

Retirement and Saving: Lessons from Abroad

Symposium on Saving and Retirement: New Perspectives

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Introductory Remarks

- I thank to the NZ Treasury and the ORC for sponsoring my visit. It is always a pleasure to visit this wonderful and beautiful country.
- ORC has a very impressive set of research papers available on its web site. I have learned a great deal about the history and current issues confronting superannuation in New Zealand from these papers. They also provide an excellent summary of the state of the academic literature on retirement and savings and I recommend them highly even to non-specialists.

- Despite having read these papers and having received concise yet comprehensive background briefings at the Treasury, I am reluctant to pass any judgements on specific retirement issues that are currently being debated in New Zealand. Far be it for me — an outsider lacking a deep understanding of your social, political, and economic history — to attempt to advise you on the form of the “best” superannuation scheme.
- What I can do as an economist is lay out the basic tradeoffs, and describe several of the key superannuation schemes that are being considered around the world. I will summarize what economic theory tells us about the pros and cons of these systems and summarize the historical experience with these various schemes in other countries. I will attempt to relate this to the New Zealand experience and the current debate over superannuation as best I can.

- A final caveat: I do not regard myself as a leading expert on saving and retirement issues. Although I have served as a member of the Social Security Advisory Board and was a member of a U.S National Academy of Sciences panel that produced a report on retirement income modeling, and I am currently an advisor to the Social Security Administration, my expertise is really more in the area of *economic modeling* of retirement behavior. I attempt to be “scientifically neutral” regarding policy making, leaving this to the politicians and bureaucrats who must ultimately provide the leadership to get better policies enacted. They are the ones who usually take the responsibility (or blame) if some of these policies fail to deliver the promised benefits.

- To be realistic, it is impossible to be completely objective and impartial in studying these issues. In the spirit of open disclosure, I will reveal my political biases:
- I am a conservative democrat who supports progressive tax and transfer systems. The rich, by virtue of their resources, are by in large able to fend for themselves. In many cases substantial wealth is inherited or a result of good luck and is not necessarily just a result of hard work and greater ability. Even if their wealth is due to greater ability and/or hard work the rich have a special responsibility to help those who are less fortunate by paying a higher fraction of their income/wealth in taxes/transfers. Social insurance policy should focus on trying to help those who are least able to fend for themselves: the poor, disabled, aged, widows/widowers, and children who do not have good alternative sources of support.

- Since I can no longer claim complete impartiality, I will make some recommendations in this talk, but mostly about the *process by which policies are evaluated* rather than passing judgement on specific policies themselves. I will argue that in the past governments around the world have more or less “blundered and groped” in the process of attempting to design better social insurance policies. While there have been a few general economic principles guiding the design of policies, by in large economists have not contributed as much as they ought to have toward the design and practical implementation of state pension and social insurance schemes.

- I am going to argue that the current “trial and error” process that governments have applied in the historical evolution of public pension schemes is crude, costly, and inefficient. More importantly, it creates real uncertainty and insecurity among the population, particularly among the elderly and poor, who are most reliant on social insurance benefits. To some extent governments have treated these people as “human guinea pigs” as they have repeatedly changed pension schemes in an evolutionary process that has tended on average to produce better social insurance institutions, but which has occasionally resulted in costly mistakes that have created serious economic inefficiencies and inequities.

I am going to describe some new strategies for policy evaluation that are less costly, time-consuming, and hopefully more “scientific” than the trial and error approach that has been used in the past. These approaches include:

1. Cross-country comparisons of the impact of different social insurance institutions (learning from the mistakes of others)
2. *Ex post* analyses of historical “policy experiments” in a given country (learning from our own mistakes)
3. Controlled social experiments (learning from the experience of a smaller set of human gineau pigs)
4. Econometric simulation models (learning from “virtual social experiments” using computerized gineau pigs).

