Effects of Taxes and Safety-Net Pensions on Life-cycle Labor Supply, Savings and Human Capital: The Case of Australia

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The Australian Social Security System

The Australian social security system is ranked among the best in the world by Mercer, the OECD, IMF etc.

Two components:

1. "Superannuation"
   - Defined contribution pension plan
   - Mandatory employer contributions to private accounts (9.5%)
   - Workers choose among investment options
   - Accessible from age 65 (Age 60 if retired)
   - Avoids fiscal burden on government
2. Age Pension
   - Provides safety net at ages 65 +
   - Benefits do not depend on work history (unlike SS in US)
   - Pure means-tested transfer ("welfare") program

Age Pension Benefit Rule

Estimate Effective Income and Asset Taper Rates

$$\text{benefit}_{\max} = \underset{(183.96)}{10,759.73} + \underset{(173.52)}{1,846.92}(\text{when year} \geq 2010),$$

$$\text{pension} = \max\left\{\text{benefit}_{\max} - \max\left[\max\{\underset{(0.020)}{0.27794}\,\text{income}, \underset{(0.0004)}{0.00499}(\text{wealth} - \underset{(46,895.27)}{117,082.60})\}, 0\right]\right\}$$

Age Pension Benefits

We estimate effective taper rates of only:

- 27.8% on Income
- 0.5% on Assets

The low taper rates lead to very poor targeting (75% get some benefits). This means the Age Pension is a large program:

- Income Taxes = \$ 180 bil. (2014)
- Age Pension = \$ 50 bil. (2014)

Goal: Use structural model to assess:

- Effects of Age Pension on:
  - Labor supply
  - Asset and human capital accumulation
- Effects of changes in Age Pension rules designed to improve targeting of benefits

Main model design features

- Labor supply elasticity $\Rightarrow$ Human capital accumulation
  Borrowing constraint
  Wage risk and wealth process
- Intensive and extensive margins $\Rightarrow$ Endogenous retirement without absorption
- Frictions on the labor market $\Rightarrow$ Discreteness of labor supply
- Heterogeneity in effects $\Rightarrow$ Observed (education), Unobserved (types) heterogeneity

Results and conclusions

Labor supply

- Large variation of labor supply elasticities by age and education:
  - Labor supply elasticities increase with Age
  - Elasticities are smaller for higher education groups

Age Pension

- The program has large negative labor supply effects
- The program is expensive (Largest welfare item in budget)
- It is poorly targeted $\Rightarrow$ Very low effective taper rates
- Doubling of Taper Rates combined with 5.9% tax cut would be Pareto improvement

Summary of the stochastic life cycle model

1. Discrete time = age from 19 to 100 (stochastic survival)
2. Annual decisions on
   - Consumption (continuous choice)
   - Hours from [0, 24, 40, 45, 50, 60] per week (discrete choice)
3. Stochastic elements in the model
   - Survival (longevity risk)
   - Idiosyncratic wage shock
4. Human capital accumulation
   - Learning-by-doing → Accumulating work experience
   - Human capital increases future wage → part of compensation
5. Observed and unobserved heterogeneity in the population
   - Education → Initial endowment and human capital technology
   - Unobserved types → Initial endowment and preference for leisure

Hours, human capital and wage + wealth and consumption

Hours of labor supply $h_t \in H$ (choice variable)

Human capital $K_t = f\left(\sum_{\tau=1}^{t-1} h_\tau, \text{age}, \text{education}, \text{type}\right)$

Wage $wage_t = K_{t-1} \cdot R_t \cdot \epsilon_t^{wage}$,
$R_t = 1$ is rental rate of human capital,
$\epsilon_t^{wage} \sim lnN(0, \sigma_t^{wage})$

Consumable wealth in the beginning of the period $M_t < M_{max}$

Consumption $c_t \leq M_t + a_0$ (credit constraint)

Intertemporal budget
$M_{t+1} = \left(M_t - c_t\right)(1 + r) + h_t \cdot wage_{t+1} + \text{transfers}_{t+1}$

State variables

1. Consumable wealth M_t
2. Human capital $K_t = f\left(\sum_{\tau=1}^{t-1} h_\tau, \text{age}, \text{education}, \text{type}\right)$
3. Education
4. Unobserved type

$X_t = (M_t, K_t, \text{education}, \text{type})$ is not perfect

$0 \leq M_t \leq M_{max}$

$0 \leq K_t \leq \sum_{\tau=1}^{t-1} \max\{h_\tau : h_\tau \in H\} \leq (t-1)h_{max} \leq (T-1)h_{max}$

State variables (more convenient way)

1. Consumable wealth M_t
2. Human capital $K_t = f\left(\sum_{\tau=1}^{t-1} h_\tau, \text{age}, \text{education}, \text{type}\right)$
3. Education
4. Unobserved type

$X_t = \left(M_t, \mathcal{E}_t, \text{education}, \text{type}\right)$, where $\mathcal{E}_t$ is fraction of total working time to total time budget, i.e. work experience

$0 \leq \mathcal{E}_t \leq 1$

$$\mathcal{E}_t = \frac{1}{t \cdot h_{max}} \sum_{\tau=1}^{t-1} h_\tau \;\Leftrightarrow\; \mathcal{E}_{t+1} = \frac{1}{t+1}\left(\mathcal{E}_t t + \frac{h_t}{h_{max}}\right), \mathcal{E}_0 = 0$$

$$K_t = f\left(\mathcal{E}_t \cdot t \cdot h_{max}, \text{age}, \text{education}, \text{type}\right)$$

Preferences

Utility of consumption

$$u(c_t) = \frac{c_t^{1-\zeta} - 1}{1-\zeta}$$

Utility of (accidental) bequests

$$w(B_t) = b_{scale} \cdot \frac{(B_t + a_0)^{1-\xi} - a_0^{1-\xi}}{1-\xi}$$

$B_t = M_t - c_t$ bequeathed wealth

$b_{scale} > 0,\ \zeta > 0,\ \xi > 0$ parameters to be estimated

a_0 credit constraint (maximum amount of borrowing)

Disutility of work

$$v_t(h_t) = \mathbb{1}\{h_t > 0\} \cdot \kappa_{type}(\tau_{uh}) \cdot \kappa_{age}(t) \cdot \gamma(h_t)$$

Type: high ($\kappa_{type} = 1$) and low ($\kappa_{type} = 1 + \kappa_1$)

Simple age effects:

$$\kappa_{age}(t) = 1 + \kappa_2(t-40)^2 \cdot \mathbb{1}\{t > 40\} + \kappa_3(t-25) \cdot \mathbb{1}\{t < 25\}$$

$\gamma = (\gamma^{(1)}, \ldots, \gamma^{(5)})$ disutilities of the discrete levels of hours

Correction for the young ages

Labor supply in ages 19 to 25 was persistently overpredicted

1. Scrutinize the definition of schooling and graduation time
   Make college graduates start their career later than everybody else
2. Transfer from parents
3. Additional disutility of work at young age

$$M_{t+1} = (M_t - c_t)(1+r) + h_t \cdot wage_{t+1} + \text{transfers}_{t+1}$$

$$\downarrow$$

$$M_{t+1} = (M_t - c_t)(1+r) + h_t \cdot wage_{t+1} + \text{transfers}_{t+1} + tr_{t+1} \cdot \mathbb{1}\{t+1 \leq 22\}$$

