Introductory Thoughts about Innovations in Pension Payment

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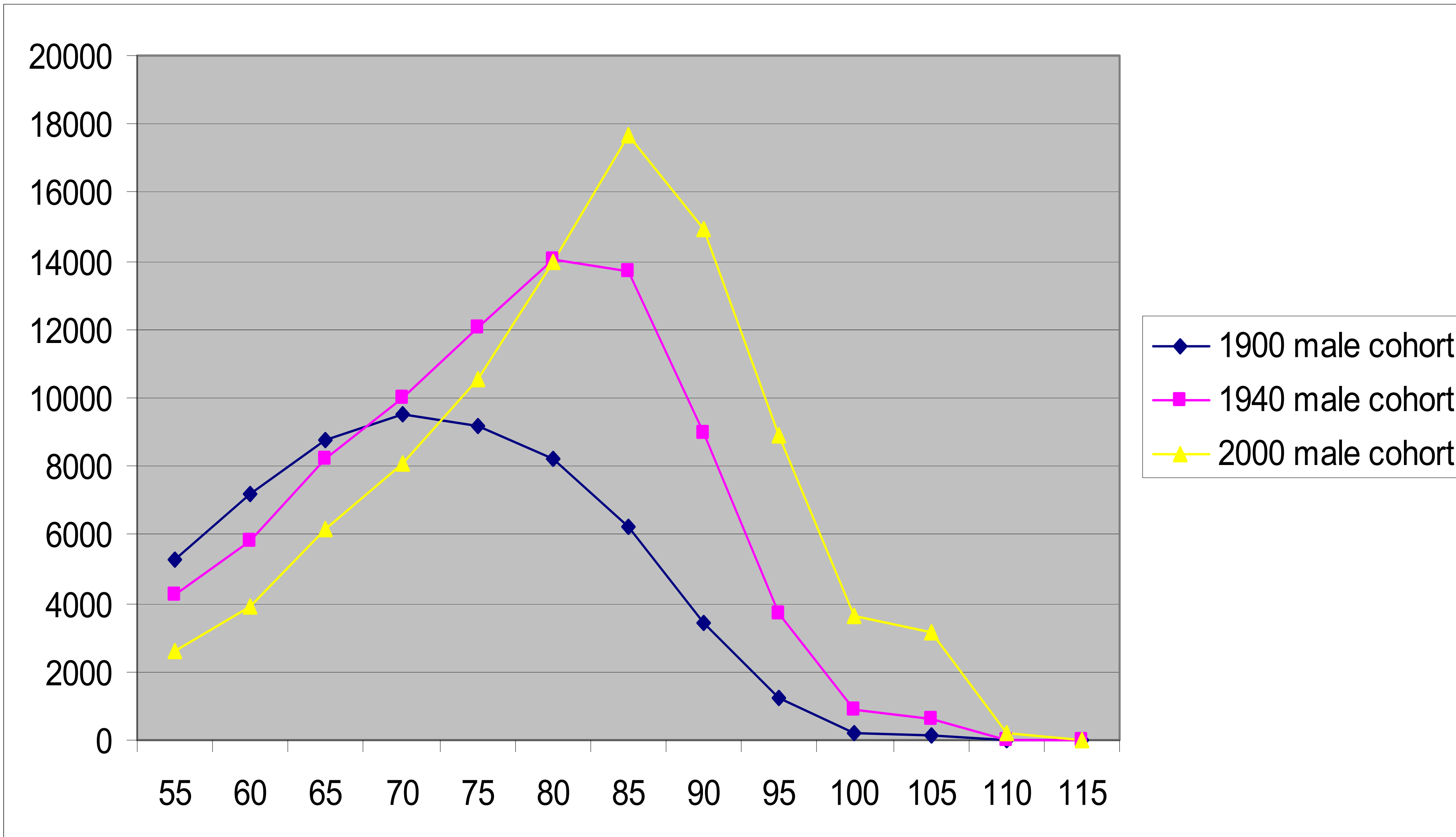
Old-Age Insurance or Forced Savings?

