



True North in
Canadian public policy

The Truth About the Unemployment Rate:

Why we put too much faith in one measure
of the economy and how to better understand
what labour statistics are telling us

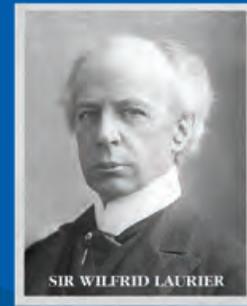
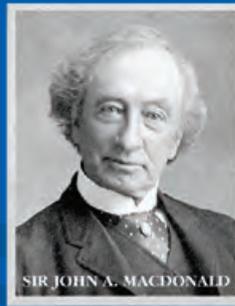
BY PHILIP CROSS



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Executive Summary

In Canada, the unemployment rate is currently the lowest it has been since 1976 when records began. At the same time, governments are running large deficits, citing the need for fiscal stimulus, and a wide range of other economic indicators remain lacklustre. Clearly there is a disconnection here.

But Canadians still greatly overvalue the unemployment rate as an indicator of economic health, a preoccupation since the Great Depression seared fear of joblessness into the North American psyche. According to polls it is the most widely-recognized economic measure. It is time to unseat the unemployment rate from its lofty perch.

In recent years, the unemployment rate has increasingly become an incomplete and misleading reflection of how the labour market and the economy are faring. While unemployment is indeed low, it doesn't accurately reflect what is happening in the labour force because our aging population is leading to more people retiring from the labour force at the same time as youths are also withdrawing because their job opportunities are squeezed by a weak economy and by government policies ranging from higher minimum wages to more licensing requirements. Faced with often bleak job prospects, many are simply staying in school. With fewer older and younger people in the labour force, the unemployment rate is bound to be lower, but this isn't necessarily good news for the economy.

In recent years, the unemployment rate has increasingly become an incomplete and misleading reflection of how the labour market and the economy are faring.

“Unemployment” is actually quite complicated to measure. It involves the interaction of two variables: employment and the labour force. For example, in what is called the “additional worker” effect, the actual or prospective loss of income may lead some other people in a household to enter the labour force and look for a job, which boosts labour force participation. Conversely, the “discouraged worker” effect causes people to decide it is futile to even look for work and instead they stay at home or go to school, which reduces labour force participation. A further complication is that the 2008–2009 recession coincided with the first wave of baby boomers reaching retirement age, so some of these workers chose to retire rather than become unemployed.

Statistics Canada is aware of the limitations of its official unemployment rate. Every month it publishes nine different unemployment rates that attempt to capture “hidden” unemployment. Among these are measurements that include the erratic nature of student and military employment, that count discouraged workers as still in the labour force, and that record those involuntarily working in part-time jobs or who are otherwise under-employed. But all of these measurements are still heavily influenced by demographic and economic factors.

Several organizations, including the Bank of Canada, have tried to come up with an alternative to the unemployment rate. For many, the employment rate seems to be an answer. However, while the employment rate for people aged 15 to 65 may be superior to the unemployment rate, it is still far

from perfect. After considering a wide range of measures, this paper finds the best alternative to the unemployment rate is the employment rate for workers in their prime, between 25 and 54 years of age. This group has had relatively stable labour force participation rates since 2000, is closely related to the overall business cycle, and is less susceptible to demographic forces.

The latest reading of the employment rate for workers in their prime was 82.5 percent holding a job in March 2018. While this represents a relatively high level by historical standards, equalling the peak set in early 2008 before the recession, it has declined slightly from its recent high of 82.7 percent in December 2017. This is a reflection of how growth has slowed in recent months, even as the unemployment rate has remained near all-time lows.

Following this paper, the Macdonald-Laurier Institute will be issuing a quarterly analysis that goes beyond the superficial unemployment numbers to see what the trends are really telling us about the nature of work, job precariousness, disruption in the labour economy, and Canadians' future prosperity.

Sommaire

Au Canada, le taux de chômage est actuellement à son plus bas niveau depuis 1976, date à laquelle on a commencé à colliger ces statistiques. Parallèlement, les gouvernements accumulent d'importants déficits en invoquant la nécessité de relance budgétaire, et un large éventail d'indicateurs économiques demeurent médiocres. Il est clair qu'il y a là une discordance.

Or, les Canadiens surestiment encore énormément l'utilité du taux de chômage comme indicateur de la santé économique, un sujet de préoccupation depuis que la Grande Dépression a instillé la peur de l'inemploi dans l'esprit de bien des Nord-Américains. D'après les sondages, il s'agit toujours de la mesure économique la plus largement reconnue. Il est temps de faire redescendre le taux de chômage de son piédestal.

