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WELFARE AND THE LABOUR MARKET IN THE EU

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Abstract

Over the last two decades, EU institutions have been increasingly concerned with the issues of unemployment reduction and job creation. The EU has recommended that member states develop welfare systems that moderate the negative effects of market relationships on the one hand, and enhance the efficiency of market performance on the other.

This paper provides an overview of labour market policies to protect individuals from unemployment. It shows that in the context of EMU and EU enlargement, policies such as unemployment insurance could improve welfare, to the extent that it encourages labour mobility, but has negative effects on individuals' job search efforts. To counter welfare and inactivity traps, member state governments are asked to reform benefit and tax systems towards more employment-friendly policies. Further, the effect of population ageing on the labour force is considered, along with options to sustain labour force supply and state pension provision. The paper concludes that measures to expand the range and quality of employment opportunities available to older workers will become increasingly important and that governments will have an important educational and coordinating role to play in facilitating these adjustments.

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Introduction

Although unemployment fell in most of the European Union countries in the second half of the 1980s, in 1990 it started to rise again. In the following two years unemployment reached new heights and took a central place on policy-makers' agenda. Individual governments developed their own responses. Also, unemployment reduction and employment promotion took on a new importance for the EU, as stressed by Casey (2002).

The EU accords a great role to governments in guiding markets and overcoming market failures. Hence, the EU would tend to advocate a welfare state as a productive factor that, by increasing security, encourages the acceptance of change and so enhances growth. The EU developed its welfare strategy in the form of recommendations. The aim of this paper is to present an overview of how the member state governments meet the EU recommendations when implementing welfare state policies that intervene to moderate the negative effects of market relationships on the one hand, and to enhance the efficiency of market performance on the other.

The roots of the EU strategy have been tracked back to the publication of a new strategy for cooperation for growth and employment in mid-1992, a document that inspired the Delors growth initiative at the Edinburgh summit of 1992 and the subsequent White Paper on growth, competitiveness and employment. The Essen summit at the end of 1994 issued a series of employment recommendations, but the strategy was crystallised in the Amsterdam Treaty of 1997. This gave the Council the competence to set out recommendations upon which member states were required to act, while a special jobs summit in Luxembourg at the end of 1997 developed the first set of employment guidelines. In each succeeding year, the end-of-year summit has added to or amended these.

The nature of the recommendations was predicated upon the diagnosis of the problem. The EU was conscious not only that unemployment, but also structural unemployment was high. This was symptomatic of an insufficient ability to adapt to change. Moreover, although an employment strategy implies a focus upon policies concerned with labour, the EU recognised that the achievement of flexibility had been hindered by the instability of the macroeconomic environment and inappropriate macroeconomic policies. Indeed, the Luxembourg jobs summit concluded, before laying out the details of any 'employment guidelines', that with regard to the macroeconomic context, it is essential for the Union to pursue a policy of growth geared to stability, sound public finance and structural reform.

Turning from the macroeconomic environment to the labour market itself, for enhancing labour market adaptability, the EU requires member states to examine proposals for new provisions and incentives to make sure they will contribute to reducing barriers to employment. Moreover, tax and social security systems, and namely unemployment and related compensation systems, may generate disincentives to work. Thus the EU guidelines ask member states to make social protection systems more 'employment friendly'. Member states are asked to review and, where appropriate, reform their benefit and tax systems to reduce poverty traps, and provide incentives for unemployed or inactive people to seek and

take up work or measures to enhance their employability and for employers to create new jobs. However, the EU recognises that benefit cuts cannot be pursued without limit, since there is some level of ‘poverty’ below which people cannot be allowed to fall (Casey, 2002).

In order to overcome the negative implications of an approach that is based upon reducing benefits, the EU promotes active labour market policies. The European Union makes it clear that increasing the employment rate can help ensure the sustainability of social protection. The EU strategy makes repeated reference to battles against exclusion and the importance of bringing groups on the margin of the labour force or even outside the labour force back to work. Therefore, under guidelines to increase employability, it concerns itself explicitly with older persons and first-time job seekers.

In the following sections, we examine how those different strategies are implemented in the EU. In section 1, we give an overview of labour market policies to protect people against unemployment. We study the potential benefits and costs of the unemployment insurance system (section 1.1) before moving to a more employment-friendly policy inspired by the tax credit mechanism implemented in the US (section 1.2). We then study the early retirement policies implemented in the EU, which aim at improving young job seekers’ employment prospects (section 1.3). We demonstrate that such policies could have perverse effects in the ageing demographic context of the EU. Indeed, early-retirement policies create more financial distress by increasing the dependency ratio, and therefore exacerbate the financial imbalance of the pay-as-you-go (PAYG) social security systems in the EU. The last two sections are devoted to the question of population ageing in the EU. Indeed, in the face of rapid population ageing and the trend towards early retirement, there is an urgent need to reform old-age pensions and to promote better employment opportunities for older persons. In section 2, we give an overview of the demographic evolutions in the European Union and raise the question of how to best support older workers. In section 3, we address this urgent question by first studying the different options for retirement reforms in the EU (sections 3.1 and 3.2). Then we consider the need to improve the job skills and working conditions of older workers (section 3.3).