- Slipped from one paradigm to the other
- More and more forced (or encouraged) savings not feasible
  - Longevity gains
    - Surviving to “old age”
    - Living longer thereafter
  - Implies contribution rates that are not realistic
    - Can’t have infinitely more “late life” leisure
    - 20 to 30 percent ceiling?
- At the same time, politics and economic restructuring have been moving thresholds ages downward.
- See next slides about US trends in last century

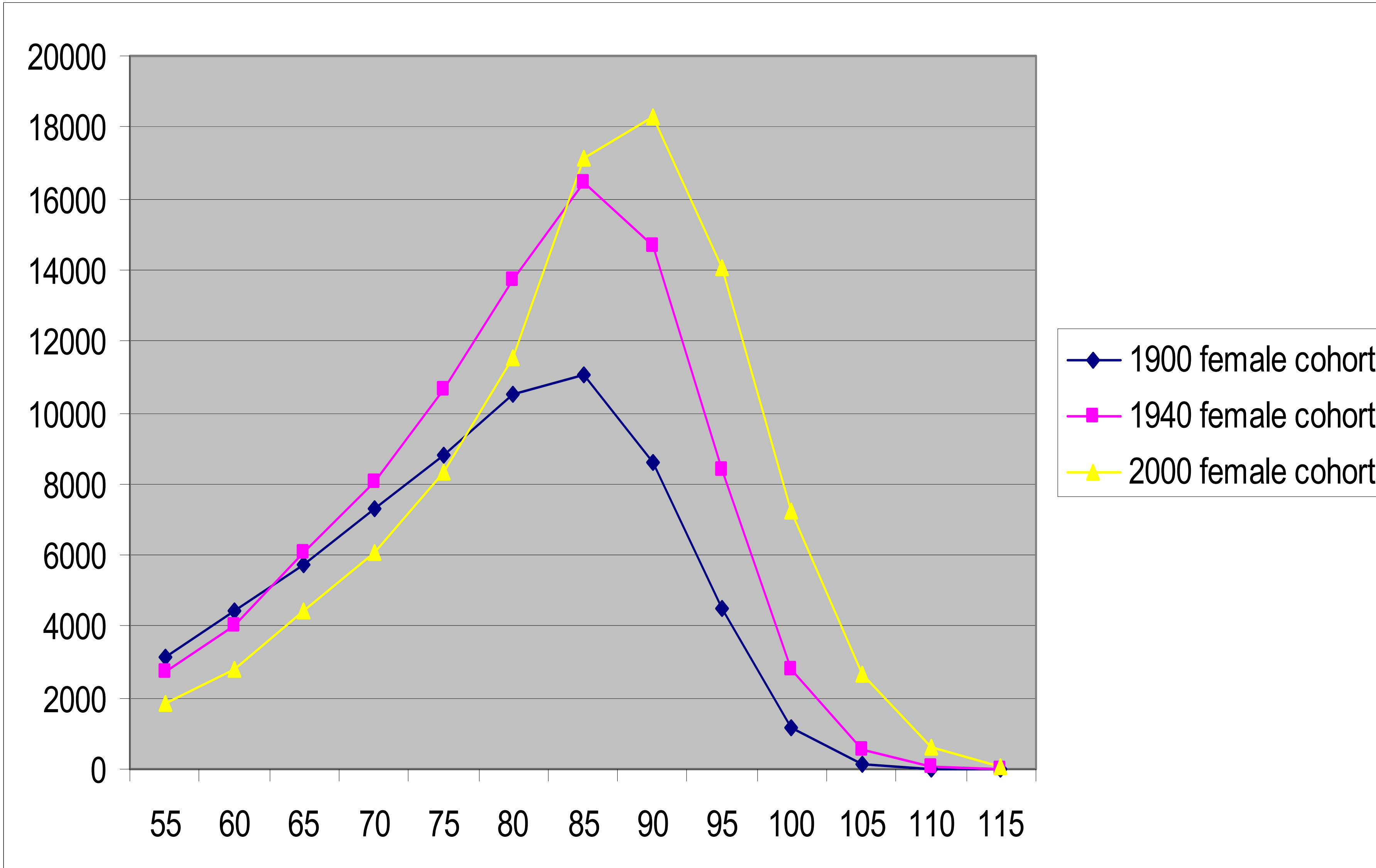
Male deaths per 100000 after age 55

Cohorts born 1900, 1940 and 2000



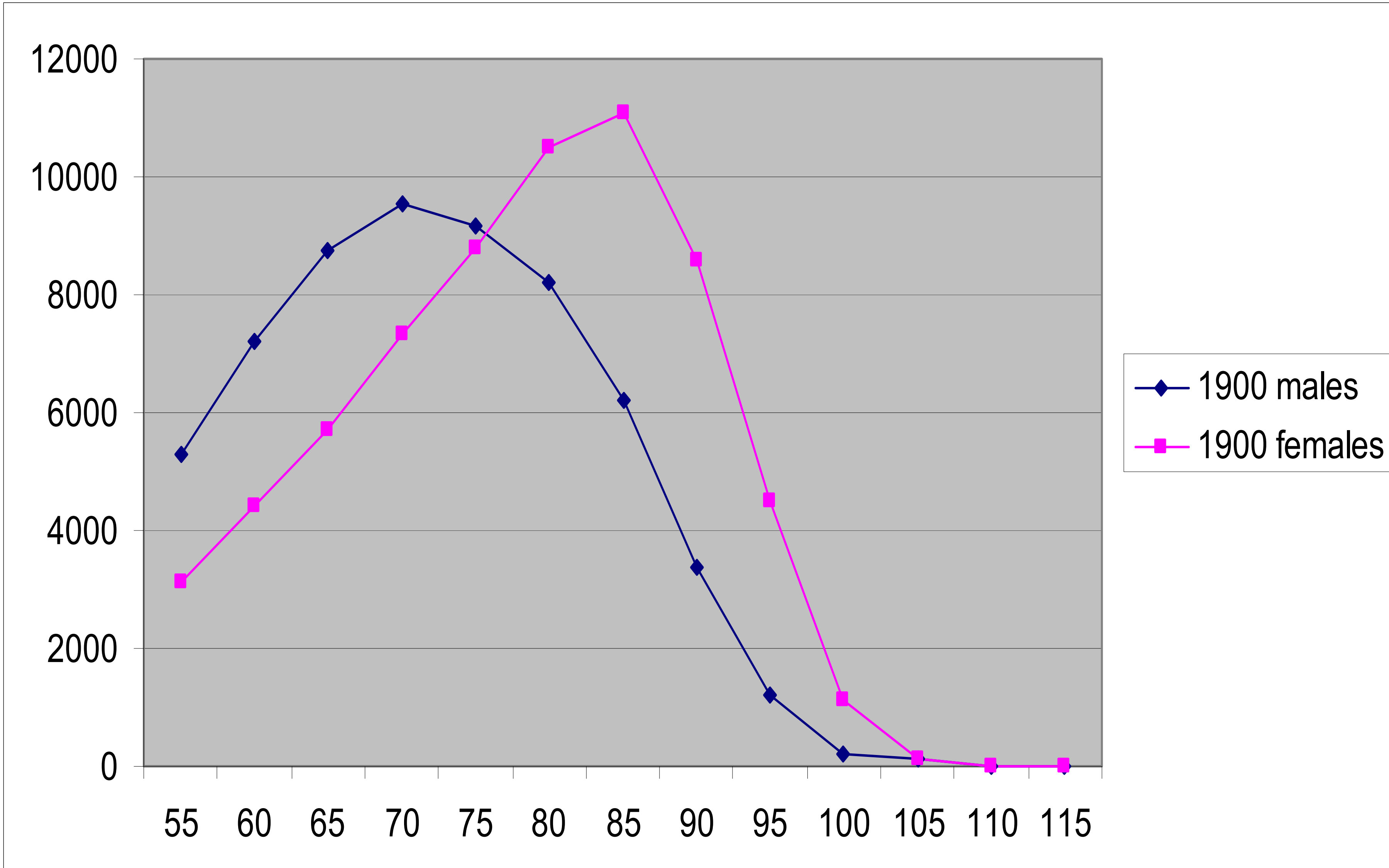
Female deaths per 100000 after age 55

Cohorts born 1900, 1940 and 2000



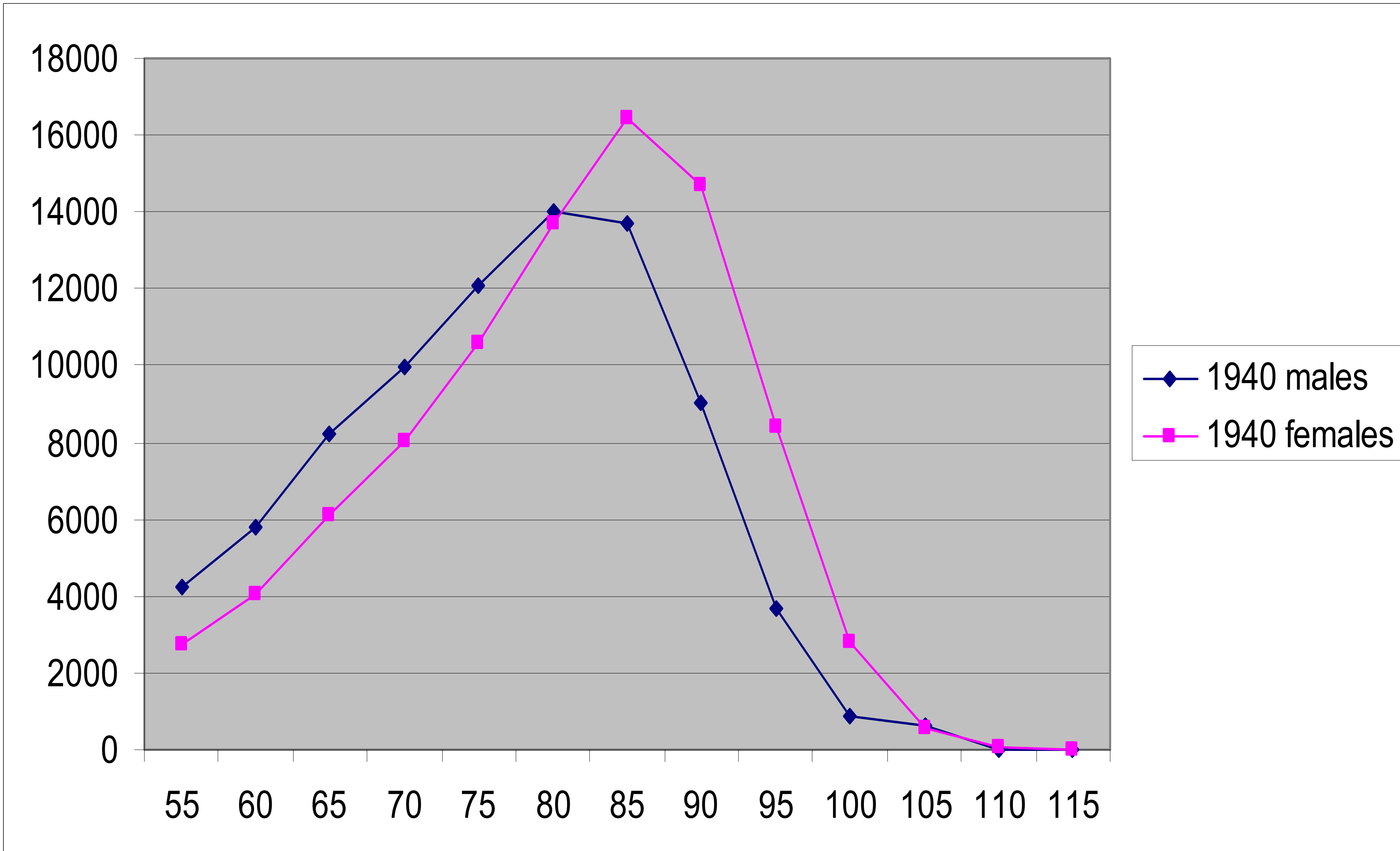
Cohort born in year 1900

deaths per 100000 after age 55 by gender



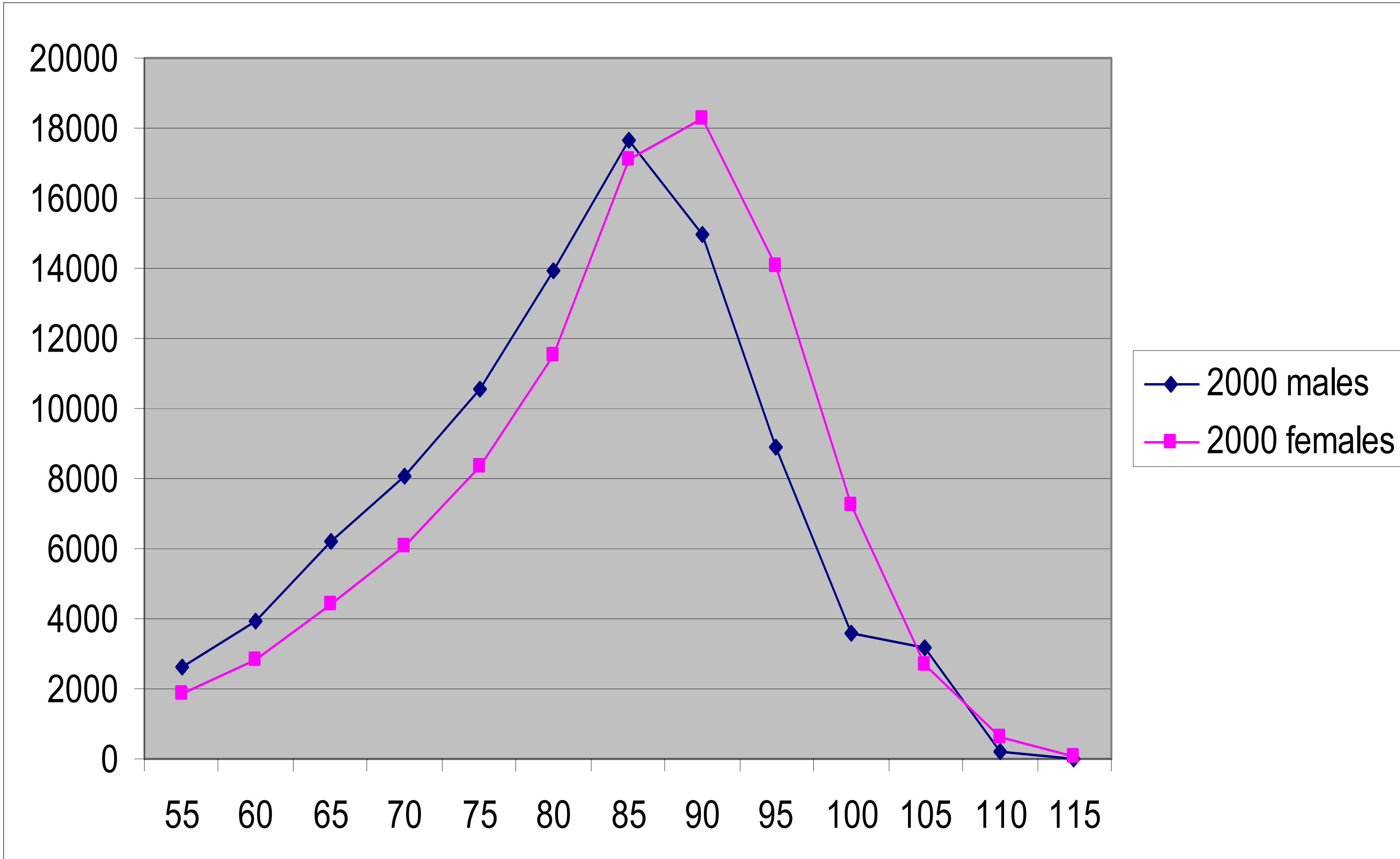
Cohort born in year 1940

deaths per 100000 after age 55 by gender



