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Market Reforms in Pension Systems

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SUMMARY PAPER

Optimal Pension Policy Issues

Abstract

Private pension funds in most economies are imbedded in a system of public and private pension plans, often with several forms of pension plans coexisting or offered as options (e.g. defined benefit and defined contribution plans), and a tax regime. Varying demographics and economic conditions may be relevant to the goals of policy. This paper raises the question about what policy goals are relevant to the design of an optimal pension system under a range of circumstances and lists some issues and/or contradictions separating pension policies and economic policy goals that are raised by current pension treatment in representative economies.

Introduction

A large portion of growing government deficits in economies around the world is due to the increasing obligations of public pension funds relative to workers' contributions to those funds. A great deal of attention is paid to reform of public pension plans to deal with these growing drains on government revenues. On the other hand, pension fund benefits are only paid when workers retire, and surprisingly little attention has been paid to the economics of the retirement decision. The point of this paper is that there are many, many policy variables available to government policy-makers, including pension and retirement rules, policies concerning taxation of labor and capital, and a variety of subsidies to workers and their families, that have been developed without a comprehensive set of policy objectives concerning labor force participation and retirement. Recent policy initiatives have focused on the government budgetary implications of pension policy. However, the goal of pension policy analysis should be an optimal pension policy in the much broader sense of promoting the maximum social welfare rather than a focus on government budgets.

Labor Force Participation and Age

The well-documented and often discussed aging of populations in many developed nations and in emerging-market countries like China have focused attention on the

declining number of non-workers relative to workers in economies. Projections of “dependency ratios” (the ratio of the very young and the old, dependent on income provided by workers, relative to the working population) have raised serious concerns in some countries (like Japan) about declining incomes and possibly the reduced incentives for work because of the tax burden on wage income necessary to finance retirement benefits for the elderly.

Several economic developments could ameliorate the economic consequences of these reductions in domestic labor forces. Migration is one; increased migration has been observed in many economies, including Japan and South Korea. Diversifying capital into economies with larger labor supplies is another. The “de-industrialization” of some economies can be viewed in this light. These and other developments are however often viewed as undesirable for a number of reasons, including problems with cultural values or national policies.

One straightforward way to increase domestic labor supplies is of course to extend the working lives of older laborers. This is intuitively reasonable since the issue of population aging is raised by two developments, decreased fertility and increased life expectancy. There are many discussion of the causes of reduced labor-force participation of older people, but little of the discussion is in terms of developing “optimal” or “efficient” allocations of labor and leisure across age groups. This discussion focuses on the policy tools and assessments of their role in the declining labor-force participation of older people.

Policy Tools Relevant to the Retirement Decision

In an economy without government taxes and subsidies, retirement decisions would be made by individuals and families based on savings, expected life expectancy, and expected wages and returns on current and future savings. Workers and their families would seek an optimal trade-off between increased leisure (partial or total retirement) and current and future consumption and any desired bequests. In developed and more advanced economies these tradeoffs have been distorted by a number of policies, including public pension plans, encouragement of company and private retirement savings programs, and so forth. The enormous variety of rules, tax rates, and requirements for these programs mean that many policies are working at cross purposes to the encouragement of workers to continue working in order to achieve their personal optimum strategy.

For example, rules on publicly financed pension funds in OECD countries mean that retirement ages for males have decline substantially. In 1950, all twenty-four countries studied had retirement ages well above 65, where in 1995 only once country (Iceland) was still above 65 while all the rest were well below 65, including six below 60 (Austria, Belgium, Finland, France, Luxembourg, and the Netherlands).¹

¹ See Table II.1 in Bloendal *et al*, p. 53.

Two sets of rules governing public pension plans influence this result: first, there are the specific values establishing eligibility for early retirement (at partial benefit levels) and full retirement. Second are the rules relating contributions to the pension plan and future benefit payments. Assumed returns and actuarial calculations are not the only factors determining the relation between continued contributions while still in the work force and benefits upon retirement. In many if not most cases, foregoing a year of benefits for higher future benefits upon retirement has a negative wealth impact on lifetime consumptions.² The relation between the change in the value of lifetime retirement benefits and another year of work can be positive or negative, and when negative are often considered to be implicit taxes on work. These two aspects of public pension plans have induced earlier departure from the labor force in many economies.

Public pension plans in the OECD are embedded in social safety-net systems with a variety of income support plans related to unemployment, disability, and illness. The decision to not work is a complex one, with many alternative sources and levels of income support and incentives in the form tax treatment. For example, in the United States it has been calculated that the marginal tax³ on work for 65-year olds when all government support and taxes are considered will be a fairly modest 25 percent or under for those with incomes from \$21,400 to \$42,800 at the beginning of their working careers. However, for those earning \$85,700 or above, the comprehensive tax is above forty percent, since these high wage earners do not receive government subsidies while young.

