Strengthening welfare states and pension systems: The role of the state, solidarity and risk sharing

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Strengthening welfare states and pension systems: The role of the state, solidarity and risk sharing

1. Why a flourishing welfare state is essential
2. Some pension economics: A brief but necessary digression
3. Core messages for pension strategy
4. Pension design: Some examples
5. Possible directions of travel

1 Why a flourishing welfare state is essential

- In a civilised society – access to adequate education, nutrition, health care, etc.
- Why do we have a welfare state?
  - Well-known that the welfare state exists to provide poverty relief, redistribute income and wealth, and reduce social exclusion
  - Less well-known: the welfare state exists for efficiency reasons, to do things that private markets would either not do at all, or would do badly
- Thus the welfare state is not a socialist plot, but exists to promote equity *and* efficiency
- Useful to explain briefly why markets might not be efficient

Why might markets not do things efficiently?

- Imperfect information (addressed by the economics of information, Nobel Prize 2001)
- Non-rational behaviour (addressed by behavioural economics) Nobel Prize 2002, 2017)
- Search frictions (Nobel Prize 2010)
- Incomplete markets, incomplete contracts (Nobel Prize 2016)
- Distortionary taxation (addressed in literature on optimal taxation, Nobel Prize 1996)

Market failure and the welfare state

- The welfare state has many elements, including health care (day 3 of the Regional Seminar) and pensions – the subject of this talk
- The various market failures both ***explain*** and ***justify*** why a flourishing welfare state is an essential part of a modern economy
- In particular, imperfect information etc. create problems when making choices about complex products like pensions
- Good pension design takes account of such market failures

What makes a good pension system

- Respects multiple objectives
  - Consumption smoothing
  - Insurance
  - Poverty relief
  - Redistribution
- Respects constraints
  - Fiscal
  - Behavioural
  - Institutional capacity
  - Shape of the income distribution

What makes a good pension system (2)

- Design to improve gender equality
- Women on average receive lower pensions than men for one or more of the following reasons
    - Lower hourly pay
    - More likely to work part-time
    - More career breaks
    - A lower retirement age than men
    - Where single-sex annuities are permitted
- Good pension design seeks to counteract these effects

2 Some pension economics: A brief but necessary digression

Don’t overstate the usefulness of consumer choice

- Not a talk about economic theory, but important to explain why the policies I discuss later are good design
- The simple model (well-informed consumer, rational behaviour, etc.) is a bad basis for policy design for complex products like health care or pensions

Problem 1: Imperfect information

- About quality (pharmaceutical drugs over the internet that may be fake or low quality)
- About price, e.g. administrative charges for pensions
    - If your pension fund charges you 1% of your accumulation per year to manage, over a full career your accumulation (and hence your pension) will be 20% smaller than without the administrative charge
    - Statement is not an opinion but an arithmetic fact
- About the future (inflation in future years)

Problem 1: Non-rational behaviour: Lessons from behavioural economics

- What conventional theory predicts
    - Voluntary saving over working life
    - Voluntary purchase of annuities at retirement
- What actually happens
  – Bounded rationality
    - Procrastination: people delay saving
    - 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: impossible to process information about more than 800 different funds (90% go into Swedish default fund)
  – Bounded will-power: people do not save, or do not save enough
- Separately, someone with low pay frequently cannot afford to save

Outcome: many consumers make bad choices about pensions

- The model of choice and competition is the wrong model because
  - Choice has high administrative costs
  - Consumers often do not make a good job of choosing: they often
    - Do not save enough
    - Retire too soon
    - Delay choice or make no choice and/or
    - Choose an unsuitable portfolio
  - Firms exploit asymmetric information (evidence from US & Australia)
    - High charges, often with little relation to fund performance
    - Sometimes biased advice
- Thus
    - Mistaken to think that most people will make good choices
    - Mistaken to think that people will act in the ways simple competitive theory predicts, e.g. that they will move from less good providers to better ones
- Implications for pension design: more below (section 4.1)

3 Core messages for pension strategy

- Saving matters
- Solidarity matters
- Strong central administration matters

3.1 Saving matters

- Declining fertility in many countries will lead to a smaller workforce
- A rational response is to make each individual member of the smaller workforce more productive through increased investment in human and physical capital
- To that end, higher saving is important provided that it leads to investment in productive assets

The ‘So what?’ question: Why do we have financial markets?

