



3º SEMINÁRIO INTERNACIONAL DE PREVIDÊNCIA COMPLEMENTAR

Freedom of the saver and retirement security in voluntary private pension plans

Realização:



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1

Freedom of the saver and retirement security in voluntary private pension plans

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Ministry of Labor and Social Security, Brazil

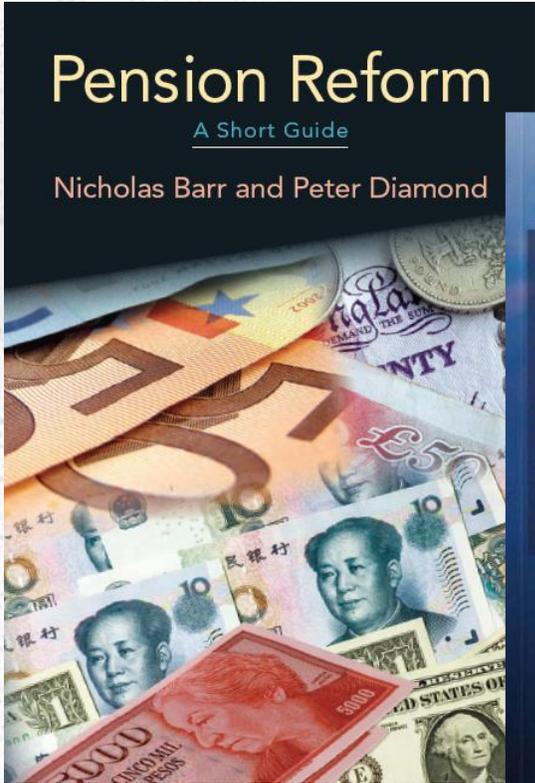
1 December 2021

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1. The backdrop

2. How much freedom of choice should workers have?
3. Should workers be allowed early access as a Covid-19 response?
4. What difference does the changing nature of jobs make?
5. How should drawdown be arranged?





Pension Reform

A Short Guide

Nicholas Barr and Peter Diamond

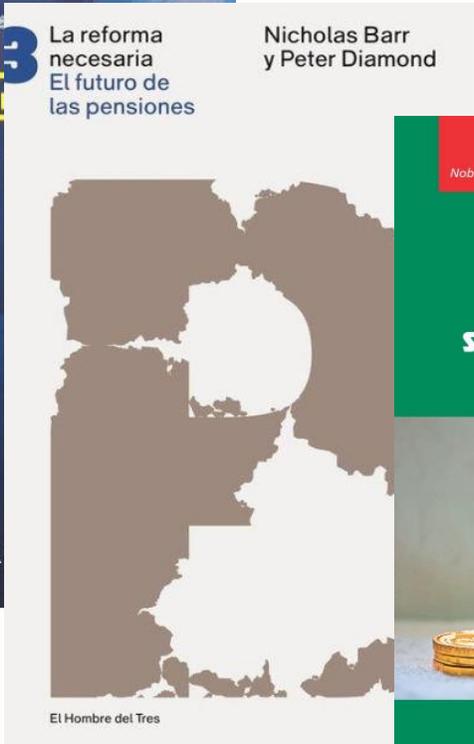


尼古拉斯·巴尔 (Nicholas Barr)
彼得·戴蒙德 (Peter Diamond)

养老金改革理论精要

Pension Reform:
A Short Guide

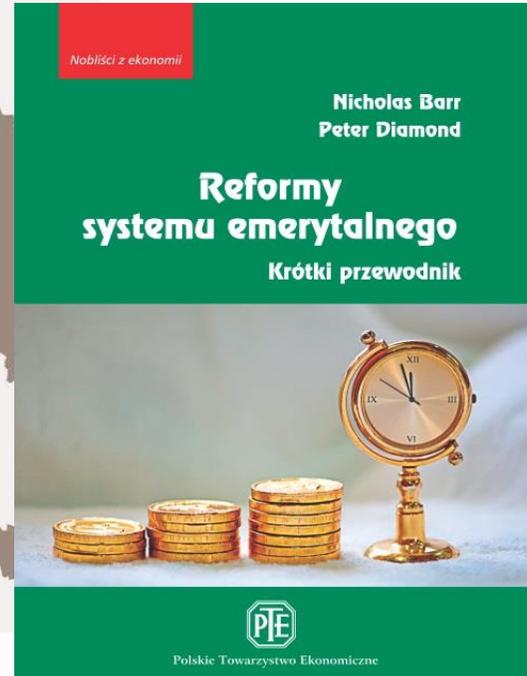
中国劳动学会



La reforma necesaria
El futuro de
las pensiones

Nicholas Barr
y Peter Diamond

El Hombre del Tres



Nbliści z ekonomii

Nicholas Barr
Peter Diamond

Reformy systemu emerytalnego

Krótki przewodnik



Polskie Towarzystwo Ekonomiczne



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What makes a good pension system

