Summary of "Road Map to More Integrated Policies in Housing, Healthcare, and Retirement"

Bart, F., B. Boon, A.L. Bovenberg, C. van Ewijk, N. Kortleve, E. Rebers, and M. Visser (2016), "De routekaart naar een meer integrale benadering van wonen, zorg en pensioen", Netspar Occasional Paper, January 2016.

1. Introduction

The topic of the interrelationships between housing, healthcare, and retirement is a top priority for the Dutch Social and Economic Council (SER) and various government ministries. It is also part of the broader social dialogue concerning the Dutch pension system. As such, various studies have been performed at the macro level in recent years into this interrelationship. Given the pressing nature of the theme, Netspar has also made it a top priority in its research agenda. With its "Road Map to More Integrated Policies in Housing, Healthcare, and Retirement," Netspar hopes to advance the discussion by looking directly at the financial planning of individual households. Achieving a good balance in housing, healthcare, and retirement resources can lead to an economic boost of 3% to 5.5%. But any combination of pension policies with housing and healthcare modalities will, of course, involve trade-offs: and these must be accorded a central role in the social debate.

In this report, we have developed a comprehensive framework for economic analysis from the perspective of individual households. A central premise of this is life course financial planning. What are the bottlenecks that households face, and what kinds of general trade-offs exist within the various solution alternatives for linking these domains together? While the report touches briefly on the behavioral economics aspects of comprehensive financial planning, fiduciary duty, and good choice architecture, these all certainly deserve more attention than can be given here. The report presents a number of possible solution directions based on the current legislation (including tax law) and framework for analysis, but presents no grand design. Given the restrictions of the existing framework, it should be noted that, in some cases, the solutions proposed for the bottlenecks identified must be qualified as second-best or even no more than a "Band-Aid solution." We conclude by presenting a road map toward a more comprehensive approach to housing, healthcare, and retirement policy and a research agenda for possibilities that would enable other possible, or more lasting, solutions in the long term.

2. Framework for Analysis

This chapter presents the framework for analysis. A financial planning model was used to look at the kinds of decisions individuals need to make during their lifetime and the trade-offs they make in doing so.

For many people in the Netherlands, financial planning occurs as part of mandatory participation in standard schemes. Such schemes are not designed to take the heterogeneity in the needs and preferences of individuals much into account. In many of them, for instance, the retirement goals for all participants are tied solely to income. Yet there are other possible variables that can significantly impact personal financial planning. These include household composition, number of children, home ownership (mortgage versus rent), and ownership of other financial assets. Other events in life that people may have less control over, such as illness or disability, also play a significant role. These factors influence people's decisions regarding consumption now and later, taking out insurance for unforeseen circumstances, and the need for flexibility and liquidity across all stages of life.

Optimal Life Course Planning as a Framework for Analysis

Financial planning tends to address these three fundamental needs people have by three means:

1. Saving, dissaving and borrowing
2. Insurance
3. Investing

Saving, dissaving, and borrowing distribute consumption over time. Insurance helps people guard against particular idiosyncratic risks. Investing allows people to select an ideal profile for systematic and particular risks.

Many existing institutions often combine various functions of financial planning. So, while people save for retirement in a pension plan during their working years, for example, that is generally also a form of insurance against employment disability and for their survivors in the event of their early demise. Moreover, pension providers are busy investing assets in order to distribute the systematic risks and profit from risk premiums. After retirement, the mandatory annuity payout represents not only a staged decumulation, but also a form of longevity insurance. Another example pertains to cases where people own their home free and clear, which protects them from rent increases and longevity risks because their living expenses are lower. They do not have to worry anymore about whether they have saved enough to keep paying rent well into the future. But these people could also consider that equity as precautionary savings for paying for extra care or a place in a private nursing facility. By cashing in on their home's value they could also supplement their pension. Figure 1 shows a summary of needs, functions, and financial instruments related to life course planning.