Bellman equation, without EV(1) taste shocks

$$V_t(X_t) = \max_{\substack{0 \le c_t \le M_t + a_0, \\ h_t \in H_t(\tau)}} \Big\{ u(c_t) - v_t(h_t, \tau_{uh}) + \delta_t \beta(\tau_{edu}) E\big[V_{t+1}(X_{t+1}) \,|X_t, c_t, h_t \,\big] + (1-\delta_t) w(M_t - c_t) \Big\},$$

Note: c_t continuous, h_t discrete

$\tau = (\tau_{uh}, \tau_{edu})$ types for education and taste of work

$H_t(\tau)$ type-specific choice set in period t

$\beta(\tau_{edu})$ discount factor dependent on education

δ_t survival probability

Bellman equation with EV(1) taste shocks

Chocie-specific EV i.i.d. taste shocks ϵ_h

$$V_t(X_t) = \max_{h_t \in H_t(\tau)} \Big[v_t(X_t, h_t) + \lambda \epsilon_h \Big]$$

$$v_t(X_t, h_t) = \max_{0 \le c_t \le M_t + a_0} \Big\{ u(c_t) - \nu_t(h_t, \tau_{uh}) + (1-\delta_t) w(M_t - c_t) + \delta_t \beta(\tau_{edu}) E\Big[\mathrm{LogSum}\big(v_{t+1}(X_{t+1}, h_{t+1})\big) \Big| X_t, c_t, h_t \Big] \Big\}$$

$$\mathrm{LogSum}\big(v_t(X_t, h_t)\big) = \lambda \log \Big(\sum_{h_t \in H_t(\tau)} \exp \frac{v_t(X_t, h_t)}{\lambda} \Big)$$

$$P(h|X_t) = \exp \frac{v_t(X_t, h)}{\lambda} \Big/ \sum_{h_t \in H_t(\tau)} \exp \frac{v_t(X_t, h_t)}{\lambda}$$

Labor supply becomes probabilistic with standard logit choice probability

HILDA data

Household, Income and Labor Dynamics in Australia survey (HILDA)

- The primary source of data is the Household, Income and Labor Dynamics in Australia Survey (HILDA).
- Annual waves 2001-2016, Australian national representative sample
- Family dynamics, income and labor supply (each year)
- Data on wealth, health and health insurance, retirement, fertility, literacy and numeracy (particular years, reoccurring)
- Approximately 20,000 households in total

Structural estimation sample:

- Single and married men between age 19 and 85
    - 10,133 individuals, unbalanced panel of 81,197 observations
    - Individuals born 1912 - 1997

Australian institutional settings

1. Old Age Pension (safety net)
    - Universal from age 65
    - Not dependent of working history
    - Financed from general revenue
    - Subject to means testing
2. Superannuation (compulsory savings)
    - Defined contribution system, accumulation subject to market risk
    - Individual accounts in private super funds
    - Employers are compelled to contribute a fraction of wage
    - Accessible from age 65

Incorporating institutional settings in the model

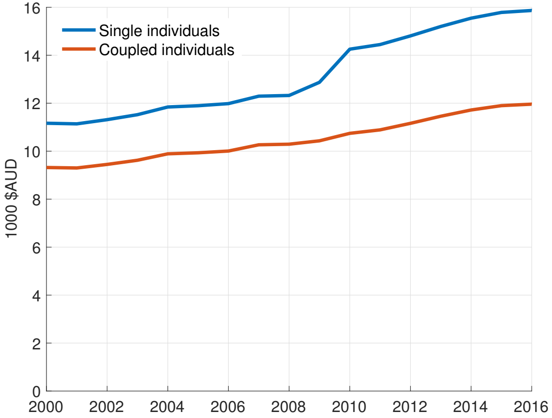
Age Pension

$$\text{Pension} = \max\left\{0, \text{full benefit} - \max\{\text{income test}, \text{asset test}\}\right\}$$

$$\begin{aligned}\text{Income test} &= \max\left\{0, \text{income taper rate} \cdot (\text{income} - \text{income threshold})\right\} \\ \text{Asset test} &= \max\left\{0, \text{asset taper rate} \cdot (\text{wealth} - \text{asset threshold})\right\}\end{aligned}$$

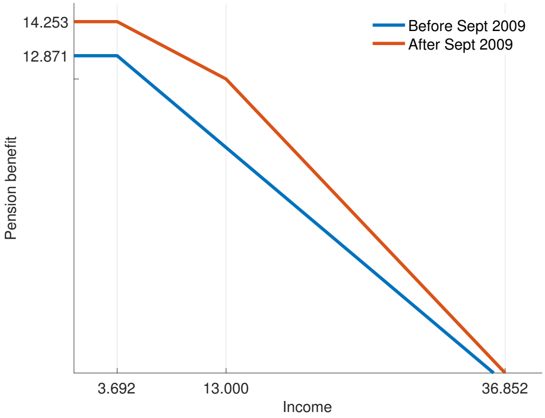
- Need to represent within the state space (with minimal additions)
  - Use simplified institutional rules and formulas?
  - Use approximation obtained from observed data? ◀

Means testing and 2009 reform



- Slight increase in maximum pension benefit
- Jump in 2009 for single individuals

Means testing and 2009 reform



1. Slight increase in maximum pension benefit
2. Changes in taper rate (second threshold)

Age pension equation

$$\text{benefit}_{\max} = \underset{(183.96)}{10,759.73} + \underset{(173.52)}{1,846.92}(\text{when year} \geq 2010),$$

$$\text{pension} = \max\left\{\text{benefit}_{\max} - \max\left[\max\{\underset{(0.020)}{0.27794}\,\text{wage}, \underset{(0.0004)}{0.00499}(\text{wealth} - \underset{(46,895.27)}{117,082.60})\}, 0\right]\right\}$$

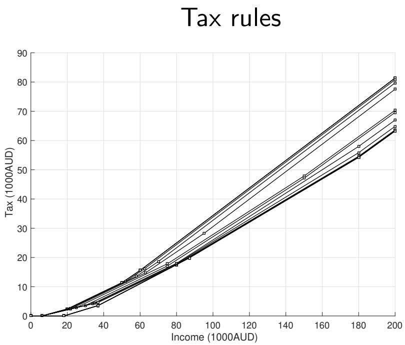
Superannuation

- Superannuation is a function of the labor supply throughout career $\rightarrow$ function of accumulated human capital
- We need to simplify the rules:
- Disregard the details of retirement income $\rightarrow$ paid as lump sum at age 65

$$super_t = \rho_0 + \rho_1(\tau_{edu}) \cdot K_t, t = 65$$

- Not a completely unrealistic assumption: market for annuities is extremely thin

Income tax function



$$\text{tax} = \begin{cases} 0, & \text{if income} < \text{thld}_1 = \underset{(0.10016)}{17.39184}, \\ \underset{(0.00096)}{0.29907} \cdot (\text{income} - \text{thld}_1), & \text{if } \text{thld}_1 \leq \text{income} < \text{thld}_2, \\ \underset{(0.00556)}{0.37930} \cdot (\text{income} - \text{thld}_2) + \underset{(0.00096)}{0.29907} \cdot \text{thld}_1, & \text{if income} \geq \text{thld}_2 = \underset{(0.59292)}{73.17661}, \end{cases}$$

