REVIEWS

Forced Saving


Reviewed by Matt Benge

Concerns about an ageing population and a rising cost of public pensions have caused governments in many countries to consider pension reform. Policy options include tightening eligibility criteria for public pensions and measures to increase the private provision of retirement savings.

One method of increasing the private provision of retirement savings is to make savings for retirement mandatory. Under Australia’s Superannuation Guarantee Surcharge, Australian employers are required to contribute 9 per cent of an employee’s salary into a private superannuation scheme. This sort of policy has been advocated by a number of authors. However, Australia is one of a relatively small number of OECD countries that have adopted such a scheme.

The book contains little discussion the pros and cons of a scheme of mandatory private retirement savings (MPRS) relative to merely allowing individuals to make voluntary savings for retirement. The main focus of the book appears to be on the economics of consumption and savings decisions and on issues that need to be thought through when designing an MPRS scheme if such a scheme is to be introduced. There is, however, a short discussion in the first chapter of the pros and cons of an MPRS scheme relative to a pay-as-you go (PAYG) social security scheme. Under a PAYG system, tax payments by those who are working fund the retirement incomes of those who are retired with payments normally dependent on the employment history of retired workers.

My overall impression of the book is that it makes a very useful contribution. It provides a good and very clear discussion of the economics behind work and savings decisions. It goes on to examine a very broad-ranging set of issues that need to be considered when developing public policy on pensions. Particular emphasis is placed on issues arising with an MPRS scheme. Material is presented in a way that is accessible for the non-economist while at the same time being very helpful to economists by collating and synthesising a very broad and up-to-date academic literature on the subject. Its central focus on Australian provisions together with a good discussion of developments in other countries makes it of particular interest to Australian readers.

The first chapter provides some helpful facts and figures. Most developed countries have some PAYG retirement income provision. These schemes become much more difficult to finance when the population ages. Moreover, health costs
are likely to increase as the population ages. The chapter provides projections on population ageing around the world. These provide the main impetus for pension policy reform. It also reviews reasons why the government might wish to intervene by providing pensions in retirement and why private savings for retirement may be suboptimal. One negative aspect is that at times I was unclear about the conclusions readers were expected to reach from the discussion. For example, I was unsure whether the list of reasons why private savings decisions might be suboptimal was meant to provide a case in favour of an MPRS scheme relative to a system of voluntary savings. Of course, even if private savings decisions are suboptimal, this does not establish that an MPRS scheme would be preferable. A full evaluation of this would need to assess whether the costs of government intervention are likely to outweigh the benefits and the book does not really provide such an assessment.

The chapter also offers criteria for assessing retirement incomes policy. Not everyone will agree with these criteria. Some such as offsetting myopia (a concern that individuals are short-sighted and may save too little for retirement) are controversial. Moreover, it seems difficult for a reader without a substantial knowledge of the literature to assess whether there is a well-established case that individuals are myopic. In a subsequent chapter (on page 49) the book cites contrary evidence that people might save too much, rather than too little, for retirement.

Chapter 2 discusses work and saving over the life cycle. It provides a very good and helpful discussion of the economics of intertemporal consumption decisions. It examines the life-cycle theory of consumption and saving, the life cycle model of retirement, a buffer-stock model of consumption and saving and models where individuals suffer from lack of self-control. Overall this chapter is stimulating and provides an interesting overview of a broad literature.

Chapter 3 discusses the accumulation phase of an MPRS. The chapter considers issues of governance of the entities responsible for the management of mandatory contributions and possible regulation of assets or investment returns. Chapter 4 discusses financial risks over the life cycle. The chapter discusses the vast array of ways in which people can save for retirement. Privately managed defined contribution (DC) schemes (whether as part of an MPRS scheme or as voluntary private retirement savings) can allow individuals to have savings invested in ways that meet their preferred risk-return profiles. They can also allow for age-phasing. A theoretical proposition is that rational households will progressively lower their exposure to risk as they age. Young people can respond to poor returns on risky investments by altering labour supply decisions in ways that are not possible after retirement. The book provides some supporting empirical evidence.

Chapter 5 discusses mandatory retirement income streams in a privatised system of retirement savings. This chapter introduces the reader to a large array of annuity products that can be desirable in different circumstances. These include life annuities, variable investment annuities, allocated annuities and deferred life annuities. It discusses policy options to help make annuities less risky and
examines international practice. The chapter presents convincing evidence that adverse selection (the problem that those likely to die young are unlikely to buy annuities) may be an important problem in annuity markets. It argues for mandating annuities but leaving individuals with considerable flexibility about the types of annuity they acquire. I found this a very interesting and helpful chapter.

Chapter 6 discusses the taxation of retirement savings. Here the main focus appears to be not on the mandatory component of savings but on voluntary savings over and above the regulated minimum. It provides an interesting overview of how private pensions are taxed in a substantial number of countries together with a standard breakdown of ways in which pensions can be taxed. The chapter assumes that there is an income tax but a tax-preference for owner-occupied housing. It argues that in this context pensions should be given expenditure tax treatment (contributions to pension schemes and accumulations should be free of tax and distributions taxed at the tax rates of beneficiaries). The best way of taxing private pensions is a complex issue. I suspect that the discussion in the chapter is too brief for readers to find policy conclusions particularly convincing.

The chapter summarises a very small number of studies that have concluded that a comprehensive tax on income or wealth is likely to be less distorting than having a mixture of income tax and expenditure tax provisions. This does not provide a very robust case for arguing expenditure tax treatment for superannuation in Australia. Even if the Australian tax system were appropriately characterised as providing expenditure tax treatment for housing, the relevant comparison would be between one hybrid system with another.

Moreover, in Australia there is no deduction for mortgage interest that may mean that incentives to invest in housing for those who are required to borrow to invest may be very different from what would be afforded under expenditure taxation. It discusses other so-called problem of inter-asset distortions because super funds in Australia have incentives to invest in domestic equities ahead of foreign shares because of the Australian full imputation scheme. However, it fails to explore any reasons why the Australian government might have deliberately introduced such a policy. Issues are more complex than the brief summary treatment in this chapter can provide. The chapter does, however, raise an interesting issue of whether pension tax treatment may artificially encourage early retirement.

Chapter 7 extends the model laid out in earlier chapters to consider administrative charges. Administration charges are likely to absorb a substantial fraction of retirement savings. It provides evidence on important policy trade offs. Greater individual choice of fund tends to increase administration costs but may have benefits in providing competition between funds and in allowing for preferred product choice. Finally, chapter 8 concludes.

Pension policy design is difficult and perhaps no one book is likely to map out a completely convincing and extensive set of policy recommendations. It seems to me that the main strength of this book is not its policy recommendations, many of which are open to debate. Its main strength is in providing a very good summary of a very large set of issues that need to be thought through in
considering public policy on pensions and in introducing the reader to an extensive academic literature on the subject. As such I would strongly recommend this book to readers with an interest in this area of public policy.

Matt Benge is Senior Lecturer, School of Economics, Australian National University