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How Not to Take the Worry out of Growing Old

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Background

The government's recent proposal for an old age pension scheme is being promoted as a plan which takes the worry out of growing old. Contrary to its claims, the proposal will achieve the exact opposite and make the vast majority of the population less secure in old age. The proposal was clearly conceived in haste, with little analysis of the broader and more long-term implications, and it will surely spell disaster for Hong Kong.

In December 1993, the government, in a totally unexpected move, reversed its previous position and proposed a universal old age pension scheme with central redistributive features. The move was all the more puzzling since there was no public pressure for a redistributive scheme. To most observers, the Hong Kong government was a most unlikely candidate for proposing such a scheme, which most societies have been trying hard to avoid or to eradicate. The details of the original proposal were sketchy but included two key features. First, the scheme was to be financed by a 6 percent payroll tax, with employers and employees each contributing 3 percent of salaries. Second, benefits were to be in the form of equal payments to elderly individuals. A monthly entitlement equivalent to roughly 30 percent of the median monthly income of the working population, i.e., $2,300 in 1994, was initially proposed. The figures were tentative and were to be finalized pending an actuarial study.

Whether the proposed old age pension scheme will be solvent depends on:

(1) the change in demographics over time;
(2) the rate of growth of salaries over time;
(3) leakages in collecting tax contributions; and
(4) the level of entitlement benefits.

Accurate estimates will be very hard to obtain because of the difficulty in predicting economic and demographic changes in Hong Kong over the long run. A number of economic studies have since indicated that the original proposal cannot be financially viable. Professor Isaac Ehrlich, who analyzed the figures, concluded that the scheme would become insolvent

in less than one generation. Others have come up with similar results.

The current revised proposal makes a few important changes that enhance the financial viability of the scheme. First, it maintains the level of entitlement at $2,300 in 1994 HK dollars permanently. The level of benefits will be adjusted over time for inflation, but not for increases in real monthly salaries. Second, the payroll tax has been reduced from 6 percent to 3 percent to be shared equally between employers and employees. Employees earning less than $4,000 per month do not have to contribute their share of 1.5 percent, but their employers must contribute.

Pay-As-You-Go System: Recipe for Insolvency

The proposed scheme is a pay-as-you-go system. It does not operate as individual savings accounts into which one can make regular contributions and from which one can withdraw funds after retirement. One set of rules defines the level of tax contributions and another set defines the level of entitlement benefits. It is not required that an individual's level of tax contribution match his level of entitlement benefits. However, society as a whole has to be concerned as to whether total receipts and total disbursements will be balanced in the long run, as they must for the scheme to remain solvent.

Although there are suggestions that contributions to the scheme will be hypothecated, this is nevertheless a pay-as-you-go system. Hypothecation of funds is an irrelevant concept in such a system because it is an entitlement program supported by taxes. Contributions and entitlement benefits are not tied together through investment returns. Any shortfall would have to be met by adjusting the level of entitlement or taxes in exactly the same way that fiscal budgets are balanced. The scheme contrasts sharply with the earlier proposals for fully funded schemes: the Retirement Protection Scheme put forth by the government and the Central Provident Fund supported by the Legislative Council.

As it stands now, the scheme will probably be solvent if all the key propositions remain essentially unaltered in the future. But this is unlikely to be the case. If monthly payroll increases, at 2.5 percent annually after inflation, are accounted for, then salaries will double in 30 years and triple in 45 years. An individual who starts working at the age of 20 today and retires at age 65 will find his real monthly payroll tripled in his working life. One cannot envision how a pension entitlement that is pegged at the same level in real dollars today would be adequate support in his old age. Political pressure to enhance entitlement benefits will certainly begin the very day the proposal is put in place, for there is one thing everyone, and especially politicians, can agree on, and that is that the level of support will not be adequate for taking the worry out of growing old.

If entitlement benefits are to be increased, and politicians will of course see to it that this takes place, then the scheme will become insolvent unless the level of payroll taxes is increased. Thus, the 3 percent tax that is being proposed today is an illusion.

Experience has proven this to be the case time and again in every known society. Looking at the democracies in the industrialized West, one immediately sees the tremendous pressure to increase entitlement benefits until they become unaffordable. The growth of the welfare state is an imminent danger, and one which the community has to take very seriously indeed. A high welfare burden would mean a high tax rate, and this works against the interest of Hong Kong.

