

2015

What is the Relation between Public Pensions and Private Savings?

Marta Lachowska

W.E. Upjohn Institute for Employment Research, marta@upjohn.org

Michał Myck

Centre for Economic Analysis

Citation

Lachowska, Marta, and Michał Myck. 2015. "What is the Relation between Public Pensions and Private Savings?" *Employment Research* 22(3): 1-3. [https://doi.org/10.17848/1075-8445.22\(3\)-1](https://doi.org/10.17848/1075-8445.22(3)-1)

This title is brought to you by the Upjohn Institute. For more information, please contact ir@upjohn.org.

UPJOHN INSTITUTE

Employment Research

JULY 2015

In this issue . . .

Marta Lachowska and Michał Myck
What Is the Relation
between Public Pensions
and Private Savings?

Carolyn J. Heinrich
The Role of Performance
Management in Good
Governance and Its Application
in Public Education

New and Noteworthy Books

Upcoming Conference

Vol. 22, No. 3

Employment Research is published quarterly by the W.E. Upjohn Institute for Employment Research. Issues appear in January, April, July, and October.

The Institute is a nonprofit, independent research organization devoted to finding and promoting solutions to employment-related problems at the international, national, state, and local levels. The Institute is an activity of the W.E. Upjohn Unemployment Trustee Corporation, which was established in 1932 to administer a fund set aside by Dr. W.E. Upjohn, founder of the Upjohn Company, to conduct research on the causes and effects of unemployment and seek measures for the alleviation of the hardships suffered by the unemployed.

W.E. Upjohn Institute
for Employment Research
300 S. Westnedge Avenue
Kalamazoo, MI 49007-4686
(269) 343-5541
www.upjohn.org

Randall W. Eberts
President

Marta Lachowska and Michał Myck

What Is the Relation between Public Pensions and Private Savings?

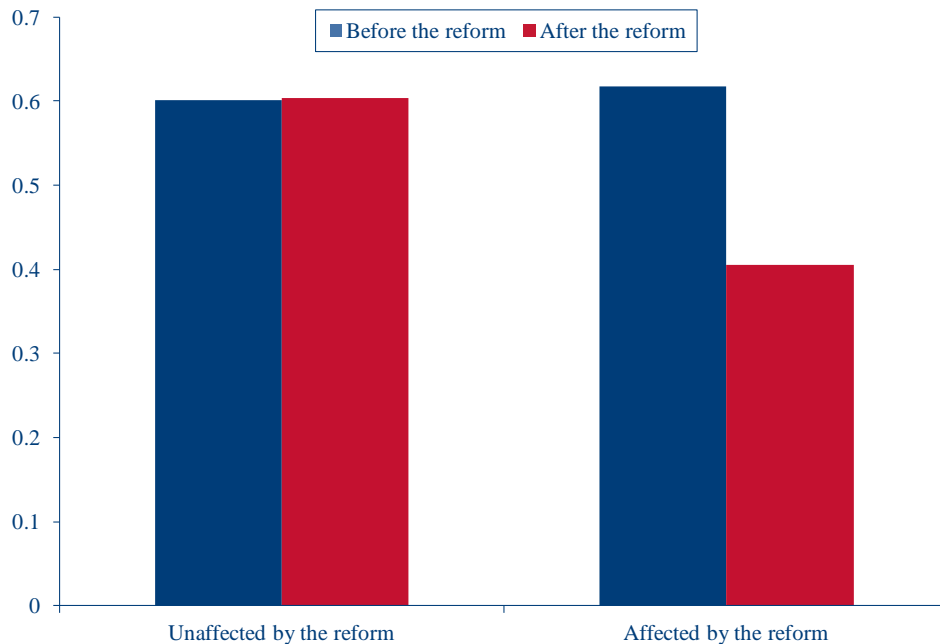
Pension systems where current pension benefits are financed by current revenues, also known as pay-as-you-go systems, are vulnerable to demographic changes such as increased longevity and declining fertility. In part because of lower birth rates in the United States, a 2014 Social Security Board of Trustees report projects that by 2033, the costs of Social Security programs will increase so that revenues will pay for only about 77 percent of scheduled benefits (U.S. Government Printing Office 2014).

To deal with such demographic changes, over the past 20 years many European countries, including Italy, Poland, Sweden, and Germany, have reformed their pension systems (see, for example, Szczepański and Turner [2014]). A common theme of pension reforms has been to change the design of future pensions in order to encourage people to work longer and save more for retirement. Such reforms provide an opportunity to estimate whether, in response to lower future pensions, people save more on their own, or, equivalently, to answer whether pay-as-you-go public pensions crowd out private saving. The public pension crowd-out is an important policy parameter, because it tells us how much people would save on their own if Social Security benefits were lowered.