1. Protecting individuals against unemployment

1.1 Unemployment insurance systems

1.1.1 Unemployment benefits and labour mobility

Two common ways of protecting individuals against the risk of being unemployed are to provide unemployment benefits and to adopt employment protection legislation. Most European countries use both methods but differences in degree are substantial. A clear trade-off between the use of employment protection legislation (EPL) and unemployment insurance (UI) seems to exist. For instance, southern European countries adopt stronger dismissal restrictions while providing smaller unemployment insurance programmes. However, this kind of unemployment protection design is inappropriate in the context of economic and monetary union (EMU) and the eastern enlargement of the EU, given the new demands for labour mobility. As suggested by Boeri et al. (2002), southern European countries should adopt more ‘mobility friendly’ policies, such as unemployment benefits.

Indeed, in the presence of stronger competitive pressures, especially those associated with price transparency under EMU or the EU’s enlargement with low-cost labour countries, the

adjustment to new conditions is expected to require significantly more labour reallocations. In that context, unemployment insurance has a better performance than employment protection legislation in encouraging labour reallocation. As a matter of fact, employment protection provisions decrease labour mobility, whereas unemployment insurance can have positive effects on the probability that an unemployed person will move for a new job.

In a recent paper, Tatsiramos (2002) studies how unemployment benefits affect the incentives of unemployed workers to move to another region to accept a job, that is, to what extent unemployment benefits affect regional labour mobility. It is a fact that labour mobility rates in Europe are very low compared with the US. While low mobility rates across European countries can be justified by cultural and language barriers, it is hardly convincing that these are the determinants of low mobility within countries. What makes European workers more geographically attached? The research on low regional mobility has focused on institutional factors such as the unemployment insurance system, which can explain the differences in mobility rates between the US and the EU member states. The attachment arises because of the disincentive effect of unemployment insurance benefits, which reduces the probability of exiting unemployment and consequently changing regions for a new job. Nevertheless, using the European Community Household Panel (ECHP) for Germany, France, the UK, Italy, Greece and Spain, Tatsiramos (2002) shows that the unemployed are significantly more likely to move compared to the employed in Europe. Moreover, Tatsiramos (2002) considers the effect of UI benefits on the probability of migrating for a restricted sample composed of Germany, France and the UK, and demonstrates that unemployed persons with benefits are more likely to move to another region compared with unemployed individuals without benefits.

In the context of EMU and the EU's eastern enlargement, a labour market policy such as unemployment insurance is a 'welfare-improving' policy, in the extent that it encourages labour mobility. Nevertheless, such a policy could also have perverse effects, in the extent that it has a disincentive effect on the job search effort.

1.1.2 The perverse effect of unemployment insurance on job search efforts

Unemployment insurance is the most common concern of empirical studies on unemployment duration and job search behaviour. The standard prediction is that unemployment benefits tend to increase the duration of unemployment, because of the disincentive effect of benefits on job search efforts, explaining the difference in unemployment rates between the US and EU member states. Despite the important political influence of this view, the empirical evidence of the level, entitlement and duration of benefits varies among the countries. Such differences are probably related to the different characteristics of the unemployment insurance systems across the countries. However, according to Arranz and Muro (2002) differences might have also resulted because many of those studies did not properly consider unemployment assistance (UA) after the expiration of the UI. How do unemployment insurance and assistance benefits influence the chances of exiting unemployment?

Using administrative data sets from the Spanish Labour Office, Arranz and Muro (2002) show on the one hand that UI increases the likelihood of exiting unemployment during the first 12 months and is insignificant onwards; on the other hand, the UA level negatively affects the transition rates from UA to a job. Concerning the tendency to cease unemployment during the final days before the end of UI benefits, Arranz and Muro (2002) demonstrate that the unemployed who receive UI increase the likelihood of exiting unemployment when UI exhaustion approaches, whereas UA recipients escape quickly at the beginning of UA and

their rate of exit does not increase near the time of UA exhaustion. On the whole, unemployment insurance and assistance benefits have perverse effects to the extent that they negatively influence the job search effort of the unemployed. Consequently, they have a significant detrimental influence on the duration of unemployment and the probability escaping from unemployment to a new job.

How bad are such labour market policies for the unemployed and the fluidity of the European labour markets? In other words, does a ‘welfare trap’ exist in Europe? Indeed, as pointed out by Hansen and Lofstrom (2002), understanding the dynamic processes underlying the observed utilisation of government transfer programmes is essential. If, for example, observed serial persistence of welfare utilisation is the result of permanent, unobserved heterogeneity, i.e. individuals have time-invariant, unobserved preferences for welfare participation, the observed dependence is spurious and policies directed at moving individuals off welfare are less likely to be successful.

On the other hand, if the persistence is the result of ‘structural’ dependence, in the sense that previous participation directly affects the current probability of participation, i.e. a ‘welfare trap’ exists, changes in benefit rules are more likely to meet their objectives of reducing utilisation. There is a lack of empirical evidence about that question in Europe. One exception is the paper by Hansen and Lofstrom (2002), which investigates the possible existence of a welfare trap in Sweden and, if it does exist, whether programme participation differs between immigrants and natives in Sweden. They find evidence on the existence of such a trap, especially among immigrants. They suggest that programmes aimed at assisting labour market entry or re-entry are more likely to be successful among the portion of the population that does not show a preference for welfare participation.¹

EU recommendations to counter the welfare trap and help unemployed persons escape from the inactivity trap seek reforms of benefit and tax systems. Such reforms would provide incentives to unemployed workers to search for and take up work. It is particularly important to give incentives to low-skilled workers, who are the most likely to fall into welfare and poverty traps. Generally speaking, reforming social protection systems to be more employment friendly consists of implementing a tax-credit mechanism, such as the Earned Income Tax Credit in the US. The issues of a tax credit scheme and how to make work pay for welfare recipients are reviewed in the next section.