- The primary purpose of financial markets is to translate the savings of individual savers into productive investment, where
  - ‘Investment’ means physical capital (factories, machines, infrastructure) and human capital (skills)
  - ‘Productive’ relates to output growth both now and in the future
- Choice of assets can be made in the private sector, public sector or a mix
  - By central administration outsourcing fund management to private fund managers (US Thrift Savings Plan, UK NEST)
  - By an independent public body ***genuinely*** at arm’s length from government (Canada, Norway)
  - By government for the government default, and by private fund managers for private pension plans (Sweden)

3.2 Solidarity matters

- Have discussed reasons why the welfare state is necessary in areas where private markets do not work well
- But, as noted, the welfare state also exists to provide poverty relief, to redistribute income and wealth, and to reduce social exclusion
- Thus loud cheers for the solidarity pension in Chile
    - Interestingly with strong support from at least three Finance Ministers – Andrés Velasco, Alberto Arenas and Mario Marcel
    - And rightly supported unanimously by the Bravo Commission
- However, there is room for risk sharing more widely than the solidarity pension; later in this talk I will discuss a proposal for collective insurance which adds this dimension

3.3 Strong central administration matters

- Role of central administration is to provide the overall framework within which the pension system operates
- Distinction 1: a public body organising the framework does not mean that the whole activity must be public
  - Example: UK National Health Service provides some services itself and brings in others from the private sector (e.g. MRI scanners, pharmaceutical drugs)
  - More examples below
- Distinction 2: useful to think separately about two different parts of pension systems
  - Account administration (e.g. record keeping): beneficial if centralised (e.g. Sweden)
  - Fund management, i.e. the choice of financial (and other) assets bought with a worker’s savings: can be private, public or mixed

Different ways in which central management can work

- Sweden
    - A central clearing house collects contributions, keeps records and passes contributions to the worker's chosen pension fund
    - Workers can choose from private providers or be in the government-organised default fund
- Canada Pension Plan
    - National plan is partially funded
    - National entity keeps records
    - Choice of assets made by the Canada Pension Plan Investment Board, a public body at arm's length from government
- Norway Sovereign Wealth Fund similar
- UK NEST pensions: more below

4 Pension design: Some examples

4.1 Pension plans and pension systems

- Plans and systems
  - A pension system is made up of multiple plans, e.g. a non-contributory plan, a risk-sharing plan and individual accounts
  - Current Chile system comprises the solidarity pension and individual accounts
- Can combine multiple elements in different proportions
- A system does not have to include individual accounts, but if it does, the design below is superior to current arrangements in Chile

4.2 A better way to organise individual accounts

- Design questions
  - Q1: Should a pension system include individual accounts? Yes, at a minimum to offer a good method for voluntary pension saving
  - Q2: Should individual accounts be mandatory? Not necessarily, but if mandatory
  - Q3: Should individual accounts be a major part of the system (Chile) or a small part (Sweden)?
  - Q4: If a system has individual accounts, how should they be designed? What is needed are simple savings plans
    - A limited range of choices (conclusion from behavioural economics), and
    - With low administrative costs
- Three principles of good design (Barr and Diamond 2017)
    - People who wish to make choices about pensions and retirement should generally have room to do so
    - But as widespread international evidence makes clear, some people will not make choices, choice can be costly, and some people may make bad choices. Thus:
    - The pension system should work well also for people who make no choice – and making no choice should be an acceptable option

If a system has individual accounts, how should they be designed?

1. Membership could be mandatory, or with automatic enrolment, or voluntary
2. Keep choices simple
3. Include a good default option that includes life-cycle profiling
4. Keep administrative costs low by decoupling account administration from fund management
   - Centralised account administration
   - Fund management
     - Wholesale, competitive; or
     - Sovereign wealth fund; closest example is Norway

Simple, cheaply administered individual accounts

- An example of the approach is the UK National Employment Savings Trust (NEST) (www.nestpensions.org.uk)
- Design explicitly based on the findings of information and behavioural economics

Key elements of the NEST design

- Automatic enrolment
- Limited choice
    - Default fund for a worker who makes no choice: or choice from
    - A higher risk fund, i.e. potentially higher growth
    - A lower growth (hence lower risk) fund
    - An ethical fund
    - A Sharia fund
- Centralised account administration
- Wholesale fund management
    - NEST managers decide in-house on overall exposure to building block funds and asset classes, e.g. what fraction of savings is held in global equities, government bonds, etc.
    - Fund management outsourced to private fund managers on a competitive basis
    - Quarterly updates https://www.nestpensions.org.uk/schemeweb/nest/aboutnest/investment-approach/other-fund-choices/fund-factsheets.html

Advantages of the approach

- Respects lessons from the economics of information and behavioural economics
- Simplifies choice for workers
- Keeps administrative costs low
- Locates competition in the right place
  - Financial markets have a hugely important task
  - They do so efficiently with well-informed participants on both sides of the market – the NEST design does that

