Welfare society and pensions

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Outline

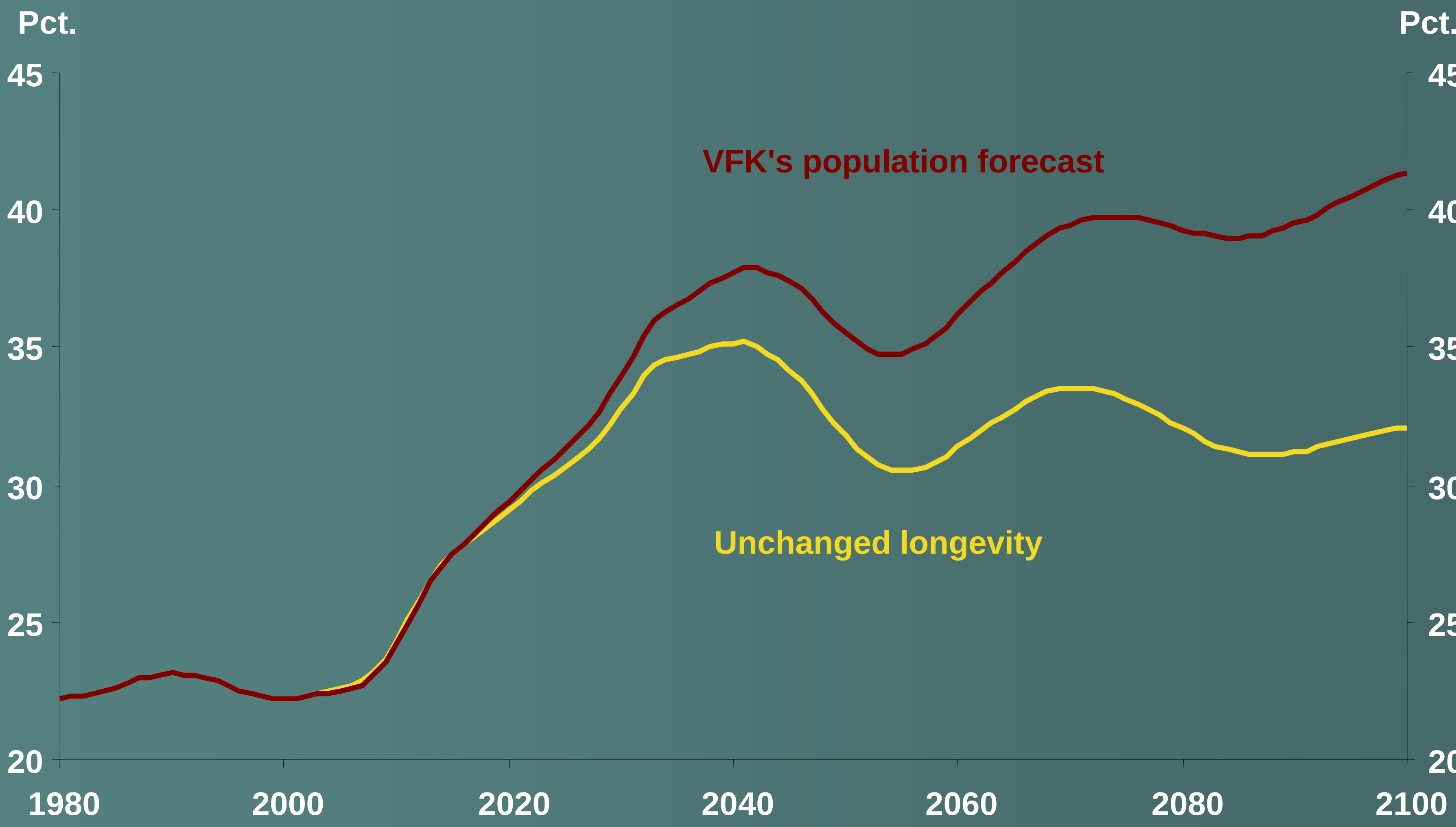
- Demography
- Welfare society – fiscal sustainability
- Private and public pension schemes
- Taxation and regulation of pension savings

Demograhics

- Strong increase in dependency ratio

- 2040:
  - work age population reduced by 350.000 (10%)
  - above 65: + 400.000 (50%)

Dependency ratio



Sustainability and need for reform?

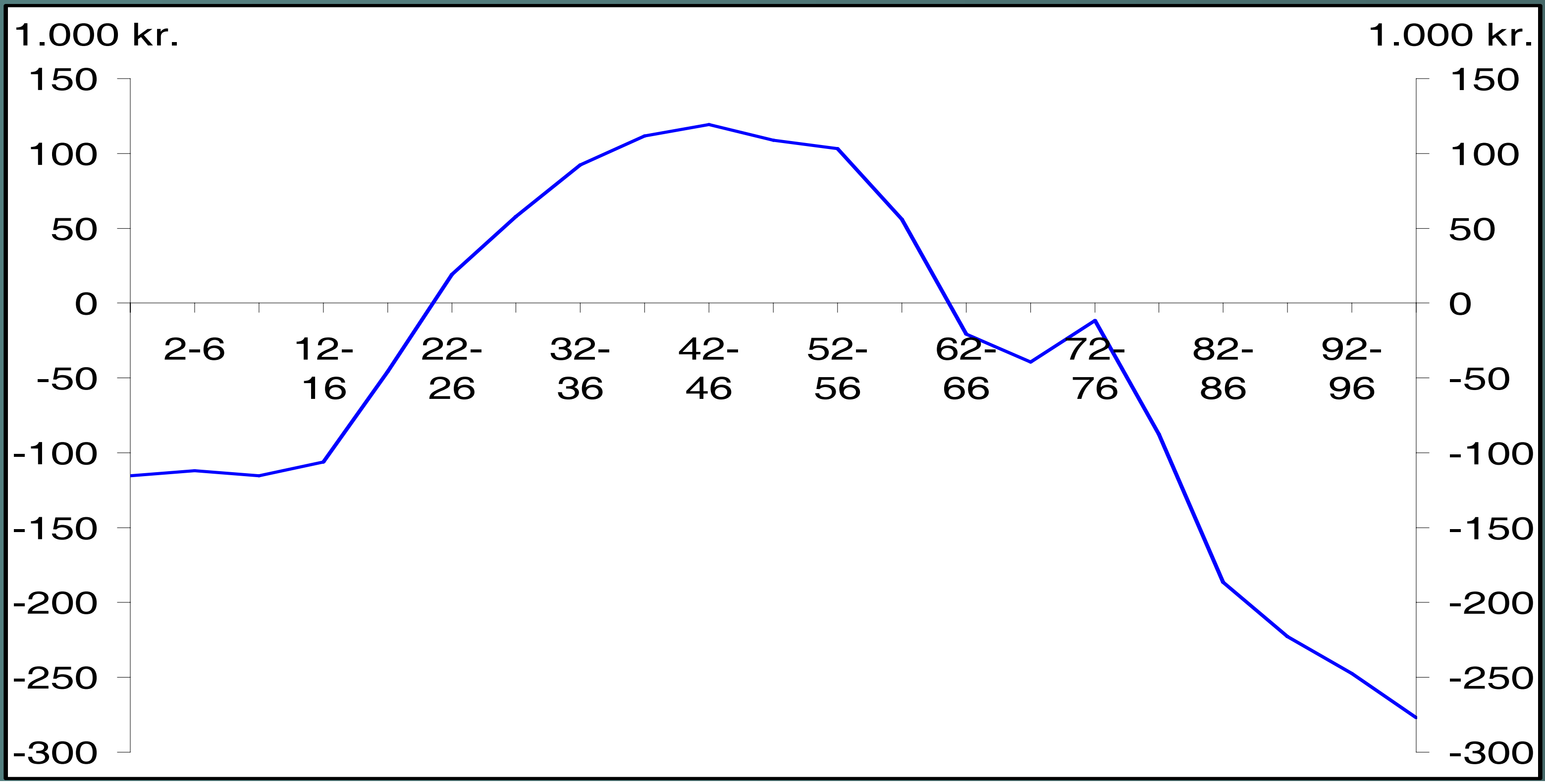
- Fiscal sustainability – can current policies be maintained?
- Outset – evaluate consequences of current policies
- Not a question of optimality, but feasibility