1.2 Making work pay

1.2.1 *Labour supply disincentives of the welfare state*

In the European Union, unemployment has been increasing since the 1970s. This development has particularly affected the unskilled. While skill-biased technological change seems to be reducing demand for low-skilled labour worldwide, wages in the EU are too rigid to absorb the adverse employment impact of this process on the low-skilled. One explanation for the lack of flexibility in the European labour market comes from the provision of generous subsistence payments to the unemployed, in conjunction with high marginal transfer-reduction rates on small labour earnings.

We can illustrate that point with the example of France, as reviewed by Fugazza et al. (2002). For instance, the French tax and transfer system contains various elements that may influence work incentives, in particular among individuals with potentially poor labour-market

¹ This also applies to immigrants in the case of Sweden.

outcomes. The main argument builds on the fact that, because of social transfers, individuals with low expected returns from the labour market would face substantially high effective marginal tax rates if they had to return to employment.

Women in the core of the labour market are the most interesting demographic group with respect to the responsiveness of work incentives to modifications of tax and transfer systems. Indeed, a major component of the French system is the family element and Fugazza et al. (2002) observe that there is a higher proportion of women than men who are single parents. The latter group is often seen as one of the principal client groups for transfer programmes. Particular attention is paid by the authors to one interesting family transfer programme, called the *Allocation Parentale d'Education* (APE), which is contingent on labour market status and history. Under this programme and before 1994, mothers with at least three children are eligible to transfer the programme if they decide to stop their professional activities. After 1994, this programme was extended to mothers with at least two children. It is observed that the employment rate of mothers of at least two children fell from 58.6% in March 1994 to 47.4% in March 1997. By contrast, the employment rate of mothers who were not eligible for the programme increased by 3 points during the same period of time. According to Piketty (1998), this fall in the employment rate is completely attributable to the extension of the APE programme. Fugazza et al. (2002) simulate the impact of the removal of such a programme. They find that the removal of the APE scheme makes employment more valuable than inactivity, even at the lowest activity level. In particular, without the APE, part-time jobs become relatively more attractive, so the rise of the female labour supply is likely to be biased towards short-term, part-time jobs.

However, even if the European strategy for employment recommends the reform of unemployment and benefit systems, it is recognised that benefit cuts cannot be pursued without limit, since there is some level of 'poverty' below which people cannot be allowed to fall. In order to overcome the labour supply disincentives of the European welfare state, reformers could better choose to increase households' in-work income, as in the US, rather than cutting effective benefits received in unemployment and inactivity.

1.2.2 Tax credit experiences in Europe

According to Fleurbaey and Maniquet (2002), who have analysed the design of a fair income tax, one key result of such a system would be that those individuals who have the lowest earning ability but work full-time, the so-called 'hardworking poor', would be granted the greatest subsidy (as a negative tax) of the whole population. This result gives a certain legitimacy to some recent evolutions of the welfare system in several Western countries, where the marginal tax rates on low incomes have been reduced. However, this result depends on the respect of individual choices of labour participation. It also sheds light on an interesting ethical issue, which deserves to be, according to the authors, the focus of public debate: the choice between a tax credit system that provide incentives for labour participation to individuals with a low earning ability and a universal transfer should take into account the fact that individuals should be held responsible for their working hours.

First in the US and then in Europe governments have chosen to implement a tax credit system. We briefly review the American experiments, before focusing on the European ones.

Over the 1990s, the US fundamentally changed the structure of its public assistance programmes to low-income families. In 1993, one of the first legislative proposals from the Clinton administration was a major expansion of the Earned Income Tax Credit (EITC). The EITC operates as a refundable tax credit through the federal tax system to subsidise low-wage

workers in low-income families. As pointed out by Blank (2002), more significant caseload declines and larger increases in labour force participation among less-skilled workers occurred than many observers would have predicted. Entry into welfare fell, and exits from welfare rose. There remains a debate as to how much these results were because of a strong economy, programme reform or their interactive effects. While some of this change in behaviour is related to traditional labour supply responses to growing wages and increased financial incentives to work, the changes were greater than historical experience would have suggested.

The experience from the US becomes increasingly relevant to the policy debate elsewhere. In contrast to earlier decades, when the different design and lower generosity of US social welfare programmes led US policies to be dismissed as irrelevant or aberrant by other Westernised nations, during the 1990s many of these countries watched the welfare experiments of the US with great interest. For instance, the Self-Sufficiency Project (SSP), designed to test a policy that makes work pay better than welfare, was implemented in Canada in 1994 (Michalopoulos, 2002). This project offered a temporary earnings supplement to selected long-term income assistance recipients in two Canadian states, namely British Columbia and New Brunswick. This policy increased full-time employment, earnings and income and reduced poverty in the two states involved in the reform.

Given the success of such policies, some European governments enacted tax credit policies. We now focus on the German and French experiences.

Bonin et al. (2003) evaluated the impact of different concepts to support less-qualified job seekers through subsidising social insurance contributions, as proposed in Germany. Using data from the German Socio-Economic Panel, they show that policies aimed at improving in-work income at the bottom end, in order to reduce the labour supply disincentives emanating from the German welfare system, do not appear to be very effective. The reason for this is that the empirical wage elasticity of the labour supply is very small, according to the authors' estimates.

Moreover, according to Bonin et al. (2003), subsidies of low labour incomes could have accidental size effects. Since leisure is a substitute for men and women, there is a tendency for husbands to reduce the labour supply to the benefit of their wives, whose lower earnings capacity makes it easier for them to fall into the net of the wage subsidy. If the subsidised income range becomes wide enough, this could even reduce aggregate labour market participation.