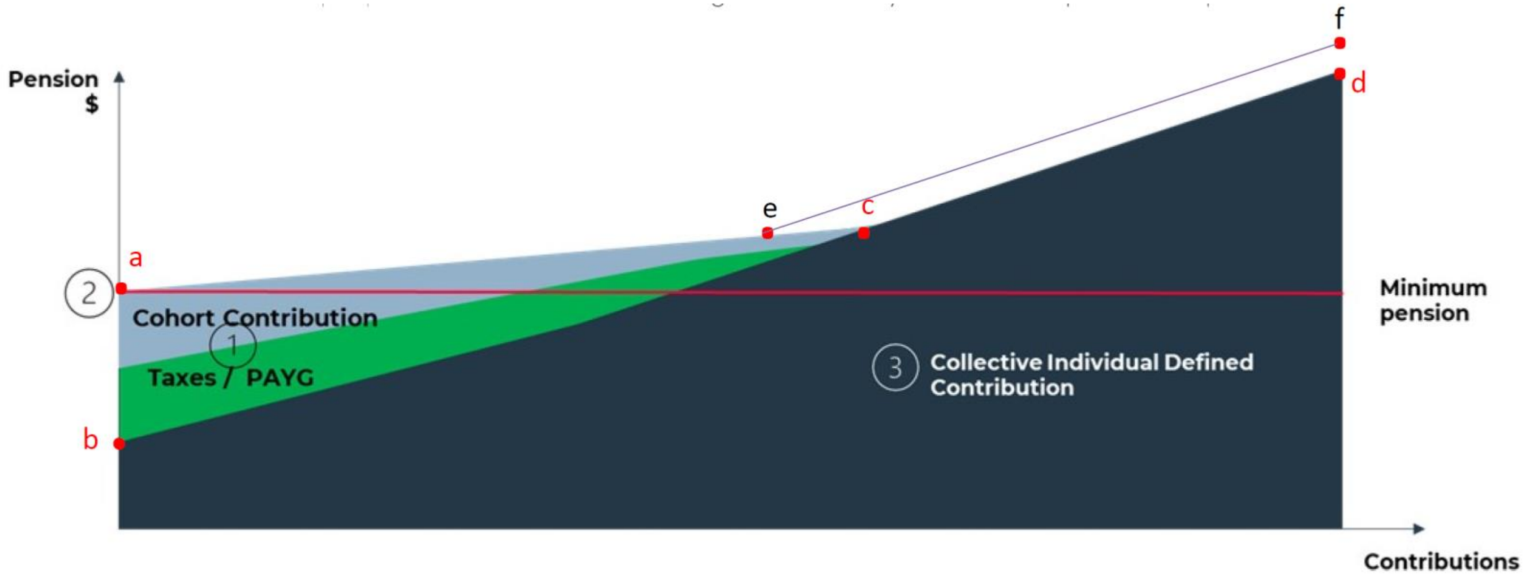
4.3 Collective insurance: A new design

- A new design proposed by a group of my graduate students (from Colombia, Chile, Peru) (Achieving a Better Mix of Pension Provision in Latin America)
- The idea of collective insurance
    - A third part of the system, alongside the solidarity pension and individual accounts
    - Collective insurance pays an additional pension that is larger for people with smaller individual account pensions

What do we mean by collective?

- With individual accounts, the individual faces all the risk (Individual Defined-Contribution (IDC) plans in Chile, Australia)
- Collective arrangements provide risk sharing, a design question being how widely risk is shared
  - Shared risk within a cohort (Collective Individual Defined-Contribution (CIDC) plans), e.g. UK NEST pensions
  - Shared risks across all cohorts (Collective Defined-Contribution (CDC) plans), e.g. the Netherlands until recently

A flexible design to accommodate economic, demographic and political circumstances



1. Collective insurance can be financed with workers contributions, taxes and / or through a PAYG contribution
2. The minimum pension in each country should depend on the feasibility to finance it
3. The percentage of contribution to each component depends on each country political capacities

Stefano Bacigalupo, Gonzalo Banda, María Ossa, Mónica Palomino & Miguel Zarama

Flexible policy choices

- Individual accounts (the line b-d)
  - Organised like NEST
  - Can be a larger or smaller part of the system
- Pension from collective insurance: policy choices
  1. Maximum collective benefit (b-a) for someone with little or no individual account pension: could be larger or smaller;
  2. Minimum collective benefit (d-f) for someone with large individual account pension: could be positive or zero
  3. The taper rate (slope of a-c), i.e. how quickly or slowly the collective benefit declines as a person's individual pension rises; taper could be steeper or less steep
  4. Division into pensions paid from (a) contributions and/or (b) taxes/PAYG contributions: PAYG element could be larger or smaller
  5. Whether the funded element is collective for single cohorts (CIDC), or for all cohorts (CDC)
  6. Speed of accumulating the funded element: could be faster or slower

Other design features

- Gender: the greater the relative importance of the solidarity pension and collective insurance the more the system contributes to gender equality
- Finance: in the context of Chile
    - The collective insurance element could be financed from the new contribution plus an initial taxpayer subsidy while the funded part builds up
    - The benefit could be larger or smaller depending on the size of the initial taxpayer subsidy
    - Collective insurance could be combined with larger or smaller individual accounts
        - An option could be to divert part of the current 10% contribution from AFPs into the funded element of collective insurance
        - BUT if reform includes that element, important that the flow of contributions diverted to collective insurance should be used for the funded element – for the reasons set out earlier, maintaining or increasing saving is an essential response to declining fertility

5 Possible directions of travel

- Maintain and strengthen the solidarity pillar
- Individual accounts: a government AFP organised along the lines of NEST
    - Centralised record keeping
    - Cheap administration
    - Thoughtfully limited choices for workers
    - Note: in a survey by the Bravo Commission 69% of respondents said that if a government AFP was offered they would move to it
- Collective insurance: further detailed work in the context of the economic, political and institutional situation in each country

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