Intertemporal budget constraint (updated)

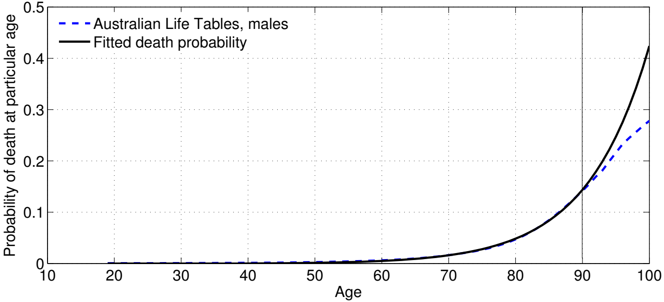
$$M_{t+1} = (M_t - c_t)(1+r) + h_t \cdot wage_{t+1} + \text{transfers}_{t+1}$$

$$\downarrow$$

$$\begin{aligned} M_{t+1} = (M_t - c_t)(1+r) &+ h_t \cdot wage_{t+1} - \text{Tax}_t \\ &+ tr_{t+1} \cdot \mathbb{1}\{t+1 \leq 22\} \\ &+ pens_{t+1} \cdot \mathbb{1}\{t+1 \geq 65\} \\ &+ super_{t+1} \cdot \mathbb{1}\{t+1 = 65\} \end{aligned}$$

$tr_{t+1} \cdot \mathbb{1}\{t+1 \leq 22\}$ transfers from parents to youth

Survival process



$$\delta_t = \begin{cases} 1 & \text{if } age_t < 40 \\ 1 - \underset{(0.0000249)}{0.0006569}\left[\exp\left(\underset{(0.0008145)}{0.1078507}(age_t - 40)\right) - 1\right] & \text{if } age_t \geq 40 \end{cases}$$

Education levels

Original HILDA classification	N obs	%	Coarsened 3 level classification	N obs	%
Postgrad - masters or doctorate	557	5.50	College	2,391	23.60
Grad diploma, grad certificate	503	4.96			
Bachelor or honours	1,331	13.14			
Advanced diploma, diploma	922	9.10	High school	5,254	51.85
Certificate III or IV	3,178	31.36			
Certificate I or II	0	0.0			
Certificate not defined	0	0.0			
Year 12	1,154	11.39			
Year 11 and below	2,488	24.55	Dropouts	2,488	24.55
Undetermined	0	0.0			
Total	10,133	100.00		10,133	100.00

Choice of hours levels

K-medians cluster analysis

h_t	Nobs	med(annual)	med(weekly)	min	max
0	18,168	0	0	0	500.00
1	4,484	1200	24	500.03	1600.00
2	15,930	2000	40	1600.02	2124.90
3	5,466	2250	45	2133.36	2368.03
4	8,735	2500	50	2375.10	2750.00
5	6,259	3000	60	2750.10	4200.00

Choice of discrete levels of hours

K-medians cluster analysis — Correspondence to HILDA

h_t	Nobs	annual	week	Empl FT	Empl PT	Unemp	OLF
0	26,411	0	0	353	1,877	2,216	21,960
1	6,711	1200	24	1,303	5,408	0	0
2	23,387	2000	40	23,212	175	0	0
3	7,622	2250	45	7,622	0	0	0
4	12,115	2500	50	12,115	0	0	0
5	8,368	3000	60	8,368	0	0	0

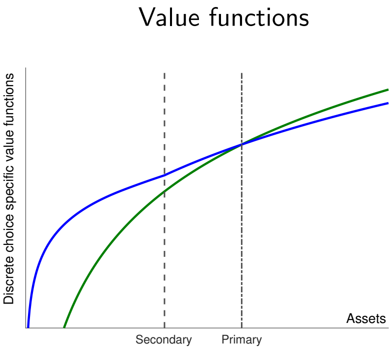
Model solution: DC-EGM

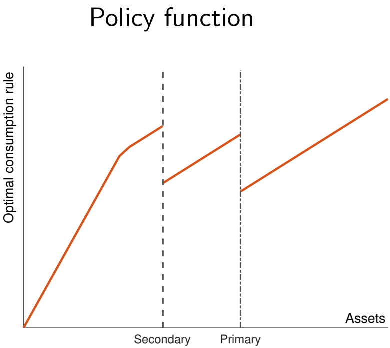
- Iskhakov, Jørgensen, Rust, Schjerning (2017) *QE*
  The Endogenous Grid Method For Discrete-Continuous Dynamic Choice Models With (Or Without) Taste Shocks
- Carroll (2006) *Economics Letters*
  The method of endogenous gridpoints for solving dynamic stochastic optimization problems.

Main idea of the endogenous grids

- Instead of searching for optimal decision in each point of the state space (traditional approaches)
- Look for the state variable (level of assets) where arbitrary chosen decision (consumption $\rightarrow$ savings) would be optimal (EGM)

Kinks and discontinuities with discrete-continuous choice





Primary kinks

1. The d-specific value functions intersect
(due to trade-off between income and disutility of work)
$\Downarrow$
2. The upper envelope of the value functions has a kink
(this is what we call a primary kink)
$\Downarrow$
3. Discrete choice policy is to work on the left of the kink, and to retire on the right of the kink
$\Downarrow$
4. Working and retiring have different corresponding optimal consumption policies
$\Downarrow$
5. Combined consumption policy has a discontinuity

Secondary kinks

1. Value function in $t+1$ has a primary kink
(because d-specific value functions intersect in $t+1$)
$\Downarrow$
2. In the non-concave region around a primary kink in $t+1$
the maximand in the Bellman equation has multiple local optima
$\Downarrow$
3. The Euler equation for the corresponding values of wealth has multiple solutions, all solutions are found in EGM
$\Downarrow$
4. "Suboptimal" endogenous points have to be dropped: find the point where global maximum shifts from one solution to the other
$\Downarrow$
5. Optimal consumption rule in period t has a discontinuity, the value function has a corresponding secondary kink

Adding extreme value shocks

Properties of the full solution

1. Value functions are non-concave and have kinks
2. Consumption functions have discontinuities
3. Discontinuities/kinks propagate through time and accumulate

Extreme value distributed taste shocks

- Smooth out primary kinks
- Extreme value distribution $\rightarrow$ closed form expectations for choice probabilities and expectation of the max (logsum)
- Two interchangeable interpretations
  - Structural: unobserved state variables
  - Logit smoothing: to streamline the solution
- Prevent propagation of kinks and discontinuities
- No complete smoothing in general: secondary kinks may persist

Estimation: Method of Simulated Moments

McFadden (1989) *Econometrica*
A method of simulated moments for estimation of discrete response models without numerical integration

- Method of simulated moment estimator
- Diagonal weighting matrix
- Logit smoothed simulator for better numerical performance
- Non-convex values functions create problems for derivative based methods
- POUNDerS derivative free trust region minimization algorithm

