) and budget constraints (14)–(16) for a generation in the three periods of life:

$$N_{t+1}^s = (1 - I_{t+1}^s) \left[ (1 - \chi) N_t^j + p_{t+1} \left\{ 1 - (1 - \chi) N_t^j \right\} \right]; \quad (13)$$

$$c_t + s_t = \sigma R_t b_{t-1} + (1 - \tau_t^j) w_t^j N_t^j - T_t; \quad (14)$$

$$d_{t+1} + z_{t+1} = R_{t+1} s_t + b_{t+1}^i I_{t+1}^s + (1 - \tau_{t+1}^s) w_{t+1}^s N_{t+1}^s - T_{t+1}; \quad (15)$$

$$\sigma e_{t+2} + \sigma b_{t+2} = R_{t+2} z_{t+1} + \sigma b_{t+2}^r - \sigma T_{t+2}. \quad (16)$$

$R_t$  is the gross rate of interest.  $s_t$ ,  $z_{t+1}$  and  $b_{t+2}$  stand for savings in the three periods of life. Bequests  $b_{t+2}$  are passed on to the next generation. Inactive senior workers receive an early retirement (inactivity) benefit  $b_{t+1}^i$ . Old workers receive a retirement benefit  $b_{t+1}^r$ . Taxes on wages are  $\tau^j$  and  $\tau^s$ .  $T$  is a (positive or negative) lump sum tax per household member and we assume that it does not depend on the generation. These lump sum transfers are set to keep the government budget in equilibrium (see section 2.5). Equation (13), the law of motion of senior employment, is not customary in standard Walrasian OLG models. Here, it reflects the constraint laid by the frictional labor market and hence is crucial to the seniors' participation decision. Equation (16) reflects the perfect insurance within the household (generation). It is synonymous with the postulate of an annuity market by the means of which the wealth of those who die with probability  $1 - \sigma$  is redistributed among their brothers and sisters. The first order optimality conditions associated with this optimization program are:

$$P_{c_t} = \beta R_{t+1} P_{d_{t+1}}; \quad (17)$$

$$P_{d_{t+1}} = \beta R_{t+2} P_{e_{t+2}}; \quad (18)$$

$$P_{e_{t+2}} = V_{b_{t+2}}; \quad (19)$$

$$b_{t+1}^i = \pi_{t+1}^s \left[ (1 - \tau_{t+1}^s) w_{t+1}^s - \frac{D_{N_{t+1}^s}}{P_{d_{t+1}}} \right] - (1 - \pi_{t+1}^s) \frac{D_{U_{t+1}^s}}{P_{d_{t+1}}}. \quad (20)$$

Equations (17) and (18) describe the optimal consumption profile. Equation (19) represents the tradeoff between utility from old-age consumption and the joy of leaving a bequest. Equation (20) determines the participation rate of the seniors. We define  $\pi_t^s = \frac{N_t^s}{1 - I_t^s}$  as the probability of a senior to be employed. The seniors compare the cost and benefit of being active. The cost is the pre-retirement benefit receipt forgone when exiting inactivity. The gain is the expected income from being active – the weighted average of income from employment and unemployment. The former includes the wage after tax, less the disutility of work. The latter is the disutility of search when unemployed. For simplicity we abstract from unemployment benefits. Equation (20) implies that, at given wage and early retirement benefits, a lower matching efficiency leads to a lower participation rate  $(1 - I)$  by reducing the probability  $\pi$  of being employed.

The values for the household of an additional junior or senior job, calculated from (12) subject to constraints (13)–(15), are as follows:

$$\frac{\partial W_t^H}{\partial N_t^j} \frac{1}{P_{c_t}} = (1 - \tau_t^j) w_t^j + \tilde{\beta}_{t+1} (1 - p_{t+1}) (1 - \chi) (1 - I_{t+1}^s) \left[ (1 - \tau_{t+1}^s) w_{t+1}^s - \frac{D_{N_{t+1}^s} - D_{U_{t+1}^s}}{P_{d_{t+1}}} \right]; \quad (21)$$

$$\frac{\partial W_{t-1}^H}{\partial N_t^s} \frac{1}{P_{d_t}} = \left[ (1 - \tau_t^s) w_t^s - \frac{D_{N_t^s} - D_{U_t^s}}{P_{d_t}} \right], \quad (22)$$

where the discount factor  $\tilde{\beta}_{t+1}$  is defined by:

$$\tilde{\beta}_{t+1} = \beta \frac{P_{d_{t+1}}}{P_{c_t}}. \quad (23)$$

The first term of (21) means that in the current period the household gains the after-tax wage. The second term of (21) represents the value of being employed today that carries into the next period. If a worker is not separated with probability  $\chi$  or does not pre-retire with probability  $I_{t+1}^s$ , when senior he earns the after-tax wage less the disutility of work. The value of being employed today is lower when the probability of getting matched again in the second period  $p_{t+1}$  is high, that is when the gain from employment when senior can be obtained with higher probability by taking part in matching again rather than by holding on to the old match. Equation (22) represents the after-tax wage earned by a senior worker. Both values will be used in the wage bargaining.

## 2.4. Firms

There are two productive factors, labor and capital. Senior workers are more productive than junior workers by a factor  $\lambda$ . Firms rent capital at cost  $R_t$ . The representative firm maximizes the discounted value of dividends (profits) that will be distributed to shareholders. Profits at time  $t$  are given by:

$$\Pi_t = F(K_t, N_t^j + \lambda N_t^s) - (1 + \zeta_t^j) w_t^j N_t^j - (1 + \zeta_t^s) w_t^s N_t^s - R_t K_t - a V_t. \quad (24)$$

The value of the firm can thus be written as:

$$W_t^F = \max_{K_t, V_t} \left\{ F(K_t, N_t^j + \lambda N_t^s) - (1 + \zeta_t^j) w_t^j N_t^j - (1 + \zeta_t^s) w_t^s N_t^s - R_t K_t - a V_t \right\} + \tilde{\beta}_{t+1} W_{t+1}^F \quad (25)$$

subject to (8) and (10). Firm's discount factor (23) maximizes household welfare.  $F(\cdot)$  is a CRTS production function,  $\zeta$  is employer taxation,  $a$  is per-period vacancy cost. The first-order optimality conditions yield<sup>8</sup>

$$R_t = F_{K_t}; \quad (26)$$

8.  $F_{K_t} = F_{K_t}(K_t, N_t^j + \lambda N_t^s)$ ,  $F_{N_t^j} = F_{N_t^j}(K_t, N_t^j + \lambda N_t^s)$ ,  $F_{N_t^s} = F_{N_t^s}(K_t, N_t^j + \lambda N_t^s)$ .

$$a = q_t^s \left[ F_{N_t^s} - (1 + \zeta_t^s) w_t^s \right] + q_t^j \left[ \left( F_{N_t^j} - (1 + \zeta_t^j) w_t^j \right) + \tilde{\beta}_{t+1} (1 - \chi) (1 - I_{t+1}^s) \left( F_{N_{t+1}^s} - (1 + \zeta_{t+1}^s) w_{t+1}^s \right) \right]. \quad (27)$$

While (26) is standard, (27) is a vacancy creation condition. The firm sets the cost of opening a vacancy equal to the expected gain from filling it by a senior or junior worker. Employing a junior has a dynamic component since, by the means of (8) and (10), next-period employment of the seniors depends on the current level of vacancies. By (10), senior employment depends on current junior employment. By (8), current junior employment depends on the number of current vacancies.