Cohort born in year 2000

deaths per 100000 after age 55 by gender



US Male Survival Probabilities for cohorts born 1900, 1940 and 2000

From 0 to	***55***	***60***	***65***	***70***	***75***	***80***	***85***	***90***	***95***	***100***
1900	0.59	0.54	0.47	0.38	0.28	0.19	0.11	0.05	0.01	0.00
1940	0.82	0.77	0.72	0.63	0.53	0.41	0.27	0.14	0.05	0.01
2000	0.92	0.89	0.85	0.79	0.71	0.60	0.46	0.29	0.14	0.05
From 20 to	***55***	***60***	***65***	***70***	***75***	***80***	***85***	***90***	***95***	***100***
1900	0.75	0.69	0.59	0.48	0.36	0.24	0.14	0.06	0.02	0.00
1940	0.87	0.82	0.76	0.67	0.57	0.44	0.29	0.15	0.05	0.01
2000	0.93	0.90	0.86	0.80	0.72	0.61	0.47	0.29	0.14	0.05

US Female Survival Probabilities for cohorts born 1900, 1940 and 2000

From 0 to	*55*	*60*	*65*	*70*	*75*	*80*	*85*	*90*	*95*	*100*
1900	**0.65**	**0.62**	**0.58**	**0.52**	**0.45**	**0.36**	**0.25**	**0.14**	**0.06**	**0.01**