HILDA data

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- Family dynamics, income and labor supply (each year)
- Data on wealth, health and health insurance, retirement, fertility, literacy and numeracy (particular years, reoccurring)
- Approximately 20,000 people in total

Structural estimation sample:

- Single and married men between age 19 and 85
  - 8,836 individuals, unbalanced panel of 56,090 observations
  - Individuals born 1916 - 1993

Choice of moments to match

	High school		Dropouts		College	
Moments	Ages	N	Ages	N	Ages	N
working	19 - 85	67	19 - 85	67	23 - 85	63
hours|working	19 - 75	57	19 - 78	60	23 - 71	49
wage|working	19 - 73	55	19 - 69	51	23 - 69	47
var of wage	19 - 73	55	19 - 69	51	23 - 69	47
hours20	19 - 85	67	19 - 85	67	23 - 85	63
hours40	19 - 85	67	19 - 85	67	23 - 85	63
hours45	19 - 85	67	19 - 85	67	23 - 85	63
hours50	19 - 85	67	19 - 85	67	23 - 85	63
wealth	19 - 85	55	19 - 85	55	23 - 85	49
work2work	19 - 74	56	19 - 77	59	23 - 70	48
nowork2nowork	19 - 85	67	19 - 85	67	25 - 85	61
super lumpsum	65	1	65	1	65	1
Total		681		679		617

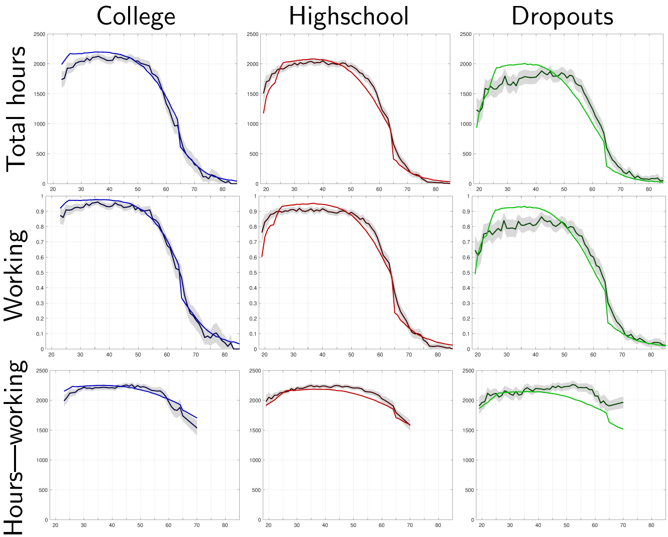
Estimates of the preference parameters

Parameter	Description	Estimate	Std.Err.
ζ	CRRA coefficient in consumption	0.80989	0.06206
γ_1	Disutility of working 1000 hours (20 per week)	0.92654	0.24025
γ_2	Disutility of working 2000 hours (40 per week)	0.82177	0.16702
γ_3	Disutility of working 2250 hours (45 per week)	1.64690	0.39486
γ_4	Disutility of working 2500 hours (50 per week)	1.51608	0.35264
γ_5	Disutility of working 3000 hours (60 per week)	2.16258	0.57946
$\kappa_1(\tau = \text{low})$	Correction coefficient with disutility of work	0.61153	0.58616
κ_2	Quadratic coefficient on age for older workers	0.00142	0.00062
κ_3	Linear coefficient on age for young workers	0.04804	0.03242
ξ	CRRA coefficient in utility of bequest	0.46775	0.48061
b_{scale}	Scale multiplicator of the utility of bequest	0.67227	2.02012
$\beta(\tau = \text{hs})$	Discount factor, highschool	0.96944	0.00297
$\beta(\tau = \text{dr})$	Discount factor, dropouts	0.96970	0.00403
$\beta(\tau = \text{cl})$	Discount factor, college	0.96963	0.00367
λ	Scale of EV taste shocks	0.83949	0.39929

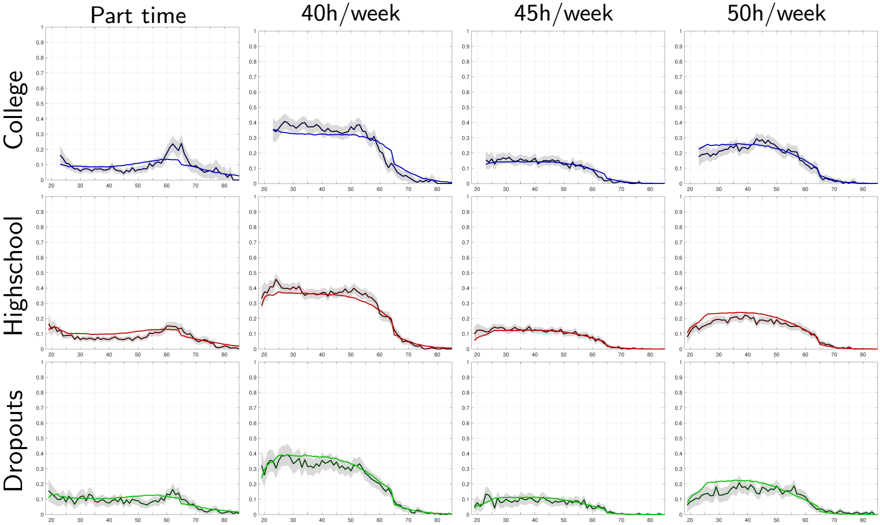
Human capital accumulation process

Parameter	Description	Estimate	Std.Err.
$\eta_0(\tau = \text{cl})$	Constant for college	2.93936	1.37286
$\eta_0(\tau = \text{hs})$	Constant for high school	2.61254	1.56208
$\eta_0(\tau = \text{dr})$	Constant for dropouts	2.38097	1.38154
$\eta_0(\tau = \text{high})$	Constant for high type	0.13360	1.60836
η_1	Age (time index)	0.02753	0.01937
η_2	Age (time index) square	-0.00076	0.00044
$\eta_3(\tau = \text{cl})$	Work experience for college	0.03125	0.02754
$\eta_3(\tau = \text{hs})$	Work experience for high school	0.02200	0.02893
$\eta_3(\tau = \text{dr})$	Work experience for dropout	0.01991	0.03011
$\eta_4(\tau = \text{cl})$	Work experience square for college	-0.00017	0.00130
$\eta_4(\tau = \text{hs})$	Work experience square for high school	-0.00002	0.00120
$\eta_4(\tau = \text{dr})$	Work experience square for dropout	-0.00000	0.00118

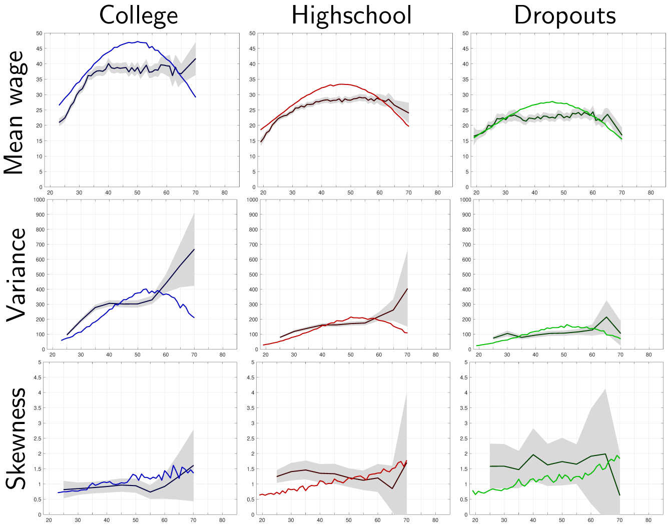
Goodness of fit: total hours and participation