The values for the firm of an additional junior and senior job, that will enter into the wage bargaining problem, can then be calculated as follows:

$$\frac{\partial W_t^F}{\partial N_t^j} = \left[ F_{N_t^j} - (1 + \zeta_t^j) w_t^j \right] + \tilde{\beta}_{t+1} (1 - \chi) (1 - I_{t+1}^s) \left[ F_{N_{t+1}^s} - (1 + \zeta_{t+1}^s) w_{t+1}^s \right]; \quad (28)$$

$$\frac{\partial W_t^F}{\partial N_t^s} = F_{N_t^s} - (1 + \zeta_t^s) w_t^s. \quad (29)$$

## 2.5. The government

We assume that retirement and early retirement (inactivity) benefits are, respectively, equal to a fraction  $\rho^r$  and  $\rho^i$  of current senior wages. Wages are taxed at flat rates zeta and tau for employers and employees, respectively. The rates can *a priori* be different for junior and senior workers wages. To avoid issues related to public debt, we assume that the lump-sum tax  $T$  adjusts to balance the budget in every period. The value of  $T_t$  is thus such that the following equality holds true:

$$\rho^i w_t^s I_t^s + \rho^r w_t^s I_t^o = (\zeta_t^j + \tau_t^j) w_t^j N_t^j + (\zeta_t^s + \tau_t^s) w_t^s N_t^s + (2 + \sigma) T_t. \quad (30)$$

## 2.6. Wages

Wages are renegotiated in every period. They are determined by a standard Nash bargaining rule, for junior and senior workers separately. All workers' bargaining power is  $\eta$ .

### 2.6.1. Senior worker wage

The generalized Nash product for a senior worker is:

$$\max_{w_t^s} \left( \frac{\partial W_t^F}{\partial N_t^s} P_{dt} \right)^{1-\eta} \left( \frac{\partial W_{t-1}^H}{\partial N_t^s} \right)^\eta.$$

The first-order optimality condition can then be written:

$$(1 - \eta) \frac{1}{P_{d_t}} \frac{\partial W_{t-1}^H}{\partial N_t^S} = \eta \frac{1 - \tau_t^S}{1 + \zeta_t^S} \frac{\partial W_t^F}{\partial N_t^S}. \quad (31)$$

Marginal employment values have been defined in (22) and (29). After substitution, one obtains:

$$(1 - \eta) \left[ (1 - \tau_t^S) w_t^S - \frac{D_{N_t^S} - D_{U_t^S}}{P_{d_t}} \right] = \eta \left[ \frac{1 - \tau_t^S}{1 + \zeta_t^S} F_{N_t^S} - (1 - \tau_t^S) w_t^S \right]. \quad (32)$$

Let us denote by  $S_t^S$  the total surplus (net of wage taxes) associated with the employment of a senior worker:

$$S_t^S = \frac{1 - \tau_t^S}{1 + \zeta_t^S} F_{N_t^S} - \frac{D_{N_t^S} - D_{U_t^S}}{P_{d_t}}. \quad (33)$$

Using this definition, (32) yields:

$$(1 - \tau_t^S) w_t^S = \frac{D_{N_t^S} - D_{U_t^S}}{P_{d_t}} + \eta S_t^S. \quad (34)$$

The net wage of a senior worker is the sum of the reservation wage plus a fraction  $\eta$  of the total surplus.

### 2.6.2. Junior worker wage

The Nash product for a junior worker is:

$$\max_{w_t^j} \left( \frac{\partial W_t^F}{\partial N_t^j} P_{c_t} \right)^{1-\eta} \left( \frac{\partial W_t^H}{\partial N_t^j} \right)^\eta.$$

The first-order optimality condition can then be written:

$$(1 - \eta) \frac{1}{P_{c_t}} \frac{\partial W_t^H}{\partial N_t^j} = \eta \frac{1 - \tau_t^j}{1 + \zeta_t^j} \frac{\partial W_t^F}{\partial N_t^j}. \quad (35)$$

Marginal employment values have been defined in (21) and (28). After substitution, one obtains:

$$\begin{aligned} & (1 - \eta) \left\{ (1 - \tau_t^j) w_t^j + \tilde{\beta}_{t+1} (1 - p_{t+1}) (1 - \chi) (1 - I_{t+1}^S) \eta S_{t+1}^S \right\} \\ & = \eta \left\{ \left[ \frac{1 - \tau_t^j}{1 + \zeta_t^j} F_{N_t^j} - (1 - \tau_t^j) w_t^j \right] + \tilde{\beta}_{t+1} (1 - \chi) (1 - I_{t+1}^S) \frac{1 - \tau_{t+1}^j}{1 - \tau_{t+1}^S} \frac{1 + \zeta_{t+1}^S}{1 + \zeta_t^j} (1 - \eta) S_{t+1}^S \right\}. \end{aligned}$$

Let us denote by  $S_t^j$  the total surplus (net of wage taxes) associated with the employment of a junior worker:

$$S_t^j = \frac{1 - \tau_t^j}{1 + \zeta_t^j} F_{N_t^j}. \quad (36)$$

Using this definition and solving for the net wage yields:

$$(1 - \tau_t^j)w_t^j = \eta S^j + \eta(1 - \chi)(1 - I_{t+1}^s) \frac{(1 - \eta)\mathcal{S}_{t+1}^s}{R_{t+1}} \left[ \left( \frac{(1 + \zeta_{t+1}^s)/(1 - \tau_{t+1}^s)}{(1 + \zeta_t^j)/(1 - \tau_t^j)} - 1 \right) + p_{t+1} \right]. \quad (37)$$

The net wage of a junior worker is equal to his reservation wage (0 in this case since there is no unemployment benefit and no work disutility), a fraction  $\eta$  of the current surplus  $S^j$  and a fraction  $\eta$  of the discounted value of the surplus the firm expects to obtain tomorrow with the same worker if he remains employed, weighted by a measure of distortion between senior and junior taxes and employment probability of an unemployed  $p_{t+1}$ .

The intuition behind the junior wage equation is as follows. If the tax wedge is larger for senior workers, firms make more profit when they hire a junior worker. This has a positive impact on junior wages. Now turn to the effect of tomorrow's employment probability  $p_{t+1}$ . First, consider the extreme case where  $p_{t+1}$  is equal to 1, so that having a job today adds nothing to the expected future income of a junior worker, although it brings extra positive value for the firm because the job will survive till next period ( $(1 - \chi)(1 - I_{t+1}^s) > 0$ ). Wage bargaining then gives a junior worker a fraction  $\eta$  of that extra value. At the other extreme, if worker's future employment probability is zero ( $p_{t+1} = 0$ ), having a match today provides an expected benefit tomorrow for both the firm and worker. Given the bargaining process that will take place tomorrow, these extra future gains turn out to be the same for both parties (see (32)), and so would not affect the current bargained wage. In general though, the worker's future employment probability is positive and smaller than 1 ( $0 < p_{t+1} < 1$ ) and the expected future surplus associated with a job affects the junior wage.

### 2.6.3. Seniority wage premium

The wage equations can be combined to obtain the seniority premium.<sup>9</sup> Taking the difference between senior and junior wages, and focusing on stationary state (to simplify the notation), one obtains:

$$(1 - \tau^s)w^s - (1 - \tau^j)w^j = \left[ \frac{D_N - D_U}{P_d} \right] + \eta(S^s - S^j) - \eta(1 - \chi)(1 - I^s) \frac{(1 - \eta)\mathcal{S}^s}{R} \left[ \left( \frac{(1 + \zeta^s)/(1 - \tau^s)}{(1 + \zeta^j)/(1 - \tau^j)} - 1 \right) + p \right]. \quad (38)$$

The first and most important component of the premium is the difference in reservation wages, which in our model equals the disutility of work for senior workers as the corresponding disutility for the young is assumed nil. The second is related to the difference between the employment surpluses. This term reflects again the differences in reservation wages, as well as in the productivities of the

9. Not strictly in conventional sense, as not due to experience or human capital accumulation.

seniors and juniors. It can be positive or negative. When the senior worker's reservation wage (disutility of work) is large, the term can be negative. The last term corresponds to the fraction of the senior surplus that is already included in the junior's wage (see the second term in (37)). It is affected by the probability of finding a job  $p$  and the participation rate  $(1 - I^s)$ .

