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Pensions in Asia: Incentives, Compliance and Their Role in Retirement

Public Pensions, the Labour Market and Compliance

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**Pensions in Asia: Incentives, Compliance and their Role in Retirement
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**Public pensions, the labour market and compliance
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I have been invited to make summary comments on the presentations which have been made over the last two days. I will focus on two issues. The first concerns the wider implications of population ageing, and the second, a critical administration topic. The first topic concerns industrialized countries now and developing countries later; the second applies to all contributory social security schemes.

Clearly, we all agree that public pension schemes face the challenge of producing a continuing and adequate retirement income throughout a person's retirement years and those of his or her dependants, and that this challenge becomes more difficult in the face of population ageing.

Similarly, we agree that public pensions are consumption allocation mechanisms – arrangements for transferring resources from workers to pensioners at the time the pensions are paid. Under the pay-as-you-go system the transfer is direct through contributions or taxes paid by workers. Under the funded system, pensioners liquidate assets which they have accumulated by selling their assets to workers. In both cases workers' disposable income is reduced by the amount of resources transferred to retired persons.

Enormous attention has been focused on whether the challenge of providing sustainable pensions through equitable transfers can be achieved by defined benefit or defined contribution schemes, financing by pay-as-you-go or funding, public or private management and with price or wage indexation of benefits. Attention to these features of a public pension scheme has obscured the fundamental issue – how ageing societies will be able to produce the goods and services required by all segments of the population.

The effect of population ageing on pensions has attracted much attention, despite other implications of population ageing such as the demand for health care, probably because robust projections of future expenditures to meet public pension promises can be made. And, unlike future health care expenditures, cutting future pensions is thought to be feasible.

The problem of supporting ageing populations is not solved by funding public pension schemes. In pay-as-you-go schemes it is uncertain whether declining relative proportions of active workers have the capacity and the will to pay the pensions of increasing numbers of pensioners. In funded schemes the uncertainty is whether there will be a systemic decline in asset values when pensioners seek to realize their assets by selling them to the declining relative proportions of active workers

According to Barr (1998), the fundamental issue is not the financial system which is used to determine how output is divided between workers and pensioners. Rather, "The choice between PAYG and funding in the face of demographic change is [therefore] relevant only to the extent that funding ... systematically *causes* output to be higher." [emphasis in original]

Support of increasing numbers of retired persons is possible only if output grows – only if economic growth is sufficiently robust to generate the resources to be transferred to retired

persons without unduly depriving active workers.¹ It is held by some that if economic growth continues as it has since World War II, there will be sufficient output to distribute under pay-as-you-go systems. See, for example, Eisner (1995), Mullan (1999) and Baker and Weisbrot (1999).

Many have sought to demonstrate that increased saving through operating a funded scheme will stimulate economic growth. While this proposition is intuitively persuasive – a funded scheme should ultimately increase saving and the increased saving should result in increased investment and thereby increased output – given uncertain market capacities and the uncertain allocation of investments, convincing empirical evidence of the effect of a funded public scheme on saving has been elusive.

Labour market issues – Retirement age

It is the potential labour market implications and consequent economic distributional and output issues arising from population ageing – not the the relative merits of different public pension arrangements – which are the key to designing sustainable public pension schemes.

The World Economic Forum *Pension Readiness Initiative* focuses on population ageing from the perspective of macroeconomic concerns over productivity and the standard of living of the entire population. Virtually everyone living in a society is a consumer and, in general, all consumers are dependent on workers in a society to produce the goods and services they consume. Hence the issue becomes labour supply – not simply how much a retired person's pension costs – but how much output and general welfare is lost because the person is not working. Rather than focusing on reforms of existing public pension schemes, attention should be on “potential policies that specifically target the deterioration of public budgets as a result of population aging and public pension schemes and [to explore] policies and institutional changes that would promote economic growth to ameliorate the aging burden problem”.

Economic output depends on the supply of workers, capital and technology. If current working patterns persist, the labour force growth which most industrialized countries have experienced over the last half-century is likely to be reversed in the near future. For example, in Japan the population base of the labour force (all persons aged 15 to 65) was 60% of the total population from 1950 to 1975, rose to 68% in 2000 and is projected to fall to 60% by 2025 and 51% by 2050. (Based on *World Population Ageing 1950-2050*, United Nations (2002).) Slower growing or contracting workforces will create labour shortages which can lead to economic stagnation or decline. In turn, this would lead to lower rates of improvement or to a decrease in living standards.

If the labour force is declining as a proportion of an ageing population and improvement in living standards is slowed, which parts of the population will bear the brunt of the slowdown? If retired persons benefit generously from worker productivity growth, then the standard of living of workers and their dependants will not fully reflect workers' productivity increases. Will workers be eager to achieve higher levels of productivity if they do not benefit substantially from any increases? Alternatively, if workers are insulated from the economic implications of ageing populations, the standard of living of retired persons will decrease. Ultimately, under this scenario the choice becomes (1) how to allocate diminishing output among different segments of society or (2) what policies should be pursued that will sustain economic growth and thereby allow all segments of society to benefit.

According to the *Pension Readiness Initiative* while increased capital investment can improve worker efficiency, this cannot make up for the entire shortfall in productivity. Rather, the policies required involve fundamental changes in current labour force patterns. In

particular, labour force participation of younger retirees, women and young adults should be increased.