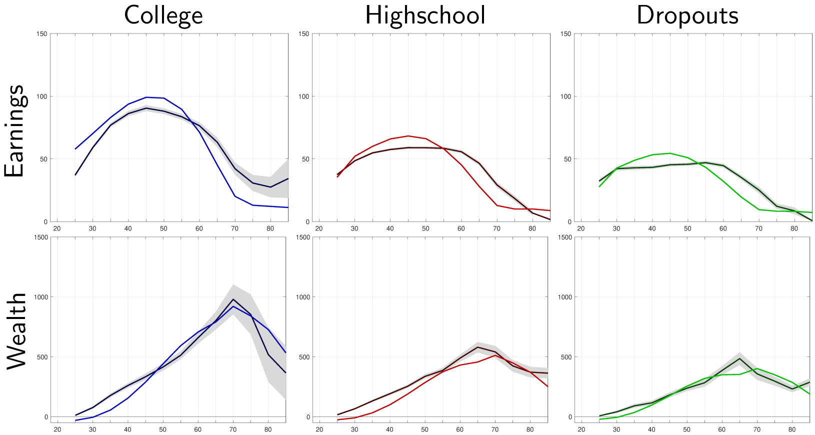
Goodness of fit: discrete level of hours



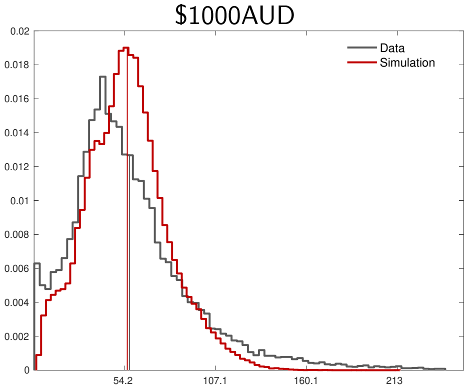
Goodness of fit: lifecycle wage distribution

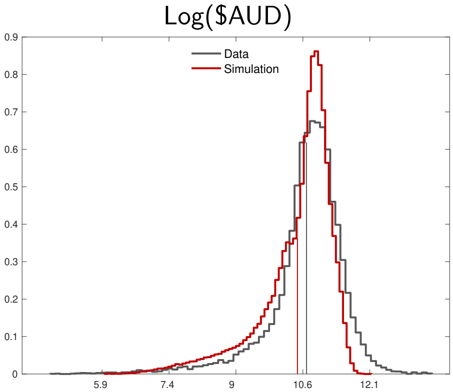


Goodness of fit: earnings and wealth



Goodness of fit: overall income distribution

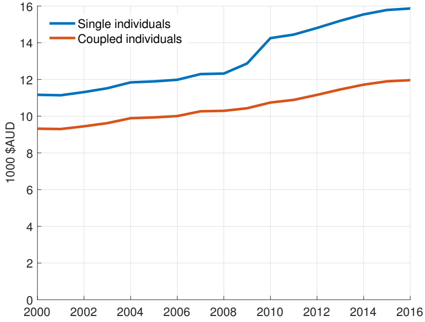


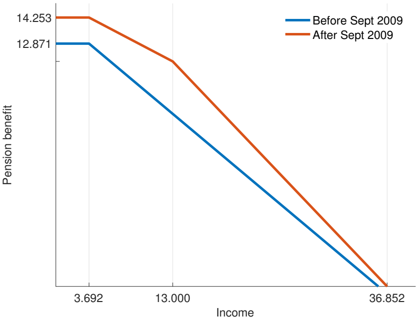


Validation of structural models

- Gold standard: randomized experiment
  1. Estimate the model using control (treated) group
  2. Match the effect of the treatment by simulation
- Second best: observed policy change
  1. Estimate the model using data from before policy change
  2. Match the effect of the policy by simulation
- May be hard to do due data availability

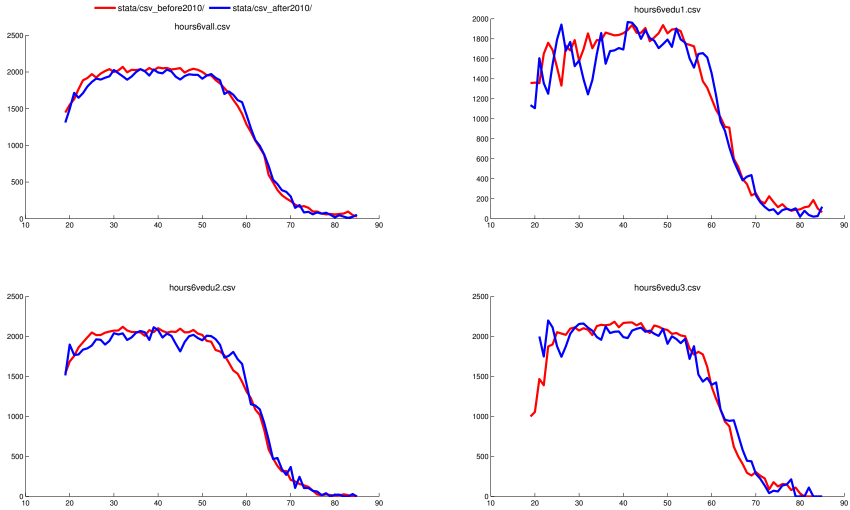
Validation using 2009 reform



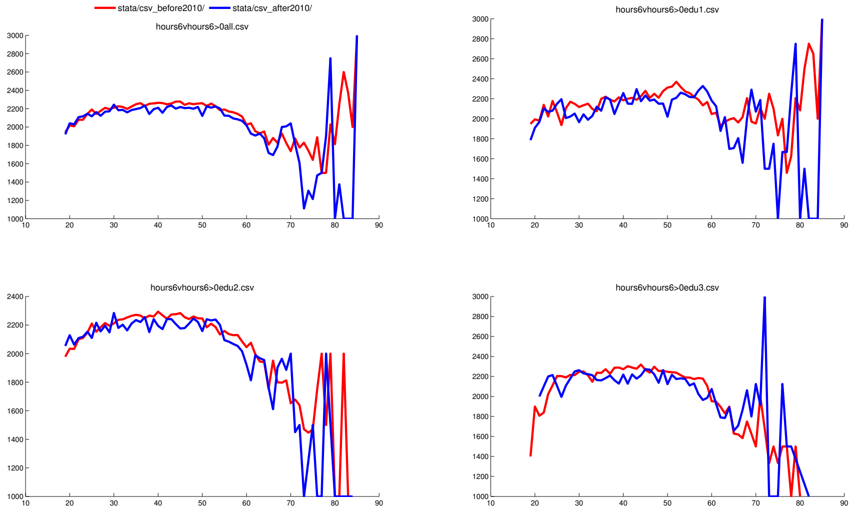


1. Increase in maximum pension benefit for singles
2. Changes in taper rate (second threshold)
3. Gradual increase in the eligibility age