This question is also central in the contribution by Fugazza et al. (2002), which assesses the impact on the female labour supply of the *Prime Pour l'Emploi*, a tax credit mechanism introduced in France in 2001. First, they simulate the impact of more generous schemes equal to and above that expected to be effective in 2003.² In the simulated scheme, they show that employment for some numbers of hours supplied is more rewarding than inactivity. Nevertheless, in general, the impact remains relatively weak and could lead to an insignificant labour supply response.

According to the authors, the family component of the tax credit scheme, in which couples with only one spouse working are given substantial, incremental financial support, has an

² Indeed, as argued by Cahuc (2001), this tax credit scheme has not been effective in creating labour supply incentives because of its relatively low generosity. This is particularly true when compared with other existing schemes such as the SSP in Canada and the EITC in the US.

ambiguous effect on the other spouses' labour supply. Fugazza et al. (2002) simulate the removal of the family component and show that it could induce women to become pickier with respect to part-time jobs.

Finally, the authors simulate the case where the level of the credit tax depends exclusively on the wage rate per hour, meaning that working part-time or full-time gives the same amount of credit for a similar wage rate per hour. The reform largely increases the attractiveness of part-time work.

As a conclusion, the tax credit scheme generates disappointing results in terms of labour supply incentives, because earning improvements are very weak. Nevertheless, as suggested by Fleurbaey and Maniquet (2002), tax-credit mechanisms implemented in France and Germany are policies that harshly punish the individuals working part-time and give exclusive subsidies to full-time jobs. European governments should consider part-time jobs as a reduction of the persons' earning ability. An individual who only finds a part-time job should be treated like a person who works full-time at a half wage-rate. This last economic policy recommendation is sustained by the simulations of Fugazza et al. (2002), who find that when the duration of work and the tax credit amount are completely dissociated, labour supply is expected to respond sensitively because of an increased attractiveness of short-term positions.

Policies aimed at making work pay are quite recent. In the last 30 years, faced with a restructuring environment and increasing unemployment, European governments made widespread use of a variety of early-retirement programmes. This policy seemed to be the royal route to improving the employability of the young and fighting unemployment. In the next section, we show that the beneficial labour-market effects of early-retirement policies have been rather modest in the EU as a whole.

1.3 Early retirement programmes

1.3.1 A social security system with early retirement

In the last 30 years, most European countries have experienced a dramatic drop in the labour force participation of their middle-aged and older workers. The average labour force participation rate of male workers aged between 55 and 64 years has decreased from approximately 80% in the 1960s to around 50% in the year 2000. At the same time, in most European countries generous early pathways out of the labour market were made available to redundant or unemployed older workers under a wide array of early retirement schemes. These included special pensions to unemployed older workers (in Austria, Finland and Germany), special contracted pensions for redundant workers (in Belgium, France and Germany), and disability benefits awarded on the basis of labour market considerations (in Denmark, Germany, the Netherlands and Spain). During the 1970s and 1980s, these eligibility criteria were relaxed and early retirement provisions became more widely available to older workers.

Blöndal and Scarpetta (1998) have analysed the characteristics of the workers who have used these early pathways from the labour market, in terms of their educational attainments and the sector in which they last worked in. In all EU countries – except the UK – the proportion of early retirees is higher among the less and moderately educated group. The sectoral breakdown shows that early retirement is more common in manufacturing and in construction.

After those two main observations, it is important to explain why there has been such a widespread adoption of early retirement policies, although these measures have been proved to be largely responsible for the decrease in the labour force participation of middle-aged and older workers, which has resulted in financial distress in the social security systems.

Gruber and Wise (1999) have suggested that early retirement policies may have been created to encourage older persons to withdraw from the labour force in order to provide more job opportunities for young workers.

According to Conde-Ruiz and Galasso (2003a), the adoption of early retirement policies was because of the appearance of a significant group of redundant or unemployed older workers, who were not yet entitled to an old-age pension. Several measures – such as the introduction of formal early retirement provisions or the weakening of the eligibility criterion – allowed this mass of redundant or unemployed older workers to withdraw from the labour market on a pension transfer. These authors argue that the initial political support and the long-run political sustainability of early retirement provisions require two conditions. The first one is a large initial shock to the labour market that gives rise to a mass of redundant older workers and the second one is some degree of intragenerational redistribution in the provision.

To discriminate among these explanations, Conde-Ruiz and Galasso (2003a) use data provided in 1986 by the Economic Commission for Europe at the United Nations on the institutional details – such as the retirement age and the eligibility criterion – of the first early retirement provision to be introduced in European countries. These institutional characteristics suggest that almost everywhere in Europe, between 1961 and 1977, generous early pathways from the labour market were offered to redundant or unemployed older workers, who were allowed to collect benefits under a wide array of welfare schemes.

The long-run political sustainability of this policy – as suggested by Conde-Ruiz and Galasso (2003a) – is based on the generosity of these provisions and on the existence of some redistribution between cohorts. In other words, to be politically sustainable, this policy has to be persistent. In fact, the political support of a relevant fraction of the current young and middle-aged workers hinges on their expectation that the early retirement provisions will be in place when they are able to take advantage of it. Over the last 30 years, these expectations have been fulfilled.

Conde-Ruiz and Galasso (2003b) find that early retirement provisions have perverse effects because they introduce economic distortions. The next section examines this view and the alternative policies that could have been adopted rather than early retirement.