Warning!!!!!

- The following is not an attempt to make long-term forecasts
- The aim is to provide an informed basis for discussing the need and structure of reforms

The social contract

Net-contributions to the public sector depending on age



Anm.: Det gennemsnitlige nettobidrag for aldersgrupperne 67-76 år er højere end for omkringliggende aldersgrupper pga. tekniske forudsætninger i DREAM vedrørende placeringen af skat og arveafgift på kapitalpensioner.

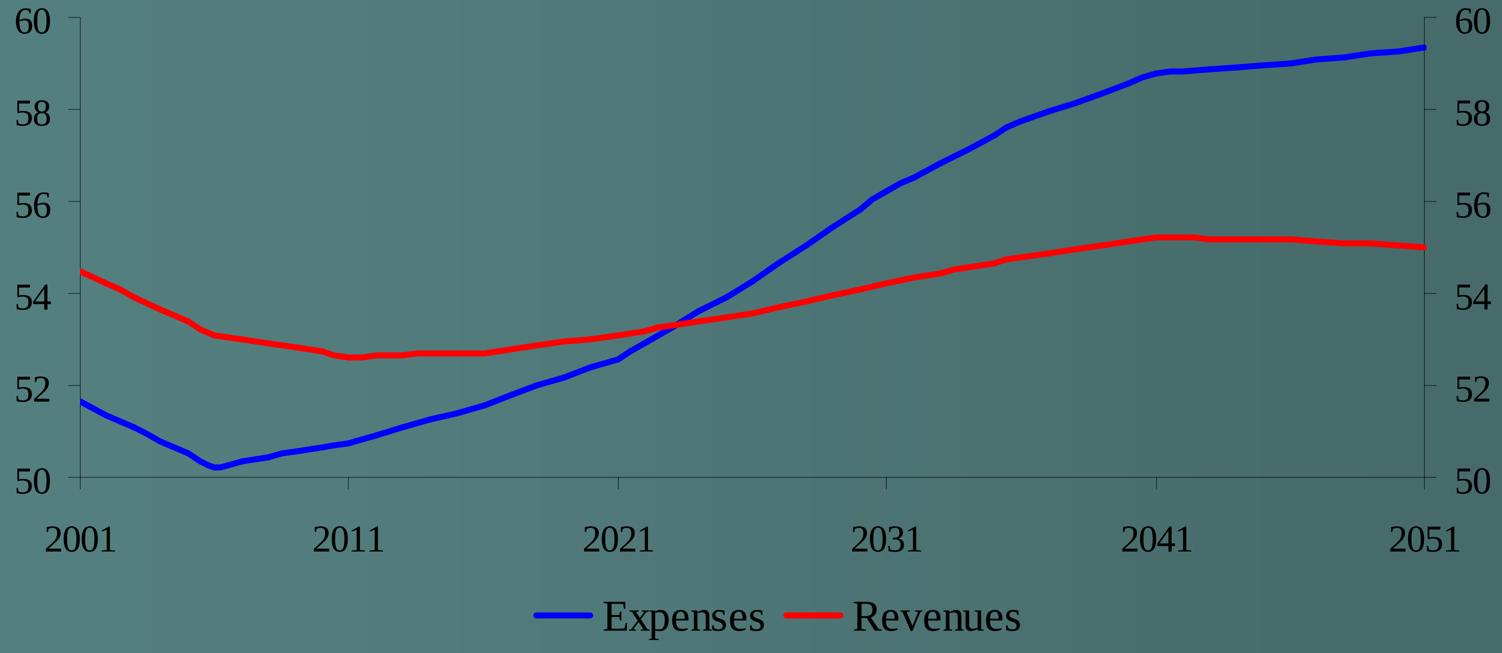
Kilde: Egne beregninger på baggrund af DREAM-modellen.

