COMMENTS ON SESSION 1
PENSION REFORM AND THE LABOUR MARKET

Johannes Clemens[*]

As agreed previously, I will focus my comments on the papers by Najat El-Mekkaoui De Freitas and Joaquim Oliveira Martins: "Consumption Structure, Welfare Goods and Retirement Income: Linking the Ageing Puzzles", and by Paul Rodway: "Public Pensions and the Labour Market in New Zealand". I found both papers very stimulating and well founded.

1 Discussion of "Consumption Structure, Welfare Goods and Retirement Income: Linking the Ageing Puzzles" by Najat El-Mekkaoui De Freitas and Joaquim Oliveira Martins[1]

The paper by El-Mekkaoui De Freitas and Oliveira Martins is very ambitious, as it deals with no less than four pension puzzles. These are correlations economists would not usually expect because of their belief in the lifecycle theory:

i) People are not perfect consumption smoothers. Instead, they tend to consume less in old age;

ii) People are net savers even in old age. In a lifecycle world they should rather dissave;

iii) Countries with more pension fund assets have lower private household saving rates. If PAYG contributions are regarded as substitutes for private savings, the opposite result could be expected;

iv) Rising longevity seems to be correlated with lower savings, although a longer life needs more private provision for retirement.

Puzzles (i) and (ii) can be illustrated by hump-shaped consumption age profiles. Consumption smoothing in reality obviously does not mean perfect equalisation of consumption potentials in all phases of our lives. It rather means consumption planning, and thereby taking into account all income sources as well as consumption necessities in old age. If rational consumers save in old age, this should be driven by bequest motives. Another explanation might be special purpose savings or consumption smoothing within the retirement period. The fear of needing (not fully subsidised) long-term care at the end of one's life might drive the observed savings.

The OLG model is very insightful. However, the longevity puzzle does not really seem to be solved. Perfect consumption smoothing might lead to higher consumption during the working years if the expected income in old age rises. But if it rises only in sum because of a longer retirement phase, it is very hard to follow the author's argumentation. The saving-longevity puzzle remains striking. Maybe people not only take into account their increased longevity but also the necessity to work longer (hopefully in good health). Perhaps they have to adapt their bequest plans because they live longer and dissave more than envisaged during retirement.

It remains difficult to explain the saving-capitalisation puzzle. There were very numerous attempts to find empirical evidence for the Feldstein thesis of a wealth substitution effect when introducing a PAYG pension scheme. Even Feldstein himself mentioned the countervailing retirement effect. According to this effect, people retire earlier purely because of the existence of a pension scheme. As a result, however, they have to save more and consume less. The

[*] Deutsche Bundesbank.

[1] The discussion refers to the original version of the paper which has been revised in the aftermath.

Barro-Feldstein controversy is well known. But all the empirical cross-section, time-series and cross-country studies have not yet brought absolute clarity to the saving-capitalisation debate.

Finally, there is some good news in the findings; due to the hump-shaped consumption age profile, demographic ageing would be consistent with lower per capita growth rates, which is nevertheless to be expected because of the shrinking working force. If the elderly do not want/need to consume as much as younger people, less production is needed to keep the welfare status constant. Indeed, it might be misleading to place too much emphasis on the expected decrease in the per capita growth rates.

2 Discussion of "Public Pensions and the Labour Market in New Zealand" by Paul Rodway

The paper by Paul Rodway deals with the interaction of the New Zealand statutory pension scheme, called NZ Superannuation (NZS), and the labour market participation of the elderly. It is well known that the demographic change will put public finances under pressure. The post-war baby boom will (temporarily) cause strong increases in the number of pensioners. The more or less linear rise in further life expectancy will continuously worsen the ratio of tax payers to pensioners. And finally, the tax base will erode due to insufficient birth rates to stabilise the population.