- Respects multiple objectives
 - Consumption smoothing
 - Insurance
 - Poverty relief
 - Redistribution
- Respects constraints
 - Fiscal
 - Consumer behavioural capacity
 - Institutional capacity
 - Political capacity



Principles of good pension design

- The primary purpose of pensions is old-age economic security
- People who wish to make choices about pensions and retirement should generally have room to do so
- But
 - Some people will not make a choice
 - Choice can be administratively costly, and
 - People often make bad choices (section 2.1)
- Thus: the pension system should work well also for people who make no choice – and making no choice should be an acceptable option (section 2.2)



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2.1 The problem

- Simple theory assumes what economists call a first-best world, in which everyone
 - Is well-informed
 - About their future needs and circumstances
 - About financial markets and financial products
 - Is rational, with a long time horizon
- What is needed is what economists call second-best analysis
 - Imperfect information (the economics of information, Nobel Prize 2001)
 - Non-rational behaviour (behavioural economics, Nobel Prize 2002, 2017)
 - Search frictions (Nobel Prize 2010)
 - Incomplete markets, incomplete contracts (Nobel Prize 2016)
 - Distortionary taxation (necessary to finance redistribution; addressed in the literature on optimal taxation, Nobel Prize 1996)
- Thus the simple model is right for an imaginary world but in complex areas is a bad basis for policy design



Imperfect information and non-rational behaviour are pervasive

Lessons from information economics

- 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
- Few people realise the significance of administrative charges for pensions: **over a full career an annual management charge of 1% reduces a worker's accumulation by about 20%**



Non-rational behaviour

- Simple theory predicts
 - Voluntary saving to maximise lifetime utility
 - Voluntary purchase of annuities
- 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 hundreds of different funds (in Sweden, with choice from over 800 funds, 90% of workers go into the default fund)
 - Bounded will-power
 - People do not save, or do not save enough
 - People (including financially knowledgeable people) spend too little time on their pension affairs given time/energy/attention constraints



Example Financial literacy is shockingly limited

Lusardi, Annamaria and Olivia S. Mitchell. 2014. "The Economic Importance of Financial Literacy: Theory and Evidence." *Journal of Economic Literature*. 52(1): 5-44

- Interest: you have \$100 in a bank account paying 2% interest a year. How much would you have in the account after 5 years:
 - less than \$102?
 - equal to \$102?
 - more than \$102?
 - don't know?
- Inflation: suppose that the interest rate on your bank account is 1% a year and that inflation is 2% a year. After one year, with the money in this account, would you be able to buy
 - more than today?
 - the same as today?
 - less than today?
- Risk. True or false? Using \$100 to buy shares in a single company usually provides a safer return than buying \$100 of a unit trust (i.e. something that holds a wide range of shares)?



As a result

- Individuals save too little
- Make bad choices of portfolio and provider
- Start to draw down too soon, and
- Do not annuitise enough



2.2 Implications for the design of individual accounts

1. Make pensions mandatory or use automatic enrolment
2. Keep choices simple: highly constrained choice is a deliberate and welfare-enhancing design feature
3. Include a good default option which includes life-cycle profiling if the system requires annuitisation
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



Examples

- The US Thrift Savings Plan (www.tsp.gov)
 - Auto-enrolment plan for federal civil servants
 - Workers choose from five funds
 - Centralised account administration
 - Wholesale fund management
- UK National Employment Savings Trust (NEST) (www.nestpensions.org.uk)
 - Similar design to TSP for similar reasons
 - Phased in from 2012
- Kiwisaver



Key features of NEST

- If a country wishes to have funded individual accounts as part of its pension system, the NEST approach is the way to do so (www.nestpensions.org.uk)
- The design is explicitly based on the findings of behavioural economics
- Key elements
 - Auto enrolment
 - Limited choice
 - Centralised account administration
 - Wholesale fund management



Limited choice

- Workers are automatically enrolled in the default fund
- A worker who wants to make a choice has 5 options
 - A higher risk fund, i.e. potentially higher growth
 - A lower growth (hence lower risk) fund
 - An ethical fund
 - A Sharia fund
 - A pre-retirement fund
- For details, see

<https://www.nestpensions.org.uk/schemeweb/nest/aboutnest/investment-approach/other-fund-choices.html>