1.3.2 The perverse effects of early retirement policies

Conde-Ruiz and Galasso (2003b) argue that the generous incentives to retire early induce workers to accumulate less human capital. This effect is stronger for less-skilled workers, who have a relatively high evaluation of leisure, since their opportunity cost, i.e. their foregone labour income, is smaller. The growth rate of the economy will thus be reduced, thereby introducing long-term distortions.

Thus the question arises as to whether this pre-retirement policy was the only possible response to the appearance of redundant workers with no entitlement to a pension? According to Conde-Ruiz and Galasso (2003b), a wide variety of temporary policies were available to transfer resources to the workers initially hit by the negative shock in their old age. However, these one-time policies did not typically enjoy the support of a large share of workers, and thus did not constitute a political equilibrium. To see this, the authors analysed alternative

policies that provide those older persons with an incomplete working history with the same transfer option as the early retirement pension. Such provision has no impact on the older persons entitled to a full retirement pension, and it provides a lump-sum transfer to the young.

Conde-Ruiz and Galasso (2003b) find that a clear trade-off emerges from comparing this policy to the early retirement provision. To win the support of the less-skilled young, such a policy has to generate enough income redistribution among the young. Thus, unlike the early retirement measure, this policy does not reduce long-term economic growth, but imposes a larger tax burden on the current young generation of workers. In a comparison of data by pairs, early retirement wins the support of the high-income workers who do not plan to retire early but prefer this provision because of its lower current tax burden, as well as the support of low income workers who expect to retire early.

Conde-Ruiz and Galasso (2003b) argue that pre-retirement policies have been implemented in Europe because there was substantial political support for early retirement. The authors also suggest that in the context of an ageing population, the political support for such a policy would be even greater.

Is there, however, a limit – either a financial or political constraint – to the size of a social security system? The political setting of Conde-Ruiz and Galasso (2003b) requires the burden imposed by population ageing to be almost entirely on the workers, whose labour income is taxed heavier in order to guarantee the vested interests of the elderly, and thus the value of their old-age pensions.

It could reasonably be argued that a political system should allow the negative effects of demographic shocks to be shared across generations. For instance, the social security tax rate that finances the pension transfers could be directly voted upon. In that case, young workers may choose to oppose the increase in the tax rate needed to retain the pension transfer in an ageing society. In this different political environment, a majority of voters may eventually choose to dismantle the existing pay-as-you-go social security systems.

It appears in this last section that the context of population ageing (which is the case in most European countries), increases the political support for early retirement. In such a demographic context, this support leads to more financial distress by increasing the dependency ratio and therefore exacerbating the financial imbalance of the PAYG social security systems in European Union. Before studying the question of reforming the retirement system in a context of population ageing, we briefly resume the demographic developments in the European Union for the last and next few years.

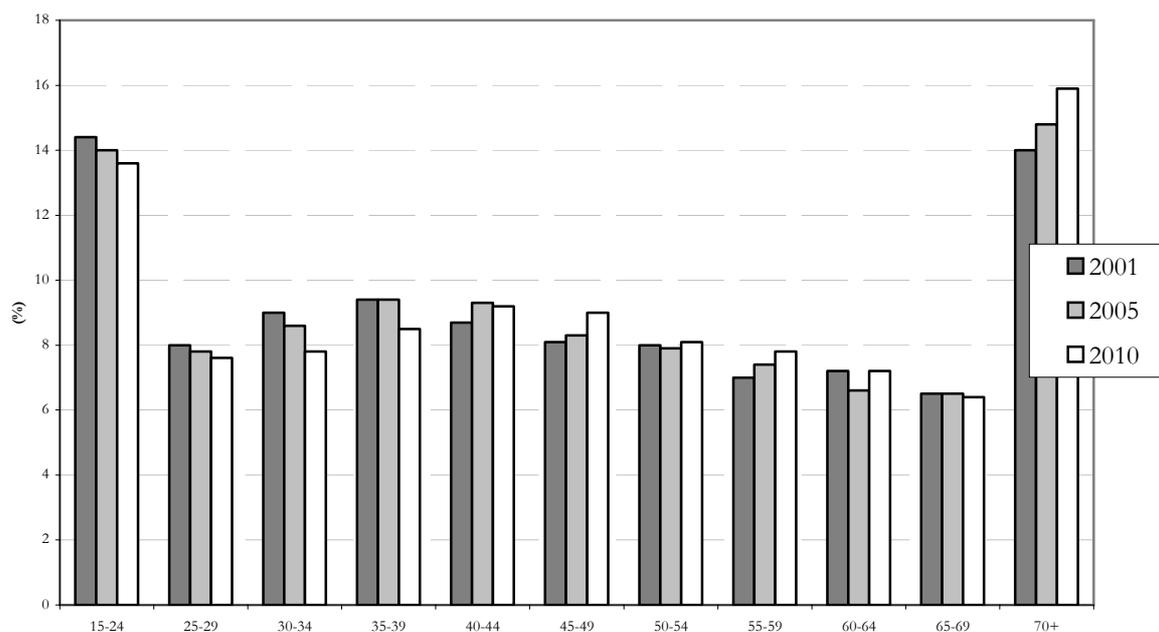
2. Demographic evolution in the EU

According to initial demographic estimates for 2001 published by Eurostat, the population of the euro area is estimated to be slightly over 300 million. Of this total, around 136 million people make up the labour force, either in employment or among those actively searching for a job. In the period 1996-2001, the euro-area labour force increased by an average of 0.8% per year, compared with average growth rates of 0.3% over the first half of the 1990s. Moreover, over the last two decades, the age composition of the labour force has changed quite substantially. The proportion of young persons (those aged 15 to 24 years) in the total labour force fell quite sharply, from 19% in 1983 to 12% in 2001. The percentage of people aged 50 to 64 years decreased steadily from 20.1% in 1983 to 18.7% in 1996 but rose to 20.4% in 2001. According to Genre and Gomez-Salvador (2002), this ageing process in the labour force of the European Union will become worse in the next ten years.