Unchanged policy

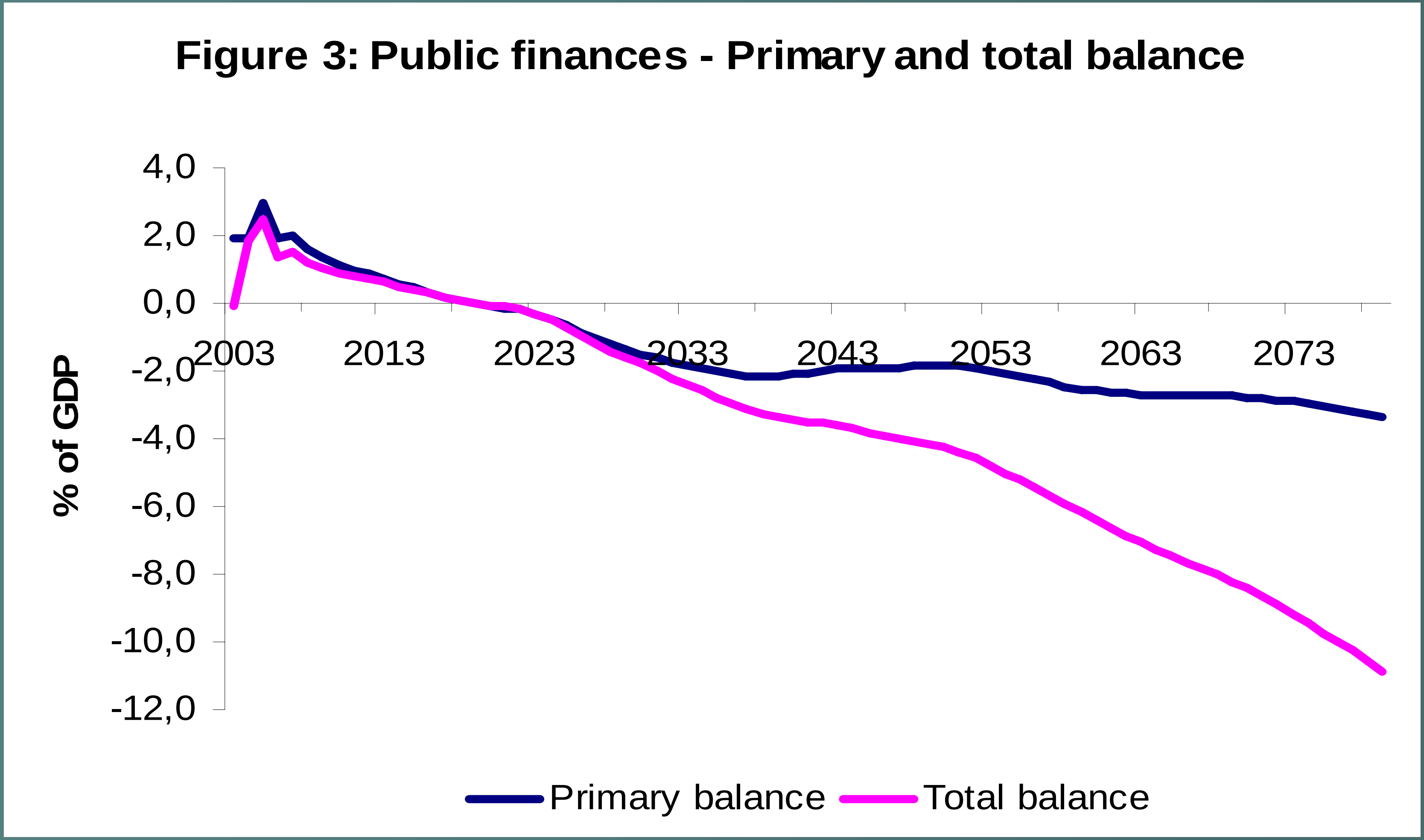
- Transfers indexed to wages
- Unchanged welfare services -transfers (frequencies – age, gender, ethnicity)
- Unchanged tax rates
- Unchanged working time etc.

Passive Policy
Public expenditures and revenues

% of GDP



Public finances – passive policy

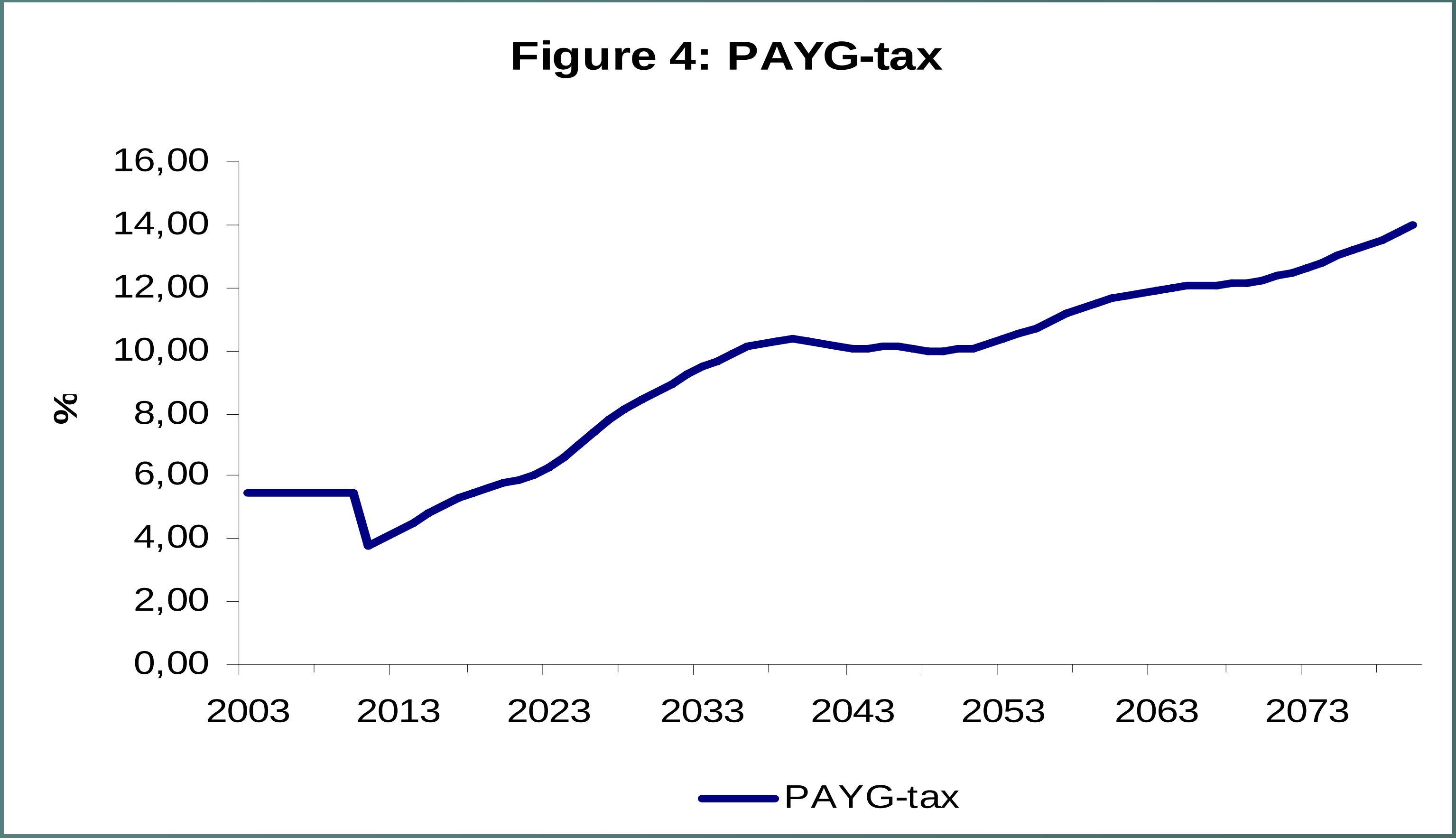


Assessing the orders of magnitude

- Period-by-period: change the tax rate to balance the budget (PAYG)