The 1999 Pension Reform

To answer whether public pensions crowd out private saving, in a recent Upjohn Institute working paper, Lachowska and Myck (2015) study Poland's 1999 pension reform, which created a setting similar to a "quasi-experiment." The reform lowered future pension benefits but had a different impact on individuals, depending on their year of birth. Individuals who were older than 50 at the time of the reform were not directly affected. However, those who were between 30 and 50 years old at the time of the reform will receive pension benefits computed according to a less generous postreform pension formula.

Figure 1 shows the median replacement rate, defined as the ratio of the first pension benefit of the head of household to his or her last preretirement salary, before and after the reform for the cohorts affected and unaffected by the reform. Prior to the reform, many could expect a replacement rate of about 60 percent. After the reform, the replacement rate for the cohorts unaffected directly by the reform remained the same; however, the replacement rate for the cohorts affected by the reform fell by about 20 percentage points. We use the arbitrarily set cutoff at age 50 to identify whether this drop in pension generosity led to an increase in the private saving rate.

Figure 1 Median Replacement Rate Before and After the Pension Reform

NOTE: Replacement rate is defined as the ratio of first gross pension benefit to last gross salary of the head of the household.

SOURCE: Authors' calculations using BBGD 1998 and 1999.

We want to stress that this quasi-experimental variation is valuable because a person's future pension benefits depend on one's earnings, and the determinants of earnings are in turn likely to be correlated with how much one saves. Hence, because of unaccounted-for confounding factors that affect both earnings and savings, simply comparing the savings of somebody with a high future pension to the savings of somebody with a low future pension may not isolate the effect of pension on saving. However, by comparing the saving rate before and after the reform and across similarly aged people—some of whom were affected by the reform and some of whom were not—we can identify the effect of the change in pension generosity on the saving rate.

Methods

To estimate the responsiveness of private savings to pensions, we use data from the Polish Household Budget Surveys for years 1997–2003. We begin by estimating multiyear “difference-in-differences” regressions comparing

household saving before and after the 1999 reform for the cohorts affected and unaffected by the reform. These comparisons tell us how much the saving rate changed because of the reform. In a second step, we estimate the change in PLN (Poland's currency) of the private saving rate for a change of 1 PLN in pension wealth—that is, the public pension crowd-out. To do this, we compute what the pension wealth would have been under the prereform and postreform legislation and relate this variable to saving. As before, we use the fact that the 1999 pension reform changed the amount that similarly aged people could expect to receive in public pensions.

Figure 2 shows the point estimates from a multiyear difference-in-differences regression using the saving rate as the dependent variable. The point estimates show the difference in the saving rate of the households affected by the reform relative to the saving rate of households unaffected by the reform and relative to year 1998—the year preceding the pension reform. In order to interpret the point estimates

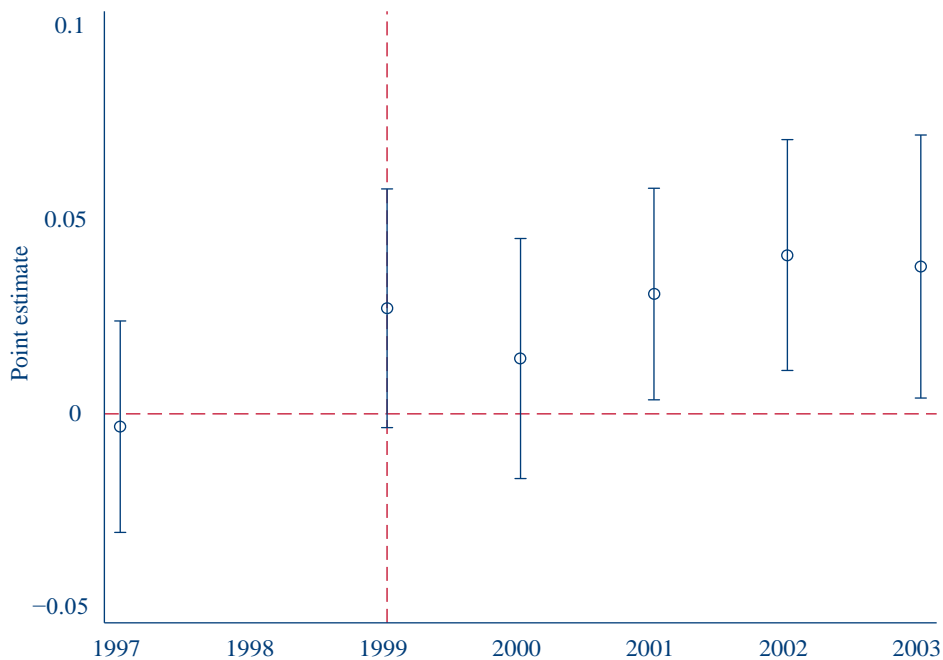
as effects of the reform on the saving rate, we should not see any statistically significant differences in the rate between the households affected or unaffected by the reform in the years preceding the reform. If we do, we would worry about preexisting group and time trends in saving rates that would confound the estimated effect of the reform. However, in the years following the reform, we expect to see an increase in the saving rate of the households whose expected pensions were reduced by the reform.

