Adequate and sustainable pensions: What reform directions?

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1 Introduction

2 A view from the North Pole: Four policies in search of a politician

3 What role for the Commission?

1 Introduction

- The main part discusses directions for reform arising from recent developments in economic theory and current international trends
- Caveat: I am not an expert on EU institutions nor EU politics, so this talk is intended mainly as food for thought
- I warmly welcome the fact that the Green Paper looks at pensions as pensions, rather than as
    - A vehicle for growth, or
    - To contain public spending, or
    - To assist the development of the single market.
- Though these objectives are important, the central purpose of pensions is old-age security, which has the following elements

The objectives of pension systems

- For the individual
  - Consumption smoothing
  - Insurance
- Additional objectives of public policy
  - Poverty relief
  - Redistribution

Key principles of analysis

- It is essential to think of the different parts of a pension system as a *system*
- There is no single best system for all countries

There are sound principles of design, but no single best pension system (key conclusion of Barr and Diamond (2008)

- Objectives: consumption smoothing, insurance, poverty relief, redistribution
- Constraints include
  - Fiscal capacity
  - Institutional capacity
  - Political sensitivities
  - Empirical value of behavioural parameters
  - Shape of the income distribution
- No single best system because
  - Policy makers attach different relative weights to the different objectives
  - The pattern of fiscal and institutional constraints differs across countries
- Thus
  - What is optimal will differ across countries and over time
  - Pension systems look different across countries; this is as it should be

2 A view from the North Pole: Four policies in search of a politician

- Four policy directions
    - Non-contributory pensions
    - Redefining retirement
    - Simple, cheaply-administered DC arrangements
    - NDC systems
- Why these four?
    - Directions 1 and 2 have clear connections with adequacy and sustainability (sessions 1 and 2 of the conference)
    - Directions 3 and 4 have connections to mobility (session 3) and safety (session 4)
    - All four are relatively recent developments both in theory and policy, so interesting to explain the thinking that lies behind them
    - None of them rule out traditional DB schemes
    - Repeat: no single best system for all countries

2.1 Relieving poverty: A non-contributory basic pension

- Definition: a public pension paid at a flat rate, on the basis of age and residence rather than contributions
- Why?
    - The contributory principle assumed workers with long, stable employment, thus coverage would grow
    - History has not sustained this argument

The world then

- Social policy in 1950 was based on a series of assumptions
  - Independent nation states
  - Employment generally full time and long term
  - Limited international mobility
  - Stable nuclear family with male breadwinner and female caregiver
  - Skills once acquired were lifelong
- Though not true even then, true enough to be a realistic basis for policy

What has changed?

- Increasing international competition ('globalisation')
- **Changing nature of work, with more fluid labour markets ('post-industrialisation')**
- Rising international mobility
- **Changing nature of the family**
  - More fluid family structures
  - Rising labour-market activity by women
- Shorter half-life of skills ('information age')
- Thus the drivers of change are
  - More diverse patterns of work: thus there are problems for coverage of contributory benefits tied to employment
  - Increasingly fluid family structures: thus there are problems basing women's benefits on husbands' contributions

Arguments for non-contributory basic pensions

- Strengthen poverty relief in terms of coverage, adequacy and gender balance (the minimum adequacy theme)
- Improve incentives relative to income-tested poverty relief
- Provide good targeting (age is a useful indicator of poverty)
- Assists international labour mobility through pro-rata arrangements (the mobility theme)
- Robust in face of shocks because shares risk widely (the safety theme)
    - Across current taxpayers
    - Through government borrowing, also with future taxpayers

Containing costs

Adjusting to match budgetary constraints (the sustainability theme): three instruments

- The size of the pension
- The age at which the pension is first paid
- Perhaps also an affluence test

Country examples

- UK: illustrates problems of coverage, hence
  - Reduced contribution requirements, i.e. move towards a non-contributory basic pension
  - Discussion this week of introducing such a pension from 2015
- OECD countries with non-contributory basic pensions
  - The Netherlands
  - New Zealand
  - Australia (with an affluence test)
  - Canada (with an affluence test)
  - Chile introduced a non-contributory pension in 2008

