Individaul Accounts for Social Security Reform

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Labor Market Issues

It is often argued that, while defined benefit pension plans distort the labor market decisions of workers, reducing their hours of work, individual accounts are nondistortionary and thus would result in greater work by participants (World Bank 1994). Voluntary individual accounts can be designed to affect neither the actions of employees and employers nor the distribution of income. However, the presumption that individual accounts are nondistortionary is considerably stronger for voluntary than for mandatory plans. With voluntary plans, people may choose not to take them, while, with mandatory plans, workers may view the contributions as a tax.

An examination of the actual features of mandated individual accounts indicates that those plans generally do affect retirement and job choice (Turner 2000). Any mandatory program that attempts to increase people’s retirement savings may change their labor supply behavior, as discussed in the following sections. This impact occurs because individuals act to minimize the program’s effects and because of the effects of the worker’s greater retirement savings, if the program succeeds in that regard.

EFFECTS ON HOURS WORKED

A mandatory individual account may affect hours worked if employees view the mandatory contributions as a tax rather than as being equivalent to voluntary savings (Burkhauser and Turner 1985). How people view the contributions depends on their expectations as to future benefits derived from those contributions. If they mistrust the system and are skeptical that they will receive commensurate benefits in return, they will tend to view the payments they make as a tax (Box 6.1).

A mandatory contribution rate that is greater than what a worker would voluntarily pay may be viewed as a tax by individuals who can-
not borrow at low rates to restore their consumption to the level desired. The higher that required contributions rise above what a worker would want to pay, the more likely the person will perceive the amounts as a tax. (See Appendix B at the end of this book.) To the extent that this occurs, the contributions would have the normal wealth and substitution effects associated with taxes and would presumably reduce hours worked. These effects of mandatory individual accounts (discussed in the next section) would probably not be relevant for voluntary carve-out accounts because the total amount contributed to social security would be the same.

Coronado (1997) has attempted to estimate whether workers perceive required contributions as a tax in the Chilean mandatory individual account system. She finds that, under the individual account system, the mandatory contributions were viewed as less of a tax than under the former pay-as-you-go system. However, she is unable to rule out that participants see some of the contributions under the mandatory individual account system as a tax.

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**Box 6.1 The Distorting Effect of Taxes**

Taxes distort the labor supply decisions of workers by reducing the monetary returns from work, and thus the incentive to work and presumably the amount of work done. Some economists have argued that switching from Social Security to carve-out individual accounts would increase the amount of work done in the United States by reducing the distorting effect of taxes. This argument is based on workers viewing the Social Security payroll tax as a tax for which they receive little or nothing in return. While the amount of government services a person receives has little direct connection to the income taxes he or she pays, that is not the case for Social Security. As indicated by the annual statement workers receive from the Social Security Administration, the more they pay in Social Security payroll taxes, the higher will be their benefits. Because of the progressive redistribution within Social Security, for some workers Social Security may act as a wage subsidy rather than as a tax.
Individual accounts may affect hours worked by older persons because of the flexibility of such plans. These accounts may facilitate a phased reduction in work hours preceding retirement. For example, Sweden’s mandatory individual account system permits workers to take one-quarter, one-half, three-quarters, or full benefits. By taking partial benefits, a worker could finance a phased reduction in work hours. Workers are eligible to take either partial or full benefits at age 61. Defined benefit plans can be designed with this feature, but it is more complex to do so.

EFFECTS ON RETIREMENT AGE

While it is generally thought that mandatory individual accounts do not affect the age at which workers retire, that may not be the case. Aspects of individual accounts that may affect the worker’s retirement age include the following: interaction with other programs, the current interest rate used for annuitizing the account balance versus anticipated interest rates, the extent to which past rates of return on the account balance have been unexpected, expected future rates of return, the riskiness associated with expected future rates of return, requirements as to the age at which benefits can or must be taken, rules as to whether work must cease when drawing benefits, and the level of the mandatory contribution rate. The effects of individual accounts on retirement age can be divided into those effects that relate to the accumulation of account balances and those that relate to the way in which benefits are paid.

Account Balances

Account balances can affect the timing of retirement in several ways. First, there may be wealth effects associated with mandatory individual accounts or voluntary carve-out accounts. If individual accounts have received unexpectedly favorable rates of return, positive wealth effects may induce workers to retire (Diamond 1998). The reverse would be the case if the rates of return had been lower than anticipated.

