Reforming pensions: Principles and policy

Nicholas Barr
London School of Economics
http://econ.lse.ac.uk/staff/nb

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1 Principles
2 Policy
3 Examples

This presentation is based on Nicholas Barr and Peter Diamond (forthcoming), Reforming Pensions: Principles and Policy, New York and Oxford: OUP
1 Principles
1.1 Analytical lynchpins
Principle 1: Analysis should consider pension systems as a whole

- Pension systems have multiple objectives
  - Consumption smoothing
  - Insurance
  - Poverty relief
  - Redistribution within and across generations
- Other objectives such as growth, are not primary objectives of the pension system
- Cannot wholly achieve all objectives simultaneously; thus policy has to optimise across all, not maximise any particular one
- Optimum will depend on relative weights
Examples

• All relevant objectives
  • Individual funded accounts provide consumption smoothing but, on their own, not poverty relief.
  • Thus need to be accompanied by a mechanism to provide poverty relief.

• All elements in the pension system
  • Since a system that is strictly actuarial provides no poverty relief, another element has to perform than function
  • But in that case, there is no particular virtue in having a part that is strictly actuarial – it is the impact of the entire system that matters for the efficient provision of poverty relief, consumption smoothing and insurance
Principle 2: Analysis should be framed in a second-best context

Deviations from first-best include

- Incomplete markets, e.g. for indexation, and perhaps for annuities
- Progressive taxation and especially
- Information problems
Pervasive information problems

• Distinguish
  • Information problems
  • Information processing problems

• Implication: public financial education is useful but not a complete solution

• Growing evidence from behavioural economics
  • Saving decisions affected by immobilisation and inertia
  • Decisions about asset allocation can be irrational: herd instinct; investing in stock of own employer
  • Flawed decisions about annuities because of failure to understand underlying idea of insurance
Implications

• Pension systems can have substantial effects on behaviour, including labor supply, saving, and the division of resources within a household.
• These effects are not always and everywhere adverse.
• And even where they are adverse, the system is still welfare improving if the benefits of improved old-age security outweigh the costs of adverse incentives.
• In short, policy has to seek the best balance between poverty relief, insurance and containing distortions (note, not minimising distortions), a balance that will depend on the weights given to different objectives.
Principle 3: Analysis of funding needs to consider how funding is generated

- **Saving**: different approaches to funding have different effects on saving
  - Funding that increases saving has to reduce someone’s consumption or investment
  - Funding through new government bonds generally does not increase saving

- **Distribution**:
  - Any choice between PAYG and funding is necessarily a decision about the intergenerational distribution of income
  - Thus even if funding does increase output, the change cannot be presented as a Pareto improvement
Principle 4: Implementation matters

• Policy design that exceeds a country’s capacity to implement it is bad policy design
  • Capacity to collect contributions?
  • Capacity to record contributions across changing name and location?
  • Knowledge of people’s ages?
  • Capacity to deliver benefits
  • Robust financial institutions?

• Administrative costs are important: under plausible assumptions an annual charge of 1% of an accumulation reduces the total accumulation by 20% over a working life
1.2 Analytical naughties
Error 1: Tunnel vision

• The problem:
  – Considering one objective in isolation
  – Examples
    • Excessive focus on consumption smoothing (e.g. DC pensions), understating poverty relief
    • DC with earlier mandatory retirement age for women than for men – a double whammy
  – Considering one part of the pension system in isolation
Error 2: Improper use of first-best analysis

• The problem: ignores market imperfections
• Examples
  – Uncritical advocacy of competition, notwithstanding major information problems
  – Uncritical assumption of rational response to incentives, e.g. the argument that DC pensions lead to high compliance. Ignores
    • Imperfect information, e.g. about rates of return
    • High marginal rates of time preference
    • Imperfect capital markets, so that some people are liquidity constrained
  – Ignoring frictions, in particular administrative costs
Error 3: Improper use of steady state analysis

• The problem: improperly compares pension systems in steady state; this is inappropriate if the question being analysed is a move from one steady state to another, e.g. PAYG to funded

• Example: comparing the simple stock market return with the rate of growth of the wage bill in comparing rates of return to funded and PAYG pensions
Error 4: Incomplete analysis of implicit pension debt