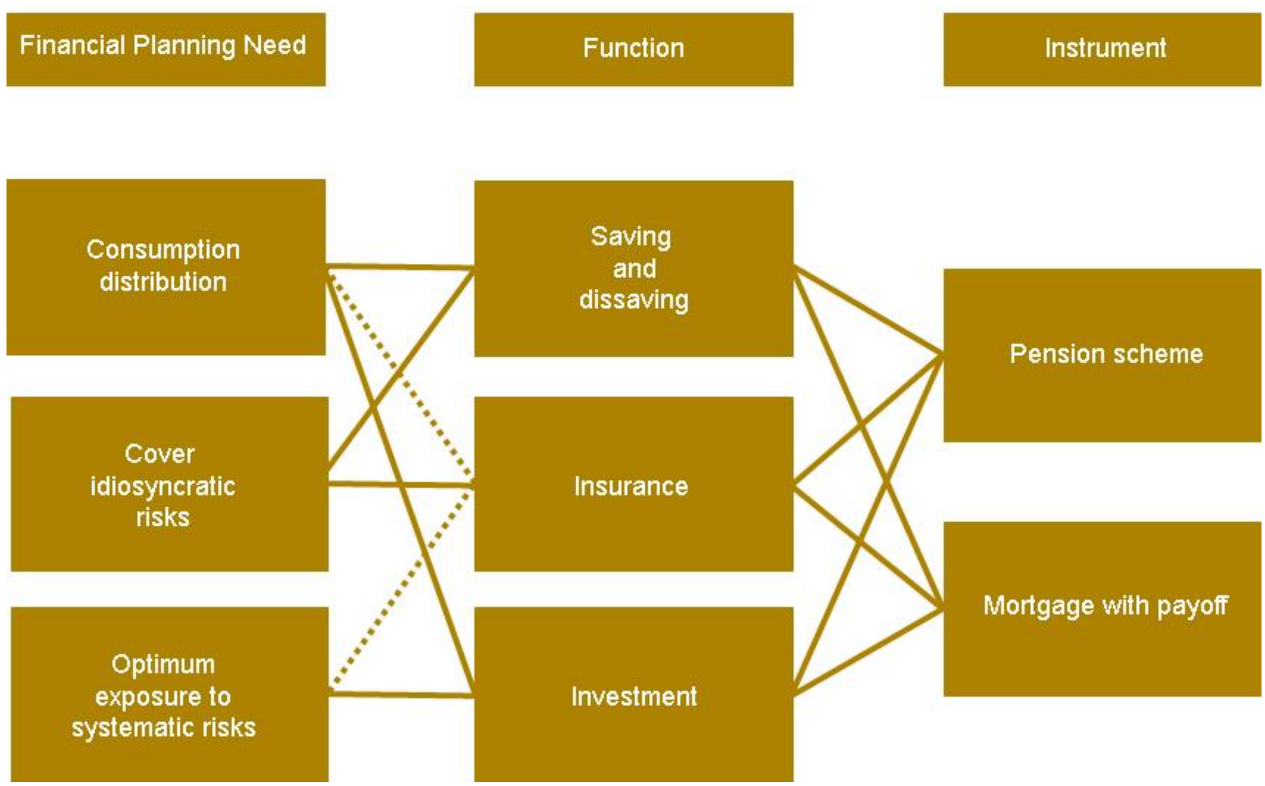

Figure 1: Financial planning for households: Needs, functions, and instruments

Existing regulations and institutions operating in the areas of housing, healthcare, and retirement influence such things as expendable income, total wealth creation, hedging of idiosyncratic risks, and exposure to systematic risks. This is also true for decisions related to jobs and human capital, but those areas are not covered in this paper. For the purposes of this report, the authors have taken as the norm a life course consisting of education, early employment, career, and retirement.

Market and Behavioral Imperfections Lead to Trade-offs

Individual decision-making in the free market leads to optimum results when markets function well and conditions are such that people are in a position to make the right decisions. People do not know always know what they want, however, and often lack the cognitive capacity and foresight to estimate risk and determine what would work best for the needs of their household. Imperfections also arise due to the fact that financial markets for insurance do not always work well, because of asymmetric information and selection effects. Imperfections in market and human behavior lead to trade-offs. The degree to which people can take possession of their financial planning and decide things for themselves varies, in theory, from across-the-board compulsory participation in certain schemes to complete freedom of choice, with other good defaults (with opt-outs) in-between. Alignment of housing, healthcare, and retirement policies and taking the specific situation of an individual into account can become more desirable. This differentiation could be achieved through two routes: by the provider offering customization or by the individual being given freedom of choice. What the best solution is can vary per subject according to the available information and complexity of the decision being made.

