# THE FUTURE OF PENSIONS:
## *A Global Vision*

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*There are at least three objectives of pension systems. The first objective, consumption smoothing, is us in our middle years, redistributing to ourselves in retirement. The second objective, insurance, includes things like annuities where you trade in your pension savings for a guaranteed income for life. And the third objective is poverty relief, making sure that no person is poor in old age.*

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Simple economic theory starts by assuming that people are rational, well-informed, and make their own decisions well. And that's the wrong starting point for pensions. What's needed is what economists call "second-best analysis", which looks at the following problems: people have imperfect information, which is addressed by the literature on the economics of information for which the Nobel Prize was awarded in 2001; people behave in ways that are not rational, addressed by the literature on behavioural economics, for which the Nobel Prize was awarded in 2002 and again last year; incomplete markets and incomplete contracts, for which the Nobel Prize was awarded in 2016; and problems like distortionary taxation. If you want to have poverty relief, you have to tax richer people more in order to redistribute to poorer people. That causes problems that are addressed by the literature on optimal taxation, for which the Nobel Prize was awarded in 1996. The reason I mention these Nobel Prizes is to make the point that this is not an idiosyncratic London School of Economics view of the world.

Can people make rational choices? There are two problems. The first of all is people can't. In many areas of social policy, the model of the well-informed consumer doesn't hold. In a survey in America, 50% of the public didn't know the difference between a stock and a bond. Now, if you don't understand something as basic as that, then you're not in a position to make good choices about your own pension. Few people realize the significance of administrative charges for pensions. You've got lessons from behavioural economics. Bounded rationality is the term economists give when a problem is simply too complicated for people to be able to make good decisions.

So, a lot of people can't make good choices. There is evidence on financial literacy that shows just how bad it is. There's an international study, and they asked people three questions. The first one was: “If you have €100 in a bank account and the bank account pays 2% interest a year, how much would you have in the bank account after five years? €102? More than €102? Less than €102?” The other two questions were equally simple, but the number of respondents who got all three right in the United States was about 35% of people. In countries like Sweden, Japan, and New Zealand, only about a quarter of respondents could answer all three of those very simple questions correctly. And in Russia, only 2%. So, problem one, people can't make good choices.

Problem two, there are some people who could, but they don't. I'm writing another book on pensions with Peter Diamond, a Nobel Prize winner in Economics. When we write about this, we say people don't review their pensions often enough. Then we put in a footnote that says, "This is true of both of the authors of this book." People, even if they do understand, would

rather be playing tennis, playing with their grandchildren, writing books, making money, doing other things. So you've got a real problem.

### What does this tell us about pension design?

I think it gives us four lessons. First of all, giving people less choice is part of good design. People can't make good choices. Given the problems I've just talked about, reducing choice can improve people's welfare. So you should restrict people's choice of pension provider by giving them a limited menu of options. You should restrict people's choice about how much to save. You should either require them to save, or automatically enrol them. Second lesson is, don't overstate what financial education is capable of achieving. Financial education is enormously important. It should be taught in every school. Lesson three, choice and competition is the wrong model. Choice and competition is wonderful for computers, smartphones, restaurants, or airlines. But it doesn't work where people are not well-informed. So, none of you is allowed to go into the pharmacy and buy any pharmaceutical drugs you like over the counter. You need a letter from your doctor to give you access to more powerful medication. And that's for reasons we all understand. Pensions are much more like pharmaceutical drugs than they are like smartphones. In Sweden, where workers have to choose from a large number of funds, but there is a default fund for people who don't choose, most experts are in the default fund. So the model of choice and competition is the wrong one. And the fourth lesson is, incentives matter, but not as much as you think. Sometimes politicians say to people, "Save for your old age, and we will give you a tax deduction. We will give you a tax advantage for saving." That creates an incentive to save, and politicians think that because of that incentive, people will save more. And the evidence is they don't, or they don't very much.

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Economic theory tells us a lot about policies that don't work, and points us towards systems that are simpler and which give people less choice. So what does that tell us about the way ahead? First of all, labour markets have changed. There are much more fluid labour market relations today than in the past. Secondly, as we know, demographic change and population ageing. And the third big challenge is risk and uncertainty.

Looking at those in turn, in 1950, most people were employed on a full-time contract, and they stayed with their employer long-term. Today, labour market relations are much more diverse. People can be employed, or self-employed, they can be outside the paid labour force, they can be full-time, part-time, or on zero-hour contracts. And you've got people moving across those, people who may be full-time for some of the time, but then they move to part-time, or they move to self-employed. What that means is that if you have pension contributions tied to someone's paid formal employment, you will get less good coverage today than you would've done in 1950. So the policy direction that that points you towards is to have a system of non-contributory pensions to provide the poverty-relief element. So these are flat-rate, tax finance pensions awarded when you reach pension age, and based on a test of residence. This strengthens poverty relief because everybody, once they reach pension age, gets the non-contributory pension. It improves adequacy if the benefit is high enough, and it's got good gender effects, because women generally have less good contribution records than men.

So there are good arguments for having a non-contributory pension as the base element in a pension system. This is not just a bit of academic theory. Some countries have non-contributory pensions. Australia has an affluence test, meaning most Australians get the non-contributory pension, but the best-off don't. Canada has a non-contributory pension. The 5% of richest Canadians don't get the pension everyone else does. Chile has a non-contributory pension, so does the Netherlands, so does New Zealand, so do a range of developing countries.

