COMMENTS ON SESSION 3
PENSION REFORM, REDISTRIBUTION, MACROECONOMIC IMPACT

Carlo Cottarelli[*]

The two papers on which I was asked to comment – "Macroeconomic Implications of Pension Reform" by Ray Barrell, Ian Hurst, and Simon Kirby; and "Poverty and Income of Older People in OECD Countries" by Asghar Zaidi – cover quite different topics and I will have to take them up in turn.

1 Comments on "Macroeconomic Implications of Pension Reform or How to Pay for the Crisis" by Ray Barrell, Ian Hurst and Simon Kirby

The paper by Ray Barrel and others uses the global macro model of the National Institute of Economic and Social Research to assess the macroeconomic effect of pension reform and, more specifically, of increases in the perception of expected life, and of increases in working life.

This is a very useful paper. The National Institute model, has many features that make it useful for the purpose of assessing the macroeconomic effects of the pension reforms, including being a general equilibrium model, its possible use for assessing the behavior of small but also large open economies, and, last but not least, the fact that its parameters have been estimated not imposed, unlike other general equilibrium dynamic models.

This said, I have some observations to offer, and some related questions.

First, as underscored by the website of the National Institute, the National Institute model (NiGEM) is "designed to be a flexible model, where assumptions on behavior and policy can be changed. Hence, there is no such thing as "the NiGEM simulation results suggest" but rather, "under these assumptions, the NiGEM simulation results suggest". In this respect, the paper does clarify what the assumptions are for the various scenarios, but the authors could have underscored better where some results depend on certain assumptions. More to the point, I would suggest undertaking more sensitivity analysis with respect to the various assumptions, including the speed through which agents respond to reforms. I will come back to this.

Second, the paper explores the macroeconomic effect of an increase in the perception of expected life. It argues that raising the retirement age will increase people's perception of their life expectancy. The question is whether there are any empirical studies to support this assumption.

Third, the paper looks first at the effect of an increase in expected life, for a given working life, then at an increase in working life, given expected life, but it does not look at a combination of the two, which would have been interesting.

Fourth, I am a bit skeptical about the quantitative results achieved for the euro area. For example, the equation describing the transfers to the population for pensions and unemployment benefits is the same across all countries and, therefore, does not take into account country-specific features of the pension system. So, I am not sure I can trust the key numerical result of the paper, namely that raising the retirement age by 2 years in the euro area would save 40 percentage points of GDP in the long run. More work is needed here.

---

[*] IMF, Senior economist, Pension Corporation.

The opinions expressed herein are those of the author and do not necessarily reflect those of the European Central Bank or the Eurosystem.

Fifth, it would have been interesting to assess some of the results in light of the current crisis. For example, the paper assumes that the availability of increased labor following an increase in the retirement age is fully anticipated, which will provide the market enough time to adjust. In practice, however, how fast markets will adjust would depend on the state of the macro economy. For instance, it would be difficult to raise capital investment in the current global economic slowdown to accommodate the increased labor supply.

This raises my last and more general point, a point that is of key policy relevance. I am referring to the fiscal costs of the current crisis. I fully agree with the authors that pension reform, to be implemented gradually but legislated quickly, should be a key component of a strategy to finance the fiscal costs of the crisis, or, in other words, to allow governments to run in the short run expansionary policies while maintaining credibility in the long run solvency of public finances. However, from a purely accounting/budgetary perspective, saying that the cost of the crisis will be 40 per cent and that we can finance this by increasing the retirement age by 2 years is a bit misleading, because even before the crisis, increasing the retirement age by 2 years or more was necessary to ensure debt stability in the long run in European countries.

This said, I think the policy message remains appropriate. We should worry less about an increase in public debt, even as large as the one that we are experiencing now in all advanced countries, if, at the same time, these countries can show the ability to undertake reforms that will address the unresolved long-term pension problem. The paper recently prepared by the Fiscal Affairs Department of the IMF on "The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis" (http://www.imf.org/external/np/pp/eng/2009/030609.pdf – published on our website on March 6 and forthcoming as an IMF Occasional Paper) includes an interesting statistic. In NPV terms, the fiscal cost of the crisis is about 10 per cent of the future cost arising from aging for advanced G-20 countries. So you can go a long way in strengthening the perception of long-term solvency, in spite of the short-term costs of the crisis, by reforming the entitlement system.

2 Comments on "Poverty and Income of Older People in OECD Countries" by Asghar Zaidi

The paper is mostly descriptive. It does includes some interesting statistics on poverty across OECD countries. However, my general comment is that its findings could potentially be very sensitive to the measurement methods and the definition of poverty adopted. Therefore, some sensitivity analysis would be required to strengthen the robustness of the results.

The most relevant case in point is that the paper should acknowledge that the discussion of absolute versus relative poverty concepts is not settled, and take this into account by showing how sensitive the results are with respect to the use of alternative measures of absolute poverty. Important drawbacks of relative poverty measures, some of them particularly relevant in the case of pensioners, include:

- first, the fact that the purchasing power of the poor is obviously very different across countries. It would be, therefore, useful to define a consumption basket that could be considered as the minimum standard. The concept of a consumption basket is also more in line with the fact that individuals derive utility from consumption rather than from income;
- second, the focus on relative poverty can lead to misleading representations of poverty developments. Examples are mentioned in the text of the paper but mentioning them is not a solution. For example, in countries that experienced sharp growth spurts in recent years, where the income of the working population increases significantly while not affecting the

income of the old by the same extent, the use of the relative poverty indicators results in concluding that poverty in old age has increased;

- the focus on relative poverty could also lead to justify redistribution in favor of individuals who may hold sufficient assets or income to live comfortably;
- in this connection, the fact that measurements of poverty in this paper do not take into account household wealth should be highlighted. With growing household access to financial markets in many OECD countries in the sample, people in retirement could potentially receive significant interest or other non pension-related income arising from their wealth.