MANDATORY PENSION SAVING AND HOMEOWNERSHIP

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Introduction

The housing affordability crisis renders it increasingly difficult for individuals to acquire real estate.

Many pension systems struggle with sustaining reasonable levels of benefits for their retirees.

Many countries such as Denmark, Sweden, and the Netherlands enroll their citizens in mandatory retirement savings scheme that requires individuals to contribute a constant share of their labor income to a tax-deferred retirement account.

Why is it taken for granted that an individual's best retirement savings pattern is a constant share of labor income? Are there any alternatives?

Our Work

Goal:
Study the impact of constant minimum contribution requirements to tax-deferred retirement accounts on housing decisions and explore three alternative ways of saving for retirement.

Methodology:
Focus on defined-contribution pension systems in which individuals have access to a tax-deferred retirement account, i.e., we assume an EET tax regime.

Set up a quantitative life cycle model of optimal consumption, savings, and housing decisions.

In our model, individuals
- can save in a taxable account, a tax-deferred retirement account, or via home equity,
- can use their home as collateral,
- receive stochastic labor income during working life and must fund their retirement benefits by drawing down their savings,
- aim at maximizing their expected lifetime utility.

Contact Information and Weblinks

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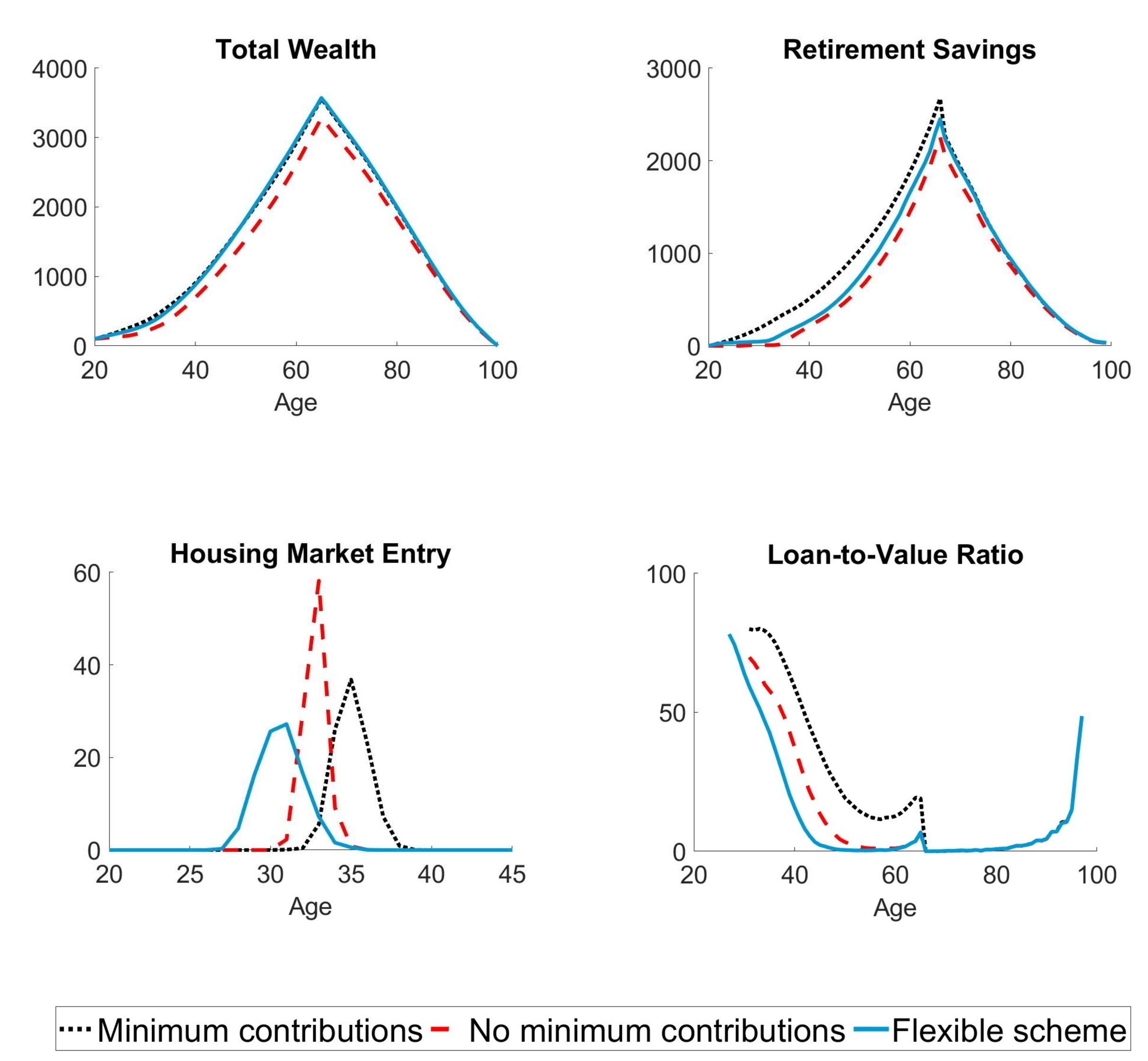
The paper can be found on SSRN: https://ssrn.com/abstract=4210537.