The authors have identified five generic trade-offs:

1. The intrinsic value people attach to freedom of choice versus the need to be unburdened, or the social tug-of-war between paternalism and liberalism
2. Offering individual freedom of choice so people can tailor their financial resources to their own needs versus protecting people against their natural inclination toward economic behavioral problems
3. Individual freedom of choice versus preserving solidarity in a circle of solidarity and preventing external effects on others
4. The differentiation needed to address heterogeneous needs versus the drive to limit costs and benefit from economies of scale
5. The degree to which people mistrust institutions versus their need to have things taken care

Trends

Some trends and developments are shifting the trade-offs described above and influencing the framework for analysis. Securing a home mortgage has become more difficult in recent years, for instance, due to stricter lending terms and conditions and new tax rules regarding repayment. In addition, people are increasingly being forced to face risks for which they must find a way to take responsibility. This can be attributed to such things as austerity measures affecting the welfare state (shorter unemployment benefits, higher healthcare co-pays), growing pressures in the labor market, and a greater reliance in pensions on financial markets. Higher levels of education and increased access to modern technology, however, have put households in a better position to take on these risks. At the same time, risk-sharing remains of vital importance in managing the adverse effects of all risk as much as possible.

The developments described here increase the need for differentiation and coordination of individual needs and foreground the advantages of adopting a comprehensive approach to housing, healthcare, and retirement. After all, better coordination between these separate domains will yield better opportunities for managing the increased risks in the best possible way, while taking into account the capacity of individual households to bear these risks.

3. Bottlenecks

This chapter uses the framework for analysis to discuss the major bottlenecks households face in balancing the housing, healthcare, and retirement domains, whereby the authors differentiate between bottlenecks that occur during employment and during retirement. Existing legislation and institutions can hamper optimum financial planning to greater or lesser degrees for different types of households. Taken in conjunction with the trends outlined above, this is already leading to a variety of recurrent bottlenecks. These pertain to oversaving and undersaving and expenditure and liquidity constraints.

The major bottleneck for many households is their inability to optimally balance their ambitions in terms of saving for housing, healthcare, and retirement. This makes it difficult for them to optimally distribute their income and consumption across all stages of life. Research has shown that households that save 50 percent more than needed for retirement give up 3 percent of their wealth over the course of their lifetime. They would have been better off if they had had more of their money to spend earlier in life and less in retirement. Households that save 50 percent "too little" lose as much as 5.5 percent of their wealth. Another important factor besides consumption distribution is good management of exposure to risk for individual circumstances and preferences, especially now that more and more risks are coming to fall on people's shoulders.

Below we outline specific bottlenecks for each of the two stages.

Limited Discretionary Spending for Young Workers

Younger households experience relatively high demands on their expendable income in the current regulatory environment. Many of them are not eligible for social housing and must either purchase a home or pay relatively high rents on the commercial market. The housing supply on the open rental market is limited and the tax rules (i.e., mortgage interest deduction) generally make buying a home more financially attractive. The new tax rules concerning mortgages, enacted in 2013, push for full repayment. Workers who own their own home are thus saving through not only their workplace pensions but also their home equity. On top of that, the uniform contribution system for pensions also impinges on their expendable income because employers must contribute a sizable pension premium on their behalf. Finally, the timing of all these savings initiatives is not always ideal. The balance between consumption now and saving for later seems particularly out of whack for young households with children.

Limited Options for Flexible Use of Pensions and Home Equity Post-Retirement

Certain groups of retired people appear to be very limited in their options for decumulation, including people who own their home or have modest pension savings or little (or no) personal savings. Tapping into one's home equity turns out to be difficult in many cases, and people must use the accumulated pension capital to purchase a life annuity. In addition, there is limited room for pension customization, which occurs now primarily through flex pension plans (within ranges) and early/delayed retirement (including bridge employment). Because assets at this stage of life are illiquid (house and pension), people are not able to easily access them when idiosyncratic risks arise. They have limited liquidity for absorbing uninsured shocks.