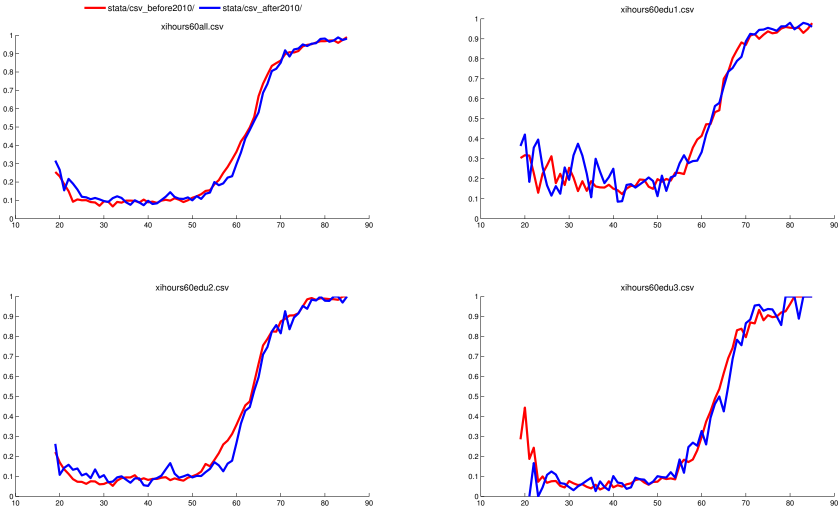
Data before and after 2009 reform: hours



Data before and after 2009 reform: hours | working



Data before and after 2009 reform: working



Policy simulations

Baseline: No policy change

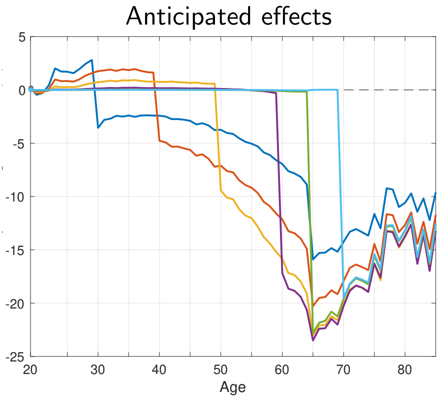
Anticipated: Fully anticipated policy change

Unanticipated: Exogenous shift from regime 1 to regime 2

- 1000 individuals in each education/type
- Identical sequence of (pseudo) random variables in all simulations
- Varying revelation age

Permanent 10% wage decrease $\rightsquigarrow$ % change in hours

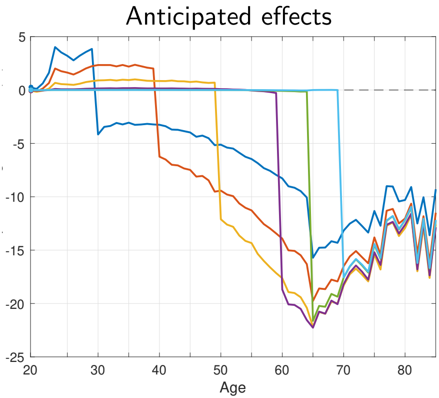
High school graduates



No compensation $\longrightarrow$ Marshall effects

Permanent 10% wage decrease $\rightsquigarrow$ % change in hours

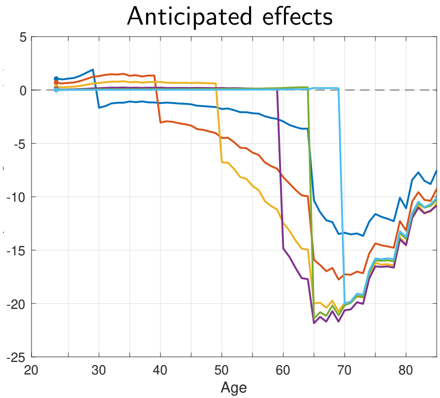
High school dropouts

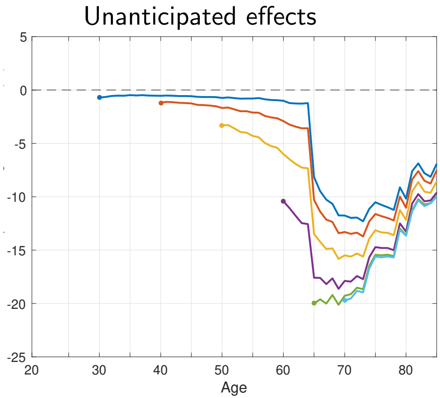


No compensation $\longrightarrow$ Marshall effects

Permanent 10% wage decrease ⇝ % change in hours

College graduates





No compensation ⟶ Marshall effects

Permanent 10% wage decrease $\rightsquigarrow$ hours

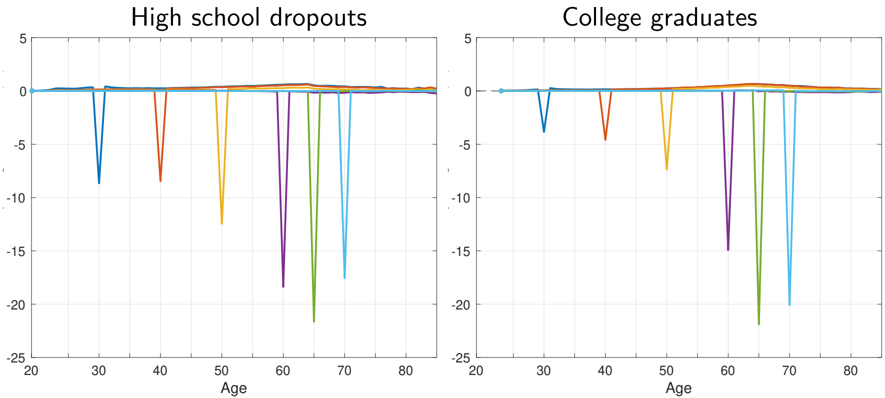
- Larger decline in hours if policy is anticipated: labor supply is shifted towards the beginning of life cycle where wage is not yet decreased

- Effect is very different at different points of the life cycle
- Much larger hours decline if wage decrease occurs at older ages

- Elasticities smaller for college grads than HS grads at younger ages
- But catch up at older ages

- Key Point: Effect of HC on labor supply elasticities not changed by hours bunching

Transitory 10% wage decrease $\rightsquigarrow$ % change in hours



Anticipated effects $\longrightarrow$ Frisch elasticities

Frisch elasticities

- Frisch elasticities increase with age
- The increase is greater for the more educated
- Consistent with earlier papers on US data:

Imai and Keane 2004 *International Economic Review*
Intertemporal labor supply and human capital accumulation.

Keane and Wasi 2016 *The Economic Journal*
Labour supply: the roles of human capital and the extensive margin.