- Sustainable tax: once and for all change in the tax rate (present value of tax revenue = present value of outlays)

II – PAYG: Path for the base tax

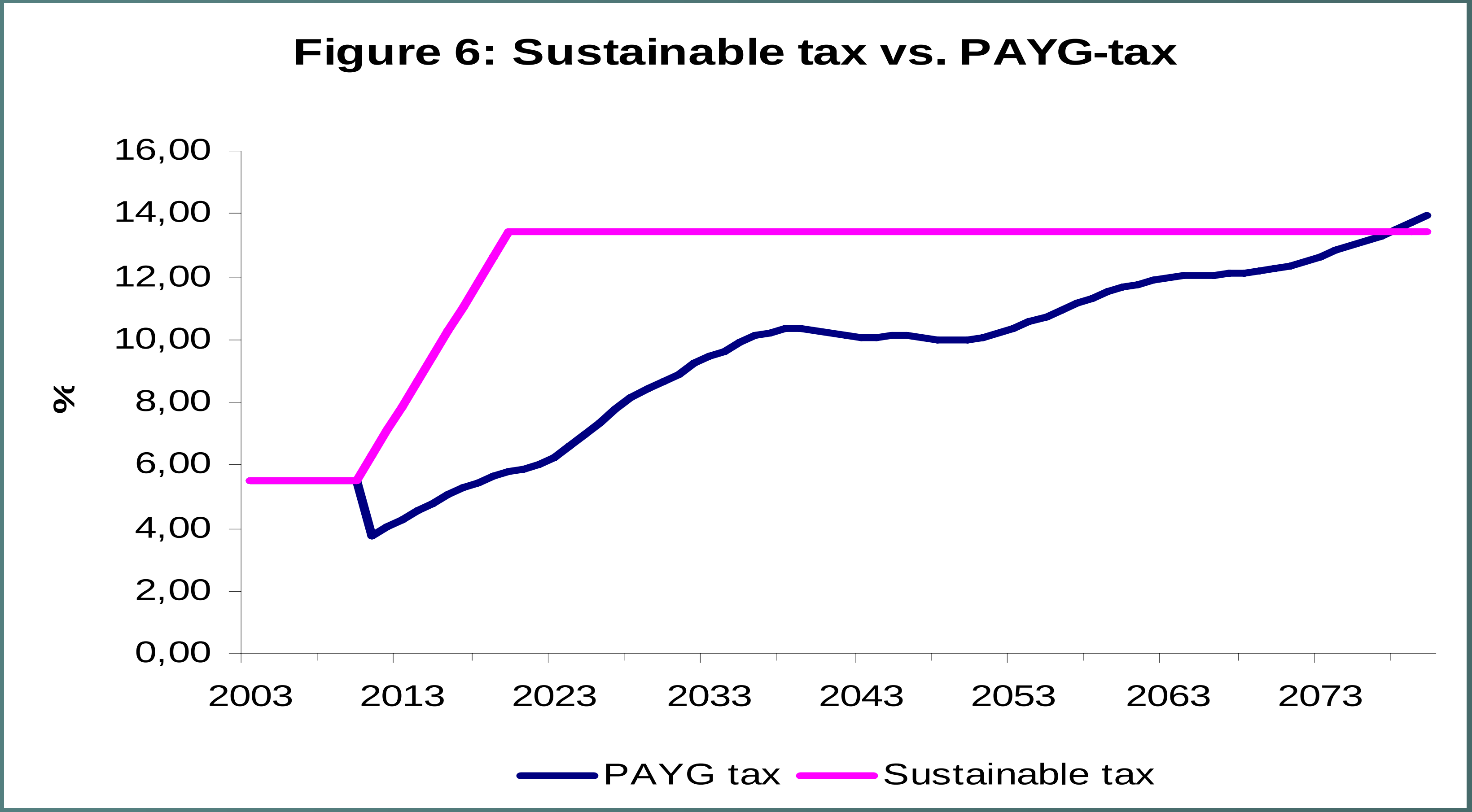


Sustainability

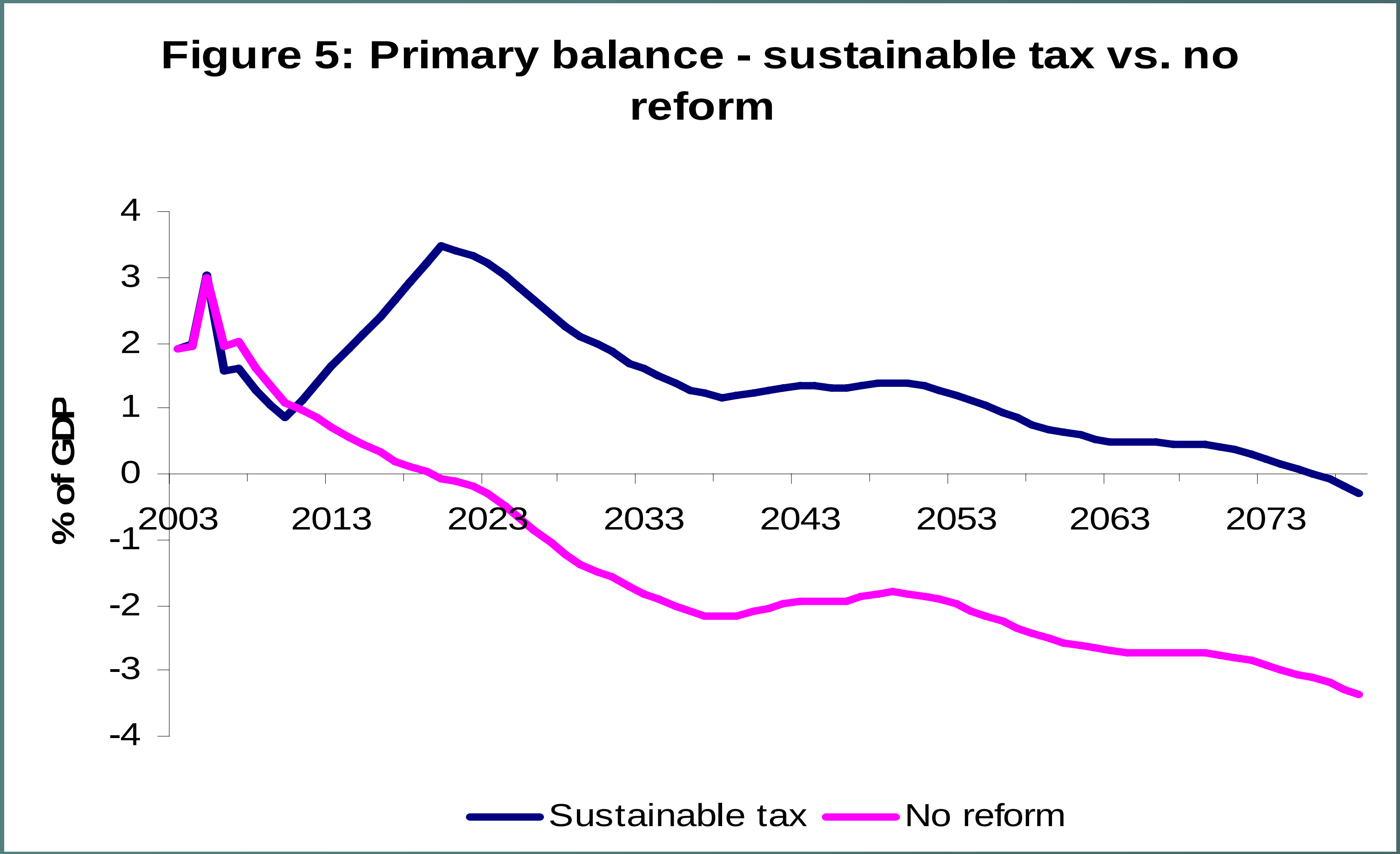
- Increase base tax by: 8 %
- Reduced public consumption: 3,2 %
- Increase employment: 225.000