If the total contributions to Singapore's Central Provident Fund can be increased from 10 percent of income to 40 percent, I am not aware of any compelling reason why Hong Kong can escape a similar fate. A government whose days are numbered cannot guarantee that the level of entitlement benefits will stay at the level originally envisaged.

Income Transfers

The government proposal implies massive income transfers from one group of individuals to another, based on income, age, and other factors. This would not have occurred with fully funded schemes.

The income redistributive dimensions are massive and will be socially divisive. The true dimensions of income redistribution and its effect on work behavior can only be understood through large-scale empirical research. But the more obvious ones can be easily identified. First, the working population will be taxed at a higher rate, and this will obviously give rise to reduced incentives to work and enhanced incentives to consume. This is a significant development in light of Hong Kong's well-known labor shortage and high inflation problems. Second, the poor will benefit at the expense of the well-off in the first-round effect. This creates perverse incentives for the poor to work less and retire earlier, whereas the well-off will have to work more and retire later, thereby expanding the gap in earned income (excluding entitlement benefits) between the poor and the well-off.

For the existing population, income transfers are positive and rise with age. The major beneficiaries are the elderly, who will benefit most without having to make any contributions. People who live longer will also benefit more. There is evidence that longevity is positively related to income and the female gender. Furthermore, those who spend a smaller fraction of their adult life working in Hong Kong benefit at the expense of others. Women will gain at the

expense of men, married couples will gain at the expense of single people, married couples in which only one partner works will gain at the expense of couples both of whom are working, immigrants and returning emigrants will gain at the expense of natives, and the list goes on and on.

Few Gain, Most Lose

Can a 3 percent tax on payroll provide adequate funding for old age security? Singapore's Central Provident Fund began in 1955 with a 10 percent tax on payroll. In Hong Kong, where the savings rate has averaged around 25 percent of gross domestic product, a 3 percent tax on payroll has to be regarded as either a joke or the tip of an emerging iceberg. The proposed low level of contribution may have been necessary to make a redistributive scheme less onerous to a society that has traditionally frowned upon the social welfare state. But in making it so, the scheme fails to help anyone but a very small fraction of the population.

To see this, consider a husband and wife each with a working life beginning at age 20 and ending at 65. Assume that life ends for both at 80. The couple contributes 3 percent (or 1.5 percent) of their income for 45 years and receives a combined monthly entitlement of $4,600 for the next 15 years. The old age pension scheme is an investment proposition to them with an implicit rate of return. Since benefits are the same for all, the real rate of return will vary inversely with the level of contribution or income. If real monthly income grows at 2.5 percent annually, one can calculate age-specific income levels for different rates of return. The following table gives the age-specific family income ceilings for achieving the indicated real rate of return.

Table
Age-Specific Family Income Ceilings for Indicated Return

Real rate of return	0%	2.5%	5%	10%
Family income at 20	$28,200	$14,200	$7,200	$2,600
Family income at 45	$51,000	$25,600	$13,000	$4,600
Family income at 65	$83,600	$42,000	$21,400	$7,400

For example, a husband and wife with a combined starting income above $14,200 will obtain a rate of return less than 2.5 percent from investing in the old age pension scheme. Two and a half percent is a long-term risk-free return. Rates of return achieved on privately managed provident funds in Hong Kong have been in excess of 10 percent in real terms for the past decade. The figures in the table show that only families with a starting level of

income of less than $2,600 a month can achieve a 10 percent return by investing in the proposed old age pension scheme. These figures clearly show that the scheme is a very poor investment vehicle for the vast majority. People are literally being conned and even coerced into putting their money into a low-yield vehicle. Anyone, except the government of course, caught doing this would have been charged with criminal fraud.

There are of course those who wish to defend the scheme because it appears to benefit the poorest individuals in society. But this is largely a false belief. Two groups will be the major beneficiaries, and they are not necessarily poor. First, those above the age of 65 today will benefit at the expense of everyone else. Since everyone grows old some day, one has to raise the question of who will provide the next generation with this free benefit when they grow old. Second, those who are able to hide their income from the Inland Revenue authorities will also gain. These include the self-employed and others who own a business.

The scheme is not even a good system for helping the poor because it seeks to provide consumption benefits for the poor rather than augment their productive capacities. The outcome of decades of social policy and welfare programs have shown that it is far better to help the poor become more productive than to provide them with a basic level of consumption. Poor people who become more productive can pull themselves out of poverty. However, maintaining their basic level of consumption condemns them to a permanent state of institutionalized deprivation. It is far better to have a system that transfers resources to the poor when they are young, so that they can invest those resources to improve their circumstances while they are still productive, than to maintain them at an above-subsistence level when they cease to be able to work.