4. Solution Alternatives

This chapter presents solution alternatives for the bottlenecks identified in the last chapter, with the following qualification: the ultimate decision (which is social in nature) will also inevitably incorporate ideological principles. This report thus outlines the solution alternatives complete with their advantages and disadvantages (i.e., the trade-offs). The authors do not express a preference, but they do indicate in Chapter 5 which solution alternatives are more viable in the short term and which might require more time and modifications. While both tax and housing market policy are relevant in this context, they are outside the scope of this study.

The experience of various other countries has served as inspiration in seeking solutions. Malaysia and Singapore, for instance, have integrated policies covering housing, healthcare, and retirement. Other countries allow greater flexibility in terms of pension accumulation and payout. In many countries, moreover, there are options for taking money out of one's pension savings during the accrual phase, often subject to restrictions and terms and conditions. In Europe, the Netherlands, Norway, and Sweden are the only countries that do not allow a lump-sum payout in the payout phase. While these experiences elsewhere can provide inspiration, they are not always applicable to the Dutch situation due to underlying differences in the national pension systems, housing markets, and healthcare systems. Moreover, the macroeconomic structures, economic institutions (e.g., labor market institutions), and cultures vary widely, so that one country might adopt more paternalistic solutions and another more libertarian ones according to what works for them.

The authors looked into the solution alternatives that could go some distance toward resolving the bottlenecks identified in Chapter 3 based on households' financial planning needs. A summary, by no means complete, of those alternatives is presented below. Solution alternatives 1 through 5 are options in the area of retirement legislation, 6 and 7 cover healthcare, and 8 and 9 pertain to housing.

Solution Alternatives:

1. Greater flexibility in pension contributions and savings
   A. Partial, one-time payout during the accrual and/or payout phase
   B. Freedom of choice with regard to the timing of contributions, with ambition remaining the same (shift in contributions over time)
   C. Freedom of choice with regard to contributions, without the requirement that these be compensated at some other time
   D. Lower ambitions in collective schemes
2. Progressive, actuarial contributions for benefits schemes
3. Use of pension contributions or entitlements to pay off mortgages
4. Use of pension entitlements as security for secondary loans
5. Options/customization of risk profiles
6. Capital accrual for elder care
7. Long-term care annuity
8. Home equity cash-out

9. Better management of real estate risks and home equity

5. Road Map to More Integrated Policies in Housing, Healthcare, and Retirement

This chapter presents a road map toward possible solutions. The first two steps (see A and B) that could be taken pertain primarily to legislation in the area of pensions. A better alignment of the pension ambitions of households in the areas of housing and healthcare and greater flexibility in pension savings would make it easier to link together all of these areas. The possibility of a limited, one-time payout upon retirement (see C) and loosening of the rules for existing pension plans of all types (see D) could also help alleviate some of the bottlenecks households currently face. Another thing that could help would be to create more options for cashing in on home equity through such instruments as a reverse mortgage or sale and rent back (see E).

A. Balancing Retirement Goals with Healthcare and Housing

The first line of connection between retirement and housing and healthcare relates to the retirement goals. The optimum level for those goals will depend on other assets (including one's home), the desired retirement age, and the desired income in retirement. Other important factors include a person's living situation and preferences in terms of additional care or assistance. Individuals must now bear a greater share of their healthcare costs, which would imply the need for higher retirement goals, all other things being equal. At the same time, if their mortgage is paid off, that means not only lower housing costs, but also that they have a nest egg they can tap into if needed. This means that the retirement goals of people who buy houses should, all things being equal, be lower - and by a considerable amount - than those of renters. All of the paying members in a pension plan benefit from a better alignment of retirement goals with their personal wealth creation in other areas. This option may come "too late" for seniors and retirees, but greater flexibility in the payout phase could well contribute to better financial planning.

B. **Transition to Personal Pension Savings Would Make Interlinking and Flexibility Easier**

Personal pension savings would make it easier to foster a better distribution of consumption across the life course through occupational pension plans, because this would allow people to mitigate selection risk. That risk could be mitigated already if people were to apply fair actuarial accounting, but this would make the elements of redistribution that result from uniform contribution more visible and that could undermine support for the collective agreements.

