



ELSEVIER

Contents lists available at ScienceDirect

The Journal of the Economics of Ageing

journal homepage: www.elsevier.com/locate/jeoa

Perspective piece on “One size fits all? Drawdown structures in Australia and The Netherlands,” by Jennifer Alonso García and Michael Sherris

Lee Lockwood

University of Virginia and NBER, USA

This paper investigates an important question: How much flexibility should be allowed in retirement income policies, and, if not completely flexible, which options should be restricted and which favored? Must people annuitize some of their wealth? Must they draw down at least some minimum amount? How much and by when?

The stakes for understanding this issue are high and rising. Several trends have conspired to make financial planning for and in retirement at once more important and more difficult. Earlier retirements coupled with longer average lifespans have increased the length of time people have to plan for. People face considerable uncertainty, especially about how long they will live and, in many countries, how much they will spend on health care. The transition from defined-benefit to defined-contribution retirement plans means that households are increasingly responsible for making their own decisions about how much to save, how to invest their savings, and how to draw down their savings during retirement. Changes in family structure and growth in female labor supply have reduced the amount of support most retirees can expect to receive from spouses and adult children, while at the same time replacement rates from government and employer pensions have declined.

The stakes are high and rising not just for older households themselves but for society as a whole. People age 55 and older hold 70% of the world’s non-human wealth (The Economist, 2007). Their decisions about how much to spend and save, how to invest their assets, and whether and how much to annuitize can have a major impact on their families (e.g., through changes in upstream support and downstream bequests) and society as a whole (e.g., through changes in tax payments and reliance on means-tested programs like Medicaid).

This paper investigates the consequences of more vs. less flexible retirement income policies by comparing two widely-admired policy regimes with large differences along this dimension: the flexible Australian system and the more restrictive Dutch system. Incorporating key features of both systems in a numerical life cycle model, it investigates the private welfare consequences of these alternative systems for households with varying bequest motives, risk aversion, income levels, etc.

A key feature of the analysis – and one that is crucial for the fundamental tradeoff between more vs. less flexible policies – is that household consumption equals household income in every period. This assumption follows work on decumulation risk management but is an interesting and important departure from the usual approach in economics, which assumes that households understand enough about their choice sets and preferences to choose their favorite allocation, regardless of how complicated the situation might be.

Perhaps the assumption of imperfect optimization should not be quite as unusual as it is. After all, a widely-cited rationale for Social Security and other retirement income policies is paternalism. Left to their own devices, this rationale has it, many people won’t provide adequately for their future selves, even as evaluated from their own private preferences and interests. Given the apparent importance of this rationale for major policies, it is strange that the vast majority of quantitative work on these policies rule out this possibility by assumption.¹

In this particular setting, the assumption that consumption equals income – especially when combined with the rich heterogeneity allowed for in the analysis – puts the different policies in stark contrast. Whereas in the absence of information and calculation costs optimizing households always prefer more options in their choice set (i.e., greater flexibility), households that mechanically set consumption equal to income have much to gain from policies that better align their income profiles with their desired consumption and bequest paths. As a result, from a particular household’s perspective, more restrictive policies that happen to match its preferences are best (e.g., the Dutch system for someone without a bequest motive), less restrictive policies are in the middle (Australian system), and restrictive policies that don’t match its preferences are worst (Dutch system for someone with a bequest motive).

The interesting analysis and results in this paper point to many areas for future research. One is developing better models of the behavior of imperfect optimizers. Although extremely difficult, doing so is of first-order importance, not just for questions of retirement income policy but much more generally. Although there have been many ingenious

E-mail address: leelockwood@virginia.edu.

¹ In his fascinating book, David Levine points out that models based on perfect learning, as clearly incorrect as that assumption might be, tend to outperform models based on other assumptions for most situations of interest to economists (Levine, 2009). The problem is that people are too smart – far smarter than any simple model of imperfect learning predicts them to be – which makes it much more difficult to develop useful models based on imperfect rather than perfect learning.

<https://doi.org/10.1016/j.jeoa.2018.10.004>

2212-828X/ © 2018 Published by Elsevier B.V.

contributions along these lines, much remains unknown.

Another is to extend the analysis to consider social welfare rather than just private household welfare. One key difference between the two in this context comes from means-tested programs, which create a fiscal externality from saving and insurance decisions. This is a major issue in many countries. In the United States, for example, 70% of nursing home residents at a point in time rely at least in part on the means-tested Medicaid program (Kaiser, 2013). Another difference between social and private welfare comes from the gift externality from giving (Kaplow 1995). Retirees' choices and retirement income policies together determine the size and risk of the bequests received by the next generation. The next generation therefore has a stake in retirees' choices, which creates a gap between social and private incentives. This is true even with altruistic retirees whose utility depends strongly positively on the utility of their heirs. Intuitively, a retiree transfers

resources to her heirs up until the point at which her own private marginal benefit and cost of doing so are equal. Making a larger transfer would involve only a second-order loss to the giver but would confer a first-order gain on the recipient. Future analyses of policies related to the flexibility of retirement saving accounts could examine the extent to which they help internalize these externalities and shrink the size of foregone gains from trade.

References

- Kaiser Commission on Medicaid and the Uninsured, 2013. Five Key Facts About the Delivery and Financing of Long-Term Services and Supports.
- Kaplow, Louis, 1995. A note on subsidizing gifts. *J. Public Econ.* 58 (3), 469–477.
- Levine, David K., 2009. Is Behavioral Economics Doomed?
- The Economist, 2007. From cheque books to checking pulses. Apr 12th.