Immigration at levels which would be required to sustain economic growth would be socially and politically unacceptable. According to *The Economist* (10 January 2004), Japan (with a population of 127 million) would have to import five million workers (along with their dependants) during the next decade simply to maintain the current rate of improvement in living standards.

Whereas a half-century ago, in the industrialized countries, the typical retirement period was around one-third of the working period, now in some countries it is approaching two-thirds of this period. Increasingly, workers opt for early retirement which means the actual retirement age is significantly lower than the normal retirement age set for the public pension scheme. Raising the normal retirement age has proved to be a difficult political choice and it is a potential cause of 'reform deadlock'. To avoid disturbing the plans of workers who are near retirement, increases in the retirement age must be phased in over long periods.

From the United States Social Security Administration (2002) life tables, in 1935 when the retirement age was set at 65, the expectation of life of a male aged 65 was approximately 12 years. Assuming a male entered the labour force at age 20, his average period in retirement would be 27 per cent of the time he had spent working. In 1980, to maintain the same ratio of the retirement period to the working period, the male retirement age should be 67. In 1983 the normal retirement age for full social security pensions in the USA was raised to 67, with the increase fully effective in 2027.

While changes in the normal retirement age in a defined benefit scheme are inevitably long-term projects, efforts can be made to discourage early retirement and encourage deferring retirement. Greater than actuarial reductions can be made to calculate early retirement pensions, and inducements can be offered for deferring retirement. A probable, albeit perhaps unintended, result of replacing defined benefit with defined contribution schemes is that successive cohorts of contributors will have to work longer than they would have had to under the defined benefit scheme in order to accumulate sufficient stocks of assets at retirement to purchase adequate pensions.

Hence, one means of helping to sustain productivity is a reform which has long been advocated – raising the retirement age in public pension schemes. But, now the reason is not only to increase the income and reduce the outgo of a public pension scheme, but the broader objective of helping to maintain or improve the standard of living of the entire population.

Compliance

Much attention is paid to design features and the economic impact of contributory public pension schemes. However, unless an administrative operation – ensuring compliance with the contribution conditions of the scheme – is well-executed, all other aspects of the scheme are irrelevant.

Compliance refers to the registration of eligible members and paying contributions in respect of them in the correct amounts when they are due in accordance with the conditions set by a contributory social insurance scheme. Contributions are normally paid by employers in respect of their employees and by self-employed persons themselves. Since non-compliance – contribution evasion – is illegal, it is difficult to obtain reliable statistics on its extent.

Contribution evasion is not confined to developing countries where administrative infrastructures are less sophisticated than in industrialized countries. In the United States, in

1997 the total of contributions not paid voluntarily was estimated to be 10.3 per cent of the estimated liability. The percentages were 4.2 and 58.7 for employees and the self-employed respectively. (See McGillivray (2001)) According to the Japan Times (5 August 2003) 37.2 per cent of the members of the National Pension Programme failed to pay their contributions in the 2002-03 fiscal year. The non-payers were generally self-employed persons (who generally have a poor record of compliance with social security schemes). Compliance in privately managed defined contribution individual accounts schemes is often weak, especially if employers pay contributions directly to individual account managers rather than to a central collection agency.

There are a multitude of motivations for employers and scheme members to evade paying contributions: employers seeking to reduce their labour costs; administrative complexity of complying; workers' current needs and perhaps myopia; workers' strategic manipulation of the pension scheme benefit formula; lack of confidence in the pension scheme.

In a defined benefit scheme, evasion reduces pensions and can threaten the solvency of the scheme. In a defined contribution scheme, evasion leads to a lower balance to be converted into a pension at the time a member retires.

Social security organizations can combat evasion, but they must have the *statutory authority* required for effective enforcement of contribution conditions. If government does not grant a social security organization the necessary authority, the commitment of the government to the social security programme is in question, enforcement is hampered and ineffective and benefit expectations are not met.

Social security schemes need:

- the unfettered right to inspect employer records;
- the right to assess and collect contributions due and unpaid and assess penalties.

Armed with statutory authority, social security organizations can take a number of steps to both encourage and enforce compliance, for example:

- streamline administrative procedures;
- strengthen enforcement activities (which are an important and legitimate expense of a scheme);
- enforce administrative penalties for evasion;
- undertake public relations campaigns;
- report regularly (annually at least) to workers on contributions paid;
- collect pension contributions along with contributions for other social security benefits;
- apply regulations which require an employer to be certified by the scheme before the employer can undertake activities involving the government;
- remedy scheme design deficiencies which encourage evasion;
- coordinate verification and enforcement activities with the tax collection agency;
- declare amnesties.

Failure to comply with the contribution obligations of a social security scheme threatens the legitimacy of the scheme, the adequacy of the social protection of members whose contributions due have not been paid and the financial viability of a defined benefit scheme. High levels of evasion can indicate low public credibility of a social security scheme, and reflect on the quality of governance and efficiency of scheme administration. Governments should beware: if widespread evasion results in generally inadequate pensions, given their political influence, the increasing numbers of retired persons will oblige governments to supplement their pensions.

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¹ Thompson (1998) disaggregates the retirement burden:

Retirement burden = Consumption of retired persons/GDP =

- (1) Total consumption/GDP
X
- (2) $\frac{\text{Average consumption of retired persons}}{\text{Average consumption of total population}}$
X
- (3) $\frac{\text{Number of retirement pensioners}}{\text{Total population}}$