So, challenge one, more-fluid labour markets, policy direction, and non-contributory pensions. Second challenge is

population ageing. Populations are getting older for two different reasons. People are living longer, and people are having fewer children. And we need to discuss each of them separately. People are living longer healthy lives, which means they need to work longer, so you need later retirement, but also you need more flexible retirement. The historical model was, you worked full-time until you turned 65, and then you retired completely. And that's a bad model in economic terms, in political terms, and in social policy terms. What you want is for somebody to work full-time until they reach pension age, and then they should be able to move from full-time work to full retirement, along a time path of their choosing. So, for example, in Sweden, when you reach pension age, you can take all of your pension, or you can take none of your pension, or you can take 25, or 50, or 75% of your pension. So you can get part of your pension, and combine it with continuing part-time work.

Secondly, population ageing because of lower fertility. The policy direction for lower fertility is to save more. The argument is very straightforward. If fertility is declining, the work force in future will be smaller. If you want to keep up national output, you need to make each individual member of that future smaller work force more productive. And the way you do that is by investing in his or her skills, and by investing in the equipment, the physical capital that he or she will be using. So the policy direction to counter declining fertility is higher investment in human capital and in physical capital, which means more saving.

There are many ways of organizing saving. One way of doing it is to have funded individual accounts from competing pension providers, which is the model in Chile and Australia. This is, in some ways, the model of choice and competition, which I've argued is the wrong model for pensions. There are other ways. You can have simpler, cheaper individual accounts with less choice. You can have industry plans based around saving, as in the Netherlands. So in the Netherlands, if a worker works for an industry, he or she

pays pension contributions, it goes into the industry pension fund. And when the worker retires, he or she gets a pension. There's a whole range of different ways in which you can organize saving. Declining fertility means you need more saving, but it doesn't have to be done in the pension system. It can be done outside the pension system. For example, in Norway, they've got the Sovereign Wealth Fund, and part of the purpose of that is to finance future pensions. So an example of the approach is to have simple savings and simple annuities.

The implications for pension design are at least three: first of all, you make pensions compulsory, or you use automatic enrolment. Automatic enrolment, if you join a firm, you're automatically put into their pension plan. You can get out of it if you want to, but you have to do paperwork. So the default is, you're put in. Second implication, keep choices simple, so have a single default fund for workers who don't make a choice. And then, outside the default fund, have a small number of very simple choices. And the third thing you do is, you need to keep administrative costs low. Administrative costs really matter. The only advice I ever give people about pensions is, look at the administrative charges your fund charges you. If your fund charges you 1% of your account per year, over a full career, your pension's savings accumulation will be 20% smaller because of that 1% charge than it would be without it.

Another example. The US Thrift Savings plan is a plan for US federal civil servants. If you join the federal civil service, you're automatically enrolled in the plan. You can choose a fund from five funds, but if you don't make a choice, then there's a default fund. Or the administration is centralized to keep costs low. And the fund management itself is outsourced to the private sector. My argument is, you need to separate two things. The record keeping, where pension providers, or pension managers, have got no particular expertise, and deciding what to do with people's savings. That's what the fund industry is there to do. So if you centralize the administration, and let the fund industry do what it's good at and it's important –namely, investing the funds–, that's a good division of labour.

NEST pensions in the United Kingdom –National Employment Savings Trust. This plan was introduced a few years ago. It was explicitly based on lessons from behavioural economics. Workers are automatically enrolled. There is a default fund which is a target date fund, where the target date is your expected retirement age. There are four other choices from which a worker can choose: a higher-risk fund, a lower-risk fund, a Sharia fund, and an ethical fund. So you've got some very simple designs.

Peter Diamond and I were asked to advise an Australian enquiry into the design of default arrangements. And the approach we took was to say that people who want to make choices about pensions should be able to do so, but some people won't make choices. And choice can be costly. And some people make bad choices. So a fundamental point was, a well-designed pension should work well for somebody who makes no choice, and making no choice should be an entirely socially acceptable thing to do. So to that end, we recommended six recommendations: a single default design, a simple choice architecture, so alongside the default you have a very small, limited number of choices. You have one account per person. In Australia, when a worker moves from one industry to another, very often they start a new pensions pot, so workers have got lots of small pensions that can easily get lost. Fourth, you need a single clearing house to collect contributions from all workers, and distribute them to providers, which is the system in Sweden. You need a single record keeper, which again, is the system in Sweden. And then, if you've got a state-run default, you need to create a level playing field with private providers, so you can have the state and the private providers competing on equal ground.

Key message is, economic theory has had a lot to say on the subject. There is not a simple solution, but there are at least some ways ahead that make sense.

**Bio**

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es profesor de economía pública en London School of Economics (LSE). Es autor de numerosos libros y artículos sobre la economía del estado del bienestar y las finanzas de la educación superior, incluidos *The Economics of the Welfare State* (Oxford University Press, 5ª edición, 2012) y *Reformas de Pensiones: Principios y opciones de política*, coautor del Premio Nobel 2010, Peter Diamond (Oxford University Press, 2008). Su enseñanza incluye la economía pública, la economía del estado de bienestar, la economía política de la transición poscomunista y temas de política pública.