

# A Review of Tito Boeri, Lans Bovenberg, Benoît Coeuré, and Andrew Roberts's *Dealing with the New Giants* and Peter J. Orszag, Mark Iwry, and William G. Gale's *Aging Gracefully*

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*Global aging will impose greater economic demands on the young and may entail dramatic consumption shortfalls for the old. Against this gloomy backdrop, many analysts hail the world's funded pension systems as a means to protect future retirement security. The monographs reviewed ask how funded pension plans might be restructured to better meet the policy challenges of global aging. Both show that the pension institution must be reformulated to better provide for both economic growth and demographic aging. Questions remain regarding how retirement policy can better integrate intergenerational adequacy and incentive considerations.*

## 1. Introduction

The causes of the global demographic revolution for both developed and developing nations are by now widely appreciated. They include stark drops in fertility, substantial improvements in infant survival rates, and continued extension of life expectancies around the world. Indeed, actuaries now estimate that age 120—or even 125—must be employed as the new statistically relevant end of the human lifespan for retirement planning calculations. The challenge posed by population aging is that most people have not under-

stood nor made provision for such an extended retirement period. Remarkably few of us will work as long as our grandparents had to—virtually all their lives—and most people today quit their career jobs and leave the labor market in their early sixties, despite having much longer to live after leaving the labor market. Even in the still poor and rapidly aging country of China, labor force participation rates for men over the age of sixty are lower than in many rich nations. Accordingly, global aging will most assuredly bring greater demands for substantial economic support from the young and may entail dramatic shortfalls for the aged in virtually every country.

Against this rather gloomy backdrop, some analysts hail the world's funded pension

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systems as one way to protect old-age security in the twenty-first century. These pension plans do wield impressive clout—their assets currently total about US\$10 trillion. At the same time, however, the question remains as to whether and how funded pension plans can be restructured so as to better meet the policy challenges of global aging.

The two monographs reviewed here take on this question and, in the process, their authors share some thinking common to analysts across the developed world. Most importantly, both volumes contend that funded pension systems are flawed in ways that prevent them from doing all they could to secure the future for tomorrow's elderly. Their concerns flow, to a substantial degree, from a similar diagnosis, namely that workers are often unwilling and unable to make adequate provision for their own old age. But the two volumes differ dramatically in their scope, emphasis, and, ultimately, in their prescriptive recommendations for funded pension policy.

To set the stage, it is worth noting that *Dealing with the New Giants: Rethinking the Role of Pension Funds* (International Center for Monetary and Banking Studies and Centre for Economic Policy Research, 2006) by the European quartet—Tito Boeri, Lans Bovenberg, Benoît Coeuré, and Andrew Roberts—takes a broad view of pensions. Indeed, the authors include in their purview not only occupational defined benefit plans, but also discuss privately managed defined contribution plans and public social security schemes. This team argues that the structure, function, and regulation of pension funds in Europe, and perhaps more generally, must be substantially revamped. Their recommended reforms are designed to overcome market imperfections, spur capital market developments, and meet social objectives, particularly within- and between-generational income redistribution. The authors go on to recommend “hybrid collective”

systems involving funded defined contribution schemes for young workers, which then automatically transition into funded defined benefit programs for older workers. They argue that their new collective model is best suited to meet the demands of European Union labor and capital markets, permitting employee involvement in pension accumulation while limiting the risk which arises when financially illiterate workers are allowed to invest their own retirement money.

By contrast, in *Aging Gracefully: Ideas to Improve Retirement Security in America* (Century Foundation Press and Retirement Security Project, 2006), the U.S. trio—Peter Orszag, J. Mark Iwry, and William Gale—is restricted to a narrower, mainly microeconomic, purview. These analysts, along with other chapter authors, explicitly omit from consideration anything having to do with how to shore up defined benefit plans, Social Security benefits, or medical care insurance for the elderly. Rather, the volume is tightly focused on U.S. tax incentives, which the authors suggest will overcome obstacles to saving by low- and middle-income Americans. The work takes as given the proposition that lower-paid people need help saving in Individual Retirement Accounts and company-based defined contribution plans, so its main purpose is to recommend enhanced saving approaches for 401(k) plans where available or automatic IRAs if not.

In what follows, I review the contributions and shortcomings of each book, followed by thoughts on tasks ahead for academics and policymakers.

## 2. *The New Giants*

The Boeri et al. volume is, most assuredly, not a traditional economic analysis replete with models, hypothesis tests, and cautious conclusions. Rather, it is intended as a policy tract on pension reform and it was delivered to the Eighth Geneva Conference on the

World Economy held in 2006. The authors are an eclectic and highly regarded European team: Boeri is a labor and political economist from Bocconi University in Italy, Bovenberg is a public and macroeconomist from the Dutch University of Tilberg, Couere is a macroeconomist from Ecole Polytechnique in Paris, and Roberts is a fixed-income strategist at Merrill Lynch with expertise in inflation-linked bonds.