One fails to see how the proposed scheme can take the worry out of growing old, as it claims to do. If anything, it makes growing old even more insecure for most people and allows some, not necessarily the poor, to benefit at the expense of others. One cannot think of a more socially divisive way of squandering valuable resources.

Impact on Economic Growth

The scheme has another serious flaw that could be very damaging for the economy. The rate of economic growth will be negatively impacted. To understand this point, one must first understand how economies grow. Fundamentally, economic growth means that future generations will have higher levels of productivity than the current generation, and their standards of living will improve. For this to happen, the current generation must invest in the next generation. The human capital investment parents make in their children in the form of education, health, work habits, etc., is a good example of such an investment. Parents invest

in their children partly for altruistic reasons, but also as a means of old age protection.

Throughout history the family had always been the single most important institution for old age protection. This remained true even in modern societies until it was undercut by social security programs. Such programs substitute the state for children as an old age protection device. As a consequence, the incentive to have children and to invest in them is reduced. Parents continue to invest in children for altruistic reasons, but less so for old age protection reasons. This decline in human capital investments in children makes the future generation less productive and lowers the economy's growth rate.

The universal decline of literacy and numeracy that we observe in modern societies despite the massive increase in the amount of public investment in education has always been a puzzle. Economist Gary Becker was the first to point out that increases in public investments probably failed to compensate for the decline in human capital investments parents made because of the disincentive effects of social security. Such a decline hurts the poor far more than it hurts the rich, because social security has a much greater impact on the investment decisions of poor families in their children than on rich families' decisions.

In 1992, Dr. Francis Lui estimated that the impact of a pay-as-you-go old age pension scheme could lower Hong Kong's annual growth rate by as much as 0.36 percent. The accumulated loss in a 30-to-40-year period could amount to HK$2,000 billion (inflation adjusted). This is an enormous amount of money to waste, and it will not go to the elderly.

The Tax System

At the moment, only 50 percent of the labor force are taxpayers, in part because it is not worthwhile to collect very small amounts of tax revenues from low-income employees. The implementation of the proposed scheme would effectively create a tax system in which employers will pay taxes on behalf of every worker. The establishment of such a system would make it a duplication of effort to continue operating the present salaries tax collection system. A possible and logical next step would be to implement a withholding tax system operated by the employer that is not dissimilar to the system in place in the U.S.

Such a development would have pervasive economic implications that go beyond the narrow consideration of the effects of an old age pension scheme. The government will have inadvertently created a tax collection machinery that could reach every worker. This would make it relatively easy to change the tax system and to raise tax revenues. Such a development should be resisted.

Neither Here Nor There

The proposed policy represents a fundamental departure from the established policy of maintaining low tax rates and a minimalist government role in social policy to help only the truly deserving. The proposal has all the hallmarks of haste and political expediency. The government is clearly not keen to establish a central provident fund for sensible reasons. The compulsory individual retirement scheme has been rejected by the Legislative Council. Is the present proposal a stalling game, as some have alleged? But this is a dangerous game to play. A social policy of such momentous dimensions is a serious matter.

To make the proposed scheme appear solvent, benefits have been reduced. This has made it possible to lower contributions as well, a political move that makes the proposed scheme more acceptable to the public, fits in better with Hong Kong's current low tax regime, and reduces the scope of income redistribution. But these changes will make it impossible for the scheme to provide adequately for old age security, as the government has promised it will.

The government's old age pension scheme is a system which, once set in motion, cannot be abandoned. Unlike fully funded decentralized schemes or a central provident fund, the government-proposed scheme cannot be wound up because of its redistributive and pay-as-you-go features. The system will become a permanent institutionalized aspect of Hong Kong society.

A much less damaging way forward at this point is to reject the government proposal in its entirety and return to the original proposal of a decentralized fully funded compulsory scheme. An even less damaging alternative is to simply enhance the old age public assistance scheme to be financed from general revenue. The scheme, as it is now, provides very modest benefits to citizens above the age of 65. Individuals are means-tested, but those above the age of 70 are exempted from means-testing. In comparison, the government-proposed old age pension scheme is much more inefficient, unfair, and detrimental to Hong Kong.

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