Welfare Effects of Pension Reforms

Abstract:

In almost all developed countries, policy makers have implemented pension reforms by increasing statutory retirement ages, lowering pension levels and/or adjusting pension formulas to address demographic change. This paper provides a novel, unifying framework to evaluate the welfare effects of such pension reforms. I show that the welfare effects of any reform rest crucially on the “behavioral fiscal multiplier”–the total fiscal effect relative to the mechanical fiscal effect (the mechanical effect is the fiscal effect absent any behavioral responses). Behavioral fiscal multipliers can be readily estimated with reduced-form methods using data on contributions to and transfers from the entire welfare state system. To illustrate my framework, I exploit a series of pension reforms in Austria. I find that increasing the early retirement age has a behavioral multiplier of 1. This means that the total fiscal effect is purely mechanical and there is no fiscal effect from behavioral adjustments. In response to the reform workers spend more time in employment, which generates additional social security contributions. However, individuals also spend more time in unemployment, which generates additional expenditures on unemployment insurance benefits. These two effects cancel, leading to a net-zero fiscal effect of behavioral responses. This finding implies that increasing the Austrian early retirement age is not welfare-enhancing–unless one thinks that $1 in the hands of an early retiree has a lower social value than $1 in public funds. By contrast, reducing pension levels generates a multiplier of 1.5. This policy induces some workers to stay longer in employment without triggering substitution to other welfare benefits. As a result, reducing pension levels is welfare improving, provided that taking $1 away from a retiree is associated with a social loss smaller than $1.5. In a standard calibration of the model, the social loss is smaller than $1.5 for reasonable values of risk aversion suggesting that reducing pension levels was welfare-improving.

My framework can also rank the welfare effects of the two reforms. Based on my estimates, a social planner with preferences for redistribution clearly favors reducing pension levels over increasing the early retirement age.

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