Ces dernières années ont vu de façon croissante le taux de chômage traduire moins fidèlement ou pas du tout la conjoncture et la situation sur le marché du travail. Le chômage est faible, mais notre population vieillissante quitte la main-d'œuvre au moment même où les jeunes s'en distancent, leurs possibilités d'emploi s'amenuisant en raison de l'affaiblissement de l'économie et des politiques du gouvernement allant des hausses du salaire minimum jusqu'au relèvement des exigences en matière de certifications. Face à des perspectives d'emploi souvent sombres, de nombreux jeunes prolongent leurs études. Compte tenu du nombre moins élevé d'âinés et de jeunes dans la population active, le taux de chômage s'abaisse obligatoirement sans que cette situation soit nécessairement une bonne nouvelle pour l'économie.

En vérité, le « chômage » est assez difficile à mesurer. En effet, la notion fait intervenir deux variables : l'emploi et la population active. Par exemple, l'effet dit du « travailleur d'appoint » entre en compte lorsque la perte réelle ou attendue de revenus incite une personne de plus dans un ménage à faire partie de la population active et à chercher un emploi, ce qui relève la participation au marché du travail. À l'inverse, l'effet dit du « travailleur découragé » est associé à une diminution de la participation au marché du travail et se manifeste lorsque les gens estiment improbable de trouver un emploi et décident de demeurer à la maison ou de fréquenter l'école. Complication supplémentaire, la réces-

sion de 2008-2009 a coïncidé avec la première vague de baby-boomers atteignant l'âge de la retraite, de sorte que certains ont choisi cette voie plutôt que celle du chômage.

Statistique Canada est conscient des limites de son taux de chômage officiel. Chaque mois, l'agence publie neuf différents taux de chômage pour tenter de saisir le chômage « caché ». Ces mesures tiennent compte notamment des mouvements irréguliers liés à l'emploi étudiant et militaire, de l'effet des travailleurs découragés - travailleurs que l'agence ajoute à la population active - et des travailleurs à temps partiel incapables de trouver du travail à plein temps ou sous-employés d'une autre manière. Cependant, toutes ces mesures sont aussi fortement influencées par les facteurs démographiques et économiques.

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Plusieurs organisations, dont la Banque du Canada, se sont efforcées de trouver une mesure de remplacement pour le taux de chômage. Pour un grand nombre d'entre elles, le taux d'emploi semble être approprié. Or, même si le taux d'emploi des personnes âgées de 15 à 64 ans est un meilleur indicateur que le taux de chômage, il est encore loin d'être parfait. Après avoir examiné un large éventail de variables, on conclut dans ce document que la meilleure mesure de remplacement pour le taux de chômage est le taux d'emploi des travailleurs dans la force de l'âge, soit ceux qui sont âgés de 25 à 54 ans. Les taux d'activité de ce groupe ont été relativement stables depuis 2000 et, moins sujets aux forces démographiques, ils ont évolué en phase avec l'ensemble du cycle économique.

Selon les données les plus récentes, le taux d'emploi des gens âgés de 25 à 54 ans était de 82,5 pour cent en mars 2018. Bien que ce taux soit relativement élevé par rapport aux normes du passé, égalant le sommet atteint au début de 2008, soit avant la récession, il est légèrement en baisse par rapport au récent sommet de 82,7 pour cent enregistré en décembre 2017. Cette baisse traduit le ralentissement de la croissance au cours des derniers mois, alors même que le taux de chômage global n'a jamais été aussi faible.

Subséquemment à la publication de ce document, l'Institut Macdonald-Laurier diffusera chaque trimestre une analyse qui ira au-delà des chiffres superficiels sur le chômage, afin de déceler ce que les tendances nous révèlent vraiment sur le plan de la nature du travail, de la précarité de l'emploi, des perturbations touchant le marché du travail et de la prospérité future des Canadiens.

Introduction

According to polls of Canadians, the unemployment rate is the most widely-recognized measure of how the economy is performing because it seems immediately relevant and easy to understand. Public anxiety about unemployment dates back to the trauma of the 1930s Great Depression that seared fear of joblessness into the North American psyche, just as inflation haunts European countries like Germany and Austria that experienced hyper-inflation in the 1920s.