Indeed, population projections suggest that the growth rate of the working-age population in the euro area will be reduced further in the next ten years, resulting in stabilisation or even a fall in the labour force.

The proportions of the different age groups in the euro-area population as a percentage of the population aged 15 years and older calculated by Genre and Gomez-Salvador (2002) are represented on Figure 1.

Figure 1. Proportions of age groups in the euro-area population



Source: Genre and Gomez-Salvador (2002).

The figure shows the expected age breakdown of the euro area population in 2005 and 2010. By 2010, the proportion of the younger age groups (aged from 15 to 39) in the total population is expected to decline, from 42% to 37%. By contrast, the weight of age groups above 45 years old rises steadily, with the exception of the group aged between 60 and 69, whose weight will remain broadly stable.

The ageing problem, as revealed by these projections, will become a major concern of the developed world. Indeed, birth rates and age-specific mortality rates are falling. The result is that the world is confronted for the first time with the fact that the retired part of the population is becoming quite substantial. The ratio of retired persons to workers (the dependency ratio), is increasing to one to three or even more. It is sometimes thought that this is a transitory phenomenon and that the ratio will return to normal values again if a new equilibrium is reached. However, according to Cardoso and Van Praag (2003a), it is easy to show that this is only partially true. In a stationary demography the average age is a decreasing function of the birth rate; similarly, it increases with rising life expectancy. In all probability, European countries have entered into a demographic situation where the population growth rate hovers at zero or even becomes negative, while life expectancy extends to 80 years or more.

Given this new situation, the question of how the retired are to be supported becomes urgent. The next section is devoted to these issues, especially those concerning reform of retirement pension systems and the promotion of better employment opportunities for older workers.

3. Welfare and population ageing in Europe: How to respond to the challenge?

The forthcoming demographic evolution in industrialised countries raises many questions. In this section, we focus on two main queries. The first one deals with the ability of pension systems to withstand these changes and avoid a conflict between generations. The second one deals with the capacity of the European labour market to adapt to a new labour supply of older workers.

3.1 Retirement pension systems and demographic evolutions

There is a widespread consensus on the extent of the population ageing problem in Europe, which is a result of the baby-boom in the early post-war period, the subsequent fall in fertility rates from the end of the 1960s and increasing life expectancy. This will begin to affect public finances significantly as the baby-boom generation reaches the retirement age over the next few decades. The impact of these developments on public finances and pension systems is a particular issue of concern and debate in all member states.

In most European economies, the retirement pension system is based on two pillars according to Cardoso and Van Praag (2003b). The first pillar is a compulsory pension insurance system, based on compulsory savings, whereby workers save for their old-age pension. This is a major source of capital investments. The second pillar is a state pension, which is financed by compulsory contributions from the worker to a PAYG system. This system does not generate capital investments.

In practice, in each European country we find a mixture of both systems, but the mix varies widely among countries and among industrial sectors within countries. There is considerable variation in how old-age pensions are financed. In the UK and the Netherlands, the role of funded systems is very significant, providing 40% of total pension income in the UK. In other countries, such as France, Italy and Germany, almost all of the pensions are fed by a PAYG system. One of the main questions is what mix between the two systems we may expect. Indeed, in recent years most countries with an ageing population have tried to reduce the role of the governments through a partial dismantling of the PAYG system.

Is there a relation between the demographic parameters (e.g. the birth rate) and the probable mix between the two pension systems and what may be expected for the total level of retirement pensions if the demographic parameters change? According to Cardoso and Van Praag (2003a), the increasing weight on leisure together with the falling population growth rate will result in a fall in the contribution rates to the PAYG system, a greater accent on the capital reserve system, a lowering of the replacement ratio and a fall in the average welfare. However, Cardoso and Van Praag (2003b) also demonstrate that a permanent reduction of the population growth rate, even if it become negative, will not lead to a total dismantling of the welfare state. What are the various options for reform of retirement pension systems in Europe? The next section is devoted to answering this fundamental issue of the new century.

3.2 Pension reform options

Population ageing will pose challenges for fiscal, labour and financial market policies as well as for overall economic performance. The need for a comprehensive reform strategy to cope with these challenges is largely acknowledged. Given the demographic changes likely to occur in Europe over the next 50 years, Roeger (2002) analysed two options for a reform of the pension system: a gradual reduction in the replacement ratio and an increase in the retirement age. The demographic context is provided by Eurostat population projections to 2050, which are presented in section 2. According to these projections, the dependency ratio will rise from the current 0.24 to 0.49 in 2050.

3.2.1 Reductions in the replacement ratio

The first option analysed is a reduction in the generosity of the pension system. A recent survey of the Economic Policy Committee among member states' finance ministries suggests that, on average, a reduction of the ratio of pension expenditure to GDP by about 2.5% in 2050 will be achieved by a reduction in the net replacement rate of the system from its present level of 74% down to 58% in 2050. This figure of 58% only reflects the proportion of retirement income coming from the public PAYG system since it does not include private pension provision.

