COMMENTS ON SESSION 3
PENSION REFORM, REDISTRIBUTION, MACROECONOMIC IMPACT

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1 Introduction

I, too, want to thank and congratulate Daniele Franco and his team for putting together this wonderful conference. I hope that my remarks will be as helpful as those of the earlier speakers. I was asked to comment in particular on Adi Brender's piece on the "Distributive Effects of Israel's Pension System" and Mallavarapu Ramaiah's "Some Reflections on Pension Reforms in India". These papers demonstrate the complexities of actual pension systems and the importance of the details in designing such programs. Because these design features depend on the goals of the pension system, it is critical to begin by outlining the principal goals of pensions and pension policies.

Let me posit the objectives for government pension policy. Of course, the overarching aim of pension programs is to provide financial well-being during retirement. Policymakers evaluate this goal by paying particular attention to several criteria: 1) the system's ability to alleviate poverty among the elderly, 2) the adequacy of retirement income relative to income during the working years, 3) the distribution of income within and across cohorts, and 4) the distribution of risk bearing and risk sharing within and across cohorts. Risk can come from various sources, including shocks to labor market and household composition, the variability of investment returns while working, and the risk from inflation and outliving ones assets when retired. As we have seen in the earlier sessions, the trick in designing a pension system is to meet these goals without distorting labor supply or savings decisions while maintaining solid public finances. This has proved difficult and has led to much reform of the pension sector. I think that most recent reforms have been driven by the desire to reduce government budget imbalances.

The design of each country's pension system and the reforms undertaken depend in large part on the relative importance of each of these goals. One canonical design is the three pillars. The three pillars are:

1) a universal poverty-level pension that is government-provided by nature.
2) a mandatory earnings-related pension, which could be either a defined benefit (DB) or defined contribution (DC) plan and which is funded by the individual, employer, or government.
3) voluntary retirement savings, where the government role may include fomenting reliable financial institutions with suitable investment products, introducing dedicated individual retirement accounts with restrictions on withdrawals and favorable tax treatment of contributions, investment returns, and/or disbursements.

With respect to the goals I outlined above, the first pillar protects the elderly from absolute poverty, but does not protect them from a large decline in their standard of living relative to their working years. It also provides some redistribution of income and risk sharing. The second pillar is in place to ensure adequate retirement income, the second goal. The design choices of how it is funded and whether it is a DB or DC plan has important implications for the distribution of income and risk sharing. Policymakers use the third pillar if the first two pillars do not generate enough retirement income or to offset distortions or incentives elsewhere. Israel has adopted a version of the three pillars. In contrast, India's structure appears to lack the first pillar, the second pillar is not

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completely formed as it has very low coverage across workers, and the third pillar is also under construction. Looking at the choices made by India and Israel, it appears that India puts relatively less weight on the goals of old-age poverty prevention and income redistribution than does Israel.

2 Comments on "Distributive Effects of Israel's Pension System" by Adi Brender

Let me turn to Adi Brender's paper on Israel. It clearly laid out the key parameters of the pension system and the simulations of the combined Old-age Allowances (OAA) and pension program were quite instructive. Israel has shifted from a DB plan to a somewhat smaller DB plan (the OAA) augmented by a DC plan with tax benefits. The DC plan is now mandatory. Thus, the plan resembles the three pillars. Brender uses 10 household types to examine the distribution of net benefits of the pension system and adequacy of retirement income. He simulates retirement income and taxes for households assuming that the DC plan is utilized up to the limit by all households and the real rate of return on the portfolio is 3.5 per cent. The simulations were quite helpful in understanding the working of the system. That said, the simulated households should be linked up with the quintile measures shown in many of the tables. For example, I think it might be helpful to reorganize the 10 types of households into 9 types with three levels of income and three types of family structures: first quintile, middle quintile and top quintile; single, married one-worker, married two-earner. This would allow the reader to link the simulations to the quintile-based analysis.

