

Is there a social security tax wedge? [☆]

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Abstract

A Beveridgean pension scheme discourages labour, and is bad for efficiency. A Bismarckian one may encourage labour, and be good for efficiency. In any case, the same contribution level will discourage labour and reduce efficiency less if the scheme is Bismarckian, than if it is Beveridgean.

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1. Introduction

The political discussion on the effects of pension policy appears to take it for granted that a pension contribution is a tax on labour, and will consequently reduce employment. Indeed, a series of empirical studies finds a negative effect of pension contributions on either employment or labour participation; see, for example, [Alesina and Perotti \(1997\)](#), [Scarpetta \(1996\)](#), [Tullio \(1987\)](#). The assumption is justified, and the empirical finding unsurprising, in countries that have given themselves a Beveridgean pension system, because individual pension benefits are then unrelated to individual contributions, and the latter are thus effectively an earmarked tax (the *social security tax*). Not so, however, in countries where the pension system is essentially Bismarckian, and thus characterized by a close link between benefits and contributions.¹ In such countries, pension contributions are a mandatory form of saving. There will be an element of tax only if these contributions are higher than would be

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¹ On this criterion, [Disney \(2004\)](#) classifies Austria, Belgium, Finland, France, Germany, Greece, Italy, Luxembourg, Norway, Portugal, Spain, and Sweden as “Bismarckian”. The countries classified as “Beveridgean” are Australia, Canada, Denmark, Ireland, Japan, The Netherlands, New Zealand, Switzerland, UK, and USA.

required to obtain the same amount of retirement income by other means. If they are lower, labour is being subsidized.

The concept of an implicit pension tax dates back to Lüdeke (1988) and Sinn (1990). More recently, Murphy and Welch (1998) and Orszag and Stiglitz (2000) also have come round to the idea. This theoretical insight has sparked-off a number of empirical studies aimed at measuring the tax element in pension contributions; see, for example, Börsch-Supan and Reil-Held (2001), and Fenge and Werding (2004). Disney (2004) takes the empirical analysis further by estimating the effects of the tax component of pension contributions on labour participation by age and sex. He finds that, if composition is not controlled for, pension contributions reduce participation as in the earlier empirical studies mentioned. If it is, pension contributions have either no significant effect, or a significantly positive one. The tax component has a significantly negative effect on female participation, but little or no effect on male participation.

If the age of retirement is an object of choice, the existence of a public pension system may affect both the length of a person's working life, and the amount of labour that this person will supply over a working life of any given duration. Although there are analogies between the two decisions, the issues involved, and the way of dealing with them, are however quite different.² The present paper has the limited objective of analytically deriving the labour distortion associated with compulsory participation in a public pension scheme, assuming that the age of retirement is fixed.

We find that a Beveridgean scheme will always impose an implicit tax on labour. By contrast, a Bismarckian scheme may tax some workers, and subsidize other. An implicit pension tax tends to discourage labour, an implicit pension subsidy to encourage it. We also find that credit market imperfection does not affect the size of the labour distortion caused by a Beveridgean pension system. By contrast, if the system is Bismarckian, credit rationing reinforces the distortionary effect of any implicit pension tax, and weakens that of any implicit pension subsidy. If it is actuarially fair, a Bismarckian system can distort labour behaviour only if the worker is credit rationed. These interactions do not appear to have been pointed out before.

These findings have important policy implications. Cutting back a Beveridgean system will definitely encourage labour, and improve efficiency, but will also raise inequality. Cutting back a Bismarckian one *may* do the very opposite. A country with a Bismarckian pension system should thus be double careful before reaching for the axe.

Sections 2–4 of the paper set out the theory. Section 5 briefly reviews the empirical evidence, and suggests ways of going forward on that front. Section 6 summarizes and discusses the findings.

2. Individual decisions in the absence of a public pension system

Let l^i denote the labour, c_1^i the working-age consumption, and c_2^i the retirement-age consumption of agent i . His utility is assumed to be given by

$$U^i = u_1(c_1^i - v(l^i)) + u_2(c_2^i), \quad (1)$$

² See Sheshinski (1978) and, more recently, Cremer et al. (2004).

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