According to the brief but enlightening characterisation of the pension system, the NZS offers a flat pension at the age of 65 to every New Zealander, notwithstanding whether he/she is in paid employment. In contrast to Bismarckian pension schemes in central Europe, the NZS includes a substantial element of explicit income redistribution. On the one hand, this makes the system successful in fighting old age poverty. 66 per cent of the net average wage for a couple implies a 100 per cent or more replacement rate for a household receiving less than two-thirds of the average gross wage. On the other, due to the absence of any equivalence between contributions and benefits, the taxes levied to finance the NZS cause distortions and lead to inefficiencies.

Paul Rodway is right to emphasise that there is no implicit tax to be taken into account by a pensioner considering whether to participate in the labour force. He/she receives the pension at the age of 65 regardless of whether he/she remains in employment. However, it should be mentioned that the explicit tax on the optional additional labour income is partly used to finance the pension scheme without giving rise to any additional pension claim. This disincentive to labour supply is the result of income redistribution within the NZS. The tax burden is the same for every cohort, but only those aged 65 or more can avoid it by leaving the labour force.

The figures on labour force participation are very instructive. They give us a hint of the importance of the retirement or, more precisely, the eligibility age. Obviously, the rise from 60 to 65 by 2001 caused a significant increase in the participation rates of those aged 55 to 64. In Germany, there was a comparable development from 1997 onwards. Here, actuarial deductions were introduced in stages in the event of early retirement (especially after unemployment or old age part-time work). Since 2005, there has generally been no opportunity to retire early (*i.e.*, before reaching the age of 65) without these deductions. The result (together with major labour market reforms) is a relatively strong increase in the labour force participation rate of the elderly in Germany (see Figure 2).

Unsurprisingly, the willingness to work after 65 diminishes. Theoretically, the positive income effect in the form of the NZS pension must lead to a lower labour supply if the demand for leisure is characterised by a positive income elasticity. This matches with the finding of a sudden cut in full-time work at 65 and – for men – a steady increase in part-time work with advancing age.

The deeper analysis of special factors that influence retirement behaviour is very interesting. According to the findings presented by Paul Rodway, the probability for remaining in work rises if a person does not have a non-working spouse. This might be interpreted as good news because secular trends moving from families to single households indicate some fiscal relief. Regarding the findings on health status, which is stated here to be rather irrelevant to decisions on whether to work, I would be cautious. Disabled persons are, by definition, no longer able to work. If they are included in the sample, one should expect some influence from health status. Persons who are not disabled but less healthy probably do not have a choice on whether to leave the labour force – unless they can count on the support of a spouse. And finally, the general trend moving from physically demanding jobs (in the production sector) to mentally demanding jobs (in the service sector) might make it easier to stay in work even with a worsened health status.

What could be done to ensure fiscal sustainability in the next 30 years and beyond? Weakening the indexation means lower replacement rates. This might be politically difficult to sell. Fortunately, however, New Zealand has a highly redistributive pension scheme. Therefore, smaller pensions would be less of a problem to low income groups than, for example, in the German pension scheme, with its high degree of equivalence of contributions and benefits. On the other hand, pension cuts would be less effective from a fiscal perspective, because there are no "big" pensioners, who would lose more than those at the lower end of the income distribution.

The first choice, therefore, would seem to be an increase in the eligibility age, preferably automatically indexed to rising life expectancy. For example, it should be possible to argue that there is an obvious necessity to stabilise the ratio of time spent in retirement to the time spent in work. Longer working time – as Paul Rodway points out very clearly – is the key to dampening the fall in potential output growth and, consequently, to strengthening the economic basis of government finances and, not least, the social security system.

Some doubts arise regarding the idea of diverting the NZS pensions to a capital funded private scheme (KiwiSaver account) while staying in work. Letting the KiwiSaver account run above the age of 65 and allowing people to put money aside on a voluntarily basis would be a good idea. However, if subsidies are involved in these private savings accounts, it should be kept in mind that extra expenditures are not consistent with fiscal sustainability. This is a general caveat of government sponsored private savings accounts because it contradicts the goal of fairer intergenerational burden-sharing.