• The problem: treating implicit and explicit pension debt as equivalent

• The simple argument about implicit pension debt
  • Focuses only on liabilities, ignoring assets, e.g. ability to tax
  • Fails to recognize important differences in the economic effects of implicit and explicit debt, e.g. can reduce implicit debt through pension reform without repudiating explicit debt
  • Erroneously implies that paying off implicit debt in full is optimal; implicit debt (like government debt) should be optimised, not minimised
  • Ignores the intergenerational distributional effects of a change in balance between implicit and explicit debt

• Implicit debt is a useful concept, but has to be interpreted properly
Error 5: Incomplete analysis of funding

• The problem: loses sight of fact that PAYG and funding are both ways of organising claims on future output

• Examples:
  • Arguing that funding necessarily assists adjustment to demographic change
  • Arguing that an actuarial relationship between contributions and benefits is possible only with a funded system, ignoring the option of NDC
Error 6: Ignoring distributional effects

• The problem: ignores the fact that any pension reform has distributional consequences.

• Examples:
  • Introducing a new PAYG system makes a transfer to the first cohort of retirees; if, instead, policy makers introduce a funded scheme, the first cohort receives no pension
  • Similarly, a move towards funding that increases saving redistributes from today’s workers and pensioners to later generations

• Thus
  • Choices about pension systems are inescapably also choices about intergenerational redistribution
  • Such redistribution may or may not be good policy
  • But ignoring distributional effects is faulty analysis; so are claims of Pareto superiority

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2 Policy
There is no single best design of a pension system

- There are sound principles of pension design
- Proper application of those principles can and does lead to widely different systems; that is entirely as it should be
- Designs that do not conform with sensible principles or with the capacity of the country to implement them do not work well
A move from PAYG towards funding in a mandatory system may or may not be welfare improving

- Explicit debt is not equivalent to implicit pension debt
- Funding may increase or decrease national savings
- Funding may increase economic growth and may improve the operation of capital markets. Either is possible; neither is inevitable
- Funding that increases national savings generally has major fiscal effects. Thus analysis needs to take account of the costs of moving from one steady state to another
- The choice of funding rather than PAYG is necessarily a decision about the intergenerational distribution of income. Thus even if funding does increase output, the change is not necessarily beneficial
Unsustainable pension promises need to be addressed directly

• There is a flawed argument which runs, ‘PAYG pensions face major fiscal problems, therefore they should be privatized’. This argument is mistaken because the word ‘therefore’ does not follow in logic

• It is necessary to distinguish two questions:
  • Is the fiscal cost of public pensions a problem?
  • Would a move towards funded pensions be beneficial?

• These are separate questions, requiring separate answers.
  • If a public pension is running a deficit that is regarded as unsustainable the only solution is to make it sustainable by increasing contributions and/or reducing benefits
  • In contrast, if there are potential benefits from funding, a move in that direction may be sound policy even where the fiscal costs of a public pension are sustainable
The main cause of the pensions ‘crisis’ is a failure to adapt to long-term trends

• Pension systems in many countries face a series of trends:
  – a long-term and continuing trend increase in life expectancy,
  – a long-term and continuing trend decline in fertility
  – a long-term trend to earlier retirement.
• Superimposed are two more recent phenomena:
  – the baby boom
  – the increase in the scale of pension systems since World War II
• The more recent trends are aggravating factors, but the problem arises even in their absence
Age pyramids 2050, China, India, USA

Source: U.S. Census Bureau, International Data Base
The main solutions to problems of paying for pensions are a combination of:

- Higher contribution rates
- Lower monthly pensions
- Later retirement at the same monthly pension
- Policies designed to increase national output
3 Examples

• Chile
• China
• US Thrift Savings Plan
3.1 Chile

- The system for formal sector workers
  - Individual accounts
  - Poverty relief through minimum pension guarantee and welfare pension
- Mistaken views about the 1981 reforms
  - Reduce public spending
  - Offer high rates of return
  - Get government out of the pensions business
Problem areas

• Pensioner poverty
• Incomplete coverage
• Gender inequality
• High administrative charges
• Fiscal cost
• Thus, ‘the system of individual accounts created by the 1981 reform is not capable of meeting the pension needs of all Chileans’ (Chile Presidential Advisory Council, 2006)
Primary lessons