As it stands, many possible trade-offs in meeting housing, healthcare, and retirement obligations have a negative impact because the uniform contribution system leads to selection risk when those options are not treated as actuarially neutral. Individual decisions with regard to pensions can then have negative consequences for the collective spirit and solidarity within a pension scheme. A transition from the current benefits schemes to DC schemes (with or without risk-sharing) would better allow the introduction of flexibility and interlinking between the domains. The degree to which existing (e.g., flex pension plans) and future options might actually lead to selection is unknown and it would be advisable to research the magnitude of the selection risk further. Any such research should also include the relationship between age and selection.

More personal pension savings could simplify the intervening trade-offs between domains. This could go some way toward alleviating acute financial problems caused by unforeseen circumstances, which influence the balance between having money now and having money later. Some specific examples of this include people whose mortgages are "underwater" and want to or have to move and people who get divorced. Of course, it is a good idea to put limits on the flexibility offered, since too much flexibility could be detrimental to the objective in pension schemes of protecting participants from short-sightedness.

Better Links between Housing, Healthcare, and Retirement

Better financial planning for all stages of life and alignment of the housing, healthcare, and retirement domains could lead to greater prosperity. A precondition to balancing these domains is building awareness among households. The government and employers are pulling back from assuming risk and the risk and responsibility for these social issues is shifting to households. It is critical, then, that households become more aware of their own role in financial planning for life.

Both customization and freedom of choice offer potential routes toward more individualized pension plans that would better meet people's personal needs. With customization, providers tailor the product for the consumer; with freedom of choice it is the individuals who choose from among options. Both paths carry opportunities, as well as risks. Providing freedom of choice would demand greater understanding and involvement on the part of individuals than customization. Moreover, it would still be possible in either case that the end result for the individual household was no better, or perhaps even worse, than the uniform plan. People tend to attach great value to having money now, so there is a real danger that freedom of choice will lead to undersaving for the future. In addition, both customization and freedom of choice increase the chance of administrative error. But with a well-thought-out design, most households will be generally at least as well or better off. A good balance among the domains of housing, healthcare, and retirement can lead to greater individual prosperity.

Some of the solutions presented in the road map (Figure 2) will be easier or quicker to implement than others. This is affected, in part, by the availability of data and modifications to existing plans. In addition to the costs of execution and justifiability of the various road map options, political and ideological preferences play a role in which tack a person might choose, bearing in mind that, as a rule, people would like to continue living in the manner they are accustomed to after retirement.