We see from Figure 2 that in 1997, relative to the unaffected households and relative to the year 1998, there was no statistical difference in the saving rate of the cohorts later affected by the reform. That the saving rate in 1997 is not different for the cohorts affected and unaffected by the 1999 reform strengthens our claim that differences in the saving rate between the cohorts observed after 1999 really are an effect of the reform. The saving rate tends to increase over time in the years following the reform for the cohorts whose pensions were reduced relative to the cohorts who were unaffected by the reform and relative to the prereform saving rate. This suggests an effect of the reform in the expected direction. The magnitude of the estimated effects on the saving rate in Figure 2 is between 0 and less than 5 percentage points, which is a large increase, given that the average saving rate in our data is about 2 percent and the median saving rate is about 9 percent.

Key Findings

How does the change in the saving rate reported in Figure 2 relate to the degree of public pension crowd-out? In our working paper (Lachowska and Myck 2015), we report the following key findings:

- Our analysis shows that public pension crowds out private saving by about 0.24 PLN for each 1 PLN.
- For older cohorts (born between 1949 and 1953), middle-aged cohorts (born between 1954 and 1968), and people with a higher education, we find a large and statistically significant crowd-out ranging between 0.45 and 1.0, which

Figure 2 Estimated Effect of the 1999 Pension Reform on Saving Rate

NOTE: The figure shows point estimates from a multiyear difference-in-differences regression of saving rate on an indicator for whether the household is affected by the reform, i.e., whether the household is “treated,” six-year dummies, and an interaction term between the year dummies and the “treated” dummy. The figure presents the interaction point estimates over time. The omitted categories are year 1998 (the year just before the reform) and the cohort born 1937–1948 (the cohort unaffected directly by the reform). The regression uses robust standard errors clustered by year of birth, and the figure presents 95 percent confidence intervals. The dashed vertical line indicates the first year of the reform.

SOURCE: Authors’ calculations using BBGD.

implies that, for these groups, private saving and pensions are close to perfect substitutes.

- Younger cohorts (born after 1968) and lower-educated households display much smaller public pension crowd-out.

Policy Implications

A crowd-out of 0.24 suggests that public pensions displace a sizable part—about one-quarter—of private savings. However, compared to other recent studies, our estimate of crowd-out is at the lower end of the range of existing estimates.¹ Also, our subsample analysis reveals that this crowd-out is not uniformly distributed in society, but rather is concentrated among certain types of households. If the goal of pension reforms is to increase private saving, policymakers should be aware of the heterogeneity in the responsiveness

of saving to pension reforms. Simply put, some households might increase their saving in response to benefit cuts, while other households might not save enough.

We speculate that the nonresponse among the younger households could be due to liquidity constraints, incomplete information, or uncertainty about how enduring the 1999 reform would be. For young people, building up a stock of wealth might simply be a question of time, and as they age they may accumulate more saving. However, the lack of a savings response observed for the less-educated households is worrisome and echoes the findings of the financial literacy literature. The concern is that by remaining passive and not adjusting their saving, these households are at risk of having a low standard of living in retirement. One policy conclusion from the passive behavior of the low-educated households is that all households do not behave according

to the predictions of the classical life-cycle model; therefore, limited financial literacy should be taken into consideration when designing pension reforms.

Note

1. For example, Attanasio and Brugiavini (2003) report a range of effects between 0.30 and 0.70; Attanasio and Rohwedder (2003) report the crowd-out to be between 0.65 and 0.75; and Bottazzi, Jappelli, and Padula (2006) estimate it to be 0.70.

References

- Attanasio, Orazio, and Agar Brugiavini. 2003. “Social Security and Households’ Saving.” *Quarterly Journal of Economics* 118(3): 1075–1119.
- Attanasio, Orazio, and Susann Rohwedder. 2003. “Pension Wealth and Household Saving: Evidence from Pension Reforms in the United Kingdom.” *American Economic Review* 93(5): 1499–1521.
- Bottazzi, Renata, Tullio Jappelli, and Mario Padula. 2006. “Retirement Expectations, Pension Reforms, and Their Impact on Private Wealth Accumulation.” *Journal of Public Economics* 90(12): 2187–2212.
- Lachowska, Marta, and Michał Myck. 2015. “The Effect of Public Pension Wealth on Saving and Expenditure.” Upjohn Institute Working Paper No. 15–223. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.
- Szczeptański, Marek, and John A. Turner, eds. 2014. *Social Security and Pension Reform: International Perspectives*. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.
- U.S. Government Printing Office. 2014. *The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*. Report No. 88-865. Washington, DC: U.S. Government Printing Office. <http://www.ssa.gov/OACT/TR/2014/tr2014.pdf> (accessed June 12, 2015).
- Marta Lachowska is an economist at the W.E. Upjohn Institute. Michał Myck is the director of the Centre for Economic Analysis (CenEA) in Szczecin, Poland. The authors gratefully acknowledge the financial support from the Polish National Science Centre (NCN) through grant number 2012/05/B/HS4/01417.