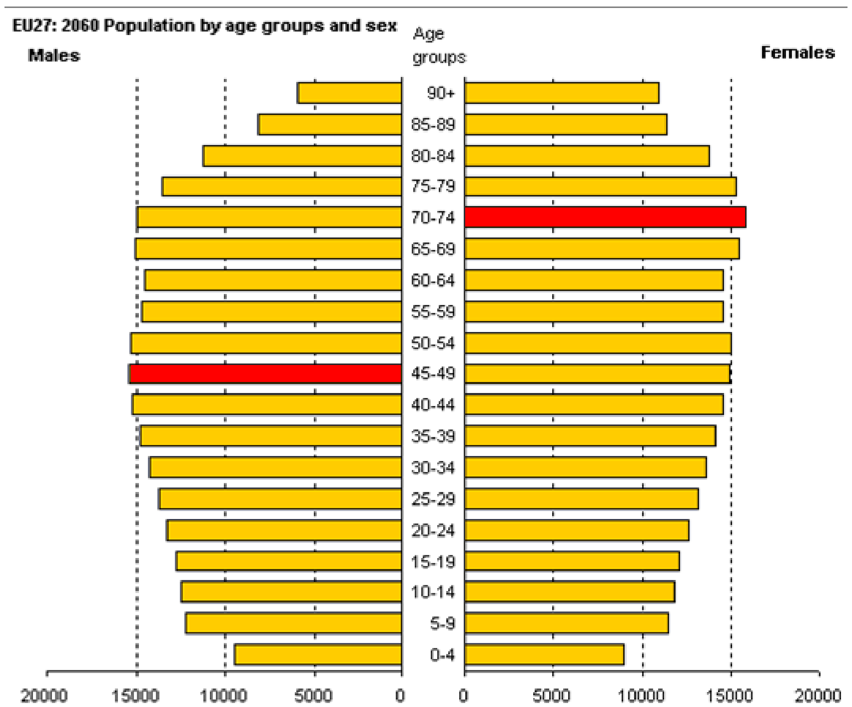
2.2 Redefining retirement: Later and more flexible retirement

- If there are problems in paying for pensions there are **four and only four** solutions
    - Break promises to pensioners: though promises may have to be adjusted, a substantial reduction may be unpalatable
    - Increase contributions: but in many countries not feasible
- We are then left with
    - Increase savings
    - Raise retirement age
- These are statements of logic, not political statements