#### 2.6.4. Bargaining power

Equation (38) implies an ambiguous relationship between bargaining power ( $\eta$ ) and seniority premium. The ambiguity is mainly associated with the second term of the equation. If it is positive, a lower bargaining power will produce a lower seniority premium. The opposite holds true when the term is negative. Because we assume that the senior worker is more productive ( $\lambda > 1$ ), the difference between the two cases comes from the senior worker's disutility of work. When the senior worker's labor disutility (reservation wage) is large relative to the junior one, the senior worker's wage becomes much less sensitive to bargaining power changes. Hence, lower bargaining power hits mostly junior workers and increases the seniority premium.

To illustrate that, assume steady state and no taxes. Senior and junior wages in (35) and (38) then simplify, respectively, to:

$$w^s = \eta\lambda F_N + (1 - \eta)\frac{D_N - D_U}{P_d}, \quad (39)$$

$$w^j = \eta F_N + \beta\eta(1 - \eta)(1 - \chi)(1 - I^s)p\left(\lambda F_N - \frac{D_N - D_U}{P_d}\right). \quad (40)$$

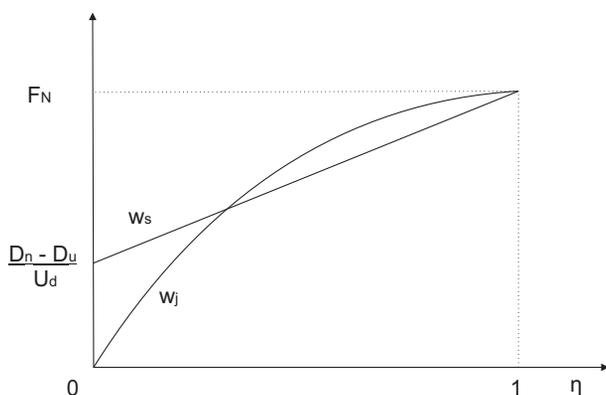
Wages are drawn in Figure 1. For a given inactivity rate  $I^s$  and a job finding probability  $p$  (or effectively for a market tightness  $\theta = \frac{V}{\Omega}$  as  $p$  is a function of  $\theta$ ), both wages are increasing in the worker's bargaining power  $\eta$ :  $\frac{\partial w^s}{\partial \eta} > 0$  and  $\frac{\partial w^j}{\partial \eta} > 0$ . When  $\eta = 0$ , wages are equal to the disutility of work (no disutility is assumed for junior workers). When  $\eta = 1$ , wages are equal to labor productivity (labor productivity is assumed higher for senior workers). A change in the bargaining power (for instance an increase from low to high  $\eta$ ) has an ambiguous effect on the seniority premium. When the gap between work and search disutility is low, such a change may increase the seniority premium. When the gap is high, the same change may decrease it. For some bargaining power values, the seniority premium could even be negative, for instance, when the disutility differential is low, or  $\lambda$  close to 1 (i.e., when the productivity of seniors is not much higher than the productivity of juniors).

## 2.7. Equilibrium

Let  $Q_t$  denote the total financial value of firms at time  $t$ . In our deterministic setup, the return on equities must be equal to the market interest rate. In other words, the value of equities must be such that:

$$\frac{Q_{t+1} + \Pi_{t+1}}{Q_t} = R_{t+1}. \quad (41)$$

## Early Retirement in France and Germany



**Figure 1** Wages (drawn for  $\lambda > 1$  as in the calibration)

We implicitly assume capital depreciation rate equal to 1. The equilibrium on the capital market then implies:

$$K_{t+1} + Q_t = s_t + z_t + \sigma b_t. \quad (42)$$

### 3. CALIBRATION – YEAR 1968

We use the following functional forms: Cobb–Douglas forms for the matching and production functions, logarithmic forms for the utilities of consumption and bequest, and linear forms for the disutilities of work and search – reflecting a perfect risk-sharing in the household:

$$\begin{aligned} M(V_t, \Omega_t) &= \bar{m} V_t^\alpha \Omega_t^{1-\alpha} & F(K_t, N_t) &= \epsilon K_t^\mu N_t^{1-\mu} \\ P(\cdot) &= \ln(\cdot) & V(b_t) &= \vartheta \ln(b_t) \\ D(N_t) &= D^n N_t & D(U_t) &= D^u U_t. \end{aligned}$$

We calibrate the model for France and Germany in 1968, the initial steady state. A period is 20 years, 80 quarters. One can think of generations of 25–45 (junior), 45–65 (senior) and 65–85 (retired) years old. The pre-retirement concerns the second half of the second period (55–65) and so the data pertaining to pre-retirement can be easily averaged out over the 20-year period. The calibrated parameters fall into three categories: (i) the standard values found in the models of this type (two parameters: the elasticity of matches with respect to vacancies  $\alpha$  and the discount rate  $\beta$ ); (ii) the parameters specific to this particular model for which we have some empirical information (six parameters: two replacement ratios  $\rho^j$  and  $\rho^r$ , the survival probability  $\sigma$ , the productivity differential  $\lambda$  and tax rates  $\tau$  and  $\zeta$ ); (iii) the parameters specific to this model for which we do not have direct information but which we fix so that the model reproduces the steady states similar to the French and German economies (six parameters: the matching efficiency  $\bar{m}$ , the job separation rate  $\chi$ , the vacancy cost  $a$ , the elasticity

of output with respect to capital  $\mu$ , the bargaining power  $\eta$ , and the parameter of the relative disutility of work to search  $e^{D^j - D^u}$ ). Table 1 summarizes the parameters.

The standard calibrated values (i) are the following: the elasticity of matches with respect to vacancies  $\alpha$  set at 0.5, the usual value used in literature; and the discount factor  $\beta$  set at 0.45 so that it corresponds to the quarterly discount factor of 0.99. The data driven parameters (ii) are as follows. The pre-retirement and retirement replacement ratios,  $\rho^i$  and  $\rho^r$ , are, respectively, 0.43 and 0.75 for France, and 0 and 0.6 for Germany, based on Duval (2003). In 1968, the survival probability at 65 for the next 20 years was  $\sigma = 0.62$  for France and  $\sigma = 0.6$  for Germany (MaxPlanckInstitute, 2009; Vallin and Meslé, 2002). We assume that in both countries the old are 10% more productive than the young ( $\lambda = 1.1$ ), based on Aubert and Crépon (2003) and Skirbekk (2004). Wage taxation refers to social security charges levied on workers and firms. The rates are set equal for all workers and firms ( $\zeta = \tau$ ) at 0.118 for France and 0.155 for Germany, based on the earliest historical data available (OECD, 2004).

Finally, in the category (iii), we match the junior unemployment rates in 1968 at 0.02 in France and 0.01 in Germany by setting the matching efficiency  $\bar{m}$  to 0.98 and 0.99, respectively. The 20-year period job separation rate  $\chi$  is set to 0.9 in both cases to match the senior employment rate of 0.84 in France and 0.875 in Germany. The vacancy cost per period  $a = 3.11$  in France and 5.43 in

**Table 1** Calibration: Year 1968

Parameters	France					
(i) Standard	$\alpha$	$\beta$				
	0.5	0.99 <sup>80</sup>				
(ii) Empirical	$\rho^i$	$\rho^r$	$\sigma$	$\lambda$	$\tau$	$\zeta$
	0.215*	0.75	0.62	1.1	0.118	0.118
(iii) Implied	$\bar{m}$	$\chi$	$a$	$\mu$	$\eta$	$e^{D^u - D^j}$
	0.98	0.9	3.11	0.3	0.79	2.12
Steady state Variables	$U^j$	$N^s$	$F^s$	$K/F$	$LS$	$w^s/w^j$
Model/data	0.02	0.84	0.14	0.135**	0.672	1.3
Parameters	Germany					
(i) Standard	$\alpha$	$\beta$				
	0.5	0.99 <sup>80</sup>				
(ii) Empirical	$\rho^i$	$\rho^r$	$\sigma$	$\lambda$	$\tau$	$\zeta$
	0	0.6	0.6	1.1	0.155	0.155
(iii) Implied	$\bar{m}$	$\chi$	$a$	$\mu$	$\eta$	$e^{D^u - D^j}$
	0.99	0.9	5.43	0.3	0.75	1.03
Steady state Variables	$U^j$	$N^s$	$F^s$	$K/F$	$LS$	$w^s/w^j$
Model/data	0.01	0.87	0.125	0.135**	0.641	1.1

Notes: \*0.43 over 10 years for 55–64, \*\*2.7 on annual basis. Labor Share  $LS = (w^{iN^j} + w^{sN^s})/GDP$ , with  $GDP = F - aV$ .