In Canada, the unemployment rate is currently the lowest it has been since 1976 when records began. This has led to the contradictory picture of politicians trumpeting the best labour market conditions in generations while a wide range of other economic indicators remain lacklustre. In particular, a booming economy should generate so much tax revenue that governments generate fiscal surpluses. Instead, governments in Canada are running large deficits, citing the need for fiscal stimulus. This exposes the emptiness of claims that today's low unemployment rate signals a return to buoyant economic conditions.

Why has the unemployment rate in recent years increasingly become an incomplete and often misleading reflection of how the economy is faring? The unemployment rate is now a less accurate barometer of both the labour market and the overall economy partly because our aging population means people are retiring from the labour force. Meanwhile, youths are also withdrawing from the labour force because their job opportunities are squeezed by a weak economy and by government policies ranging from higher minimum wages to more licensing requirements. Fewer older and younger people in the labour force makes it easier to attain a lower unemployment rate.

The unemployment rate only counts people as unemployed if they are actively looking for a job. The numerator is the number of people looking for a job but who cannot find one; the denominator is the total labour force (the sum of people employed plus the unemployed). Unemployment is not measured by the number of people receiving Employment Insurance benefits, because some unemployed do not qualify for benefits (the formerly self-employed, for example), others have seen their benefits expire, and nearly half of beneficiaries qualify for reasons other than losing a job (such as being on paternity leave). As well, the statistics on employment and the labour force cover all people 15 years and older.

There is widespread agreement among economists that the unemployment rate is an imperfect proxy of how the labour market is performing. A Library of Parliament study concluded that “some analysts believe that focusing solely on the official unemployment rate may not paint an accurate picture of the labour market. That is because the unemployment rate does not capture all types of slack in the labour force” (Preville 2013, 1). Recently the Bank of Canada constructed and regularly incorporates into its analysis its own Labour Market Indicator (LMI) because “other labour market measures have not shown as much improvement as the unemployment rate” (Zmitrowicz and Khan 2014, 51). These other measures include long-term unemployment, hours worked, and the rates at which people leave and are hired into jobs. Even Statistics Canada acknowledges that its own “offi-

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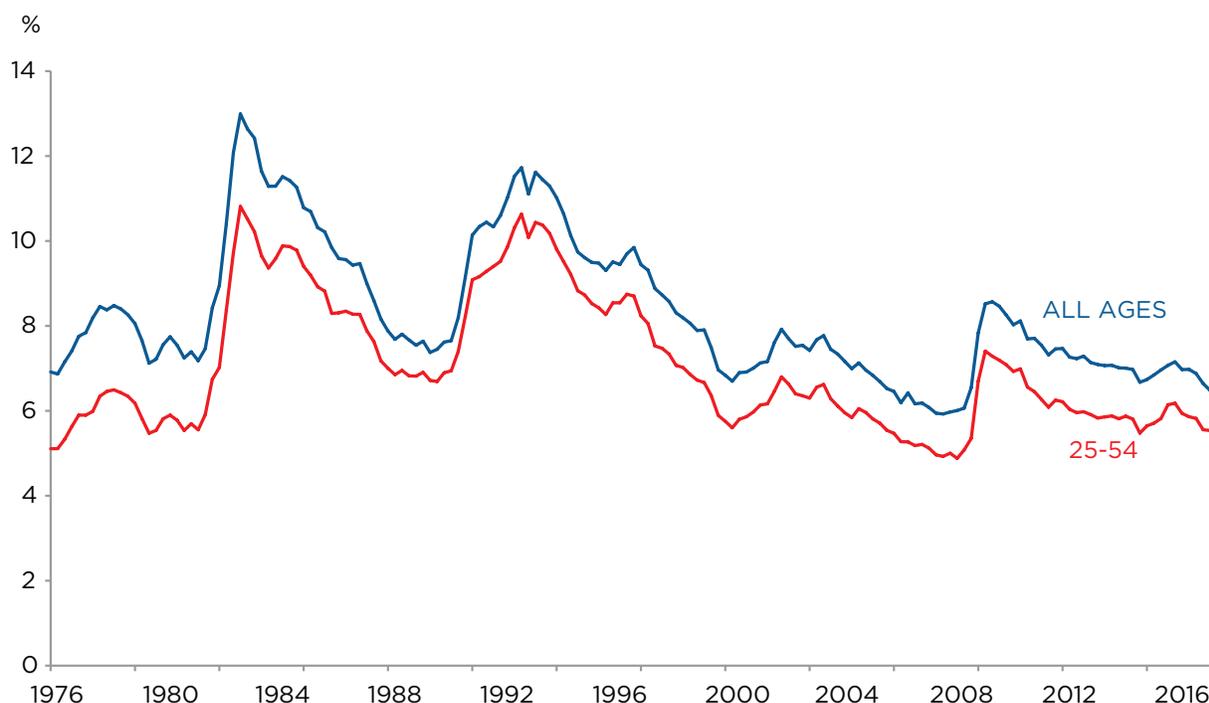
cial [unemployment] rate reported each month by Statistics Canada may not be measuring the full extent of the problem” (Devereaux 1992, 1).