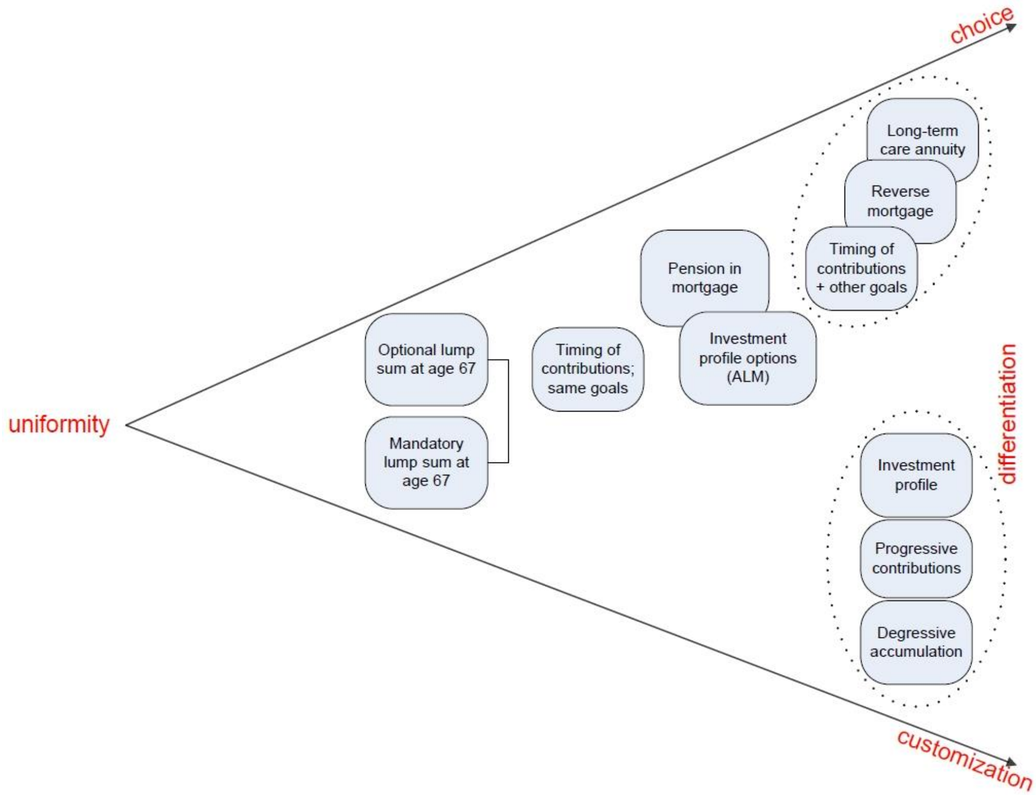

Figure 2: Diagram of uniformity versus differentiation and customization versus freedom of choice

The authors of this paper have plotted a road map along two dimensions: how much differentiation do people want and who will make the decisions? More differentiation is not always better. The more differentiation desired, the more data is needed to make good decisions (depending on who is making those decisions, the provider or households). More information is needed about the specifics of a household, and possibly also its needs and preferences, in order to either design a good customized package (provider) or choose among options (households). Growing digitization is making the relevant information more readily available at increasingly lower costs, putting the options shown on the right in Figure 2 more within reach. But more differentiation inevitably has costs associated with it, as well. Setting the prices for greater differentiation is a complicated issue. If differentiation is expected to have no undesirable redistribution effects and not jeopardize valuable risk-sharing, then this will have to be taken into account.

The second axis represents who makes the decisions: a provider offering customization or an individual choosing options. Some important factors in the trade-off between having providers or households decide are: who has the best information, privacy and confidence in the provider versus confidence in one's own decisions, complexity and the chance of mistakes (also in administration), choice overload, and fiduciary duty. In reality, a spectrum of options is available, including combinations of customization and freedom of choice that could limit potential adverse effects. One example would be a default scheme (customization) with an opt-out option (freedom of choice). Another would be having the government or provider specify a range of choices among which individuals could choose. For a detailed study of fiduciary duty design, we refer readers to the December 2015 report "Zorgplicht bij pensioenproducten" issued by the Communications and Duty of Care project group at Netspar.

C. Greater Flexibility in Pension Benefits: Limited Lump Sum Payout upon Retirement

For people who already have considerable pension savings, there are options in place that allow some forms of flexibility in the short term. These will primarily offer greater flexibility to people over the age of 50 and/or retirees who have a fair amount of excess equity in their home, in addition to a supplemental pension. A lump sum payout upon retirement would contribute to greater flexibility and give households the option of using some of their pension savings to modify their residences or start a savings fund for future health costs. It could also help people absorb short-term shocks. The lump sum payout could be viewed as just another variation to be added to the existing options upon retirement, such as the flex pension plan. Allowing such a lump sum payout at any point *after* retirement would give individuals even more options in terms of optimum planning, but it would also increase the selection risk, so the authors still do not recommend it. Allowing a lump sum payout *upon* retirement is a better choice. There are still questions about how much people should be allowed to withdraw and whether the allowable maximum should be a percentage of the pension capital accrued or a fixed amount.

D. Greater Flexibility in DC Schemes

DC schemes provide more flexibility for tailoring risk profiles to the individual (e.g., based on age and living situation). The social partners could also build more flexibility into the plans, for example by using the cafeteria model and leaving it up to participants to choose whether they want to contribute more to pension savings or would prefer more income to use for, say, paying off a mortgage. One disadvantage of this is the risk that the participant will consume too much now and not build enough pension and then have to accept less consumption after retirement, have to work longer, or possibly have to rely on collective benefits, such as healthcare and rent subsidies.

Benefits schemes also provide similar possibilities for introducing flexibility in the pension system. There is often already a lot of leeway, and it is more a matter of providers and social partners taking advantage of the room that exists by making changes in the scheme. These pertain primarily to the ambition levels and, to a lesser degree, customization of the risk profile. Customization of the ambition level could take the form, for instance, of lowering the collective pension accumulation and giving the contributions thus freed-up to the employee or putting them into individual plans with a great deal of flexibility and structured options (good default, opt-out, etc.). A well-designed choice architecture can minimize the risk of undersaving for people with lower incomes or those who do not own a home.