According to Roeger (2002), this reduction in generosity could be achieved in a large number of ways, including cutting benefits directly, changes in the eligibility criteria, such as the number of years needed for full pension entitlement, or by changes to the rules applied with regard to indexation. Roeger (2002) assumes that all of the decrease in generosity is achieved through a movement on behalf of public pension schemes towards some form of price indexation. The author estimates that thanks to such a reform, budgetary gains are significant. However, the stabilisation of the EU's PAYG pension system would not appear to be achievable solely by shifting from a system that is 100% indexed on wages to one based exclusively on prices. In addition, a decline in the generosity of the PAYG system would have a significant impact on growth. Hence the fall of the replacement ratio would be partially offset by the loss in pension contributions owing to the fall in GDP growth.

3.2.2 Increase in retirement age

The second option analysed by Roeger (2002) is an increase in the retirement age. In this retirement simulation, the effective retirement age, which is presently close to 60 in the EU, is brought back up to the average statutory retirement age of 65 gradually over the next ten years. Part of the rationale for this simulation is the fact that since the 1960s there has been an enormous deterioration of the so-called 'passivity ratio', which measures the number of years worked relative to the number of years spent in retirement. In the 1960s, the passivity ratio was over 4.25.³ By 2000 this ratio had fallen to less than 3 owing to increases in life expectancy and falls in the effective retirement age to less than 60, along with early retirement policies (see section 1.3).

By bringing the retirement age back to 65, the passivity ratio is expected to improve over the next ten years, but to deteriorate again over subsequent decades. This pattern of change over the next five decades is driven by the ongoing increase in life expectancy over the period as a whole. Under the retirement simulation made by Roeger, the number of years spent in work rises to the 1960s level of 45, which unfortunately is still insufficient to stabilise the passivity

³ In other words, workers spent 4.25 years in employment for every 1 year spent in retirement.

ratio. This objective can only be achieved if governments plan to link the retirement age to changes in life expectancy. According to Roeger's simulations, such a reform has major benefits in terms of growth and budgetary sustainability, as well as being relatively favourable with regard to income distribution, given that the consumption of both the working age population and pensioners is rising relative to the baseline.

3.2.3 *Is one reform better than the others?*

In Roeger (2002), the impact of a reduction in the replacement ratio and an increase in the retirement age is analysed. With regard to a reduction in pension-scheme generosity, while such a reform option provides clear budgetary gains, less success is discernible in terms of easing the growth loss associated with population ageing, and income-distribution difficulties are evident. No such problems exist with the simulation of an increase in the retirement age. This conclusion is shared by Chateau et al. (2002) for the French case, by Desmet et al. (2002) for the Belgium case and by Lassila and Valkonen (2002) for the case of Lithuania.

According to Chateau et al. (2002), the doubling of the dependency ratio in 50 years in France would lead, in the absence of reform, to an increase in subscription rates and so of the fiscal wedge. At the same time, keeping the subscription rates at their initial level would lead to a serious decline in the relative income position of the elderly population. For Chateau et al. (2002), an increase in mandatory work duration is an interesting way to mitigate these effects. Such a disposition is, however, strongly resisted in France; for this reform to be successful, a change in firms' behaviour towards senior workers would be needed.

Lassila and Valkonen (2002) simulate the impact of reforms to retirement income systems in Lithuania. Indeed, population ageing in Lithuania takes place later than in many other countries. This gives policy-makers time to consider retirement-age policies that are conditional on the demographic outlook, which usually is not the case because increasing the retirement age affects the pension system only after some delay. Lassila and Valkonen (2002) show that the size of the future increase in pension contribution rates is very uncertain, because of the uncertainty inherent to demographic projections. However, increasing the retirement age reduces the increase in contribution rates and appears to be the best policy to implement in the Lithuanian case.

Considering the Belgium case, Desmet et al. (2002) simulate the impact of a 'common reform', which creates an identical system across all countries in the European Union. The common system has a benefit equal to 60% of average lifetime earnings at normal retirement age, which is increased to the age of 65 in the EU as a whole. Average lifetime earnings are supposed to correspond to the highest 40 years of earnings during an individual's working life. Early retirement is available as of age 60, with an actuarial adjustment of 6% per year of anticipation. Once again, increasing the normal retirement age is the key parameter of the reform proposed by the authors.

The option of increasing the retirement age is also explored by Eso and Simonovits (2002), who consider the problem of designing optimal, flexible, pension benefit rules so that social security systems remain feasible. They show that a socially optimal, incentive-compatible benefit rule leads to redistribution from individuals with shorter expected lifespans to individuals with longer expected lifespans.

As a conclusion, all the papers presented in this section converge on one finding: the most realistic option to save the PAYG system is to modify the normal retirement age. The scale of the increase will then depend on the demographic characteristics of each country. However, as

mentioned by Chateau et al. (2002), the main problem of such a reform is the behaviour of employers concerning the oldest workers. The next section examines the employment prospects of older workers.

3.3 Ageing and employment in the European Union

Labour force ageing in European countries is likely to be substantial over the next several decades. In many countries, labour force growth will also slow and educational attainment among older workers will rise rapidly. Pension policy changes designed to raise the effective retirement age will magnify labour force ageing, but offset part of the projected fall in labour force growth.

European labour markets have adapted to significant shifts in the age structure of the labour force in the past. However, the ageing projected over the next several decades is outside the range of recent historical experience. Hence, it is uncertain how easily such a large increase in the supply of older workers can be accommodated, including the implications for earnings and employment of older workers.