Given the limitations of the unemployment rate as a guide to the underlying state of a labour market, this paper follows other institutions such as the Bank of Canada and Statistics Canada in looking at alternative measures of labour market conditions. After considering a wide range of measures, it finds the best alternative to the unemployment rate is the employment rate for workers in their prime, between 25 and 54 years. Unlike the unemployment rate, the employment rate maintains a close relationship to the overall business cycle and is less susceptible to demographic forces.

Unemployment during recent recessions

It became apparent during the 2008–2009 recession that the unemployment rate was being affected by demographic factors as well as the recession. In the previous two recessions in Canada, a 3 percent loss in jobs in 1990–1992 was reflected in the unemployment rate soaring to over 11.2 percent, while a 5.2 percent drop in jobs in 1981–1982 sent unemployment to a peak of 12.0 percent. However, while job losses in 2008–2009 were nearly as severe at 2.4 percent, the unemployment rate rose to “only” 8.3 percent, well below its double-digit highs in previous recessions (see Figure 1). This is because many of the older workers who lost jobs decided to simply retire (or a few simply hit their planned retirement date). The recession marked when cyclical influences joined with the secular trend of an aging population, since people born in 1946 at the beginning of the baby boom turned 65 years old in 2011.

FIGURE 1. UNEMPLOYMENT RATE IN CANADA, 1976 TO 2017



Source: Statistics Canada, CANSIM Table 282-0087

Not all of the drop in labour force participation in 2008–2009 reflected the aging of the population. A large number of youths, faced with especially bleak job prospects, decided to stay in school. This was a smart decision, since the opportunity cost of passing up the low prospect of getting a paying job while getting more education may help their long-term earnings potential. However, it was also a factor in capping the increase in unemployment during the recession.

As a result, the labour force participation rate (the percent of people employed or actively looking for a job) fell from 67.6 percent in 2008 to 67.1 percent in 2009, and then continued to fall during the recovery to its low of 65.7 percent in 2016. Without this decline in the labour force, the unemployment rate would have been much higher in the recession and recovery.

The unemployment rate has a looser relationship with the business cycle than employment. Since 1976, when employment data began, at the point the overall economy turns from recession to recovery, employment also turns within an average of one month. Moreover, there has been little variation in the relationship between employment and the overall economy, with the two synchronized in the same month in two of the six instances, lagging one month in three other cases, and two months in the recovery that began in April 1992. By comparison, turning points in the unemployment rate diverged from the overall economy by an average of 5 months, ranging from a lag of seven months in the recovery in 1992 to a lead of 12 months before the onset of the recession in October 2008. This makes the unemployment rate an unreliable indicator of turning points in the overall economy.

Unemployment reflects changes in both employment and the labour force

While the idea of unemployment seems easy to understand, in practice it is surprisingly difficult for statisticians to measure. This is because unemployment involves the interaction of two variables, employment and the labour force. Unemployment is conventionally defined as the percent of the labour force actively looking for a job who are not employed. Total employment moves closely with the overall economy, moving into recession and then emerging from recession to recovery within one month of the turning points in Canada's GDP in the last three recessions in 1981–1982, 1990–1992 and 2008–2009.

Conversely, the number of people in the labour force is only loosely correlated with economic conditions, and this relationship appears to be weakening further with the aging of the population. As mentioned, unemployment reflects the interaction of both the number of people holding jobs and the number of people in the labour force. The crux of the problem is that the labour force does not move as closely as employment with the overall business cycle, for a number of reasons. It is well known that economic theory cannot predict whether a recession will lead to an increase or decrease in the number of people looking for jobs, especially if another family member loses their job. In what is called the “addi-

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tional worker” effect, the actual or prospective loss of income may lead some people in a household to enter the labour force and look for a job. Conversely, the “discouraged worker” effect means people decide it is futile to even look for work and instead stay at home or go to school, which reduces

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labour force participation. In practice, the discouraged worker effect tends to dominate and labour force participation typically slows or declines during recessions and increases as the economy strengthens, but the force of these two opposing movements will vary from cycle to cycle, depending on the severity of job losses. As well, there will be lags in how quickly people react to a deteriorating job market as it takes time for word to spread on when and where jobs are disappearing.