## Early Retirement in France and Germany

Germany allows to obtain by (27) the senior inactivity rates of 0.14 in France and 0.125 in Germany. All labor market data come from OECD (2013a) for men. Note that the senior employment and inactivity rates imply senior unemployment rates of 0.02 and 0.01 in France and Germany, respectively. The elasticity of output with respect to capital  $\mu$  is set at 0.3 for both countries to obtain the capital–output ratio of 2.7 on the annual basis. Worker’s bargaining power  $\eta$  is set at 0.79 and 0.75. It allows to match the labor share of 0.672 in France and 0.641 Germany. Like in Bentolila and Saint-Paul (2003), Daudey and Decreuse (2006) and OECD (2012a), we focus the labor share corresponding to the business sector, which includes an imputed labor remuneration for the self-employed. The relative disutility of work to search  $e^{D^y - D^o}$  is 2.12 in France and 1.03 in Germany, calculated to reproduce the ratios of old to young wages of 1.3 and 1.1, respectively (Lazear and Shaw, 2009).<sup>10</sup>

### 4. RISE OF EARLY RETIREMENT: 1968–2007

While the first column of Table 2 recalls the levels of key labor market variables in 1968, the second column ‘Data (1968–2007)’ shows that the labor market both in France and Germany has undergone dramatic changes over the four decades. The participation rate, as well as the employment rate, of senior workers fell. Contrary to the common wisdom, this exit of seniors from the labor force was not accompanied by a rise in the employment rate of junior workers. At the same time, an increase in the seniority premium and a fall in the labor share were observed.

Throughout the same period, European labor markets were hit by different shocks. Two are well known: (i) a widespread use of early retirement schemes and (ii) population aging. The other two have been well documented but have been less frequently mentioned in the context of early retirement: (iii) a decline in the bargaining power of labor and (iv) an increase in the heterogeneity of workers and jobs leading to lower matching efficiency. We perform a number of numerical simulations for French and German economies between 1968 and 2007 to understand if the mentioned shocks, individually or together, can explain the observed evolutions of the labor market variables, in particular the rise of early retirement.<sup>11</sup> We start by considering the *observed* shocks to early retirement transfers and longevity. Next, we quantify and analyse the *unobserved* shocks to the bargaining power of labor and matching efficiency. Table 3 summarizes the shocks under our consideration. Throughout the simulations, we adjust lump-sum taxes  $T_t$  to balance the government budget and avoid issues related to public debt; all other parameters remain the same. In all simulations, technically we assume unanticipated and permanent shocks that take place progressively (and equally) in both periods.

10. The motivation for this choice is further discussed in section 4.3.1.

11. In our model, 1968–2007 corresponds to exactly two periods, and 2007 corresponds to precrisis level allowing us to abstract from anomalies caused by the great recession.

**Table 2** Data and simulations

	Data/model	Data	Transfers	Longevity	Transfers longevity	Bargaining power	Matching efficiency	Full model
			$\rho^i$	$\sigma$	$\rho^j, \sigma$	$\eta$	$\bar{m}$	$\rho^i, \sigma, \bar{m}, \eta$
		1968–2007	(i)	(ii)	(iii)	(iv)	(v)	(vi)
<i>France</i>								
Senior part. rate	86	-17	-34.6	+19	-21	-46.6	+43.8	-14.7
Senior emp. rate	84	-19	-25.9	+16.5	-11.5	-15.8	-15.2	-17.9
Junior emp. rate	98	-5	+17.7	-2.3	+15.7	+87.9	-48.5	-5.3
Seniority premium	30	+10	-2.1	-0.3	-2.4	+28.4	-6.6	+9.6
Labor share	67.2	-3.9	-0.6	+0.2	-0.4	-3.9	-0.5	-4.2
<i>Germany</i>								
Senior part. rate	87.5	-6	-14	+16.2	+0.8	-7.6	+1	-7.3
Senior emp. rate	87	-15	-12.9	+17.5	+3.2	+11.1	-24.2	-14.6
Junior emp. rate	99	-8	+1.5	+1.5	+3	+26.2	-31.2	-10.2
Seniority premium	10	+5	+0.1	-0.4	-0.3	+0	+0.1	-0.1
Labor share	64.1	-1.8	+0	+0	+0.1	-2.3	-0.2	-2.5

Notes: Senior part. rate =  $1 - F$ , senior unemp. rate =  $U^S/(1 - F)$ , senior emp. rate =  $N^S$ , junior emp. rate =  $U^J$ , labor share =  $(w^{NJ} + w^{NS})/(F - aV)$ , seniority premium =  $w^S/w^J - 1$ . Shocks to matching efficiency match the evolution of the aggregate unemployment rate. Scenarios (i)–(iv) correspond to simulations for the period 1968–2007. Results expressed in percentage point deviation from the initial steady state.

**Table 3** Exogenous shocks 1968–2007

France		1968	2007	Change
Transfers	$\rho^i$	0.215	0.32	+48.8%
Longevity	$\sigma$	0.62	0.91	+46.8%
Bargaining power	$\eta$	0.79	0.64	-19.0%
Matching efficiency	$\bar{m}$	0.98	0.65	-33.7%
Germany		1968	2007	Change
Transfers	$\rho^i$	0	0.075	+0.075
Longevity	$\sigma$	0.60	0.85	+41.7%
Bargaining power	$\eta$	0.75	0.67	-10.7%
Matching efficiency	$\bar{m}$	0.99	0.79	-20.2%

Note:  $\rho^i$  is the early retirement benefit ratio,  $\sigma$  is the survival probability at age 65,  $\bar{m}$  is the matching efficiency,  $\eta$  is the worker bargaining power.

#### 4.1. Transfers and longevity shocks: calibration and predictions

Shocks to pre-retirement benefits and longevity are directly observable. Seen in Table 3, the pre-retirement replacement rates  $\rho^i$  increased from 0.43 in 1968 to 0.64 in 2007 (or from 0.215 to 0.32 if taken over a 20-year period) in France and from 0 to 0.15 (or from 0 to 0.075 over a 20-year period) in Germany (Duval, 2003). The longevity  $\sigma$ , measured as the survival probability at 65 over the following 20 years, rose by 46.8% in France and 41.7% in Germany (MaxPlanckInstitute, 2009; Vallin and Meslé, 2002).

The effect of old-age welfare and aging on early retirement have been widely studied in the literature. Generous retirement benefits are believed to encourage early retirement, while longevity encourages labor force participation in order for the elderly to save for a longer future. Using the model, we explore how the two have affected the senior labor force participation, but also confront their effect on other labor market variables – the senior and junior employment rates, seniority premium and labor share. Scenario (i) in Table 2 shows the impact of the rising early retirement replacement ratios on the labor market. As expected, in both countries the seniors pull out from the labor market and their participation and employment rates fall, which corresponds well to the actual evolutions, although the magnitudes are too strong. However, contrary to the data and due to lower job competition from the seniors, the employment of the young rises.<sup>12</sup> The effect on wages, both for the senior and the junior workers, is weak and the seniority premium and labor share remain almost unchanged. Thus, while old-age transfers have a potential to explain the rise in early retirement, they are insufficient to account for other labor market variables.