All are permanent changes!

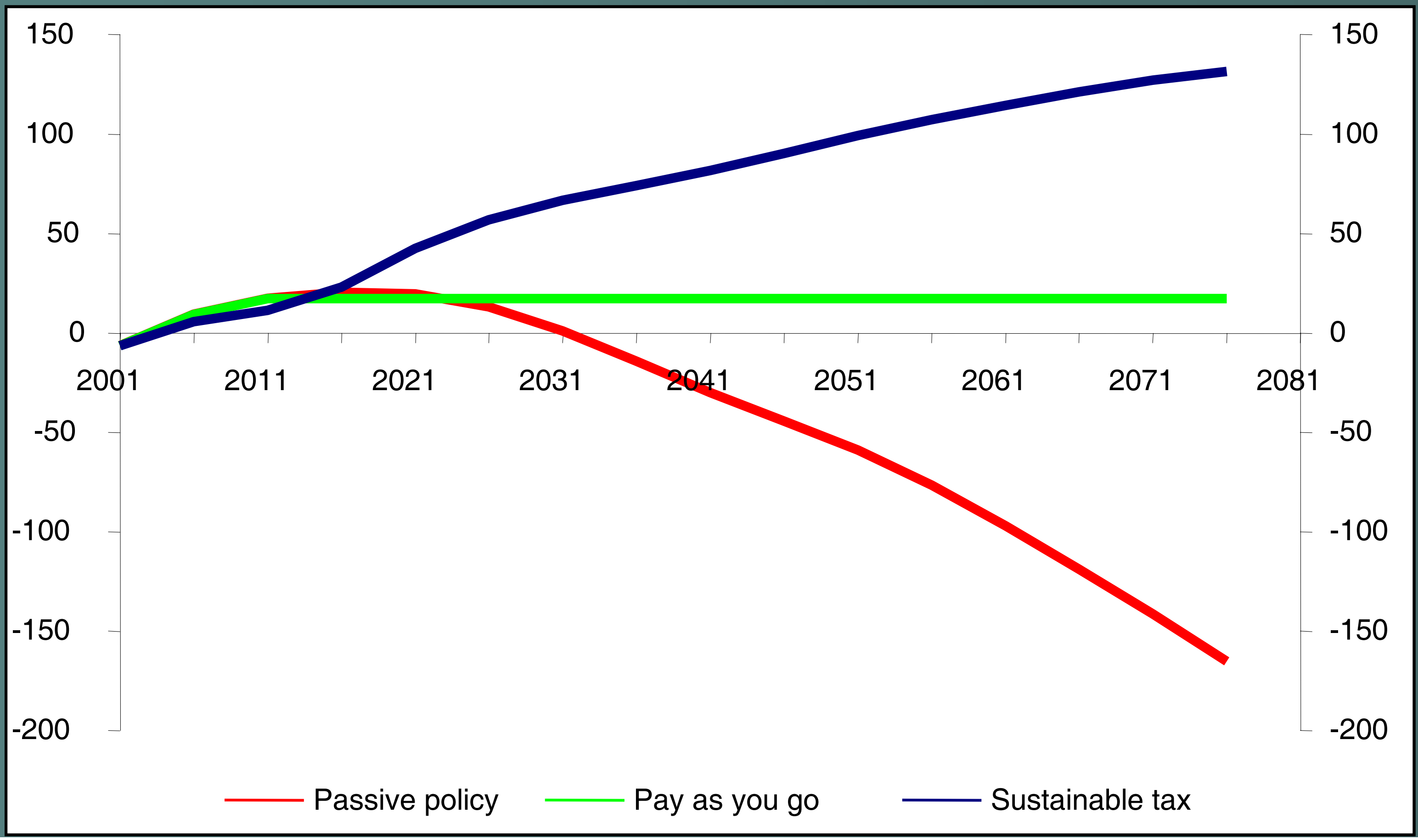
PAYG-tax vs sustainable tax



Primary and total balance – unchanged policies nd under a sustainable policy (tax increase)



Public wealth/debt – alternative policy strategies



Pensions

- Considerable increase in private pension savings
  - Labour market pensions
    - Contribution rate 2007 LO/DA: 10,8 %
  - Private pensions

- Pension wealth: more than 140% of GDP

- Contributes to ensure a reasonable standard of living for a large group of elderly

Pensions and public finances

- Means tested supplements and services
- Tax subsidy (tax value of deduction higher than taxation of pension income, favourable taxation of returns)