An additional complication for labour force participation began to materialize during the recession starting in 2008. The onset of this recession coincided with the first wave of baby boomers reaching retirement age. This gave some older workers the option to retire rather than face the prospect of losing their job and becoming unemployed. The rapid aging of the labour force over the past decade has seen a drop in labour force participation because the growing weight of older workers (with lower participation rates than younger workers) is pulling down the overall labour force. The relative labour force participation rates of older and younger people is key: while it is noteworthy that older workers are more likely to remain active in the labour force than ever before, they are still less likely to be in the labour force than middle-aged workers, and so the aging of the population depresses the overall participation rate.

In recent years, the labour force participation rate has been influenced by both the cyclical effect of a sluggish economy and the structural effect of an aging population. Statistics Canada concluded that “while economic growth usually is accompanied by rising participation rates, since 2003, the aging of the population appears to have offset much of this effect” (Wyman 2011, 3.9). Even before the 2008 recession, the labour force had stopped growing despite plentiful job opportunities. Without the aging of the population after 1997, Statistics Canada estimates that the labour force participation rate would have been three percentage points higher in 2011 (Wyman 2011, 3.1).

So labour force participation is not only determined by the contradictory forces of the additional worker and discouraged worker effects, but increasingly these cyclical forces are being overwhelmed at times by the structural trend of an aging population. This further muddies the interpretation of short-run movements in the unemployment rate as a guide to labour market performance.

Different unemployment rates

Statistics Canada (and other statistical agencies such as the Bureau of Labor Statistics in the US) has long been aware of the limitations of its official unemployment rate. As a result, every month it publishes nine different unemployment rates. These measures can be grouped into five categories. The first two measure unemployment for groups that are especially affected by unemployment, specifically, the long-term unemployed (those without a job for 26 weeks or more) and for persons heading a family with one or more children under age 16. These unemployment rates are invariably lower than the official measure.

Two other alternatives adjust unemployment for students and soldiers—groups with varying degrees of attachment to the labour market. One excludes full-time students, the other includes full-time members of the armed forces (in Canada, the latter adjustment makes little difference in practice). Then there is an unemployment rate for the part-time labour force. Statistics Canada notes that this measure “is the most erratic” partly because of the seasonal impact of students looking for part-time jobs in the summer.

Two more measures capture aspects of “hidden” unemployment. The first measures the unemployment rate if discouraged workers were counted as still in the labour force. The second measures unemployment for full-time members of the labour force as well as those involuntarily working in part-time jobs. The latter captures in the unemployment measurement the shift some people make by taking part-time jobs when full-time jobs disappear. One problem with the measure of discouraged workers is that relatively few people admit to giving up the search for jobs; there is a suspicion that the actual number of discouraged workers is greater than what is measured in the survey. In any event, this adjustment in practice tends to make little difference to the overall unemployment rate.

Another measure captures the underutilization rate based on hours lost through unemployment and underemployment, the latter due to either working fewer hours in their current job or shifting outright to part-time work.

Finally, Statistics Canada publishes every month what the unemployment rate would be if measured on the same basis as the US unemployment numbers. Briefly, the US excludes 15-year-olds from its survey (Canada insists on including them) and is also more rigorous in defining what counts as actually looking for a job (Cross 2015).

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However, all of these alternative unemployment rates have problems similar to those of the official rate, as their behaviour is heavily influenced by demographic as well as economic factors. For most of the measures this is because they do not address the fundamental issue: that labour force participation falls as our society grows older. However, the two measures of unemployment that focus on the length of the periods of unemployment show that long-term unemployment is lower among older workers because older workers, when faced with an extended bout of unemployment during a recession, often simply retire from the labour force.

Alternatives to the unemployment rate

The Bank of Canada has constructed a Labour Market Indicator (LMI) of labour market conditions. Not only does it include measures of the utilization of labour, which could be considered alternatives to the unemployment rate, but it also includes variables such as wages, which are not a measure of utilization but are influenced by a wide range of factors such as unionization, government controls on its compensation of its own employees, aging, foreign competition, and so on. While it is an interesting measure of the overall labour market, it is not a barometer of the overall economy. Another practical problem with the LMI is that it is not available on a timely basis.