Hermes and Ghilarducci (2006) present evidence for the United States suggesting that negative wealth effects from the decline in stock
markets in the early 2000s caused some pension participants to postpone retirement. They argue that this effect of individual accounts destabilizes labor markets because workers are encouraged to postpone retirement at the time when the economy is doing poorly and firms are likely to be laying off workers. As a result, firms have greater difficulty adjusting to economic fluctuations, and workers seeking employment have a harder time securing a job.

Second, there may be a substitution effect related to anticipated rates of return on the assets held in the pension plan. The substitution effect can be thought of as the option value of delaying retirement and contributing to an individual account for another year. This effect would lead to postponed retirement if the worker expected to receive a relatively high rate of return on the pension fund balance or on pension contributions that depend on continued employment (Disney, Palacios, and Whitehouse 1999). For example, employees might be induced to delay retirement if they were forced to annuitize their account balances at retirement but felt they could receive a better rate of return on pension investments if they continued working and thus were able to continue investing their account balance.

Third, the higher the contribution rates and the more money accumulated in the plan, the more likely is the plan to affect retirement if the worker is liquidity-constrained. Being unable to borrow against his account balance to finance current consumption, the worker would need to retire to gain access to the cash in his pension account.

The Chilean pension system has a feature that allows people in physically demanding occupations to retire earlier than other workers. In those occupations, the employer must contribute an additional 2 percent of wages to each individual’s pension account. Economic theory suggests that workers would bear those added costs through reduced wages. The extra payment permits workers to accumulate sufficient account balances to retire earlier than they otherwise would be able to.

Fourth, the riskiness of the plan’s investments will affect the degree of certainty that individuals attach to their intended retirement age. The riskier the plan, the more uncertain workers will be as to their likely account balances at the age at which they expect to retire. The effect of riskiness of the asset returns on retirement age may depend on workers’ attitudes toward risk-taking (Kingston 2000). Financially conservative persons, when the perceived risk-return trade-off improves, will tend to
stop working earlier: retirement has become cheaper to finance in terms of the risk that must be borne. However, workers who tolerate more risk will postpone retirement: by taking the same amount of risk, they will receive higher returns, which will allow greater future consumption.

Finally, the early retirement age in social security may play an important psychological role, acting as a signal of the age at which the government considers it reasonable for people to retire. Thus, the age at which workers can begin receiving benefits from individual accounts may send a message that could cause people to retire earlier or later than otherwise.

**Benefit Receipt**

Several aspects of benefit receipt may affect when workers retire. One factor may be the extent to which individual accounts pay benefits as a lump sum. At least two aspects of uncertainty are associated with whether a lump sum will provide adequate retirement income. First, length of life is unknown. Second, there is unpredictability as to the future value of the lump sum because of fluctuations in market rates of return. These factors may induce workers, who are concerned that they not run out of money, to postpone their retirement age from the age at which they would choose to retire in a plan providing an annuitized benefit of equal expected value (Munnell, Cahill, and Jivan 2003). However, if lump sum benefits are available at an earlier age than are annuitized benefits, myopic workers may take the lump sum benefits.

Individual accounts may affect retirement age because of their interactions with other government programs. For example, by retiring at the earliest possible age with nonannuitized benefits, low-income workers in Chile may be able to qualify later for government-subsidized minimum benefits after they have spent down their pension assets. A similar strategy may be used by Australian low-income workers in order to receive increased means-tested benefits at a later age. Australia’s individual account system suffers from an incentive for workers to retire early and rely on the government pension once they are eligible. By taking early retirement, workers reduce the pension benefit that is based on their own contributions and receive a larger benefit from the income-tested and asset-tested age pension.
If workers are unable to borrow against their individual accounts, which is generally the case when individual accounts are part of social security, and they are otherwise liquidity-constrained, they may be induced to retire, as that would be the only way to access their funds. However, if people cannot withdraw funds from their account before a certain age, or cannot withdraw them before a certain age without tax penalty, or cannot withdraw them before other criteria are met (such as a minimum replacement rate provided by the account), workers may be induced to postpone retirement until they meet the necessary requirements.

If the account balance is annuitized, individual accounts, either mandatory or voluntary carve-out, may affect workers’ retirement decisions because of the effect of changes in the interest rate on the level of monthly benefits provided by an annuity. The lower the interest rate, the lower the monthly benefit resulting from converting the account balance to an annuity. Workers with individual accounts may retire early or postpone retirement based on how favorably they view the interest rate in the annuity market compared to their expectations for future rates. This effect would not be considered to distort behavior since it is a reaction to market prices rather than to the effect of taxes distorting prices.

