Who is Subsidized? Allotment of Earmarked Bonds in Pension Funds

Eitan Sheshinski, **Ido Kallir**

The Israeli pension system operates on two levels: first, the **old age pension** that is intended to enable a minimal standard of living; the second, the **employment pension**, is designed to provide savers with a standard of living that is similar to what they had prior to retirement. The primary recent reform to the pension system was the application of an adjusted financial savings model (similar to the "Chilean Model") in 2016. The model divides pension fund investments in the capital market by age, into three periods:

A. From the time a citizen enters the workforce until the age of 50: 20 to 30 years.

B. From the ages of 50 to 60: 10 years.

C. Over the age of 60: A period of between two years for women and seven years for men.

The earmarked bonds are those issued by the State to pension funds exclusively, and they guarantee an annual interest of 4.86%, plus linkage to the Consumer Price Index (CPI). Until now, savings in pension funds were eligible for earmarked bonds, and they represented 30% of savings portfolios. Meanwhile, the State guarantees 30% of the money found in pension savings, while the rest of the portfolio is invested in the capital market. With the aim of providing grater protects for elderly savers, the Ministry of Finance's Capital Market Authority announced in 2016 that a change in the way designated bonds were distributed would be implemented. According to the plan, savers over the age of 60 would be eligible to receive 60% of these bonds, while the balance would be dispersed to other savers, with this remainder to decrease over time[1]. While the new scheme refers to age, it does not address differences in salary levels.

However, many studies are showing an increase in income inequality as well as a growth in income gaps, which have a differential effect on life expectancy. An increase in life expectancy for individuals with high income levels leads to additional profits, via earmarked bonds, which are now being used not only as a fixed-rate anchor but also as a substantial subsidy for longer periods of time, through the National Insurance Allowance.

Besides institutionalizing inequality, the growing gap between various income groups may undermine the pension system's ability to function, as well as weaken its financial position and solvency, since it is obliged to finance high annuities over a protracted period of time.

We estimate that if the plan is implemented in its current formulation, it could seriously harm the pension benefits of Israel's low wage earners. We therefore propose two alternatives, taking into consideration level of income, which, although based on the existing model and meeting the allocation limits of designated bonds, have a better performance.