Outline for the rest of this talk

1. Review of new approaches for “Scientific policy evaluation”
 - Data Requirements
 - Analytical Requirements
2. Application of these approaches to analyze specific superannuation schemes in terms of their
 - effects on savings
 - effects on labor supply and retirement
 - fiscal/budgetary costs
 - distributional consequences and overall social welfare and economic efficiency
 - and their overall economic and political viability/stability

Brief history of social insurance in western democracies

- late 1800s: Bismarck's ideas take hold and the first formal public pension schemes are created in Germany, Netherlands, and New Zealand. Private, employer-sponsored pension schemes arise in the U.S. (e.g. for railroad workers at American Express).
- 1930s: the depression decimates the human capital of a generation. Franklin Roosevelt responds by introducing the "New Deal" Social Security system in 1935. New Zealand introduces a two-tiered superannuation scheme in 1938: an income-tested age benefit payable at 60 and a small universal superannuation payment at 65 for those who are not eligible for the age benefit.
- post WWII: U.S. style social insurance systems are adopted by Germany, Italy, and other European countries.

- Up until early/mid 1960s, most social insurance systems were fairly minimalistic: eligibility was not universal, many risks were not insured, and benefits were not generous. They usually started as fully funded, but due to high population growth rates, most transformed to pay-as-you-go.
- In the 1960s and 1970s there was substantial growth in the coverage, generosity, and cost of social insurance program around the world. Somewhat naive but “well intentioned bureaucrats” created systems that had significant incentive compatibility problems. Individuals quickly learned to exploit these loopholes causing social insurance costs to increase faster than GDP, and labor force participation at older ages to decline rapidly.

- In the 1980s Europe dealt with its “unemployment hysteresis” by liberalizing entry into unemployment, early retirement, and disability to encourage older workers to exit the labor force in order to create job opportunities for younger workers.
- In the mid to late 1980s, stagflation combined with rapidly increasing social insurance costs leads to significant retrenchments in the 1970s liberalizations. 1983 “Greenspan reforms” in U.S. involved a gradual increase in the normal retirement age from 65 to 67 by 2011, an increase in the delayed retirement credit, and an increase in social security tax rates. This led to the gradual buildup of social security Trust Funds, partially prefunding the system.

- In New Zealand a series of reforms between 1979 and 1992 reduced the real level of National Superannuation. A surcharge was introduced that means-tested benefits to rich beneficiaries, although these were partially offset by a reduction in the top income tax rate from 66% to 33%. In 1991 the retirement age was increased in stages to reach 65 by 2001.
- 1980: “Radical reform” of social security was instituted in Chile resulting in abandonment of their insolvent pay as you go system and the adoption of a mandatory system of individual retirement accounts. Australia adopted a similar system in 1986.

- 1990s: U.S. public is increasingly aware that the “Greenspan reforms” have not solved the long term demographic imbalance and that further reforms will be necessary. General pessimism among young that Social Security will be a significant source of old age support. For this reason Social Security is no longer a politically untouchable “third rail.” Instead extraordinarily high stock market returns over the period 1995-1999 lead to increasing interest in reforms that would either invest the Trust Fund in equities, or create individual accounts that could be invested in equities.

Observations on the Historical Experience

- **Equity-Efficiency Tradeoff** By in large European countries and New Zealand adopted systems that were more progressive and egalitarian than the U.S., Australia and Chile. However this increased equity came at the expense of higher tax rates, a larger role for government, increased distortions and reduced incentives to work and invest compared to U.S.
- However, there is also evidence of a “political pendulum”: initial systems are minimalistic, and are gradually “over liberalized”. As the consequences of the excessively liberal policies become apparent there is typically (although not always) a counter-reaction towards excessive retrenchment.

- New Zealand's reforms/deregulations in the 1980s, particularly the lowering of the highest tax bracket from 66% to 33% reflected a greater emphasis on efficiency rather than equity. In the U.S. the lower safety net contributed to a greater incidence of severe poverty and attendant problems (slums, drugs, crime, and general urban decay).
- The adoption of the EU created additional fiscal pressures for European countries to further reduce their social welfare states in order to maintain fiscal balance and international competitiveness.