Column (ii) in Table 2 presents the effect of population aging. The impact on senior participation rates is positive, which is consistent with the findings in the existing literature. As households save more for the longer future, capital stock

12. *Ceteris paribus* this shocks leads to an unrealistic high expansion of junior employment. Some individual shocks in our simulations lead to unrealistic changes in endogenous variables, hence the importance of providing a larger picture with the full set of shocks.

and labor demand rise. As the seniors work longer to save more, they increase their labor supply. The senior employment rate thus increases unambiguously. The effect on the junior employment rates is ambiguous. On one hand, the juniors benefit from higher labor demand. On the other hand, they are crowded-out by the seniors. In France, the second effect is stronger and the junior employment rate slightly decreases. In Germany, the first effect is stronger and the junior employment rate increases. The seniority premium and labor share remain almost unaffected.

Taken together, in column (iii), transfers and aging alone are largely insufficient to match the labor market evolutions. While the senior participation and employment rates in France are somehow matched, this is not the case in Germany. Senior participation actually rises in the German simulation because the rise in the pre-retirement replacement rate is relatively small and thus the (positive) effect of aging outweighs the (negative) one of the old-age welfare. The changes in the junior employment rate, seniority premium and labor share remain unexplained.

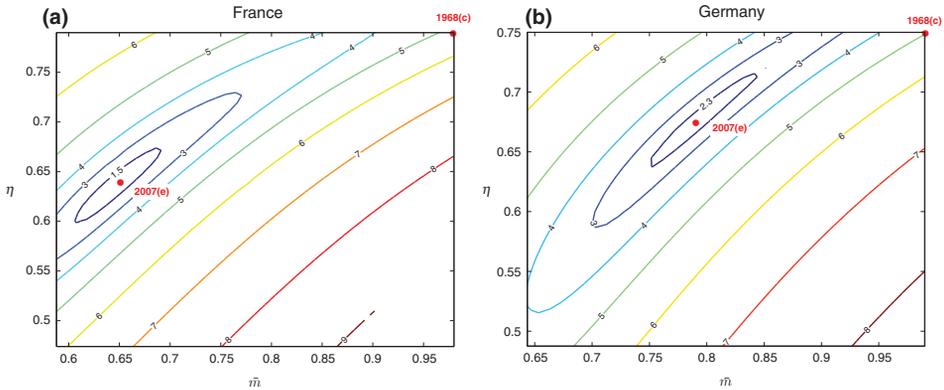
#### 4.2. Bargaining power and matching efficiency shocks: estimation and prediction

Although pre-retirement benefits, combined with population aging, could in some cases (France) explain the rise in early retirement, they are largely insufficient to match other labor market evolutions. We therefore consider two additional shocks that have hit European labor since 1960s – the structural changes in the form of lower bargaining power of workers and lower matching efficiency in the labor market. To assess their effect on the labor market, ideally we would like to know the actual magnitudes of the shocks to the bargaining power and matching efficiency between 1968 and 2007. However, this information is at best rudimentary. We therefore use the model to estimate the two unobserved exogenous shocks by minimizing the deviation between the actual and simulated data for 2007 for the endogenous variables of interest.<sup>13</sup> The isoquants for the log-error are displayed in Figure 2. The estimation implies a 19% and 33.7% decline in the bargaining power and matching efficiency, respectively, in France and a 10.7% and 20.2% decline, respectively, in Germany. These values are compatible with the evidence of the declining bargaining power and matching efficiency, reported in section 1. Both magnitudes are larger for France. This suggests that the process of wage bargaining decentralization in France might have had a more pronounced impact on workers' bargaining power than in Germany.

Given scarce literature on the topic, it is difficult to explain precisely why the relative drop in the matching efficiency is stronger in France than Germany. Rare

13. More precisely, for all combinations of  $(\bar{m}, \eta)$  such that  $0.6\bar{m}_{1968} < \bar{m}_{2007} < \bar{m}_{1968}$  and  $0.6\eta_{1968} < \eta_{2007} < \eta_{1968}$ , we simulate the model and compute error  $\sum_{v \in V} \frac{(v_{\text{model}} - v_{\text{data}})^2}{n}$ , where  $V$  contains senior participation rate, senior employment rate, junior employment rate, seniority premium and labor share, while  $n$  is the number of items in  $V$ . As we assume that shocks take place equally each period,  $\bar{m}_{1988} = \frac{\bar{m}_{1968} + \bar{m}_{2007}}{2}$  and  $\eta_{1988} = \frac{\eta_{1968} + \eta_{2007}}{2}$ . We also try an estimation under less restrictive conditions with  $\bar{m}_{1968} < \bar{m}_{2007}$  and  $\eta_{1968} < \eta_{2007}$ , but fail to obtain convergence.

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**Figure 2** Isoquants for the log-error between the simulated and real labor market data.  
 Note: Estimated parameters: worker bargaining power ( $\eta$ ) and matching efficiency ( $\bar{m}$ )

evidence suggests that these magnitudes are realistic. Only for a five-year period 1990–95, Ibourk *et al.* (2004) estimate a drop in the matching efficiency from 0.8 to 0.53 (equivalent to 34%) in France, one-third of which is due to the changes in the composition of unemployed jobseekers. In particular, the rise in the proportion of long-term unemployed was especially damaging to the matching process in France in early 1990s. Another factor detrimental in France was a rise in vacancies for non-permanent posts. For Germany, between 1980 and 1997, Fahr and Sunde (2006) find a 9% and 10% drop in the matching efficiency in the most and least efficient regions, respectively. Their estimates suggest that one of the most detrimental factors to the efficiency of matching in Germany in 1980s and 1990s were high shares of older workers, aged 50 and above. On the other hand, they also suggest that German reunification had a positive effect on the matching processes. In fact, Fahr and Sunde find that spatial dependencies in hiring between regions reduce local matching efficiencies, but the negative effect weakened after the reunification, possibly because of larger mobility and search externalities.<sup>14</sup>

Our estimates lead to a jointly counterfactual exercise presented in columns (iv) and (v) of Table 2.<sup>15</sup> The decrease in worker's bargaining power (column (iv) of Table 2) causes a direct fall in wages and reduces the senior participation rates. Pre-retirement benefits, being indexed on wages, fall as well but this is insufficient to halt the entry of seniors into inactivity. The effect is stronger in France essentially due to higher reservation wages. Senior workers in France have a high disutility of work (high  $(D^H - D^L)/P_d$  in Figure 1) and are thus less likely to bargain into lower wages, unlike the German senior workers whose wage curve is

14. However, because Fahr and Sunde (2006) and Ibourk *et al.* (2004) models are different and they are estimated over different time frames, it is not possible to directly compare the relative changes in the matching efficiency between France and Germany.
15. As the effects of the two shocks often offset each other, the estimation of each shock individually would produce smaller shock magnitudes as well smaller deviations from 1968 baselines for the variables of interest.