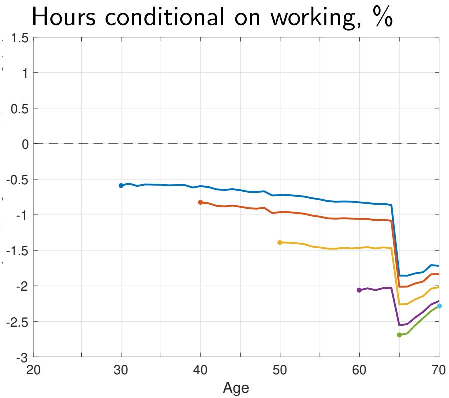
Intensive vs. extensive margin in labor supply elasticities

- Permanent 10% wage decrease $\rightsquigarrow$ probability of working
- Permanent 10% wage decrease $\rightsquigarrow$ hours conditional on working
- Relative changes (%)
- Unanticipated wage decrease

- Evidence of significantly higher elasticity on the extensive margin

Intensive vs. extensive margin

High school graduates



Note the difference in scales: extensive margin clearly dominates.

Effects of changes in age pension rules

Policy parameters in age pension:

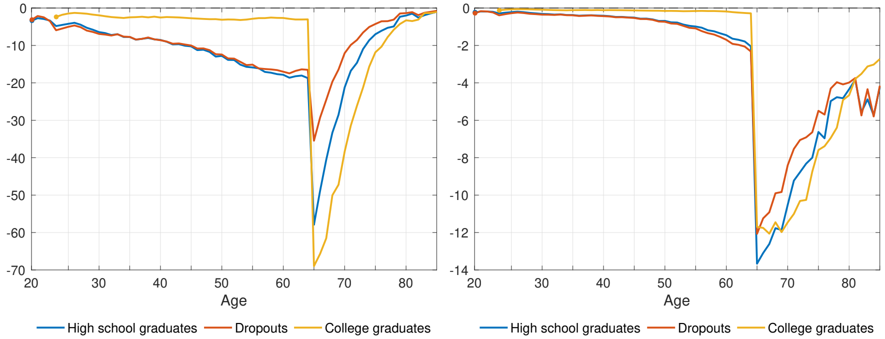
- Maximum pension benefit (+25%)
- Taper rate in income test (-10%)
- Taper rate in asset test (-10%)

Effects on:

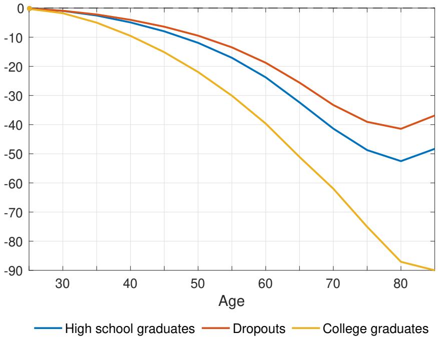
1. $\rightsquigarrow$ hours of labor supply (hours per annum)
2. $\rightsquigarrow$ wealth (\$1000)
3. $\rightsquigarrow$ consumption (\$1000)

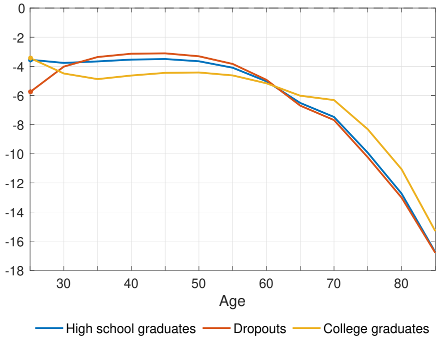
- Only high school graduates

Maximum age pension +25% $\rightsquigarrow$ hours (annual and %)

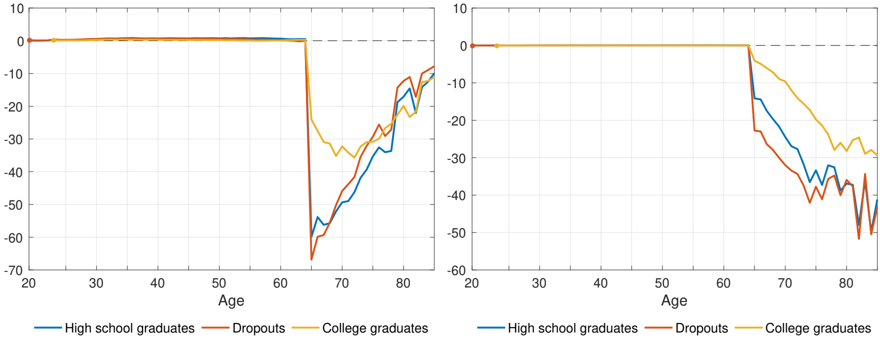


Doubling asset taper rate ⇝ wealth (annual and %)





Doubling income taper rate ⇝ hours (annual and %)



Effects of the age pension

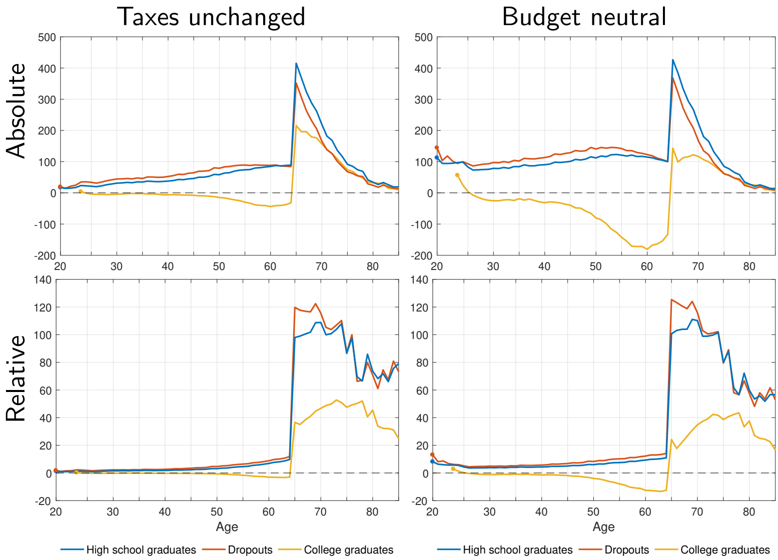
Simulate the world without Age Pension

1. Cost of program is 1/3 of income tax revenue
2. Elimination allows 33% tax cut (if no behavioral response)

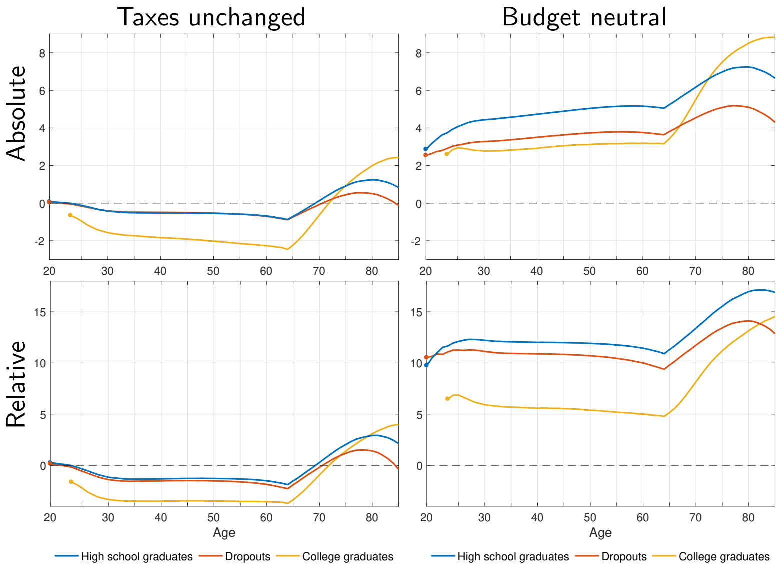
Unchanged taxes vs. Revenue neutral

- Elimination of Age Pension generates 5.8% increase in labor supply
- This allows a 37% cut in income tax rates in budget neutral simulation