The book begins by defining what the team sees as the proper role for pensions: to “help individuals save for their old age and protect the value of their pensions” (p. xv) and to “support innovation and growth.” In other words, at the outset, the authors have in mind a more proactive macro role for worker saving programs than is typically seen in U.S. academic pension studies. Following an introductory overview, the monograph offers four substantive chapters covering, respectively, the authors’ view on the optimal organization of pension funds, how to de-risk pension system assets, how to de-risk pension system liabilities, and some thoughts on interactions between human capital and pension capital. The book concludes with a summary of conference participants’ commentaries offered at the Eighth Geneva Conference.

The authors do not offer new modeling or empirical findings in this book. Rather, they set out their pessimistic view of the European status quo described as a predominately unsustainable PAYGO system covering the rapidly aging population. Unless their reforms are adopted, the team warns of exorbitant tax rates, depressed labor supply, and crowding-out of private saving, investment, and growth. Their rationale for reform includes a listing of market failures including worker myopia and financial illiteracy, both of which make it difficult for individuals to forecast their retirement needs, estimate how much to save, and invest their retirement portfolios. The authors also note that workers are often unable to monitor their

plan fiduciaries, due to lack of information and poor financial training.

This set of market failures then motivates their urgent call for rules over funded pension plan governance and supervision in the European context. They acknowledge that the 2003 European Pension Directive sought to resolve these agency problems by mandating that “persons of good repute” be selected to direct pension funds, but they critique the directive for not specifying what this should mean in practice. In addition, the authors highlight difficulties that arise when pension funds are operated by third parties, including corporate CEOs and CFOs, who on occasion have been known to mix up corporate funds and pension funds. Sparing no one, they also contend that pension consultants sometimes behave collusively with fund managers and plan sponsors to generate high fees and commissions.

To sort matters out, the authors then recommend that public pensions be limited to the provision of only a “basic” or poverty line benefit, ideally indexed to longevity and the average wage bill. They speak positively of unfunded notional defined contribution schemes now popular in Sweden, Latvia, and Italy, in which workers’ contributions are credited with a hypothetical interest rate (usually related to wage growth). At retirement, this bookkeeping entry is converted to a lifetime annuity taking into account the cohort’s survival table. The authors salute such a system for making explicit the cross-generation risk-sharing required by such public pay-as-you-go social insurance mechanisms. In their view, this first pillar governmental benefit must also be complemented by a second pillar mandatory private funded pension, which would require middle and upper income workers to save on their own. They especially favor “stand-alone” or outsourced pension funds that “focus on the interests of the participants alone rather than having to serve the objectives of the employer as well”

(p. xviii). Accordingly, occupational schemes are seen as problematic as they tie workers to a specific firm, depressing European labor mobility as a result of company-specific defined benefit pensions. More appealing, they suggest, would be pan-European funds managed by cross-national financial institutions; these would then be subject to international competition and harmonization of reporting and accounting standards across the European Union.

A U.S. reader will find much in this book of interest, both because of what it includes and what it omits. Because the authors are concerned about widespread financial illiteracy, they are reluctant to burden individual workers with portfolio investments; rather they propose “little freedom of choice for participants but lots of competition for asset management and other services” (p. 37). In this regard, their model offers less opportunity for employees to shoot themselves in the foot than do U.S. 401(k) plans, which, to this day, still permit workers to invest all their retirement funds in a single employer’s stock.

The authors also favor better pension reporting and disclosure, cross-nationally harmonized accounting standards, and better pension governance. Specifically, they propose that a trustee board should be chosen to reflect participant interests, while an external professional money management team handles capital market investments. In view of the way U.S. corporate and public funded plans work, a U.S. reader may well question whether such an arm’s-length two-board structure could actually be maintained over time. There is also little discussion of how to weight retired members’ versus active members’ interests, a topic of considerable concern in the current debate over how to handle retiree benefits promised but not funded by American manufacturers.

The book has some limitations, including the scant attention devoted to possible

disincentive effects including crowd-outs. As one example, mandatory pension saving might simply be offset by reductions in other asset holdings, family care, and/or human capital investment. The book is also disappointingly silent on how these funded pension assets might be decumulated during the retirement period. It would appear that the authors assume that annuitization is the preferred default and probably should be required. But such a presumption will be challenged on political, theoretical, and empirical grounds, as it depends on retirees’ other asset holdings, their risk aversion, their bequest preferences, and much more. Ultimately, readers will find the book useful in presenting interesting European policy options, although the policy recommendations for collectively managed asset pools are not particularly well suited for the less paternalistic U.S. pension environment.

### 3. *Aging Gracefully*

As with the book just described, the volume by Orszag, Iwry, and Gale also reads more like a position paper than a research tome. But the trio editing *Aging Gracefully* is made up of Washington “insiders,” all having had years of U.S. federal government experience and exposure. Orszag and Gale both served on the President’s Council of Economic Advisers, while Iwry worked at the U.S. Treasury directing benefits tax policy. As a result, compared to the big-picture European writers, this team brings a more focused, more detail-oriented, and ultimately more practical set of proposals for boosting household saving. Nevertheless, this book is in some ways less inspirational than the European treatise, since it seems unlikely that low- and middle-income household saving shortfalls will be easily manipulated by the policies recommended.