In net-terms: pension saving lessens the fiscal burden

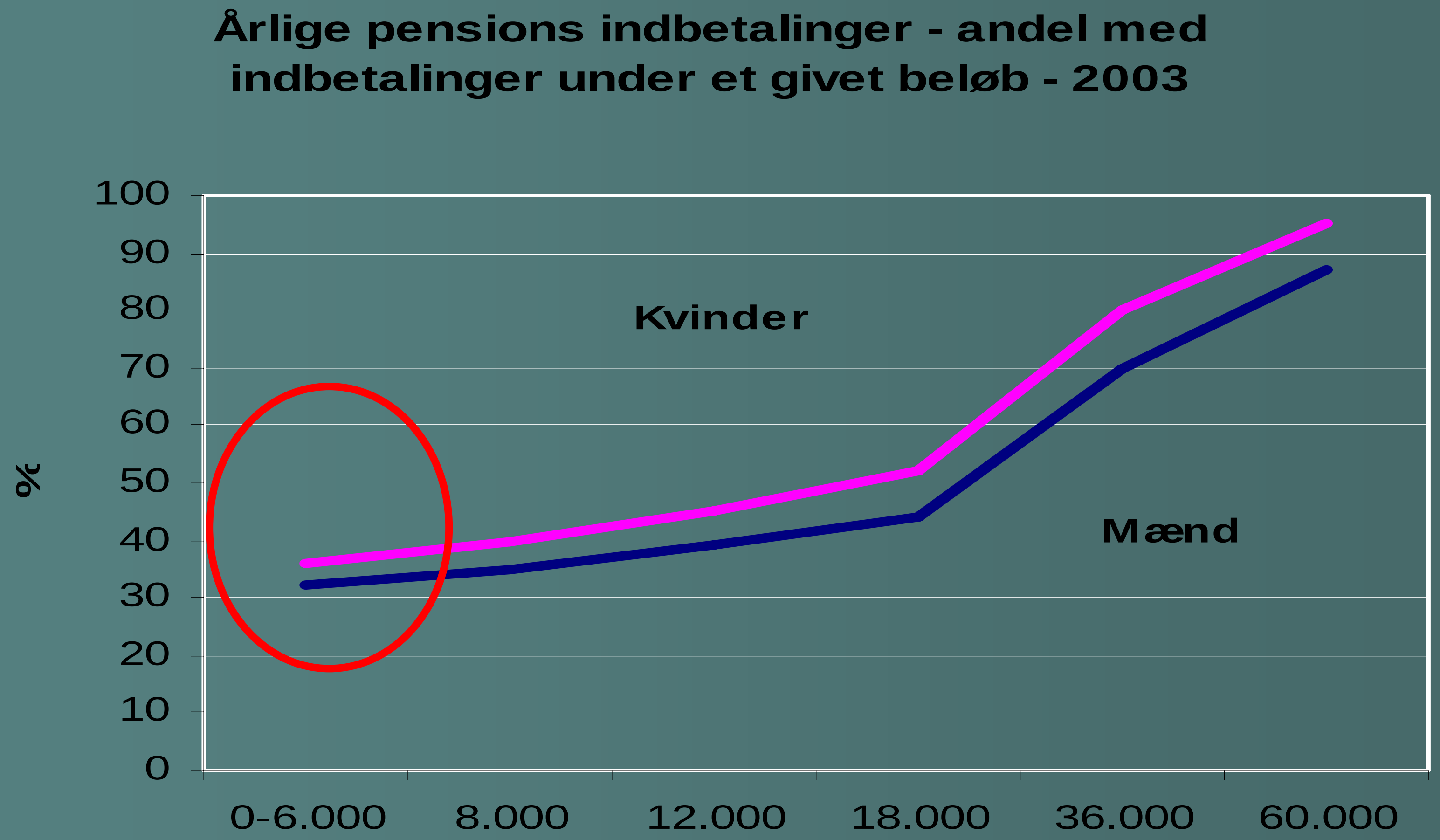
- + 3 % contribution rate to labour market pensions = improved fiscal sustainability 1 % on the base tax

Pension problem solved?

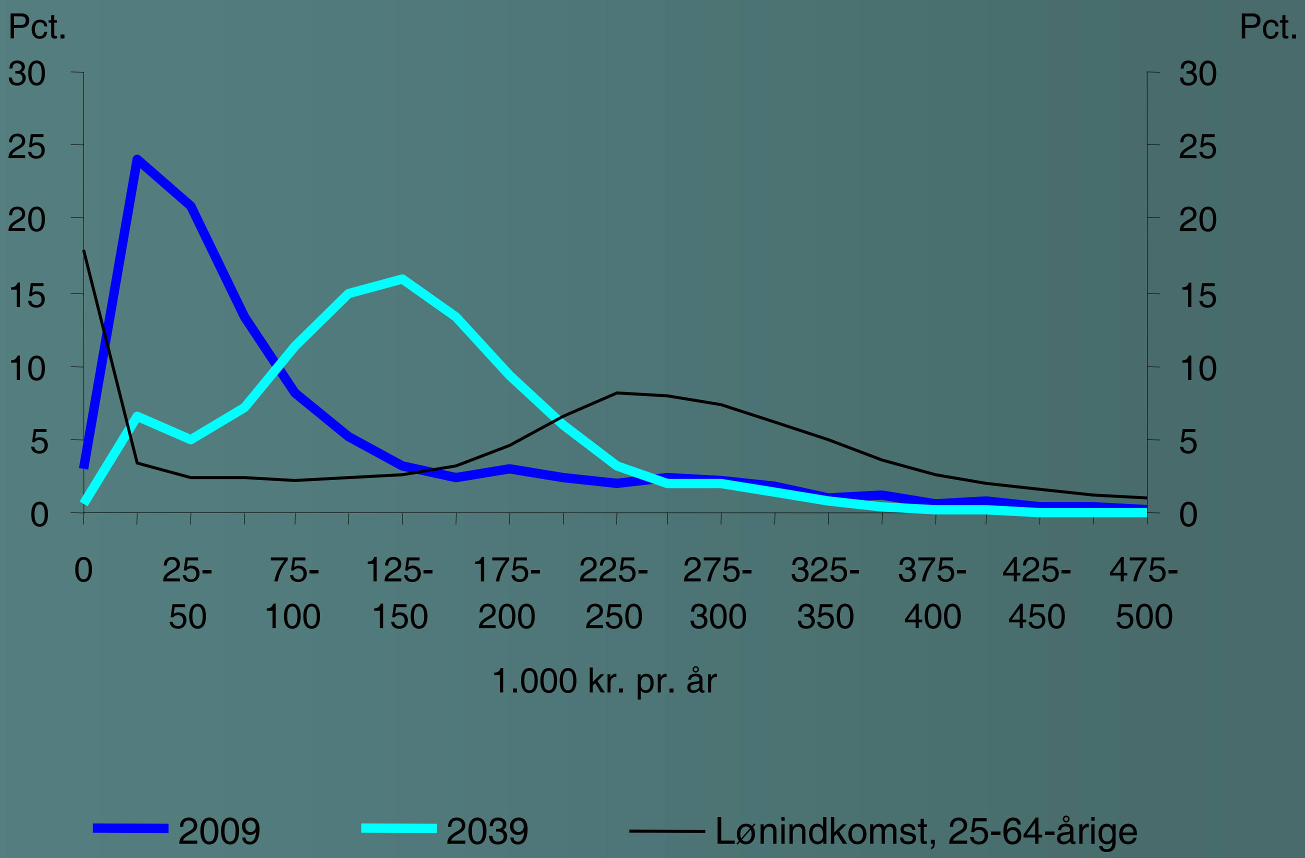
- Long build-up period
- Significant proportion of individuals have no pension savings
- Increased longevity – a particular challenge