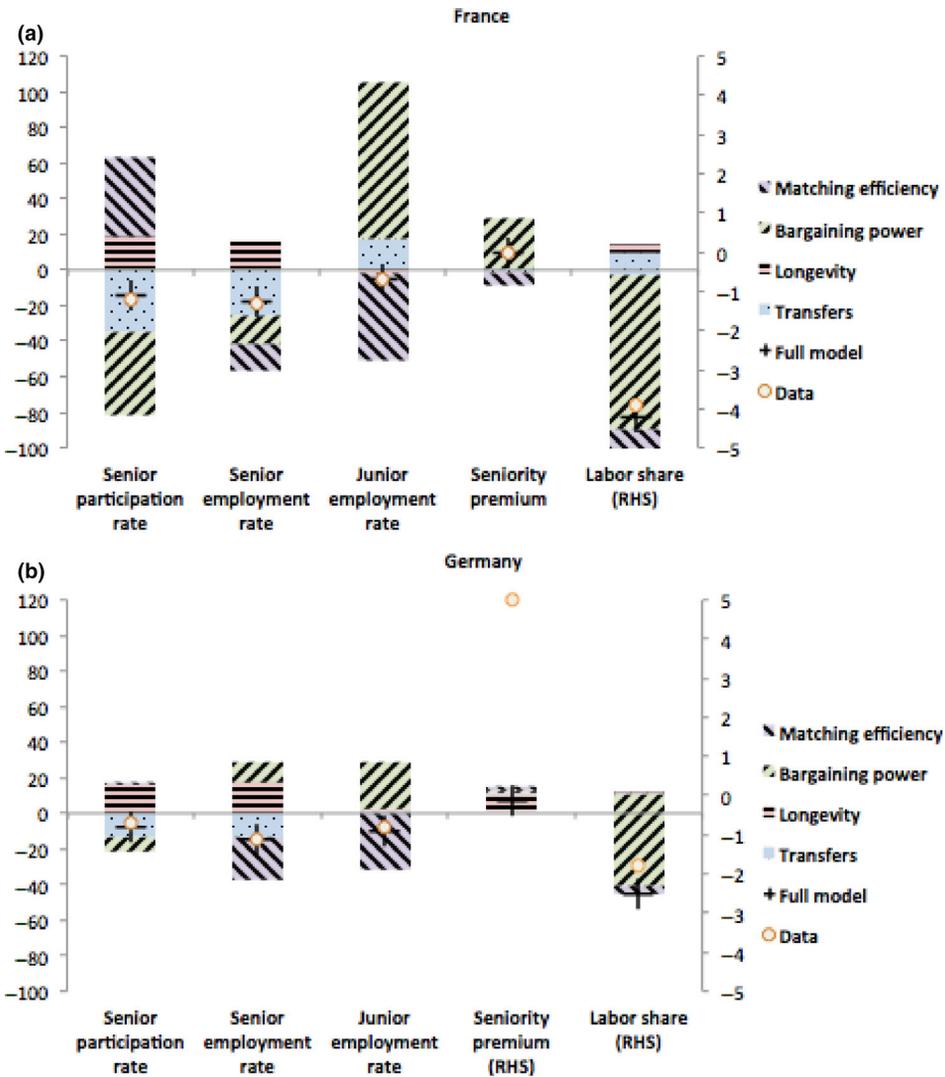
steeper (low  $(D^n - D^u)/P_d$ ). Since retirement benefits are indexed on senior wages, the generosity of the French pension system is not much affected and the seniors choose to pre-retire. In Germany, the disutility of work is low and there are no pre-retirement benefits to start with. For the same reason, the decomposition of employment response in France in Germany differs. Lower wages stimulate the opening of new vacancies and increase total employment, but the old and the young in the two economies are affected differently. Lower bargaining power mainly reduces junior wages in France, whereas it reduces all wages in Germany, as manifested by the evolutions of the seniority premium. Put differently, the vacancy increase mainly benefits the junior workers in France. In Germany, new jobs are filled by both the young and the old. Finally, the bargaining power shock is sufficient to accounts for the lower labor shares in both economies. In sum, the declining bargaining power matters for the fall in the senior participation rates and the labor share, while its effect on employment is ambiguous and depends on the reservation wages and the generosity of old-age welfare. Bargaining power also matters for the evolution of the seniority premium in the French simulation.

The effect of a negative matching efficiency shock is presented in column (v) of Table 2. As lower matching efficiency reduces the probability for the firms to fill a vacancy, the effect on the seniors is twofold. On one hand, they are negatively hit by the lower labor demand and falling wages. On the other hand, they are encouraged to increase their participation to compensate for the lower early retirement transfers. In both countries, the senior participation rate is reinforced. This is the case especially in France since benefits in Germany are negligible to start with. In both economies, the senior employment rates fall as the lower demand dominates over the higher supply of senior labor. Junior employment rates fall unambiguously. Matching efficiency thus emerges as an important force behind both the (positive) senior participation and (negative) employment changes. It has little effect on the labor share, and largely counterfactual or no effect on the seniority premium.

The four shocks – to the pre-retirement benefits, aging, matching efficiency and bargaining power – are combined in scenario (vi) in Table 2, while Figure 3 plots the shock decomposition as well as the match between the real and artificial data.<sup>16</sup> The model's predictions match the data well. For France, the model explains 86% of the rise in early retirement. In France, comparing to scenario (iii) with transfers and aging only, the model matches better the participation and employment rates, as well as the seniority premium and labor share. The senior labor force participation rate is matched better due to the (positive) effect of the matching efficiency; senior employment falls further due to the (negative) effect of both the bargaining power and the matching efficiency; junior employment is reduced by the declining matching efficiency; while the seniority premium and labor share are matched by the declining bargaining power. For Germany, there is now a considerable improvement in the participation, employment and labor share responses,

16. The model features non-linear effects and therefore the sum of effects due to individual shocks is not equal to the deviation obtained by the model with all shocks included.

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**Figure 3** Shock decomposition for the simulations 1968–2007  
 Note: Vertical axis represents percentage point deviation from the 1968 steady state.

comparing to scenario (iii), although the model overestimates the fall in the senior participation rate by 1.3%. The fall in the bargaining power is important in matching the senior participation rate and the labor share. The matching efficiency is instrumental to reproducing the senior and junior employment rates. The model only misses the rise in the seniority premium in Germany. The reason can be gauged from Figure 1. The German case corresponds to low reservation wages  $(D^n - D^u)/P_d$ , and German bargaining power

is close to high  $\eta$ , the region where a fall in the bargaining power induces a fall in the seniority premium.<sup>17</sup>

### 4.3. Estimations and simulations under alternative specifications

In this section, we discuss two alternative calibration and specification choices. First, we discuss the seniority premium and its interpretation in terms of labor disutility. Next, we stress the important role of endogenous capital accumulation by presenting the results obtained under the assumption of small open economy with fixed interest rate.

#### 4.3.1. Alternative calibration of the relative disutility of work

Our model assumes that the disutility of work is age-dependent. Similar assumption is made in Hairault *et al.* (2015). Moreover, we assume different disutility of work in France and Germany. In the benchmark calibration, we capture the higher wage seniority premium  $w^s/w^j$  in France through a higher – relative – disutility term  $e^{D^n - D^a}$  as shown in Table 1. The interpretation of the higher seniority premium in France than in Germany is, however, open to debate. In part, it is likely to reflect pure seniority effects arising, for instance, from automatic seniority pay increases. Conen *et al.* (2012) suggest that pure tenure effects, irrespective of productivity, are more important in France than in Germany. OECD (2006, 2014a) also argue that lower wage flexibility due to seniority wage premia poses a larger problem to labor market adjustment in France than in Germany. This sort of effect can be captured by an age-dependent labor disutility term. A higher disutility of work for senior workers implies that (i) wages increase automatically with age and (ii) senior wages are less sensitive to exogenous shocks, for instance, to bargaining power, as if senior workers were more of insiders, comparing to junior workers.

However, a significant part of the observed average seniority premium also results from pure composition effects. Because low-skilled senior workers have a higher probability of unemployment and of early withdrawal from the labor market, perhaps because wage rigidities and minimum wage constraints are stronger for low-skilled workers, there is a selection bias in favor of high-skilled and high-paid workers. The larger seniority premium in France could thus reflect the higher average productivity level of employed senior workers in France resulting from such a selection bias. The question is whether this composition effect, possibly reflecting different degrees of wage rigidities across skill and age groups, is best captured by an age-dependent labor disutility parameter (as done

17. An obvious extension that could possibly remedy this is the introduction of unemployment benefits to the model. Benefits would likely increase the reservation wages of seniors by more than juniors because they are indexed on higher wages and therefore, as could be seen from Figure 1, could produce a rise in premium when the bargaining power declines. We have tested an alternative model, with unemployment benefits included, but we still fail to reproduce the rise in premium in Germany. It is likely that additional shocks would be required, for instance a rise in unemployment replacement ratio over time. However, while unemployment replacement rates rose substantially in Europe until 1970s, from 1970s onwards the changes in replacement rates have been limited. See next section for further discussion.

