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Executive Summary

**Are parents in Israel saving too much  
for retirement?**

**Merav Kaplan**



## About the Milken Innovation Center Fellows Program

The Milken Innovation Center Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental challenges. Our goal is to accelerate Israel's transition from a Start-up Nation to a Global Nation with solutions that others can replicate.

The Program awards annual fellowships to outstanding Israeli graduate students. We train and deploy some of Israel's best and brightest young professionals to create pragmatic financing and economic policy solutions. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own projects during their internship aimed at barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support business and policy makers to shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

Throughout the year, Fellows receive intensive training in economic and financial analysis, public policy and research methods. They acquire tools for communication and presentation, policy analysis, leadership and project management. The fellows participate in a weekly research training workshop where they work with senior economic and government professionals, business leaders, and top academic and financial practitioners from Israel and abroad. They also participate in an accredited MBA course, taught at the Hebrew University School of Business Administration by Prof. Glenn Yago.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve in key positions in government ministries while others work at private-sector companies or go on to advanced graduates studies at leading universities in Israel, the United States and Great Britain.

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## Introduction

In recent decades, the levels of private savings as a share of disposable income in Israeli households have been particularly high. In 2019, the net household saving rates amounted to 21.4%, placing Israel second among developed countries with respect to saving rates per household (OECD, BoI). An assessment of the distribution of the assets from the total asset portfolio held by the public reveals an increase in the share of long-term assets from 22% in 2008 to 33.7% in 2019 (BoI, 2020). This is the result of, among other things, an increase in the volume of assets held by pension funds. Between 2014 and 2018 the average annual increase in the rate of the total assets managed by the new pension funds was 14.6%. In 2018 these assets amounted to a total of 329 billion NIS (MoF, 2019).

The increase in the share of long-term savings among Israeli households may be partially explained by a series of measures taken by the state in recent years to expand the scope of pension coverage and increase the rate of pension savings. Two significant steps were the 2008 decision to anchor in extension order the obligation to provide a pension for employees in Israel, and the expansion of this obligation in legislation regarding the self-employed in 2017. Pension savings serve as a tool to facilitate smooth consumption over time, and also function as an insurance mechanism to mitigate the risk of outliving resources. According to economic theory, rational individuals optimize consumption over lifetime income, to minimize fluctuations in their standard of living following changes in income. However, research indicates the existence of many biases, especially short-sightedness, so that in the absence of intervention, individuals may not save enough when their income is high to allow for decent living conditions after retirement. These findings have led to varying degrees of government involvement in pensions in developed countries. Since government involvement in determining pension arrangements limits the range of available options to adapt saving and consumption patterns to an individual's circumstances and lifelong personal preferences, it is important to assess the extent to which, on average, existing pension arrangements meet policy objectives. Therefore, one should note that just as insufficient levels of saving may be problematic, the diverting of consumption from the years before retirement to a later period, which may lead to over-saving, is also undesirable.

The main tool for assessing whether a pension system enables individuals to maintain adequate standards of living is the Retirement Replacement Rate (hereinafter: RR), which is defined as the ratio between the level of post-retirement benefit and pre-retirement salary. While a 100% RR fully preserves pre-retirement income, a lower rate is generally perceived as appropriate, due to changing consumption patterns post-retirement. In recent years, various attempts have been made

to estimate the RR in Israel. A comparative analysis conducted by the OECD shows that the RR for men earning an average wage in Israel is similar to the OECD average, while the RR for women is lower than the OECD average. It was also found that taking into account all savings components, the RR for those earning half the average wage in Israel is higher than the average RR among developed countries, amounting roughly to 100% (OECD, 2019).

In light of the above findings, some have argued that the level of mandatory pension contributions in Israel is too high, especially among lower earners and young individuals (for example: Brender 2010; Lifshitz, 2020). To assess the validity of this claim, Israel's unique demographic characteristics must be considered. Israel is typified by particularly high birth rates relative to Western countries. While the average fertility rate in OECD countries is 1.6 children per woman, in Israel it is 3.1. This is expected to affect consumption patterns, including the lifetime distribution of consumption among Israeli households. Indeed, an overview of lifetime household consumption indicates that the period of raising children is characterized by excessive spending on food, housing, and education (Strawczynski and Brender, 2014). Naturally, these temporary expenses needn't be compensated for (or “replaced”) after retirement.

### **Objectives, methodology, and findings**

This paper seeks to comparatively assess the adequacy of the existing pension arrangements in Israel in terms of ensuring smooth or stable consumption over time, while taking into account consumption patterns during childrearing years. The analysis is based on the OECD model for calculating the retirement RR, adjusted for household size, so that the adjusted RR represents the ratio between the income per household after retirement, and the standardized income per household before retirement, which is adjusted based on an equivalence scale of the fertility rate in each country.

The analysis reveals that when the RR is adjusted according to household size, Israel's situation improves relative to that of other developed countries. The adjustment led to an increase of between 47% and 50% in the RR in Israel for all income levels, compared with an increase of about 36% on average in OECD countries. Assuming no withdrawal of severance pay, the net RR in Israel is higher than 100% for households with an income of half the average wage, as well as for households earning an average wage. The RR obtained for households with the highest income, at one and a half times the average wage, is less than 100%, but is nevertheless still high.

These findings indicate that for many households in Israel (approximately 70%, CBS 2018), the individual income level after retirement is higher than that before retirement, when the latter is

adjusted for household size. Under the current arrangement, during the childrearing period, parents are required to divert some income (and potential consumption) so that they may improve their standard of living after retirement. This is undesirable for several reasons, apart from imposing a liquidity constraint on consumption smoothing at the household level, for it is during the childrearing years that parents should be investing in the welfare and human capital of their children and the diversion of resources for the sake of future consumption may impair their ability to do so optimally.

### **Policy recommendations**

To address problems in the existing policy, three alternatives were examined: the first is to revise the structure of mandatory pension contributions so that they increase as a person ages; the second is to provide the option of withdrawing from a pension fund without penalty, based on criteria such as household size and income; and the third alternative is to horizontally reduce the payment rates for the mandatory pension. Based on the evaluation of the proposed alternatives, the policy recommendation is to adopt the second suggestion. This option is more politically feasible, as it preserves the default, thus encouraging individuals to save to the extent prescribed by law. And finally, it enables flexibility, so that individuals can optimize their saving levels in accordance with their unique circumstances without distortion of employment incentives.



The Jerusalem Institute for Policy Research  
Milken Innovation Center  
20 Radak St. Jerusalem 9218604  
Office: 02-5630175 (Ext. 34)  
[www.milkeninnovationcenter.org](http://www.milkeninnovationcenter.org)