His first conclusion is that gross OAA benefits are distributed fairly evenly across households. As shown in Table 11, the complex formula for OAA benefits essentially boils down to $7 million NIS for single households and $1.1 million in benefits for couples. Given that $1.1 million NIS, when annuitized, is equivalent to 94 per cent of the wages of a continuously employed manual worker, it appears that the OAA is effective at providing poverty protection for low-income couples. Indeed, even for single households, where the benefit is only $0.7 million NIS, the replacement rate is 50 per cent of wages and the benefit is roughly equal to the poverty line. According to these calculations, the first pillar is well designed at preventing poverty among the elderly. That said, these stylized households may not capture all the variation in work and household formation experiences. For example, the paper on pension adequacy in Belgium, Italy and Germany (Dekkers *et al.*) suggests that the "messiness" of real life sometimes ends in poverty in old age – with systems that appear to be more generous than the Israeli system. Thus, I would like to know more about the adequacy of the OAA at poverty prevention for low- and moderate-income families for a wider range of work/marriage histories. I understand how challenging this would be and that it may be beyond the scope of this work; however, this is critical for judging whether the OAA is sufficient, a key determination of the paper.

The second major conclusion of the paper is that the mandatory DC program is too large for many households as it will deliver too much income in the retirement years and result in too little disposable income during working years. For example, because the OAA delivers benefits equal to 94 per cent of earnings (Table 12), low-income couples do not need additional pension income beyond the OAA to maintain their working years' standard of living (see type 1). By contrast, low-income singles (type 6), with only a 50 per cent replacement rate, will need additional income. In addition, OAA benefits for middle- and upper-income households are insufficient for adequate retirement income. For middle-income households, it appears that the OAA replacement rates are similar to those delivered by the U.S. social security system and that a second pillar is clearly needed for the middle-income group. However, the mandatory DC plan will generate too much saving for most households as is shown by column 2 of Table 12, particularly for low-income households.[1]

As a result, Brender recommends that the DC plan not be made mandatory because doing so will cause lower income groups to save too much. This would not be a problem if households could offset the over-saving elsewhere. However, I suspect that over-saving in the retirement accounts will be difficult to offset by lower saving elsewhere – e.g., less precautionary saving or less housing wealth. Therefore, with saving too high during working years, households may adjust by reducing labor supply as workers near the retirement age, thus creating a material distortion in labor supply.

But is a voluntary DC plan the best solution? In the U.S., voluntary savings plans such as IRAs and 401(k)s have only 60 per cent take up rate and fairly low levels of asset accumulation. This suggests that if the pension plan were voluntary, then many households would enter retirement with too little saving because they would rely only on the OAA. Brender presents evidence that indicates that many Israeli households do save in voluntary accounts, but that contributions rates are low for low-income employees. My reading of his evidence is that it is consistent with the U.S. experience and thus that a voluntary plan would lead to too little retirement income for many households.

An alternative response to the over-saving problem would be to make several adjustments to the parameters of the OAA and DC programs. First, since overall replacement rates are too high, the mandatory pension program could be scaled back significantly, perhaps by a third. This would reduce the amount of over-saving at the low end but would not eliminate it. Second, the relative importance of the OAA and the pension plans could be shifted towards pensions – which are proportional to income – and away from the flat benefit. In itself, this would help flatten the net replacement rate and reduce the tendency for over-saving at the bottom end of the distribution. Third, because shifting from the OAA to pensions would shift the net tax burden towards lower income families, that aspect could be undone by subsidizing a portion of the pension savings. With these three changes, the two pillars could be adjusted to largely eliminate the over-saving problem without creating an under-saving problem.

The third major contribution by Brender is his examination of the distributional aspects of the combined OAA/pension programs. He concludes that net benefits (gross benefits plus tax benefits, net of contributions) are distributed fairly evenly across households in terms of shekels per adult. Brender makes an important point that one needs to look at the whole tax system to make a judgment on progressivity, especially since it is not self-financing.

One extension to Brender's paper would be to examine the adequacy of the new pension system under different assumptions about rates of return. The new system also shifts investment risk to workers, which will create more variation in replacement rates than shown here where the real return is assumed to be constant. This also may affect desired target replacement rates as actual replacement rates will vary.