- Aggressive privatization of disability insurance and changes in unemployment insurance were instituted in Netherlands following 1996 PEMBA law. Welfare benefits were reduced and eligibility criteria tightened. The public sick pay program was scrapped: firms can either self-insure or take out private insurance to cover risk.

“Good social policy and practice not only require able administrators using appropriate policy tools, but also an intelligent design of the incentive structures ... This may seem obvious, but it took about three decades before this insight finally broke through among European supporters of the welfare state.” (Leo Aarts and Philip de Jong).

Is there an “Aging Crisis”?

- **No!** Relatively rich, rapidly growing countries with not too generous PAYGO social insurance systems such as New Zealand and U.S. can afford to make relatively moderate fiscal adjustments now (either tax increases or benefit cuts with some prefunding of pay as you go obligations). However the longer we delay action, the more painful the tax increases or benefit cuts will need to be to restore long-run balance to the pay-go system as the wave of baby boomers ages.
- The increased public interest and concern in social security reform means there may be an opportunity for consensus for adoption of newer, more efficient systems.

- U.S. and N.Z. have roughly similar demographics and levels of generosity of old age benefits (for the average worker).

Life Expectancy at 65

	NZ	US
M	15.5	15.9
F	19.0	19.2

Projected Population Share 65+

	NZ	US
2001	11.5%	10.0%
2011	13.0	15.0
2031	21.0	20.0

Replacement Rate for Average Individual

	NZ	US
individual	39.0	41.0
family	65.0	61.5

Old Age Pensions as a Percent of GDP

	NZ	US
1995	4.5	6.2
2010	4.0	6.3
2020	5.1	6.8
2030	7.0	7.5

- However for most OECD “welfare state” countries, the necessary adjustments will be much more painful, and may involve serious retrenchments that will involve significantly cutting back the role of the welfare state, lowering the social safety net and increasing inequality (and efficiency). Although these countries are not in the midst of an aging “crisis”, reform is urgent in Belgium (10.0), France (12.5), Germany (11.5), Italy (14.1), and Spain (10.0).

What are the options for pension reform in New Zealand?

1. Do nothing. Raise taxes or cut benefits as needed to maintain fiscal balance as you move into the height of retirements by baby boomers over period 2015-2035.

- **Pro:** Avoids contentious, divisive debates about alternative systems. Due to the relatively modest imbalance in the system, the postponed tax increases or benefit cuts would not be unduly painful when they are finally enacted.
- **Pro:** NZ universal flat rate system may be perceived as highly egalitarian and receives broad political support as a result.
- **Pro:** benefits not taxed or income tested, resulting in lower labor supply distortions

- **Con:** New living standard survey for the 65+ population reveals “both single and partnered CEUs had fairly modest income levels” (p. 48). Median income for singles was NZ \$12,090 and for couples was NZ \$21,000. These values are only 20% and 16% higher, respectively, than the respondent’s superannuation benefit, suggesting that the average New Zealand retiree is almost totally dependent on the National Super. To the extent the National Super benefit is not very generous, this could be *prima facie* evidence of some kind of myopia or short-sightedness leading to inadequate retirement saving on the part of a majority of New Zealanders.

- **Con:** Although home ownership rates are high, non-housing net worth is also very modest with median values of only \$7,500 for singles and \$37,500 for couples. 49.9% of singles and 46.1% of couples report that their incomes are either not enough or barely enough to meet day to day living costs. Despite these responses, only 7.5% of the sample were employed, suggesting the possibility that there could be age/sex discrimination or other employment barriers that discourage most of the individuals who report their incomes are inadequate from supplementing their incomes by returning to work on either a full or part time basis. This is additional evidence of suggesting there is inadequate “precautionary saving”.

- **Con:** Economic theory suggests PAYGO social security systems result in a) lower savings, b) higher costs and distortions relative to fully funded systems since the implicit return on PAYGO (the sum of real wage growth plus population growth, approximately 2% for New Zealand), is less than the real interest rate (5-7%). The relatively low amount of retirement savings accumulated by retirees suggests the possibility that there may be significant disincentives to individual retirement saving (e.g. the 33% tax on investment earnings), or at least insufficient positive incentives (e.g. tax incentives) to induce individuals to save enough for retirement so that they have enough asset income in retirement to augment their relatively low National Super benefit in order to provide more clearly adequate consumption levels in retirement.