1940	**0.88**	**0.85**	**0.81**	**0.75**	**0.67**	**0.57**	**0.43**	**0.26**	**0.12**	**0.03**
2000	**0.95**	**0.93**	**0.90**	**0.86**	**0.80**	**0.72**	**0.60**	**0.43**	**0.25**	**0.11**

From 20 to	*55*	*60*	*65*	*70*	*75*	*80*	*85*	*90*	*95*	*100*
1900	**0.83**	**0.79**	**0.74**	**0.66**	**0.57**	**0.46**	**0.32**	**0.18**	**0.07**	**0.02**
1940	**0.94**	**0.91**	**0.87**	**0.80**	**0.71**	**0.60**	**0.46**	**0.28**	**0.13**	**0.04**
2000	**0.96**	**0.94**	**0.91**	**0.87**	**0.81**	**0.72**	**0.61**	**0.43**	**0.25**	**0.11**

Conditions and Constraints

- Less and less DB provision from private sector
  - For good and bad reasons, but certain and steady decline
- "Collective" DC arrangements are challenging endeavors and may require a large degree of social cohesion in relatively small countries

Conditions and Constraints

- Probable limit on non-volatile financing instruments
  - Only so much indexed government bonds available
    - private sector pensions in US hold today only are about 8 percent in government bonds -- any major shift to bonds implies substantial divesting by other holders
- Private sector only now beginning to develop alternatives for households in portfolio-choice DC

Conditions and Constraints

- Longevity may be increasing more than fully functioning workplace capacities are being extended
- Technical and financial market capacities in developing countries
  - Cannot just “assume a can opener” in each and every place
  - Lessons to be learned from successfully middle-income countries more than upper-income countries

Implications for Distribution Stage

- Leads to a possible distinction between "young-old" period vs. "old-old" period
  - Work and spend-down of forced (or encouraged) and probably volatile savings in young-old period
  - True non-volatile "old age" insurance for old-old period
- Have to think innovatively and broadly about how to manage payout stage

Implications for Distribution Stage

- Have to pay some attention to settled practices and expectations
- Have to examine carefully the choices people are actually making
  - Are people really myopic about retirement planning?
  - Compulsion is best when it is aligned with incentives and most peoples' preferences most of the time

Annex
Rediscovering Old-Age Insurance vs. Forced Savings

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Old-Age Insurance vs. Life-cycle Model of Consumption Smoothing

- Social Insurance includes disability and survivors' insurance plus "old age insurance". In early 20th century, covered workers probably valued old-age insurance the least.
- Old-age insurance was "presumptive disability" at (then) an advanced age.
- Overcome "myopia" that there is some probability of living to advanced age and some years thereafter. Pre-industrial support systems were unravelling.