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so far), or whether we should instead account for it by further increasing the value of the senior productivity parameter  $\lambda$  in France.

To explore this issue, we consider an alternative calibration that keeps the same relative disutility of work in the two countries, while the wage premium is matched through the productivity ratio  $\lambda$ . For instance, assuming  $e^{D^j - D^u} = 1.22$  in each country implies  $\lambda = 1.26$  in France and  $\lambda = 1.04$  in Germany. Column '2007/ $e^{D^j - D^u}$ ' in Table A1 in the appendix shows that the shocks to the bargaining power  $\eta$  and matching efficiency  $\bar{m}$  under this alternative calibrations go in the same direction as in the benchmark. The magnitude of the shocks is now similar in the two countries, while in the benchmark the shocks were larger in France. Column ' $e^{D^j - D^u}$ ' in Table A2 in the appendix shows economic changes under the alternative calibration. New simulation results are similar to the benchmark, although the match to the data is arguably less appealing. In France, the model now reproduces less well the senior participation and employment rates, and it fails to match the junior employment rate and the seniority premium. In Germany, the new setting improves slightly on the seniority premium but worsens on the labor share.

These disappointing results are related to the consequences of bargaining power changes. With low age-dependent labor disutility, bargaining power changes affect junior and senior workers in much the same way. As shown in Column ' $e^{D^j - D^u}$ ' in Table A2, the decline in bargaining power reduces the junior and senior wages in similar proportions – the seniority premium is almost unaffected in France. The lower senior wage in turn generates unrealistically low senior participation and employment rates. In other words, the specification without an age-dependent labor disutility parameter fails to include the senior wage rigidity element needed to reproduce the data. As a conclusion, we think that the calibration with different relative disutility of work in France and Germany is preferable.

### 4.3.2. Fixed interest rates

It was observed above that the need to save for longer future is behind senior participation and employment rates rising in the presence of a longevity shock. However, capital accumulation also plays an important role in our search and matching setup because, through the interest rate, it interacts with vacancy creation. Indeed, when lifespans lengthen, capital accumulation lowers the cost of capital, which stimulates labor demand, induces firms to post more vacancies and bargain into higher wages, and *in fine* increases senior participation and employment rates. In our benchmark simulation of the full model with four shocks, the annual interest decreases from 4% to 3.1% and 3.3% in France and Germany, respectively. This is not inconsistent with empirical facts as, by the late 2000s, real interest rates in France and Germany were lower than in the late 1960s (Yi, 2016).<sup>18</sup>

18. We deliberately refrain from attempting to reproduce the real interest rates because the evolution of real interest rates is likely driven by more complex forces than those select few considered in this paper.

To better illustrate the connection between capital accumulation, lower interest rates, participation and employment, we replace the capital market equilibrium of (42) with the small open economy assumption that  $R_t = R^*$ . Column '2007/ $R^*$ ' in Table A1 in the appendix shows that – when we break the link between capital accumulation and vacancies – the estimated shocks to  $\eta$  and  $\bar{m}$  are very different from the benchmark with endogenous interest rates. We no longer obtain the fall in the bargaining power between 1968 and 2007, and the bargaining power actually increases in Germany. The matching efficiency falls only slightly in France, but increases in Germany. Increases in the bargaining power and matching efficiency are certainly counterintuitive and contradict the evidence. Moreover, column ' $R^*$ ' in Table A2 in the appendix shows that the model's ability to reproduce the data is significantly worsened. Declines in senior participation and employment rates are disproportionate, and the model fails to match junior employment rates, seniority premia and labor shares.

## 5. DISCUSSION

In this work, we suggest that the structural change in the labor markets is important not only in accounting for the rise in early retirement in Europe but also in matching the evolution of other labor market variables. We show that lower bargaining power of labor acts as an important discouragement to participation because it induces lower wages. On the other hand, lower matching efficiency encourages participation as senior workers try to compensate for the negative effect of the falling wages on the expected retirement transfers. The two structural changes matter more in France than Germany, not only because the shocks are larger in magnitude in France (Table 3), but also because of larger rigidities in the form of higher disutility of work and more generous old-age welfare in France. Our model also shows that the two structural shocks are instrumental in matching the artificial to the actual data for other labor market outcomes (Figure 3). Beyond senior labor force participation, matching efficiency is essential for the determination of the senior and junior employment rates. In turn, the bargaining power drives all the variables of interest – the participation and employment rates, as well as the seniority premium and labor share. The model only fails to account for the rise in the seniority premium in the relatively flexible German economy.

An appealing feature of the model presented is its parsimony. Despite its simplicity, the model includes a number of sophisticated mechanisms. One is the interaction, through the interest rate, between saving and capital accumulation on one hand, and vacancy creation on the other. It is a crucial mechanism shaping employment opportunities and thus early retirement decisions. Second is the intertemporal connection between senior and junior employment through the determination of junior wage. Thus policies encouraging early retirement, or shocks to longevity, have a bearing on junior employment not only through the more direct channel of job competition between the young and old. Third is the interaction between labor market institutions. Negative changes both to the bargaining power and matching efficiency, having bearing on wages and through them on retirement benefits, interact with the early retirement schemes in

determining the participation decision of senior workers. The negative income effect due to lower benefits is not enough to halt the exit of seniors from the labor force when the bargaining power is reduced, but is sufficient when the matching efficiency falls. The degree of such interactions varies between the two countries because of the differences in the wage flexibility and generosity of old-age welfare. A crucial feature in our modeling strategy is the disutility of work which increases with age and has a considerable effect on wage flexibility. The disutility of work is higher in the French economy. Important differences thus emerge in how the senior labor force participation reacts to the structural change. The seniors in France are less likely to bargain into lower wages when their bargaining power falls which, combined with generous old-age welfare, induces them to retire more willingly. On the other hand, the seniors in Germany are little affected by the falling wages when the matching efficiency is reduced because they have low disutility of work and low retirement replacement rates.

A number of extensions to the model could be envisaged. First, beyond matching efficiency, a larger array of factors have been proposed in literature to explain the European labor market dynamics, especially the rise in unemployment since 1970s. They include, for instance, unemployment insurance which our model ignores. Compiling data from various sources, Marchiori *et al.* (2011) show that unemployment insurance rose substantially in Europe between 1940s and 1970s. However, after 1970s, the changes in the generosity of the unemployment insurance schemes were limited. As we start our model in 1968, we believe that the subsequent changes in unemployment replacement rates are less important than the rise in early retirement benefits, the decline in bargaining power and the fall in the matching efficiency, all of which gained speed starting in 1970s. Moreover, unemployment insurance itself may adversely affect the matching efficiency, hence to maintain tractability we prefer to focus only on the matching efficiency shock.

Second, the drop in the labor share might also be related to other factors beyond the declining bargaining power of workers. It is widely believed that the declining bargaining power of labor *vis-a-vis* capital has been reflected in the declining labor share (Bental and Demougin, 2010; OECD, 2012a). As mentioned in the introduction, this has resulted from the changing nature of bargaining arrangements and globalization, both of which have weakened the labor market position of workers *vis-a-vis* firms. However, other factors have also played an important role. Bentolila and Saint-Paul (2003) point to technological change and capital deepening. Checchi and Penalosa (2010) find that minimum wages are associated with labor share changes in the opposite direction. Daudey and Decreuse (2006) consider the importance of more educated workforce that has mitigated the decline in the labor share in the OECD. What our model shows is that the bargaining power does matter for the labor market participation decisions, and its decline leads to participation changes in the direction consistent with the data. Increasing the number of free shocks further (now limited to  $\eta$  and  $\bar{m}$ ) would improve the match between the artificial and real data. At the extreme, a full identification scheme with the number of free shocks equal to the number of variables one wishes to reproduce would generate a perfect match.