Expanding the range and quality of employment opportunities available to older workers will become increasingly important as the population ages in European countries. Accordingly, and as stressed by Grey and Swaim (1998), there is a need to better understand the capacity of the labour market to adapt to ageing workforces, including how it can be enhanced.

Both the supply and demand sides of the labour market will be important. Strengthening financial incentives to extend working life, together with a large increase in the older population and improvement in their health, will mean that the supply of older workers will increase sharply in the coming decades. The demand for older workers, along with the efficacy of labour markets in matching supply and demand, will determine their employment and earnings prospects.

There is only weak evidence that the earnings of older workers are lower relative to younger workers in countries where older workers represent a large share of total employment (see Grey and Swaim, 1998). This may indicate that workers of different ages are close substitutes in production, so that an increased supply of older workers can be employed without a significant fall in their relative wages. However, a number of factors affect the demand for older workers at any given wage, and greater relative wage flexibility may sometimes be an important component of an overall programme to adapt to workforce ageing.

Improved job skills and access to training could help reduce the risks of unemployment and low pay for older workers. Workforce ageing will also mean that European countries will have to rely increasingly on mid- and late-career workers to meet emerging skill demands. This heightens the importance of improving the opportunities of older workers to develop new skills and to renew and re-deploy old skills. The limited evidence currently available (again see Grey and Swaim, 1998) suggests that older workers with adequate educational attainment and a history of participation in on-the-job training appear to be good training prospects, and training rates do not fall off strongly until workers approach conventional retirement ages.

Nevertheless, older workers do encounter significant difficulties if they lose their job, as reflected in a high incidence of long-term unemployment and the large earning losses experienced by older displaced workers when they do find a new job. If their labour market

mobility remains limited, these problems could increase as the workforce ages, since it is likely that increasing numbers of older workers will experience layoffs.

Firms' pay, training, recruitment and other personal practices will be key factors in determining the employment and earnings opportunities of older workers. Furthermore, proactive strategies, emphasising the skill base with which workers enter the latter stage in their careers, are likely to be more effective than remedial measures after older workers have encountered employment problems. Thus, the training and other personal practices of employers, as well as the career planning of workers, need to begin to adapt now to the prospect of workforce ageing. Governments have an important educational and coordinating role to play in facilitating these adjustments.

4. Conclusion

Over the last two decades, EU institutions have been increasingly concerned with the issues of unemployment reduction and employment promotion. The European Union developed its welfare strategy on the labour market in the form of several recommendations. These aimed at presenting an overview of how the EU member state governments meet the EU's recommendations for implementing a welfare state that intervenes to moderate the negative effects of market relationships on the one hand, and to enhance the efficiency of market performance on the other.

In section 1, we provided an overview of labour market policies to protect individuals against unemployment. We showed that in the context of EMU and the eastern enlargement of the EU policies such as unemployment insurance could improve welfare, to the extent that it encourages labour mobility. Nevertheless, it also has a disincentive effect on individuals' job search efforts. Thus, in order to prevent welfare and inactivity traps, member state governments have been asked to reform their benefit and tax systems.

Such reforms would provide incentives for unemployed workers to seek and take up work. Generally speaking, reforming social protection systems to be more employment friendly consists of implementing a tax-credit mechanism, such as the EITC implemented by the US at the end of the 1990s. The idea of such a reform is to overcome the labour supply disincentives of the EU welfare state by increasing households' in-work income.

Whereas the experience of the US becomes increasingly relevant to the EU policy debate, reforms implemented in Germany and France generated disappointing results in terms of labour supply, because earning improvements are very weak. However, we only have reports on the very first experiences of a tax credit mechanism in Europe and the future of welfare institutions is geared towards policies aimed at making work pay.

The recent history of welfare institutions is quite different. Indeed, in the last 30 years, faced with a restructuring environment and increasing unemployment, European governments made widespread use of a variety of early retirement programmes. This policy seemed to be the royal route to improving the employment prospects of the young and fighting unemployment. Yet early retirement policies have perverse effects because of the economic distortions introduced on the growth rate of the economy. Moreover, in the demographic context of most EU countries, early retirement policies create financial distress by increasing the dependency ratio, and therefore exacerbating the financial imbalance of the PAYG social security systems.

In section 2, we showed that the EU member states have entered into a demographic situation where the population growth rate hovers at zero or even becomes negative, while life

expectancy tends to be 80 years or more. Given this new situation, the question of how to best support retired persons becomes urgent. Section 3 was devoted to these issues, especially those related to reform of the retirement pension system and the promotion of better employment opportunities for older workers.

Population ageing will pose challenges for budgetary, labour and financial market policies as well as for overall economic performance. The need for a comprehensive reform strategy to cope with these challenges is largely acknowledged. Given the demographic changes likely to occur in Europe over the next 50 years, what are the various options for reform of the retirement pension system in the EU?

It appears that the most realistic option to save the PAYG system is to modify the normal retirement age. The scale of the increase will then depend on the demographic characteristics of each country. Yet the full potential benefit of such policies will only be realised if labour markets are able to generate enough good jobs for an unprecedented number of older workers.

Indeed, expanding the range and quality of employment opportunities available to older workers will become increasingly important as the population ages in Europe. There is a need to better understand the capacity of the labour market to adapt to an ageing workforce. Both governments and firms will need to take active measures to adapt wage-setting to an ageing workforce, to address the extent to which other welfare schemes act as pathways to early retirement, to tackle age discrimination and to improve the job skills and working conditions of older workers. In addition, older workers will need to change their own attitudes towards working longer and acquiring new skills. Governments will have an important educational and coordinating role to play in facilitating these adjustments.

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