Centralised account administration and wholesale fund management

- Account administration: NEST maintains all individual records
- Fund management
 - Decides in-house on overall exposure to building block funds and asset classes
 - Some investment is managed in house
 - Some is outsourced to private fund managers on a competitive basis
- Publishes quarterly updates: see

<https://www.nestpensions.org.uk/schemeweb/nest/aboutnest/investment-approach/other-fund-choices/fund-factsheets.html>



Assessment

The approach respects the lessons from the economics of information and behavioural economics

- Simple
 - Simplifies choice for workers
 - Auto-enrolment
- Keeps administrative costs low



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Early access as Covid-19 response

- Will people make good choices?
 - Might give priority to spending today at expense of long-run well being because of
 - Liquidity constraints
 - Present bias (a finding from behavioural economics)
- Will governments make good choices?
 - Short term electoral politics may dominate longer-term considerations
- Is allowing early access a good idea?
 - Earlier contributions in a DC plan are worth more than later ones because they earn interest for longer
 - Filling in contribution gaps later often does not happen, especially for the least well off
- What should happen?
 - Support pensions as part of current public spending (government as insurer of last resort: Velasco 2020)
 - 'Continue contributing to retirement plans. Governments may provide income transfers or subsidise the income of people as part of the many programmes to assist the populations facing the economic fall from COVID-19, the lockdown and the associated economic downturn' OECD, 22 June 2020, <https://www.oecd.org/coronavirus/policy-responses/retirement-savings-in-the-time-of-covid-19-b9740518/>



Generally a bad idea

- Government is, in effect, using workers' future pensions to reduce current public spending
- In social policy terms puts future pensions at risk
 - Especially true for poorer workers, who are most likely to need the money now
 - Contrast people who could work from home with no loss of income – typically higher earners
- In macroeconomic terms: given declining fertility, reducing saving is the wrong way to go
- The argument against allowing early access is stronger
 - The lower coverage of (e.g.) medical insurance
 - The smaller is any non-contributory pension



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The changing nature of work

- In 1950 the OECD norm was full time long-term employment
- That is no longer true in OECD countries, and never was true in developing economies
- Greater diversity of labour-market relations
 - Employed, self-employed or outside the paid labour force
 - Full-time, part time or flexible (e.g. zero hour contracts, gig economy)
 - Long-term or short-term
 - Formal or informal
- More movement across these relations
 - More dynamic labour markets
 - Need for more, and more frequent, training because knowledge goes out of date more quickly
- Thus contributory benefits tied to employment face problems of coverage



Implication: Less reliance on contributions related to employment status

- Why: the changing nature of work (i.e. multiplicity of labour-market connections) means contributions related to employment status
 - Are less effective in bringing about good coverage
 - Can discourage employment in the formal sector
 - Implication: where possible benefits are better financed from broadly-based taxation (Levy 2021)
- Implication: broaden sources of revenue
 - Poverty relief: non-contributory pensions (age and residence test) financed from general taxation
 - Insurance: health care financed not by a tax on formal employment but from broadly-based general taxation or a dedicated revenue source not related to employment status
 - Earnings-related benefits clearly must be contributory
 - Nudges such as auto-enrolment
 - Electronic payment opens up the possibility of basing pension contributions on consumption spending rather than income ([‘How millennials and savings apps are making asset managers wake up and smell the coffee’](#), *Financial Times*, 14 October 2018)



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Annuitisation

- Competitive annuity markets do not produce good results (UK Financial Conduct Authority, Australia Productivity Commission)
- Options include
 - Government-provided annuities (Sweden)
 - Guidance and nudge about what good drawdown looks like
 - And/or guidance about drawdown coupled with mandate to buy a deferred annuity, i.e. an annuity bought at (say) age 65 that pays benefit from (say) age 85
- A good answer will depend on
 - Institutional capacity
 - Surrounding institutions, e.g. the case for limiting drawdown is weaker where an individual (or a spouse) has annuitized benefits, for example a non-contributory pension or an occupational defined-benefit pension



Conclusion: Answering the organisers' essay questions

1) How much freedom of choice should savers have?

- Choice should be carefully constrained

2) Should workers be allow early access as a Covid-19 response?

- Early access as a crisis response is generally undesirable

3) What difference does the changing nature of jobs make?

- For poverty relief and insurance, rely less on employment-related contributions and more on broadly-based taxation

4) How should drawdown be arranged?

- Publicly-provided annuities or guidance on speed of drawdown are useful
- Deferred annuities may be also useful



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Thanks!

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