Greater flexibility in the level of contributions could provide relief for younger households without much expendable income. It could also similarly help pension participants who are temporarily short on funds. Older workers with a great deal of excess value in their home might choose to adjust their retirement goals like this: temporarily putting in smaller contributions would allow them to absorb individual shocks.

E. Tapping into Home Equity for Extra Retirement Income, Home Modifications, and Healthcare

Some of the obstacles people encounter in old age could be alleviated by creating more possibilities for tapping into the equity built up in the home, for example through a reverse mortgage or sale and rent back construction.

Ideally, people would align their personal retirement goals with the equity they had built up in their home. For the group of seniors who have a relatively low retirement income but a reasonable amount of home equity, having better options for tapping into that equity would foster a better distribution of consumption. More generally, this facility would increase the possibilities for people to finance large purchases (such as home modifications) and accidental expenses (e.g., healthcare). Looking toward the future, if more households end up with a "free" home - because of the tax incentive to fully pay off the mortgage - options for tapping into home equity will become even more important, especially among groups with not much pension (such as low-income people and self-employed).

Combinations between housing and retirement would appear to be more obvious than those between healthcare and retirement. This is because the greatest bottlenecks identified by the authors of this report pertain to the intertemporal distribution of consumption over the life course and home ownership is part of that in terms of being an asset. Another factor involves the role of healthcare in the Netherlands, where collective insurance is the norm and the individual costs and risks for households are still minimal. This could change in the future. The retirement goals and desired pension flexibility depend on the degree to which households will have to cover healthcare costs and risks themselves in the future. In this context, the authors recommend that more research be done into the concept of long-term care annuity,[1] because this would allow households to better insure themselves against additional long-term care and manage their healthcare costs and risks.

In addition, it would be helpful to have conducive policies for the housing market and tax rules in general. It seems likely that a better-functioning rental market and not having to fully pay off a mortgage to be eligible for the mortgage interest deduction could help solve some of the planning problems at the household level that are outlined here. The idea is not to increase the mortgage interest deduction again, but to change its design.

Conclusion

The authors have observed growing differences among households with regard to underlying assumptions and needs. In the pension plans now common in the Netherlands, the current approach tends to be "one size fits all," which can lead to economic losses of 3 to 5.5 percent, or even more, due to the fact that households are not always able to efficiently distribute their consumption over their life course and cannot adequately cover themselves against risks.

It is up to society to determine the desirable outcomes: households, social partners, the government, politicians, and other stakeholders will have to choose. People will have to choose between uniformity and differentiation, on the one hand, and customization and choice, on the other. The latter decision is related to a preference for libertarian or paternalistic policy. More differentiation could contribute to greater prosperity, but will inevitably bring with it higher costs and, possibly, undesirable redistribution effects, while jeopardizing valuable risk-sharing. Those are the trade-offs.

The desirable degree of differentiation is the first axis along which decisions (of a social nature) must be made. The second axis represents who makes the decisions: providers offering customization or individuals choosing options. Who can do it best depends on factors such as who has the best

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[1]A long-term care annuity is a life-long benefit that is first paid out around the date of retirement, for instance, and then pays out more as more health limitations arise. The additional monthly income can be used to cover deductibles or to pay for healthcare services not covered by insurance.

information, privacy and confidence in the provider versus confidence in one's own decisions, complexity and the chance of mistakes (also in administration), choice overload, and fiduciary duty. There will often be a sliding scale between customization and freedom of choice. Good choice architecture in the form of combinations of customization and freedom of choice could limit potential downsides. More individual choice would foster better planning among households, bringing possible economic gains and better meeting their needs. At the same time, it would increase the risk of bad decisions, as well as selection risk. If people make the wrong choices, they could suffer economic losses by failing to save enough for retirement, resulting in lower post-retirement consumption and a greater reliance on collective services. Here, again, good choice architecture is essential for limiting the risks.

Finally, the authors urge that more research be done on the institutional design of customization/freedom of choice and governance of differentiation. Similarly, research is needed on the how people set retirement goals and manage household risks at the micro level.