Results

The four panels below compare
- the evolution of total wealth,
- the evolution of tax-deferred retirement savings,
- the probability of housing market entry in %, and
- the evolution of loan-to-value ratios in %.

The three lines represent individuals
- facing constant minimum contributions requirements (black line),
- facing no minimum contribution requirements (red line)
- trading under the flexible retirement savings scheme (blue line).



Interpretation

Constant minimum contribution requirements lead to a higher accumulation of total savings as they cause a higher accumulation of retirement savings.

Constant minimum contribution requirements have unintended side effects:
- They postpone housing market entry.
- They lead to higher loan-to-value ratios, i.e., individuals subject to constant minimum contribution requirements must borrow more for a comparable home than individuals not facing these contribution requirements.
- The constrained individuals must invest at a relatively low interest rate in their tax-deferred retirement accounts and simultaneously borrow at a relatively high interest rate, thereby incurring the cost of the interest margin by borrowing their own money.

Our flexible retirement savings scheme
- ensures a similar build-up of savings as constant minimum contribution requirements, but additionally
- allows individuals to become homeowners earlier, and
- to repay their mortgage faster (before they start saving in the tax-deferred retirement account).

Flexible Retirement Savings Scheme

Goal:
Develop a retirement saving scheme that ensures a sufficient build-up of savings and alleviates the unintended side effects of constant minimum contribution requirements on housing decisions.

Approach:
Individuals are only required to save if they do not meet an age-dependent total savings target.

When forced to save, individuals still have freedom in their asset location decisions.

We advocate a savings rule dependent on labor-to-wealth ratios to ensure consumption smoothing over the life cycle.

Alternative Retirement Savings Strategies

The flexible retirement savings scheme might be challenging to implement for countries without detailed information about their citizens' wealth.

Thus, we also study alternatives to the flexible retirement savings scheme:
- Allowing for withdrawals from the tax-deferred retirement account before attaining retirement age if the withdrawn money is used for the acquisition of an owner-occupied home
- Minimum contribution requirements to the tax-deferred retirement account that are increasing with age

The results (not printed on this poster) are very similar to those of the flexible retirement savings scheme, indicating that these two alternative retirement savings strategies also do a good job of ensuring a sufficient build-up of savings while simultaneously alleviating the unintended side effects of constant minimum contribution requirements on housing choices.

Conclusion

Constant minimum contributions to tax-deferred retirement accounts delay housing market entry and increase loan-to-value ratios.

Our flexible retirement savings scheme gives individuals freedom in their asset location decisions, ensures a sufficient build-up of savings, and alleviates the unintended side effects of constant minimum contribution requirements on housing decisions.

Allowing for withdrawals from the tax-deferred retirement account for the acquisition of a home and imposing minimum contribution requirements to tax-deferred retirement accounts that increase with age are also reform ideas to be considered by policymakers.