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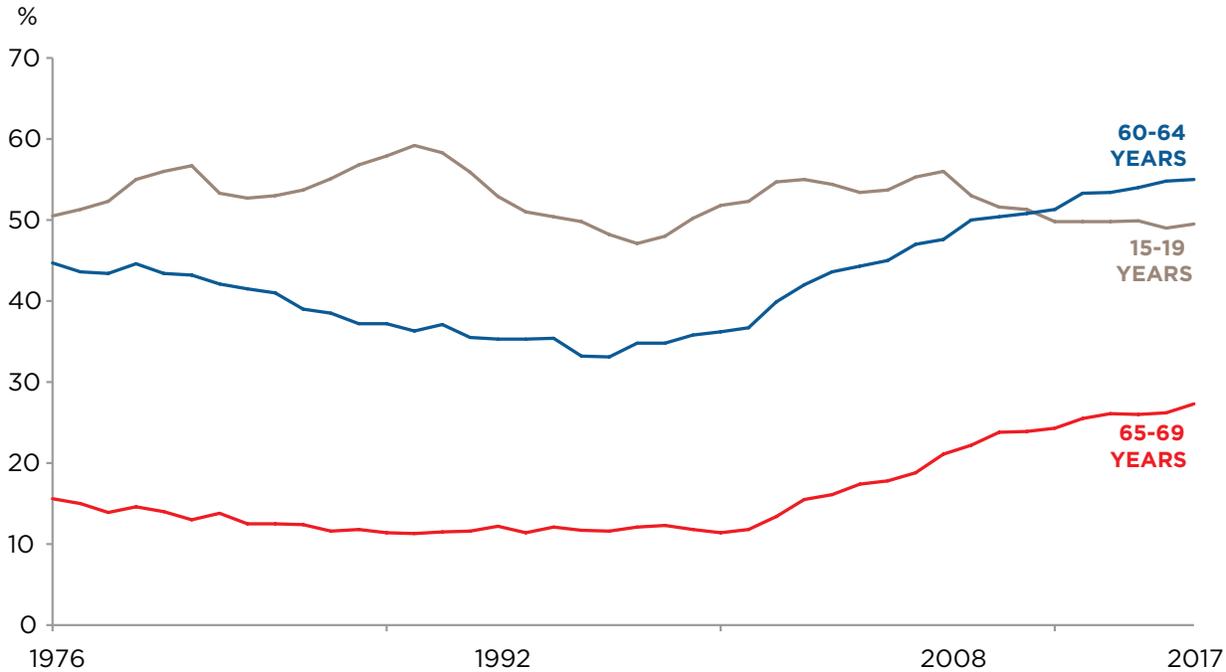
Since all unemployment rate measures are increasingly affected by long-term demographic factors at the expense of cyclical changes in the labour market, analysts need to find an alternative to the unemployment rate. The best solution would avoid depending on the concept of the labour force, since the crux of the problem is older workers leaving the labour force. One candidate is the employment rate, which is the percentage of the working age population (not the labour force) aged 15 to 65 that is employed. Given the drop in labour force participation due to the aging of the population, one study concluded that “it is increasingly clear that the employment rate rather than the unemployment rate is a better barometer of the state of the labour market” (Clemens and Palacios 2018, 1).

The employment rate is published monthly by both Statistics Canada and the US Bureau of Labor Statistics, although their press releases almost always cater to the public’s interest in employment and the unemployment rate. While the employment rate for people aged 15 to 65 years may be superior to the unemployment rate, it is still far from perfect. To start, excluding people over 65 years does not eliminate the impact of aging on the unemployment rate. This is especially true for public sector workers, who on

average retire before reaching even 60 years. The public sector accounts for one-third of all workers in Canada and its work force is older than the private sector, so there is still a considerable impact of the aging and retirement of this segment of the population on the overall unemployment rate.

Excluding all people over age 65 years misses out on one of the more striking long-term trends in the labour market over the past two decades, which is the sharply rising participation of older workers in the labour force. This is evident for workers both between age 60 and 65 years, and those between age 65 and 70 years (see Figure 2). In fact, the participation rate of older people age 60 to 65 years is approaching that for teenagers. If older people are to be excluded from the employment rate, younger people should also be excluded since they are demonstrating just as tenuous a relationship with the labour market as older workers.