Annual pensions contributions –

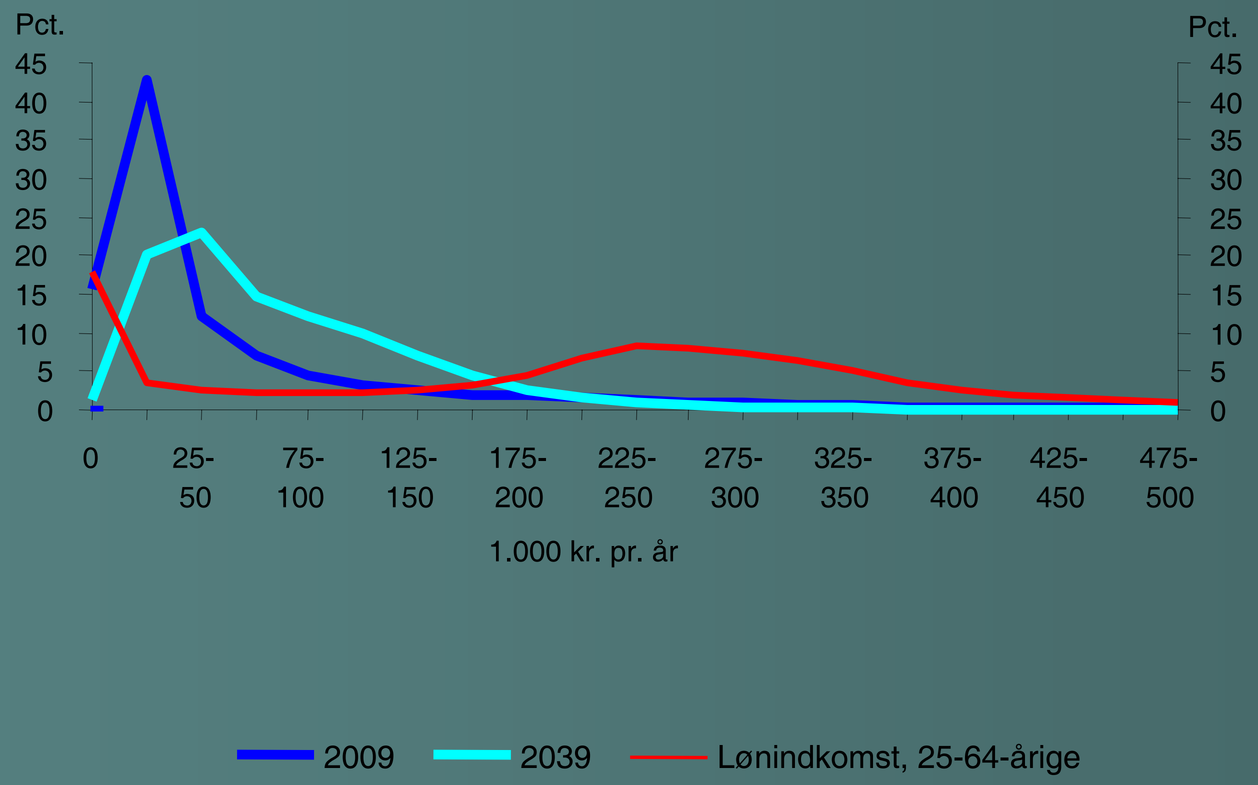
share with contribution below a certain amount



Pension income– Age 65



Distribution of pensionsincome



Subsidizing pension savings?

- Myopic households
  - Anticipated longevity is downward biased

- Excessive time preference

1980s:

- Savings deficit (current account)
- Policy: reduce consumption and increase savings

Welfare state objectives

- Decent standard of living for elderly people
- Public pension or private pension?
- Public pensions: achieve target but tax distortions
- Private pensions: uncertainty wrt target, less distortive

- 2nd best problem

  choice between tax financed scheme distorting labour markets and tax subsidies to savings

- Time-inconsistency problem:
  - What to do with those who did not save (enough)?

Taxation

- Taxation of capital income
  - Total income/consumption
  - Dual income tax scheme

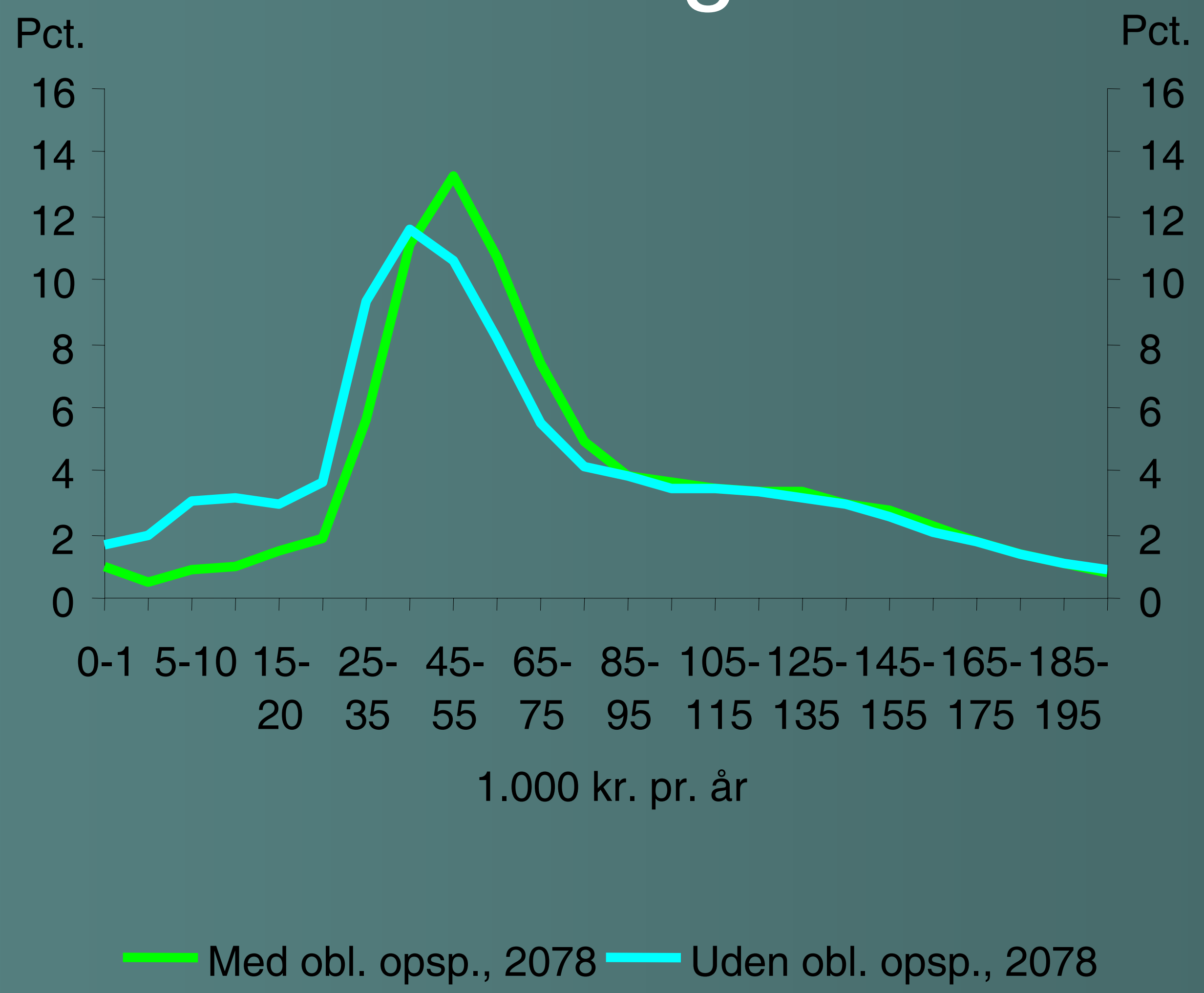
- Uniform taxation of various forms of capital income