## 6. POLICY IMPLICATIONS AND CONCLUSIONS

Proponents of early retirement measures believed that an exit of older workers from the labor market would make space for the employment of the young. Consistent with other work that explores labor market outcomes over the life cycle (e.g. Chéron *et al.*, 2011, 2013), our simple three-generation model with labor market frictions demonstrates that such reasoning ignores the dynamic effects that an exit of older, and possibly more productive, workers might exert on the economy. In particular, our model predicts that – on one hand – the young benefit from lower job-competition from the old but – on the other hand – firms' incentives to open vacancies are reduced when they face of a smaller pool of job applicants. In our calibrated model for France and Germany, the former effect dominates, especially in the French economy characterized by a rigid labor market.

Another interaction is related to saving and capital accumulation. With rising longevity, while the seniors work longer to save for longer future, lower interest rates aid job creation. Thus our model vindicates the virtue of longevity, in line with literature (e.g. Bloom *et al.*, 2007, 2014). Motivation to work longer and save will become stronger when pay-as-you-go pension systems are progressively replaced by fully funded schemes. Our model is ambiguous regarding the employment rate of the young when they are faced, as would be in such a scenario, with the growing numbers of older workers. The comparison between France and Germany shows that the effect of longevity on the junior employment rate depends on the flexibility of senior wages (scenario (ii) in Table 2).

As the concern of governments has already shifted to averting budgetary crises looming in the light of rapid population aging, attempts to raise the retirement age, to lower the retirement benefits and to reform the pensions towards self-funding have all aimed at encouraging older workers to work longer. Germany, France and other European countries have undertaken such steps (OECD, 2012b, 2013b, 2014b). In France, this has been met with much stronger opposition to the reform, including from the youths, which is consistent with our model that features a higher net disutility of work in France. Our model also predicts that the young in France might be more likely than their counterparts in Germany to gain from the early retirement of senior workers because higher seniority premia in France stifle the overall job creation.

The main feature of our model is its ability to illustrate the responses of the labor market to changes in the bargaining power of labor and the efficiency of matching workers to jobs. The bargaining power of labor has been falling for decades and the trend is unlikely to be reversed, especially in the context of the recent economic crisis. *Ceteris paribus*, we would expect more willingness on the part of the seniors to retire early, especially in France where reservation wages are relatively high. Indeed, since 2008, many firms in France have successfully offered pre-retirement options to their senior employees (OECD, 2014a). Second, with lower bargaining power, workers face downward pressure on wages. Comparing to the Germans, French older workers have been less willing to accept this, which is consistent with our model's predictions of the seniority premia. In

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line with the model, a number of German industries have successfully negotiated more flexibility with their workers, regardless of age (OECD, 2012a). In France, on the other hand, it has been the young who have suffered knock-on-effects of falling or stagnating real wages (INSEE, 2015). As job creation is currently low, this naturally translates into few vacancies but, as economy picks up in the future, it could be French younger rather than older workers who might benefit from a faster recovery of jobs.

Our model also predicts that young workers' employment would unambiguously benefit from more efficient labor markets, pointing to the desirability of measures that help workers find jobs. However, the model demonstrates an ambiguous effect of labor market efficiency on the labor force participation of the old, depending on the relative strength of the supply and demand for labor. On one hand, better matching of workers to jobs encourages job creation but, if higher wages translate to higher early retirement benefits, some seniors might retire early. This is more likely when the disutility of work is relatively high. However, if European countries progressively move away from generous pre-retirement measures and encourage workers to fund their own retirement plans, the incentive to pre-retire will weaken and higher matching efficiency will also benefit the labor force participation of older workers.

## APPENDIX

Tables A1–A2

**Table A1** Exogenous shocks 1968–2007 under alternative specifications

France		1968	2007	Change	2007/ $e^{D''-D''}$	Change	2007/ $R^*$	Change
Transfers	$\rho^i$	0.215	0.32	+48.8%	–	–	–	–
Longevity	$\sigma$	0.62	0.91	+46.8%	–	–	–	–
Bargaining power	$\eta$	0.79	0.64	–19%	0.67	–15.2%	0.79	0%
Matching efficiency	$\bar{m}$	0.98	0.65	–33.7%	0.74	–24.5%	0.92	–6.1%
Germany		1968	2007	Change	2007/ $D'''$	Change	2007/ $R^*$	Change
Transfers	$\rho^i$	0	0.075	+0.075	–	–	–	–
Longevity	$\sigma$	0.60	0.85	+41.7%	–	–	–	–
Bargaining power	$\eta$	0.75	0.67	–10.7%	0.62	–17.3%	0.83	+11.7%
Matching efficiency	$\bar{m}$	0.99	0.79	–20.2%	0.72	–27.3%	1.19	+20.2%

Notes:  $\rho^i$  is the early retirement benefit ratio,  $\sigma$  is the survival probability at age 65,  $\bar{m}$  is the matching efficiency,  $\eta$  is the worker bargaining power. Column '2007' recalls the calibration used in the benchmark simulations. Column '2007/ $D'' - D''$ ' reports the changes to the calibration when we fix the same  $D'' - D''$  in both countries, and instead match the seniority premia through different productivities of senior relative to junior workers,  $\lambda$ . Column '2007/ $R^*$ ' reports the changes to the calibration when we assume a constant and exogenous interest rate.

**Table A2** Data and simulations under alternative specifications

	Data/model	Data	Full model	$e^{D^n - D^u}$	$R^*$
	1968	1968–2007	$\rho^i, \sigma, \bar{m}, \eta$	$\rho^i, \sigma, \bar{m}, \eta$	$\rho^i, \sigma, \bar{m}, \eta$
<i>France</i>					
Senior part. rate	86	<b>-17</b>	<b>-14.7</b>	-20.6	-53.2
Senior emp. rate	84	<b>-19</b>	<b>-17.9</b>	-21.4	-49.8
Junior emp. rate	98	<b>-5</b>	<b>-5.3</b>	-2.0	+8.3
Seniority premium	30	<b>+10</b>	<b>+9.6</b>	+1.2	-2.8
Labor share	67.2	<b>-3.9</b>	<b>-4.2</b>	-3.7	-1.0
<i>Germany</i>					
Senior part. rate	87.5	<b>-6</b>	<b>-7.3</b>	-7.8	-21.5
Senior emp. rate	87	<b>-15</b>	<b>-14.6</b>	-15.0	-21.2
Junior emp. rate	99	<b>-8</b>	<b>-10.2</b>	-10.1	+0.1
Seniority premium	10	<b>+5</b>	<b>-0.1</b>	+1.5	+0.1
Labor share	64.1	<b>-1.8</b>	<b>-2.5</b>	-4.3	+2.2

Notes: Senior part. rate =  $1 - F^s$ , senior unemp. rate =  $U^s/(1 - F^s)$ , senior emp. rate =  $N^s$ , junior emp. rate =  $U^j$ , labor share =  $(w^{NJ} + w^{Ns})/(F - aV)$ , seniority premium =  $w^s/w^j - 1$ . Column 'Full model' recalls the result obtained under the benchmark simulation. Column ' $D^n - D^u$ ' reports the result obtained under an alternative calibration of  $D^n - D^u$ . Column ' $R^*$ ' reports the result obtained under an alternative specification with a constant and exogenous interest rate. Results expressed in percentage point deviation from the initial steady state.

## ACKNOWLEDGEMENTS

We are grateful for comments received from the participants of workshops at BCL, UCL and PSE, and annual meetings of SOLE, EEA and EALE. We also thank two anonymous referees for their suggestions that helped improve this paper. This work should not be reported as representing the views of the Central Bank of Luxembourg or the Eurosystem. The views expressed are those of the authors and may not be shared by other research staff or policymakers in the Central Bank of Luxembourg or the Eurosystem.

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