*Aging Gracefully* begins with a cautionary and indeed cautious tone for economic

policymakers. Specifically, the authors state that they will only discuss ways to make “401(k)-type plans and Individual Retirement Accounts work better” (p. xi), and they will offer “no implications, one way or the other, for . . . change to the Social Security system” (p. xi). They also say virtually nothing about defined benefit pensions and are silent on retiree medical insurance needs, including the financing problems faced by Medicare. In other words, in contrast to the *New Giants*, the U.S. authors eschew the big picture, thereby sidestepping all the interesting economic interdependencies between pension saving, social safety nets, labor and capital markets, pension governance, and macroeconomics. Of course, one must always narrow one’s purview, but some will find it troubling that there is no discussion of how Social Security interacts with pensions for the lower-paid. Social Security rules, for instance, pay lower-wage workers much higher relative benefits than higher-paid workers; the lower-paid also pay less tax and are more likely to receive social insurance disability income and survivor benefits. So why, then, should low-paid workers be required, induced, and/or subsidized to save, when government benefits are already proportionately rather more generous? Maybe low saving rates are optimal for the poor and middle class, especially as research has shown that Medicare, Medicaid, and other government transfers tend to crowd out private saving and insurance in the expected ways. Accordingly, the authors could have devoted greater effort to supporting their presumption that the poor should save more, before asserting that they should be “induced” to save more out of already low incomes.

It is therefore refreshing that this very point is taken up in a final chapter by Zoe Neuberger, Robert Greenstein, and Eileen Sweeney. The work is descriptive rather than behavioral, but it does a provocative job exploring the inverse link between having

a retirement plan and eligibility for Food Stamps, Supplemental Security Income, Medicaid, and other benefits. As one example, having a defined benefit pension income is excluded from means tests but having a defined contribution plan and IRA holdings are included. Unfortunately, the chapter provides only a tantalizingly descriptive flavor of what could have been addressed, but it does not offer empirical analysis of the complex incentives and possible crowd-out effects of public and private benefits.

The authors’ reforms are targeted at enhancing low-wage workers’ retirement security. Notably, the first of these has already been enacted in the 2006 Pension Protection Act, which permitted employers to make auto-enrollment the default for 401(k) plan participants. As the authors note, this can boost worker pension participation when an employer offers a plan but it will not enhance saving if no pension is offered. Accordingly, the second proposal would be to give employers a tax credit if they enroll their workers in “automatic IRAs.” This seems likely to be relatively harmless on the margin, though it might induce firms to shut down their existing plans and thus backfire; no evidence is offered on that possibility.

The third policy proposal suggested is for a complete revamping of the Saver’s Credit, which is a nonrefundable tax credit for low-income taxpayers who voluntarily contribute to their company-sponsored or individual retirement account. Under this arrangement, the crediting rate is 50 percent for lower earning households and it falls to 10 percent for filers earning up to \$50,000; the most a taxpayer can currently receive is \$1,000, or the taxpayer’s total tax liability, if less. The authors propose making the Saver’s Credit fully refundable, which would, in effect, provide a matching contribution for eligible workers’ retirement saving. This, they argue, could be handled in the context of a 401(k) type plan and would



imply an implicit government match for eligible retirement plan contributions. This is an intriguing idea, although only a single experimental study is offered as supporting evidence on whether the proposal would produce net new saving. Other studies have found that matching contributions tend to have very small incentive effects, however. Furthermore, their plan may prove to be target-ineffective, since it pays “temporarily” low-wage workers (such as college students) a subsidy, even when they go on to earn much higher future lifetime salaries later in life. Accordingly, both efficiency and equity questions remain regarding these proposals to boost low-wage saving rates.

#### 4. *Concluding Observations*

As the Baby Boom generation moves into and redefines retirement, there is much new territory ahead. These two books both make clear that economists must devote substantial new energies to reshape public and private economic institutions so they better provide for both economic growth and demographic aging.

Among the remaining questions that neither volume addresses in detail is how retirement policy can better integrate intergenerational adequacy and incentive considerations. As an example, the U.S. volume proposes specific tax policies to boost saving in 401(k) and IRA products but it lacks estimates of these tax expenditures' impacts on effectiveness, efficiency, and redistributive effects over time. The authors also are fairly uninformative on financial illiteracy and what their proposals would do to raise awareness of retirement challenges both before and after leaving the labor force. Conversely, the European volume is instructive in offering alternatives to traditional corporate pensions and insolvent Social Security systems but it seems unlikely that the authors' proposed mandatory collectively run defined benefit schemes would be adopted in the United States or other countries accustomed to the individual account model. Another question both volumes touch on, but then leave unanswered, is how funded pensions should be managed during the retirement draw-down phase. It is to be hoped that the authors will turn next to this urgent topic, as Boomers by the millions begin crossing the threshold into retirement.