- Deductability of pensions saving (upper limit?)

Mandatory pension savings

- Ensure welfare state objective for all
- Ageing is not a social event (can be predicted)
- Less distortionary (up to a certain level)

Importance of mandatory pensions savings



Interdependence: private and public pensions

- Public pension
  - life annuity
  - tied to wage developments

- Private pensions
  - some life annuities, others not
  - based on past income and return

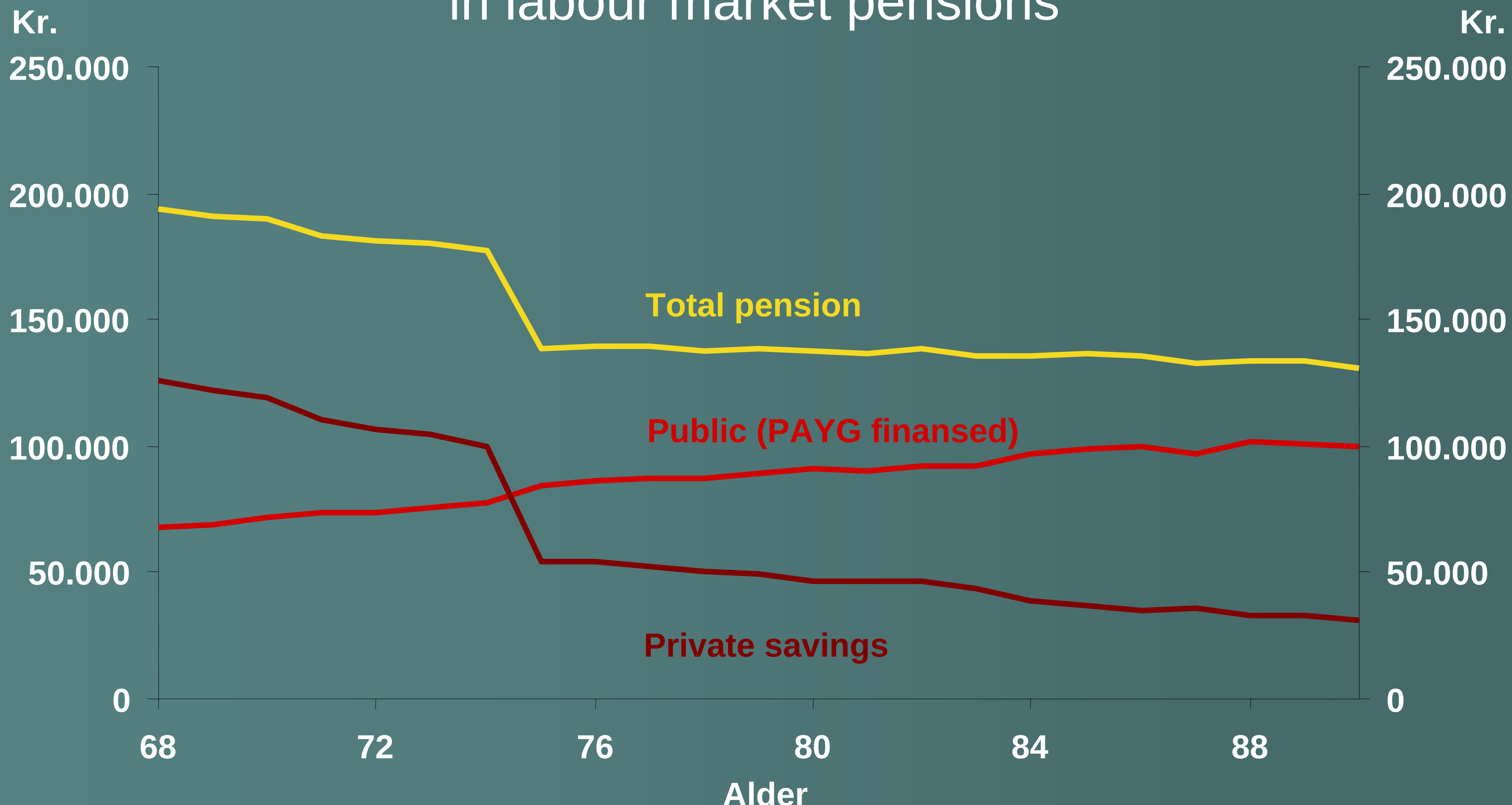
Who carries the burden of adjustment when longevity increases?

- When private savings are exhausted, public pensions take over

- Private savings in general have a duration < expected remaining life length

Age-dependent average pension income

Pension type in 2003-wage equivalents and with fully fased in labour market pensions



If tax subsidy for pension savings is to relieve public finances of a burden:

- Tax deductibility must be conditional on pensions savings made in life annuities (or a minimum share)

Conclusion

- Ageing: a major challenge for public finances
- Problem smaller but not eliminated due to increased pensions savings
- Tax incentives or mandatory requirements to boost private pensions savings