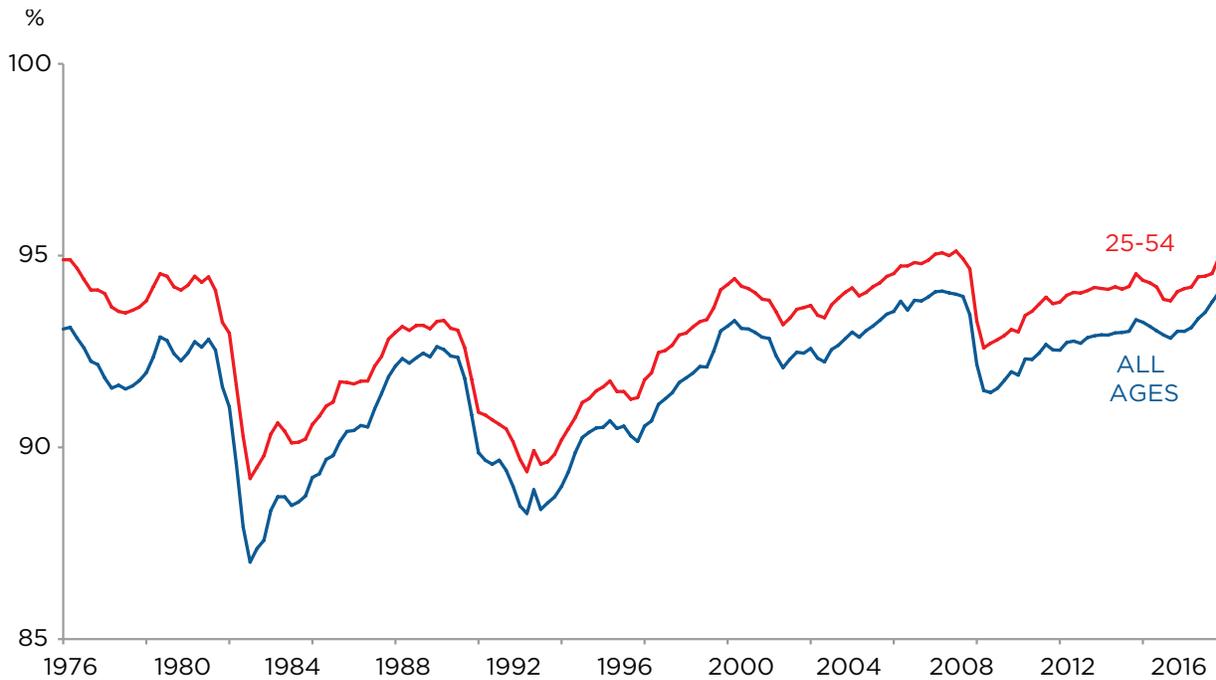
FIGURE 2. LABOUR FORCE PARTICIPATION RATE, CANADA, 1976-2017



Source: Statistics Canada, CANSIM Table 282-0002

Given that the labour force participation of both older and younger workers increasingly is dominated by secular trends and not the short-term course of the economy, probably the best indicator of the underlying trend of the labour market these days is the employment rate of workers in their prime, between 25 and 54 years old (see Figure 3). One advantage of focusing on people 25 to 54 years old is that their presence in the labour force has been constant at about 86 percent since 2000, even as youths have withdrawn from the labour market and older workers have poured into it. However, while their participation rate has been stable, the employment rate for people 25 to 54 years old has trended up slowly, and this can be expected to continue as a dearth of younger and older workers leads employers to concentrate their search for employees in this age group.

FIGURE 3. EMPLOYMENT RATE IN CANADA, 1976 TO 2017



Source: Statistics Canada, CANSIM Table 282-0087

The employment rate for people between age 25 and 54 also demonstrates a close relationship with the overall business cycle. Recall that the relationship of the unemployment rate with the business cycle was imprecise and highly variable. By contrast, the employment rate moves into and out of recession on average within one month of the overall economy, the same as total employment.

Why is the public so focused on the unemployment rate and not the employment rate? Partly it is because the fear of mass unemployment in the 1930s has never disappeared, as shown by the ongoing obsession with automation and job loss which persists to this day. More important, society has never before had to deal with a large cohort of its population aging at the same time, a reflection of the spectacular advances in life expectancy in the past century and the proliferation of retirement from a rare state to the commonplace. Shifting the focus from the unemployment rate to the employment rate is just one of many adjustments we will have to make as our population ages.

Conclusion

The unemployment rate is widely publicized, but has always been a flawed indicator of labour market conditions and how the overall economy is performing. The unemployment rate reflects what is happening in both employment and the labour force. While employment remains a highly accurate reflection of economic conditions, the labour force has always been a less precise barometer because it reflects social and demographic factors as well as economic conditions. The relationship of the labour force and labour market to economic conditions is becoming looser as the population ages and youths continue to delay entering the labour force. As a result, this paper

concludes that the ratio of employment to population of workers between the ages of 25 and 54 provides the best assessment of how the labour market is performing.