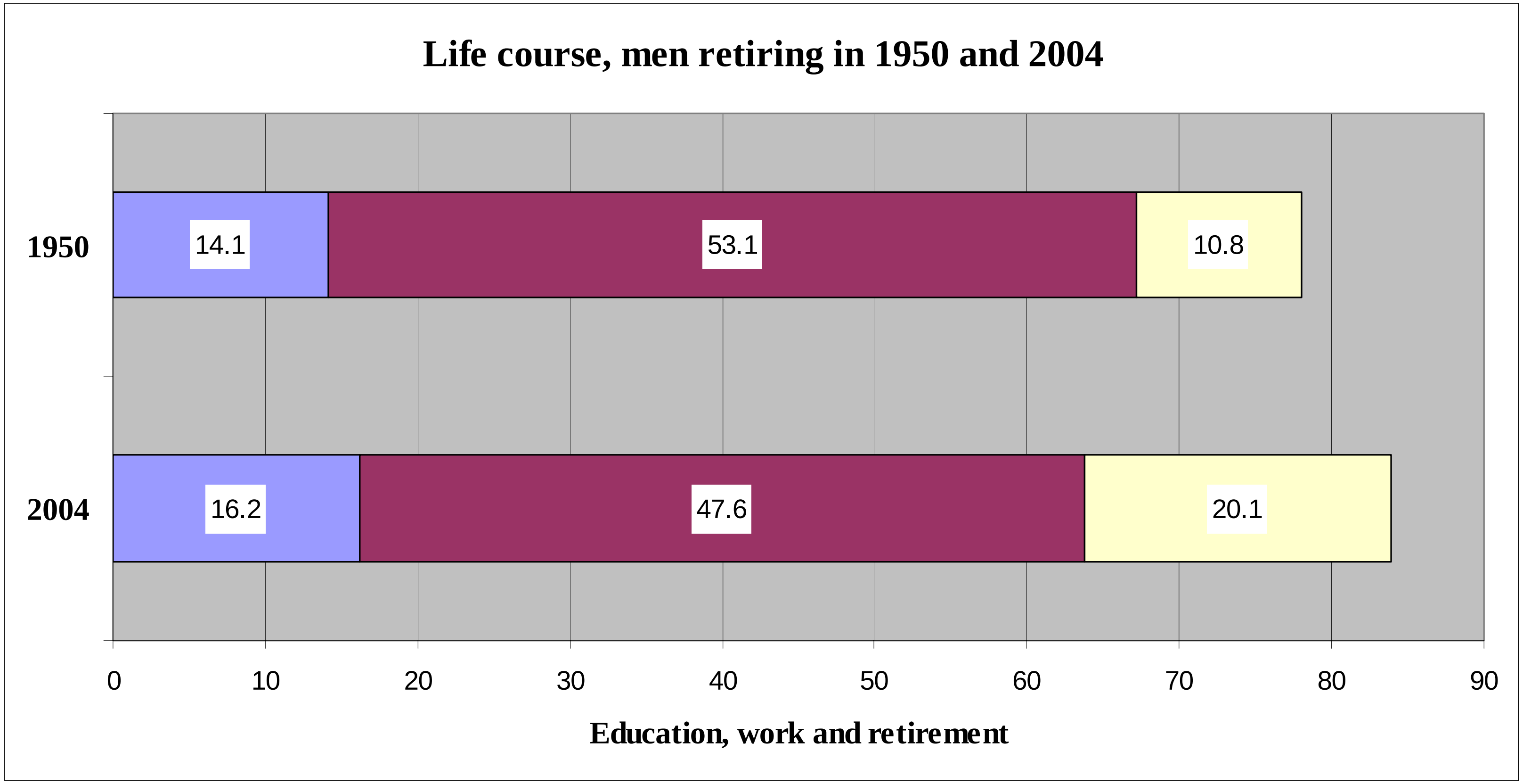
Later retirement: Why?

- Longer healthy life + constant or declining retirement age creates problems of pension finance
- The solution: pensionable age should rise in a rational way as life expectancy increases
- Most work is less physical than in the past
- The ‘lump of labour’ fallacy
- Response to the crisis: another way of sharing risk; if they have to bear some of the cost, many pensioners would prefer a shorter duration of retirement to lower living standards in retirement (sustainability, safety)

EU projected age pyramid, 2060 (source: Green Paper 2010)



The UK as an illustration



Also more flexible retirement

- Mandatory full retirement made sense historically, but no longer
- Increased choice about when to retire, and whether fully or partially is desirable
    - To promote output growth
    - As a response to individual preferences (and thus desirable for its own sake, irrespective of problems of pension finance)
- Widens options for individuals in the wake of the crisis

Later and more flexible retirement: Institutional impediments in many Member States hinder progress

- ‘Hassle factor’: flexible contracts for older workers have to be negotiated individually; this involves transactions costs and, where the law is unclear, may face legal challenge
- Labour law which impedes lower pay where a worker chooses to downshift
- Insurance impediments
- Pension design
    - A pure final-salary scheme
    - Pensions which do not allow workers to combine a partial pension and part-time work

Country examples

- USA: age for full pension of 65 (men and women) rising over time to 67
- UK: state pensionable age for 65 (men and women) will rise to 66 in 2024 and thereafter by one year each decade; recent decision to accelerate to 2020
- Norway: retirement age is already 67 (men and women)
- Retirement age is now a proper topic for polite society, at least in the UK, with clear links to sustainability, safety and greater individual choice