- **Con:** The government's attempts to reduce program costs by raising the retirement age from 60 to 65 appear to be partially offset by dramatically increased rates of unemployment, invalidity, and sickness benefit in the 60-64 age category, as well as significant increases in these rates for lower age categories. This implies that more people will be getting on the roles and staying on longer, would could significantly increase the cost of these programs. Several of these social insurance programs are growing at unsustainable rates (approximately 10% per year for invalids roles) which suggest that additional reforms will be inevitable in the near future. In general, when tightening up cost by raising the normal retirement age, it is critical to consider offsetting "leakage" or substitution into related social insurance programs.

- **Con:** The SOP survey reveals that of the single retirees: 74% are women, 76% are widowed, 82% live alone and 65% have no formal qualifications. This strikes me as a large group of potentially very vulnerable people. Furthermore, a large fraction of single retirees report relatively severe health conditions such as hypertension (40%), rheumatism/arthritis (30%), back problems (23%), and coronary heart disease or stroke (17%). 41% of single retirees report difficulty walking significant distances or up stairs and 22% report difficulty walking short distances. 30% report their health as fair or poor. It raises the question whether some sort of additional assistance is needed for these people who are heavily represented by widows with health problems and little formal educational training or work experience.

- **Con:** If the group of widows living alone is fairly large, it could account for a significant share of those who report their incomes are inadequate to meet day to day needs, yet they are unable to go back to work due to their health limitations and lack of labor market skills. Also it suggests the possibility that many New Zealand families may not have adequate life insurance coverage. If so, it suggests the need for further inquiries into why families are under-insured. If there is market failure in the life insurance market, it might even raise questions about whether some sort of survivor's benefits are called for, so that a widow does not lose all of her deceased husband's benefits.

- **Con:** Funding for the National Superannuation comes out of general tax revenues, which could make the system less “transparent” and more dependent on the outcome of political debates about alternative uses of the budget. Assessing the financial status of the system becomes more arbitrary since it depends on a specification of exactly which share of general tax revenues should be “earmarked” for the National Super. The lack of independence in pension financing could increase the level insecurity on the part of pensioners. Also, to the extent individuals would regard contributions to the National Super to be more akin to “saving” than to a tax, the perceived effective tax rate might be lower if there was a separate deduction for contributions to the National Super.

- **Con:** Finally, I note the possibility of inequities created by the failure to actuarially adjust the flat National Super benefit. Individuals who have poor health and high mortality are clearly going to receive a lower rate of return from the system than those who are in good health and will live a long time. Raising the retirement age from 60 to 65 only exacerbates the “poor health penalty” imposed by the current system. While it is intended to reduce costs, those who are unhealthy and how have boring or physically demanding jobs may pay a much higher share of the “welfare costs” of raising the retirement age than relatively rich professionals who have mentally challenging but non-physically demanding jobs.

- **Con:** (continued) It might be worth considering whether it is actually more equitable to adopt an actuarially adjusted benefit instead of the completely flat benefit level under the *status quo*. An actuarially adjusted benefit could allow individuals to retire early (say at age 55 or 60) and receive a permanently lower benefit or to postpone retirement and receive a permanently higher benefit. The weekly benefit would be adjusted so that a person of average health would receive the same expected discounted stream of benefits regardless of which age they retired. Such a policy would also be likely to take some pressure off of the sickness, invalidity, and unemployment programs by reducing the incentive to (mis) use these programs as *de facto* early retirement schemes.

2. Maintain status quo but prefund, possibly including investing in equities.

- **Pro:** To the extent prefunding comes from increased tax contributions (as opposed to borrowing to prefund the pension liabilities), New Zealand will benefit from the higher compound returns on the trust fund portfolio as opposed to the less than 2% rate of return on a PAYGO system.
- **Pro:** Allowing investments in equities could enable the government to further lower tax rates to the extent that the expected long run return on a Trust fund invested in equities exceeds the return on a Trust Fund invested in Treasury bills.
- **Pro:** Prefunding would result in “tax smoothing” and lower deadweight costs associated with distortionary labor taxation.