Defined-benefit company pension schemes often require retirement at partial or full benefits at some specific number of years, although most gear benefit levels to an average of earnings, favoring continued work until later age levels. These benefits will be taxed at the income tax rate, so tax policy will have additional impact on the retirement decision. If other sources of income are available in the presence of graduated income taxes, the after-tax benefit levels could be greater or smaller with early or late retirement. Of course, if benefits push workers into higher tax rates in progressive tax systems, there will be reduced incentives to earn labor income.

Defined contribution company and private individual retirement programs are not subject to distortions due to the connection between retirement age, years of work, and benefit levels before tax. However, the total amount of savings available to fund retirement benefits will be influenced by these tax treatments. Moreover, income taxes may influence the retirement decision to forego the increased consumption possible with continuing labor income in the presence of retirement income, since retirement benefits are subject to income taxation in the United States.

Finally, many countries use the tax system to encourage private retirement savings. For example, in the United States limited amounts of income can be saved before income taxes to fund retirement and earn returns exempt from taxation. However, policy makers

² See Bodor *et al* for a discussion of the calculations.

³ See Gukhale *et al*, Table 14. The “tax” calculated in this table is a comprehensive measure including foregone benefits and subsidies throughout the working life of an family.

have determined that fairness requires that accumulated savings must begin to be paid out and taxed after age 70.5 years using an average actuarial life span. For example, a 71-year old would be required to distribute about 4 percent of his accumulation savings, for example \$4,000 for accumulated savings of \$100,000, and of course proportionately higher for larger amounts. Given the graduated income tax in the United States, required distributions could place potential workers into higher tax classifications if retirement savings were large enough, thus discouraging participation in the labor force.

The Retirement Policy Challenge

Longer labor-force participation would be encouraged by elimination of incentives or rules such as those fixing benefits levels as a function of retirement age. Further willingness to continue working would likely result from the harmonization of explicit and implicit taxes on contributions, distributions and benefits, and adjustments to expected future benefits that are actuarially fair given contribution levels and actuarially determined life expectancies.

Given the importance of the retirement decision, little analysis exists to guide policy making in how the retirement decision is made and what determines an “optimal” retirement policy. A couple of exceptions are provided by two analyses by Kopecki and French that provide some insights into the economics of the retirement decision, but both ignore factors relevant to policy-making in the current environment. For example, Kopecki models the retirement decision where workers are trading off earnings that increase future consumption and the utility from leisure that requires “leisure goods.” Kopecki’s discounted utility model makes the age of retirement an endogenous variable in an economic environment where pension rules and taxation matter, but where the key change in tradeoffs facing workers in the last hundred years has been the reduced costs and increased value of “leisure goods.” For example, home entertainment and travel, two leisure goods involved in the major occupation of mature individuals’ leisure time, have become relatively inexpensive and more productive⁴. Kopecki can explain a large fraction of the hundred-year trend towards earlier retirement by these trends in the costs of leisure goods.

French analyses the retirement decision when health and wages are uncertain and individuals cannot borrow against future pension benefits. French focuses on the impact of pension fund rules and taxation on the retirement decision. His conclusion is:

In sum, liquidity constraints and the actuarial unfairness of the Social Security system explain little of the decline in work hours at age 62. Taxes and pension accrual appear to be the driving factors.⁵

While the French result contrasts with Kopecki’s finding, the two analyses together suggest the richness of the policy environment concerning retirement decisions and emphasize the importance of a more comprehensive approach to analyzing labor-force participation decisions of older workers.

⁴ See Kopecki (2005), Table 2/

⁵ French (2003), p.40.

Financial Market Implications of Optimal Pension Policies

With an ideal or even better set of policies towards rules concerning availability and level of pension fund benefits and the taxation or tax-exemption of income from labor, retirement savings, and other forms of wealth, it seems likely that workers would stay in the labor force longer. Most of the disincentives to continuing labor market participation around the age of 60 seem to have to do with benefit and tax policies that reduce the value of further labor income. If workers worked longer before retirement, the implications for economics and financial markets could be enormous.

Three straightforward examples of implications of longer working lives can be immediately deduced. First, if workers delayed retirement, funding for retirement benefits would involve longer duration assets than is currently the case. This could be an important source of long-term investment capital. Second, there would be a larger pool of savings and a reduced demand for taxes to fund early retirements. Both of these effects would expand the pool of savings in an economy. Finally, a wider range of financial services serving the older workers and non-retirees could expand the need for financial advice and other financial services.

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