3.3 Consumption smoothing 1: Simple savings and annuities

- Why? Lessons from
  - The economics of information
  - Behavioural economics

Useful to start with discussion of bad arguments and bad policy design

- Bad argument 1: funded pensions help adjustment in the face of economic turbulence or demographic change
    - Economic turbulence: a move to funding *increases* public spending during the transition phase, which can be long (e.g. Chile)
    - Demographic change: Barr 1979(!!!)
- Bad argument 2: competition is beneficial in the case of pension provision: lessons from the economics of information and behavioural economics

Lessons from information economics

- In many areas of social policy the model of the well-informed consumer does not hold
- In the context of pensions
    - A survey, 50% of Americans did not know the difference between a stock and a bond
    - Most people do not understand the need to shift from equities to bonds as they age, if they hold an individual account
    - Virtually nobody realises the significance of administrative charges for pensions

Lessons from behavioural economics

- What conventional theory predicts
  - Voluntary saving to maximise lifetime utility (consumption smoothing)
  - Voluntary purchase of annuities (insurance)

What actually happens

- Procrastination: people delay saving, do not save, or do not save enough
- Inertia: people stay where they are; in theory it should make no difference whether the system is opt in or opt out – in practice, automatic enrolment leads to higher participation
- Immobilisation
    - Conflicts and confusion lead people to behave passively (rabbit in car headlight)
    - Impossible to process information about 700 different funds (90% go into Swedish default fund)

Why? Recent lessons from behavioural economics

- Experimental evidence shows high discount rate in short run, much lower in long run
  - Next week's snack: 2/3 chose fruit salad, 1/3 chocolate
  - This week's snack: 1/3 fruit salad, 2/3 chocolate
- Thus people are rational for the future, but not for the present; but when the future arrives it is the present, so the short-term wins

Clinical measurement of brain activity

- Two parts of the brain
  - Mesolimbic: old part of brain: impatient – ‘eat now, won’t last’
  - Prefrontal cortex: newer part of brain: patient and rational – this is rational economic man and woman
- Clinical measurement (experiments while person is in scanner) shows that short-term decisions are made by the mesolimbic system, longer-term decisions by the prefrontal cortex
- Life is a constant fight between the two parts
- Examples: start dieting tomorrow; give up smoking tomorrow; but when tomorrow comes ...
- Results call into question the simple model of long-term rationality

Implications: pension design that gets it right

- Use automatic enrolment
- Keep choices simple
    - Highly constrained choice is a deliberate and welfare-enhancing design feature
    - But one of the options can be to allow individual choice (Marks and Spencer or Saville Row)
- Design a good default option which includes life-cycle profiling
- Decouple fund administration from fund management
    - Centralised administration
    - Fund management: wholesale, competitive

Country example: UK National Employment Savings Trust

- The system (www.nestpensions.org.uk)
  - New system, starting in 2012, deliberately based on lessons from the economics of information and behavioural economics
  - Auto-enrolment
  - Workers choose from a very small number of funds
  - Centralised account administration
  - Wholesale fund management
- Comments: respects the lessons from the economics of information and behavioural economics
  - Simplifies choice for workers, respecting information constraints
  - Keeps administrative costs low (2% of contributions + AMC 0.3%)
  - The US Thrift Savings Plan (www.tsp.gov), which has been running for longer, is similar
  - BUT one major downside: because the schemes are fully funded, they can share risk only between current participants

Country examples: collective DC plans

- In this approach workers may be required to belong to a DC scheme organised by their employer or industry
- If well-designed and administered effectively this type of arrangement addresses important problems, including excessive consumer choice and high administrative costs