• Funded individual accounts can be part of a good reform, but such a reform is not easy
• Private supply plus competition are not on their own sufficient to keep down costs or charges
• Unless accompanied by a robust system of poverty relief, individual accounts are not a pension system, but only a part of a pension system
Reform proposals

The strategy:

The Council proposes ‘to move from a system dominated by individual accounts to a pension system capable of balancing and integrating its various components …. Instead of giving preference to one pension scheme over another or developing parallel systems, the proposed system [will] be structured on three pillars: a solidarity pillar, a contributory pillar and a voluntary pillar. These pillars must be capable of complementing and integrating with one another to ensure that older people have a decent life in old age’ (Chile Presidential Advisory Council, 2006).

• The key strategic reform is the proposal to introduce a solidarity pillar
The solidarity pillar

• Above the poverty line, phased in to reach 75,000 pesos/month by the end of the Presidential term
• Payable to lowest 2/3 of population, i.e. affluence test
• Husband and wife in poor families each gets full basic pension
• Tax financed
• Replaces the minimum pension guarantee and welfare pension
Individual accounts: Recommendations include

• Extending the mandatory system to self-employed workers
• Assisting low-income workers to accumulate funds
• Addressing gender disparities
• Improving the operation of individual accounts
Comparator countries

• The old system in Chile has much in common with Singapore, based heavily on individual saving
• The reforms bring Chile much closer to
  • Australia: tax financed pension for all but the best off, plus mandatory individual accounts
  • New Zealand: tax financed pension for all, plus voluntary individual accounts
  • Netherlands: tax financed citizen’s pension plus de facto mandatory occupational schemes
3.2 China

- The system for urban workers
  - Basic pension
  - Individual funded accounts
  - Voluntary pensions
Problem areas

• Fragmentation
• System deficits
• Problems with individual accounts
• Lack of nationwide administration
Reform directions

• Obvious reform directions
  • Extending coverage
  • Improving compliance
  • Raising retirement age
  • Ensuring accurate actuarial calculations

• Fundamental questions
  • Are fully funded individual accounts *desirable* given current and projected economic conditions in China
  • Are they *feasible* given current regulatory capacity and the current state of financial markets in China?
Are funded pensions desirable?

• Is a move toward funding optimal?
  – Does it increase output by
    • Increasing savings in a country that is short of saving, and/or
    • Strengthening capital markets, improving the efficiency with which savings are channelled into investment
  – Does it have desirable intergenerational redistributive effects?

• Is a move towards funding feasible? Are economic conditions and institutional capacity such that a country can implement schemes that are
  • Safe and
  • Administratively cheap?
Conclusion: individual funded accounts

• Funded individual accounts in China
  • are not necessary to encourage savings
  • may be counter-productive in assisting efficient investment, particularly since voluntary funded pensions can help to develop capital markets
  • have perverse intergenerational redistributive effects
  • are likely to strain scarce implementation capacity

• These are conclusions for China today; do not necessarily apply to China in the future
How should individual accounts be organised?

• Notional defined contribution (NDC) pensions (e.g. Sweden)

• Advantages in the context of China
  – Offers consumption smoothing to today’s contributors, hence continues the purpose of individual accounts
  – But avoids the risks of funded individual accounts
    • Less risky for workers, since avoids volatility of capital markets
    • Because no fund is built up, does not require today’s (poorer) workers to make larger contributions, thus avoiding unsatisfactory intergenerational redistribution
    • Does not require the considerable private-sector financial and administrative capacity of funded schemes
  – NDC can be the basis for a future move to partial or full funding
3.3 The US Thrift Savings Plan

• The system
  • Voluntary for federal civil servants
  • Five funds; workers can choose
  • Centralised fund administration
  • Wholesale fund management

• Comments
  • Simplifies choice for workers, respecting information constraints
  • Keeps administrative costs low
  • The UK is considering a similar arrangement
Conclusion

• Strategic policy design and implementation are equally important
• Chile illustrates (broadly) sound implementation of a faulty strategy
• China illustrates faulty implementation of a basically sound strategy
• Thrift Savings Plan offers useful pointers
References