Elimination of Age Pension ⇝ hours



Elimination of Age Pension ⇝ consumption, $1000 AUD



Effects of the age pension

The world without the age pension (revenue neutral):

- Labor supply increases for dropouts and HS graduates at all ages
- Labor supply decreases for college graduates pre 65 (income effects), but increases greatly at 65+
- Tax rates fall by 37% in budget neutral simulation
- About 90% of workers prefer to live in a world with no age pension and lower taxes
- Only 10% of low skill type individuals experience decrease in welfare
- This result reflects the poor targeting of the Age Pension program and large labor supply distortion it creates

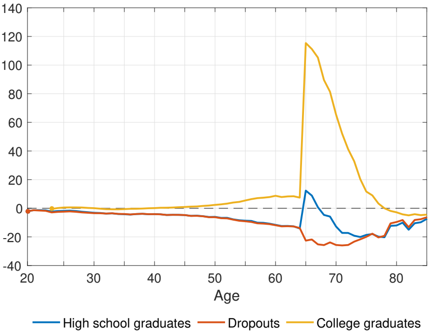
Better targeting the Age Pension

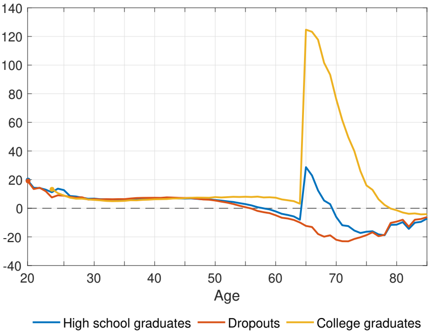
- Double income and asset taper rates:
    - Double effective income taper rate from 27.7% to 55.5%
    - Double effective asset taper rate from 1/2 cent on the dollar to one cent on the dollar
- In budget neutral simulation we can cut income tax rates by 5.9%
    - Top rate reduced from 37.9% to 35.7%
    - Middle rate reduced from 29.9% to 28.1%

Better Targeting the Age Pension

Doubling of income/asset tapers ⇝ Effects on Hours of Work

Taxes unchanged   Budget neutral



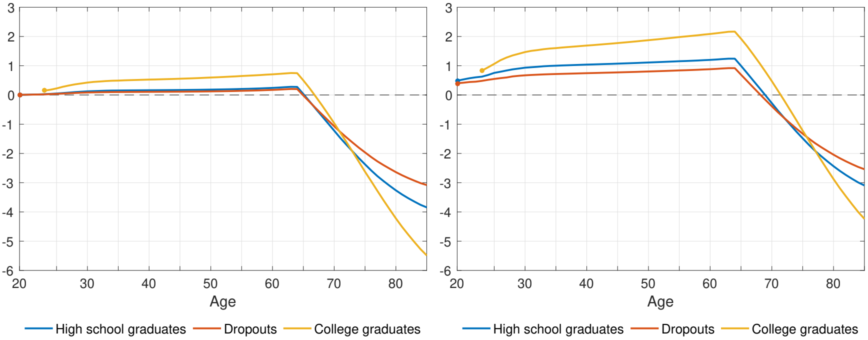


Note: Change in annual hours

Better Targeting the Age Pension

Doubling of income/asset tapers $\rightsquigarrow$ Effects on Consumption

Taxes unchanged Budget neutral

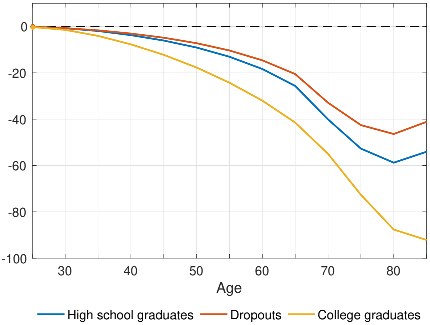


Note: Change in $1000 AUD

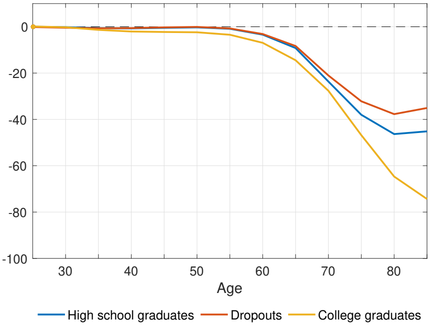
Better Targeting the Age Pension

Doubling of income/asset tapers $\rightsquigarrow$ **Effects on Assets**

Taxes unchanged



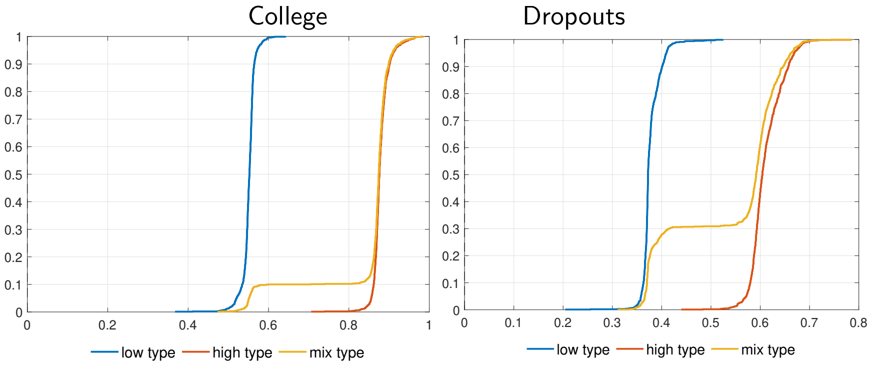
Budget neutral



(Note: Change in $1000 AUD)

Better Targeting the Age Pension

Doubling Tapers + Tax Cut ⇝ Effects on ex-ante utility



Note: Change in expected utility at the beginning of life

Better Targeting the Age Pension

Double Taper Rates + Tax cut $\rightsquigarrow$ Results:

- At age 65+ labor supply of college grads increases by 20% while that of dropouts falls by 8%
- College grads rely on age pension less while dropouts rely on it more - better targeting
- In budget neutral simulation we cut income tax rates by 5.9%
    - This causes small increase in labor supply prior to age 65
- All types better off - CEVs are \$1.4k, \$1.5k, \$1.7k for dropouts, HS, college types, respectively

Results and conclusions

Labor supply

- Large variation of labor supply elasticities by age and education:
  - Labor supply elasticities increase with Age
  - Elasticities are smaller for higher education groups

Age Pension

- The program has large negative labor supply effects
- The program is expensive (Largest welfare item in budget)
- It is poorly targeted $\Rightarrow$ Very low effective taper rates
- Doubling of Taper Rates combined with 5.9% tax cut would be Pareto improvement