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Journal of Public Economics 90 (2006) 2187–2212

JOURNAL OF PUBLIC ECONOMICS

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Retirement expectations, pension reforms, and their impact on private wealth accumulation

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Received 16 December 2004; received in revised form 9 March 2006; accepted 17 March 2006
Available online 22 May 2006

Abstract

We estimate the effect of pension reforms on households' expectations of retirement outcomes and private wealth accumulation decisions exploiting a decade of intense Italian pension reforms as a source of exogenous variation in expected pension wealth. The Survey of Household Income and Wealth, a large random sample of the Italian population, elicits expectations of the age at which workers expect to retire and of the ratio of pension benefits to pre-retirement income between 1989 and 2002. We find that workers have revised expectations in the direction suggested by the reform and that there is substantial offset between private wealth and perceived pension wealth, particularly by workers that are better informed about their pension wealth.
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JEL classification: H55; E21
Keywords: Expectations; Pension reform

1. Introduction

In all industrialized countries pension benefits represent a major component of retirement income, and therefore social security arrangements can have important effects on households' intertemporal choices. One of the most important issues in this area is to what extent individuals perceive and react to changes in pension legislation. Is private wealth a good substitute for

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doi:10.1016/j.jpubeco.2006.03.005

mandated accumulation in the form of social security contributions? Do people increase their saving and labor supply in response to a reduction in pension benefits?

Answers to these questions usually proceed in two steps. In a first step, researchers estimate expected pension wealth, that is, the expected present discounted value of future benefits that workers are entitled to. In a second step, expected pension wealth is related to discretionary wealth and/or labor supply behavior. Even in the simplest scenarios, estimating future pension benefits is a difficult task. For the working population, expected pension wealth depends, among other variables, on the age at which workers expect to retire and on the expected ratio of pension benefits to pre-retirement earnings (the replacement rate). The standard approach taken in the literature is to estimate these variables from current and projected legislation on pension eligibility rules, accrual rates of contributions, productivity growth and mortality projections. In this paper we instead take a different approach: we compute expected pension wealth by using individual expectations of retirement age and replacement rate.

The Survey of Household Income and Wealth (SHIW), a large representative survey of the Italian population carried out by the Bank of Italy, elicits retirement age and replacement rate expectations from 1989 to 2002. This is not the only survey eliciting such expectations but, to our knowledge, it is the only survey in which this information is available for an extended period spanning a set of intense pension reforms. During the period, the Italian government enacted three reforms (in 1992, 1995, and 1997), whose ultimate effect was to increase the retirement age and to reduce the replacement rate of young workers relative to older cohorts.

The availability of individual expectations enables us to assess the degree of workers' information by comparing the expected replacement rate to a replacement rate computed with the relevant pension legislation (for a given retirement age). Moreover, the pension reforms that take place in the observation period provide us with the opportunity to estimate the impact of these reforms on individual expectations. In particular, we can analyze whether the groups most affected by the reforms have perceived these changes correctly. Believing in the importance of subjective expectations to determine individual decisions, we use subjective expectations of retirement age and replacement rate to construct a measure of expected pension wealth and we relate it to discretionary wealth. We then show that the relationship between expected pension wealth and discretionary wealth differs according to the degree of individual information about pension legislation and the changes implied by the reform.

The standard life-cycle hypothesis posits that a change in expected pension benefits should offset private wealth one-for-one. This offset is what Feldstein (1974) calls the substitution effect —pension wealth crowds out discretionary wealth. There are several potential counter-effects to a complete crowding out. Bequest motives, short-sightedness, liquidity constraints, risk associated with future reforms, and non-marketable future benefits are among the most cited reasons to explain why the offset between private and pension wealth might well be less than one-for-one. But there is another element that plays a major role in our analysis: individual information about pensions. Information might be especially important at times of pension reforms, because people might not immediately understand how the reform will affect their benefits or because changes in expectations occur slowly.

Feldstein (1974) and Feldstein and Pellechio (1979) pioneered the analysis of the displacement effect of pension wealth on national saving using U.S. time series and microeconomic data, respectively. Since then, a growing literature has used individual level data to provide evidence on the degree of substitution between discretionary accumulation and pension wealth in the U.S. and other countries imputing pension wealth from legislation (see Gale, 1998; Bernheim, 2002). Existing microeconometric evidence suggests that pension wealth crowds out discretionary

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