Fluctuations in annuity rates and in financial markets may have large combined effects on the level of retirement benefits provided by individual accounts, and thus on retirement age. Workers retiring in the United States in 1969 who had a pension plan invested entirely in stock over their career and who annuitized their benefit would have received a pension equal to 100 percent of their final preretirement earnings; in contrast, because of the stock market downturn, workers retiring six years later, in 1975, would have received a pension benefit providing a 42 percent replacement rate (Burtless 2000a).

One study, using the Health and Retirement Survey, tested empirically for the effect of individual accounts on the age at which workers retire in the United States (Friedberg and Webb 2000). The finding was that, for workers who have both a defined benefit and an individual account, the greater the balance in the individual account, the greater the probability of retirement in a given period. Given that effect, it was unexpected that the authors did not see an influence of account balance on retirement age for workers having only an individual account. Another study found that U.S. workers whose employer provides only an
individual account plan tended to retire a year later than similar workers whose employer provides only a defined benefit plan (Munnell, Cahill, and Jivan 2003).

**Changes in Retirement Eligibility Age in Individual Accounts**

With gains in longevity, a given account balance at a fixed retirement age provides lower annual benefits for each successive birth cohort. Perhaps for this reason, some mandatory individual account systems have raised the earliest age at which benefits can be received.

The choice of the earliest age at which benefits can be received is an important aspect of plan design. Some empirical work suggests that about a third of the U.S. population has a high time preference rate, which implies that they will take social security benefits at the earliest age at which they are available (Gustman and Steinmeier 2005). Because these workers may take benefits at an early age if they are available, with the result being that they receive a low level of benefits, the age at which benefits are available will affect the age at which workers actually retire. The following examples tell of countries that have raised the eligibility age at which individual account benefits can be received.

**Australia**

For both men and women born before July 1, 1960, the minimum age at which the mandatory superannuation benefit (the Australian terminology for the mandatory individual account) can be received is 55. That age has been raised (as of 1999) for later birth cohorts, affecting those aged 38 and younger at the time of the change. For those born after July 1, 1960, but before July 1, 1961, the minimum age is 56. In similar fashion, the minimum age rises by one year for every subsequent birth cohort until it reaches age 60 for those born after June 30, 1964 (Kehl 2002).

**Chile**

In Chile, workers may begin drawing their pension benefits at any age so long as their benefits are at least 110 percent of the legal minimum wage, which is a minimum benefit guaranteed to all workers who
have contributed for 20 years, and at least 50 percent of their own average wage. These requirements will be raised to 150 percent and 70 percent, respectively, by 2010 (James, Martinez, and Iglesias 2004). This arrangement provides flexibility for workers, yet it is intended to ensure that people will not retire at an early age with insufficient benefits.

**Sweden**

When Sweden reformed its retirement income system in 1999 and introduced the mandatory defined contribution Premium Pension system, it raised the early retirement age in 2000 from 60 to 61 (SSA 1999).

**CONCLUSIONS**

This chapter has explored various possible effects of mandatory individual accounts and voluntary carve-out accounts on workers in labor markets. In some instances, effects depend on whether the account is mandatory or voluntary, while in other cases, the same results would be expected for either one. The hypotheses discussed here in regard to how individual accounts may affect labor supply and demand await further analytical development and empirical testing.

An important aspect of the labor market effects of individual accounts depends on whether workers view mandatory contributions as being a tax or as being savings. The higher the mandatory contribution and the greater the extent to which workers are myopic or lack confidence in the system (thus placing little value on future benefits), the more likely they are to see it as a tax (see Appendix B).

Individual accounts may have wealth as well as substitution effects. Wealth effects due to capital market changes may influence workers’ decisions as to when to retire. This consequence may be destabilizing on labor markets because workers are induced to postpone retirement during periods of economic downturn, at the same time that firms are laying off personnel. Individual accounts may affect the age of retirement for some low-income workers because of the way those plans interact with poverty programs in certain countries.
A related issue is the effect of gains in longevity on the age at which workers are eligible to receive benefits from individual accounts. As life expectancy improves, either the contribution rate must increase or the age of early retirement must be raised in order to keep constant the benefits provided by individual accounts. Some countries have raised the earliest age at which individual account benefits can be received, which can be considered as containing an aspect of political risk.