The latest reading of the employment rate for workers in their prime was 82.5 percent holding a job in March 2018. While this represents a relatively high level by historical standards, equalling the peak set in early 2008 before the recession, it has declined slightly from its recent high of 82.7 percent in December 2017. This is a reflection of how growth has slowed in recent months, even as the unemployment rate has remained near all-time lows.

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About the Author



Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the “Current Economic Conditions” section of the Canadian Economic Observer, which provides Statistics Canada’s view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee.

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Endnotes

- 1 The dates for the overall business cycle are taken from the C.D. Howe Institute business cycle chronology, available at <https://www.cdhowe.org/cpc-communique/business-cycle-council-communique---december-2017>.
- 2 Even measuring employment is not as straightforward as casual observers assume. The mix of people employed full time and part time changes with the economy more than total employment itself. As well, Statistics Canada reminds users that the labour force survey that produces the unemployment rate captures the number of people employed, not the number of jobs. The two can differ because some people hold more than one job. Strictly speaking, the payroll count from business surveys conceptually estimates the number of jobs, not the number of people employed. (See Statistics Canada 2016, 4).
- 3 The discussion in this section is based on Devereaux 1992.
- 4 While often older people stay working on their own terms, preferring to work for themselves or in small firms and keeping part-time hours, they show a growing preference to stay active. Given rising life expectancy, improved health outcomes for this new group of "young" old people, and possibly the need to keep working as private sector pension benefits have withered in recent years, there is every reason to expect this trend to continue.



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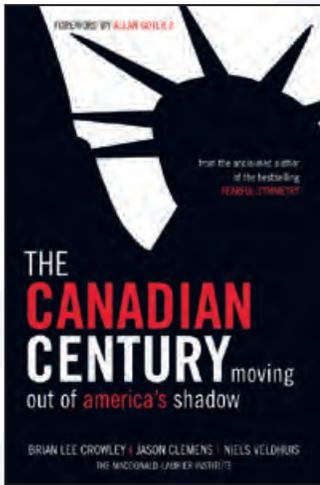
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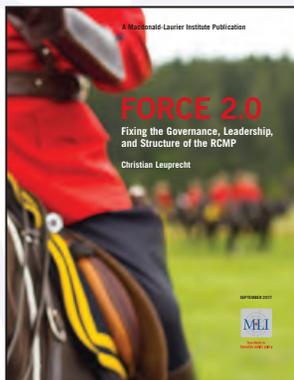
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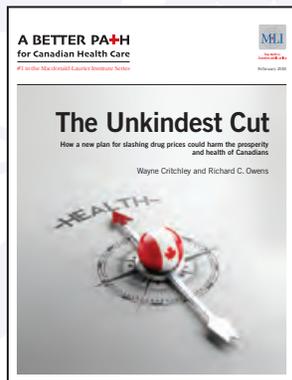
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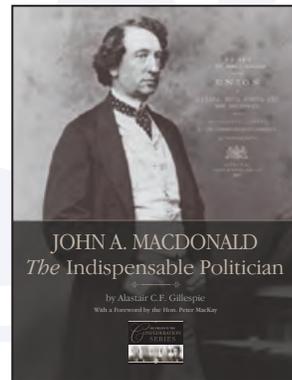
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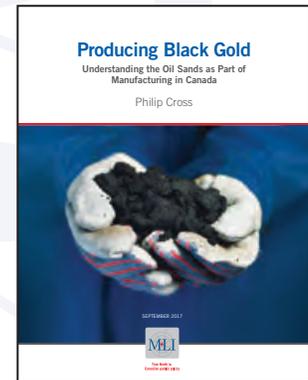
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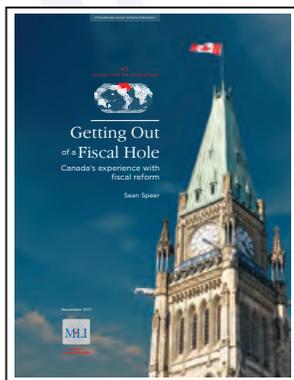
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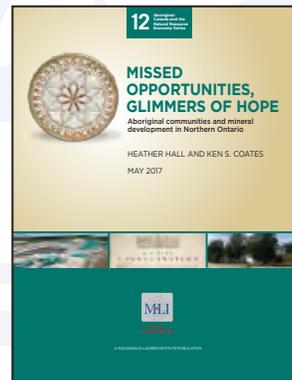
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