2.4 Consumption smoothing 2: NDC pensions

How NDC pensions work

- Mimic individual funded accounts, but on a Pay-As-You-Go basis, i.e. actuarial Pay-As-You-Go
- Workers' contributions this year pay this year's pensions
- The government keeps a record of individual contributions, each year attributing a notional interest rate to each worker's accumulation
- When the worker retires, his/her notional accumulation is converted into an annuity
- In a pure NDC system benefits are actuarial; the system can also incorporate redistribution, e.g. minimum benefits or pension credits for caring activities

Advantages of NDC

- Simple from point of view of the worker
- Administrative advantages
  - Centrally administered, hence low administrative costs
  - Does not require the institutional capacity to manage funded schemes
- People may not want to save in individual accounts (or saving may be the wrong policy, e.g. China)
- Advantages in terms of risk sharing
  - Avoids much of the risk of funded individual accounts, since avoids volatility of capital markets
  - Shares risk more widely than individual accounts, making the system more robust in the face of the economic turbulence
  - A large buffer fund offers further options for risk sharing
- Flexibility
  - NDC can be combined with a non-contributory pension
  - Can approach NDC in an evolutionary way, e.g. Germany
  - NDC can be the basis for a future move to partial or full funding as economic circumstances evolve

Country examples

- Sweden
- Poland
- Latvia
- Italy

A partially funded NDC system

- Buffer fund in the Swedish NDC means that immediate cuts can be much smaller than in a fully-funded DC
- A larger buffer fund gives greater capacity for smoothing
- In contrast with NEST, which is a (simple) DC plan, a partially funded NDC system can share risks more widely than current participants
- Ideally, a partially-funded NDC should be able to smooth over cyclical turbulence, adjusting only to long-term trends such as demographic change

Simple DC or partially-funded NDC?

- DC pensions
  - Transparent about how risks shared and thus less prone to interference
  - BUT all risk falls on current participants
- Partial funding in NDC or public or occupational DB plan
  - Allows risks to be shared more widely, with short-run shocks accommodated through longer-run adjustments rather than large immediate changes
  - BUT likely over time to require discretionary action by government, hence potentially prone to government failure. If so, the potential benefits of wider risk sharing may be offset by the costs arising from sub-optimal behaviour
- Thus there is a choice between
  - Stronger defence against government failure but less risk sharing
  - Wider risk sharing, but with less defence against government failure
  - The right answer depends, inter alia, on (a) the weight policy makers give to wider risk sharing and (b) an empirical view of the quality of government

3 What role for the Commission?

The Commission could assist adequacy, sustainability, mobility and safety through:

- Information
  - Setting out the advantages of certain types of institution
  - Where appropriate encouraging such institutions
  - Emphasising
    - The importance of wide risk sharing
    - The importance of portability during discussions of pension reform within individual Member States
- A more active role could include advisory activities, or even indicative minimum standards, e.g. of replacement rates, safety (e.g. size of buffer funds), transparency, and portability

Adequacy and sustainability

- As noted, a non-contributory pension and later/more flexible retirement interact to improve both adequacy and sustainability
- An option is to establish a guideline for replacement rates, i.e. *x*% of a worker's previous earnings but not less than *y*% of median earnings in the country
    - The guideline levels of *x* and *y* should be high enough to ensure adequacy
    - They should not be so high as to harm sustainability, nor to crowd out voluntary third-tier pensions

Mobility

- Non-contributory pensions and DC/NDC pensions offer prospects of pro-rating for workers who are mobile within and between Member States
- Greater emphasis on portability

Safety

- Adequacy, e.g. non-contributory pensions
- Default pensions
- Flexible retirement options
- Training/retraining for older workers
- Emphasis on occupational health
- Wider risk sharing
    - DC: GDP bonds; collective DC
    - Partially funded NDC: risk sharing across generations

The employment agenda

- Assisting countries in designing legislation that removes impediments to the employment of older workers
- Greater emphasis on training older workers
- A clear relation to the health agenda

The single market agenda

- Assisting countries in developing pension institutions that allow workers to accumulate pensions in ways that do not impede labour mobility (a) within a country and (b) across countries

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