- **Con:** Most of the cons associated with the “do nothing” option also apply to the maintain status quo but prefund option.
- **Con:** Allan Greenspan, Chairman of the U.S. Federal Reserve Board is opposed to investing Trust Fund proceeds in equities since it could a) lead to a political lobby for regulation of industry in order to “ensure” high rates of returns, and b) lead to lobbying for “socially responsible” or “politically correct” or “ethical” investment strategies that could penalize the overall rate of return on the Trust Fund portfolio.
- **Con:** The existence of a large pot of cash could tempt short-sighted politicians to “borrow” from it to finance other types of government spending, or to undertake unjustified tax cuts (as the Bush Administration recently did in the U.S.).

3. Reintroduce the superannuitant surcharge

- **Pro:** This option would improve the balance of the system by taxing away the National Super benefits of high income beneficiaries. It would result in a program where benefits are targeted to those most in need, and provide additional incentives to encourage the wealthiest people in New Zealand to save for their own retirement. help to counteract the net loss in progressivity of the New Zealand tax/transfer system resulting from the reduction in the top tax bracket from 66% to 33% in the 1980s.
- **Con:** By taxing away benefits of the upper income groups, there is a risk of loss of broad based support and “common bonding” or “solidarity” that is inherent in a universal, flat rate superannuitization scheme.

4. Introduce limited tax breaks for individual retirement accounts and employer-based DC accounts

- **Pro:** This policy could be combined with policy 3, where limited tax breaks would help provide compensate wealthier voters for the taxation of their National Super Benefits. It could also be combined with limited government regulation of the cash out and conversion of pension funds into annuities to promote risk pooling and reduce adverse selection problems. The amount of funds that could be EET-exempt could be limited in order to ensure the overall progressivity of the system.

- **Con:** This program is administratively more complex to administer and requires more monitoring resource to prevent cheating. It might also require additional regulations to prevent “churning” of assets, and excessive advertising costs if private investment companies are allowed to compete for the right to manage pensioners’ funds.

5. Abolish the National Super and adopt a *redistributive* Chilean or Australian style system of individual accounts

- **Pro:** Individual accounts, when accompanied with reasonable flexibility over the ages one is allowed to “cash out” or annuitize, can reduce labor market distortions.

- **Pro:** Individual accounts give all individuals access to the ability to allocate their retirement portfolios to equities, obtaining higher expected returns in exchange for bearing increased investment risk. The higher rate of return (invested over long horizons, but with reasonable policies to force investors to gradually convert their portfolios into bonds as their retirement window approaches) can significantly enhance their financial status and overall wellbeing during retirement.
- **Pro:** Individual accounts can lead to higher levels of aggregate capital accumulation relative to a defined-benefit, pay as you go system.

- **Pro:** Individual accounts are more transparent and may be less subject to “political risk”. Once individuals have their own retirement accounts with their own funds attached to their own name, it becomes increasingly likely that these would be treated legally as the individual’s property. This is likely to severely limit politicians’ ability to renege on promises, since most *ex post* attempts to reduce benefits would ordinarily require direct expropriations of people’s accounts, which may not be legally or politically feasible.
- **Pro:** Individual accounts provide a higher level of discretion and control to the individual investor (at least earlier in the life cycle, sufficiently far away from the planned retirement date), and allows all income classes equal access to the potential benefits from investing in equity markets.

- **Con:** Unsophisticated investors might dissipate their retirement savings by churning an engaging in unprofitable speculation or “day trading”.
- **Con:** Individual accounts are administratively more complex to manage. They involve a large number of auxiliary decisions about whether private firms will be allowed to compete to manage individual retirement portfolios. There are important decisions to be made about what fractions can be cashed out at various ages, if annuitization of the remainder should be mandatory, and whether contributions to the account should be discretionary or mandatory and whether supplemental contributions should be allowed, and the tax treatment for contributions and benefit payments.