Old-Age “Insurance” lost its meaning

- More and more people made it to the traditional “old age” threshold (first 70, then 65)
- Political process has lowered the real entry ages downward to around 60-62 (even lower) in most developed countries.
  - Concerns about poverty among older women; pressures from unionised sector in mining, etc.
  - Make more “room” available for younger workers
  - More wealth ➔ more leisure

Analysts and Policy-Makers moved to “consumption smoothing” model

- The state will force you (encourage you) to save enough in working period for you (and spouse) to have “adequate” consumption level in ever longer retirement.
  - Minimum level to prevent poverty?
  - Sustain most households pre-retirement consumption levels?
  - Both?
- Continuation of this model (at today’s retirement ages) and with both objectives implies retirement “contribution rates” that are unrealistic
  - Many countries are already reaching levels that are distort labour markets and encourage non-compliance.

Reinventing Old-Age Insurance

- State should force citizens to “buy” deferred annuities payable at some (real) advanced age.
- That age could be a function of –
  - What is the equivalent today of age 65 in 1910? Survivor probabilities at age 60 (e.g., 50 percent)
  - What’s the age at which disability-testing has no filtering effect?
  - Some adjustments for wealth, less children?
  - Example for discussion: age 75.

Constraints

- Capacities do diminish before 75 and disability-testing is a difficult, expensive, and often political process (with corruption potentials).
  - Economically more efficient to bunch leisure in the older years.
- Expectations that have developed over the years among workers and employers both.
  - Not all workers like their “regular” jobs.

Distinguish Between the "Early-Old" and "Old-Old" Periods

- Old-Old period is the post-age 75 period that should be covered by a mandatory deferred annuity.
  - At least equal to some absolute level of adequacy. Query if replacement rate targeting (consumption smoothing) is desirable or fiscally realistic.
- Young-Old period is the, say, age 60 to 75 period in which part-time work will become part of most persons' expectations.
  - Combined with drawdown of mandated/encouraged savings from the pre-age 60 period.

Forced Savings in the Young-Old Period

- How much partial consumption smoothing should be mandated vs. encouraged for the young-old period?
  - Countries will differ on mix of mandate vs. incentives. Cultural traditions and pre-existing institutions.
- Much also depends on how flexible labour markets become for older workers.
  - In US labour force participation of older males has increased by two percentage points in last few years of down-markets.
- Tax and pension withdrawal incentives have to become neutral about future work.
  - Whitehouse OECD work.

Lessons from Voluntary Annuity Markets About Mandated Annuities

- How intrusive should public policy be as to how “forced savings” are drawn down during the young-old period?
- Most of the recent academic work shows annuities to have high money’s worth and efficiently compensate for larger precautionary savings.
- But in most countries voluntary annuity markets are small (and largely exist only as a second-best tax shelter).

Why the contradiction?

- Housing is a preferred "annuity" – provides a stream of untaxed income.
  - Option of "reverse annuity mortgages"
  - Tax arbitrage incentives
- Concerns about other non-insurable events (long-term care), combined with bequest motives.
  - Intra-household implicit contracts.
- The likely short-lived not wanting to subsidise the likely long-lived. E.g., blue-collar male vs. well-off female. Racial and ethnic distinctions.
- Misinformation about annuity markets.

Possible Alternatives

- Forcing purchase of annuities for the young-old period would go against consumer preferences and lead to higher non-compliance. Also contrary to letting households find optimal mixes of part-time work and dis-saving during this period.
- Some restraints on what lump sums can be used for? E.g., mortgage pay-off?
- Some programmed withdrawal constraints?

Lessons from Bodie-ism

- Deferred annuities for the old-old period should be financed with “indexed government bonds”. Can take the form of:
  - Conventional but balanced DB PAYG (how defined is a constantly redefined benefit?)
  - NDC-PAYG (preferably “completed” as in Sweden)
  - Sufficient forced savings in government instruments to meet the target.
- For “secured” savings that households want beyond this objective, governments should at least help accommodate.
  - Force some of the savings for the young-old period to be in government bonds?