3 Comments on "Some Reflections on Pension Reforms in India" by Mallavarapu Ramaiah

[1] The replacement rates reported by Brender exclude any income or assets outside the OAA and DC plans. Thus actual resources available at retirement would be even higher. However, Brender's calculations exclude simulated mortgage payments from income during working years. By comparing post-retirement income to pre-retirement income excluding mortgage payments, he implicitly assumes that housing wealth is de-cumulated during retirement.

Turning to Ramaiah's "Some Reflections on Pension Reforms in India," my first suggestion is that Ramaiah should include a short description of the goals of the pension reform and which features of the reforms addressed these goals. Before the recent reforms, India essentially had a defined benefit plan with low coverage – civil servants and a portion of those in the formal economy, only 12 per cent of the workforce – which was seen as unsustainable. The new system is a defined contribution plan that is mandatory for civil servants and those in the formal workforce. The only subsidy/transfer from the government is in the form of tax benefits for the DC program. According to the paper, the key benefits from recent reforms include: a more sustainable pension system, a unified regulatory framework, improved system parameters such as portability across employers, and the creation of pension institutions that can be expanded into other sectors. However, coverage has not been expanded, and risk, in many dimensions, has been shifted from the government/taxpayer to the household. The net benefits, as they come from tax preferences, are probably regressive, but one also has to account for the other taxes to finance the system to make a judgment on the overall progressivity of the pension reforms.

This description leads me to several questions. As noted in the paper, India's demographics are very favorable. Over what horizon was the former system putting pressure on government finances? How much improvement in public finances was accomplished as a result of the reforms? Shifting from pay-as-you-go to funded systems for new entrants leaves a financing hole for the pay-as-you-go system. How was that filled? According to U.S. experience, preferential tax treatment may not boost voluntary saving for retirement significantly. What options are being contemplated to expand coverage in the private sector?

Turning to the design of the DC plan, the paper lacks some of the key parameters of the DC plan, such as size of contributions, expected replacement rates, and the type of disbursement at retirement (nominal annuity, real annuity, lump sum). DC plans for low-income workers tend to have relatively high administrative costs. It is asserted that the Indian system has low costs compared to prevalent charges in the Indian mutual fund industry, but no data are provided. How do the administrative costs for the Indian plan compare to other countries' experiences? Are the centralized recordkeeping and administration costs subsidized by the government, and does centralization materially reduce costs? According to the paper, individuals choose fund managers, and these funds have limited amount of flexibility over portfolio choice.

Ramaiah provides a substantial discussion concerning the composition of portfolios (between equities and bonds) and the creation of an "auto choice" plan with an age-varying portfolio. Given the relatively low limits contemplated for equity investments, it appears to me that the riskiness of bond portfolios may be under-appreciated in this discussion. For example, Shiller (2005) shows the rates of return are much higher for equity portfolios than for bond portfolios and the riskiness between the two is little different when examined over long periods of time.[2] The recommendations are heavily weighted towards bonds, but bond portfolios may have significant inflation risk. Are inflation–protected securities available for the investment funds, or is the government contemplating issuing them? Moreover, there is no discussion about whether the pension benefits will be delivered as a real or nominal annuity. Inflation protection of the benefit during retirement may be as an important element of risk for the household as is the portfolio return during working years.

4 Conclusion

[2] Shiller, R. (2005), "The Life-cycle Personal Accounts Proposal for Social Security: An Evaluation", NBER, Working Paper, No. 11300, April. The equity portfolio exhibited a wider range of returns, but the lowest outcome was higher than the 25th percentile outcome of the bond portfolio. Thus, the extra variance was all at the high end of returns, not a greater chance for losses.

Israel has adopted a three pillar structure for its pension system. The new system should provide good protection against poverty, *more* than adequate income security, and an adequate amount of risk sharing via the minimum benefit. Brender shows that the combined program may be too large and that better integration of the two systems is needed. India has adopted the second pillar via a mandatory DC plan (for some sectors) and is trying to improve the third pillar by improving financial institutions and by giving retirement savings favorable tax treatment. Its challenges will be to complete the roll-out of the current program, to extend the quite limited coverage, and to create a first pillar. Both papers indicate that the changes improve public finances, but the magnitude of the adjustment should be indicated. Also, it is unclear whether imbalances still remain.