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Credible Pensions*

TIMOTHY BESLEY† AND ANDREA PRAT‡

†*London School of Economics; Institute for Fiscal Studies*
(T.Besley@lse.ac.uk)
‡*London School of Economics*
(a.prat@lse.ac.uk)

Abstract

One of the main problems in pension policy is to develop an institutional framework that guarantees that public and private pensions promises are kept. This paper discusses how the governance of public and private pensions is key to making such promises credible. It argues that credibility concerns undermine the case for earnings-related pensions run by the state and private defined benefit plans.

I. The issue

There is a huge amount of concern in the policy arena surrounding the reliability of pensions, whether provided in the public or private sector. It seems fair to say that, until recently, the problems of credibility were mostly associated with public pensions. Throughout the 1990s, it became clear that many such programmes had offered pensions that were not financially sustainable at current tax levels.[1] This did not seem to be such a significant issue for those parts of the world, such as the Netherlands, the UK and the USA, that had been encouraging private alternatives to public pensions.

But since the turn of the millennium, the credibility problem has spread to the private pensions industry. A series of high-profile problems in private pensions such as Allied Steel and Wire and corporate scandals such as

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[1]See, for example, OECD (2003).

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Enron and Parmalat have dented confidence in the governance of private money. This came on the back of a series of pensions mis-selling scandals throughout the 1990s. Many apparently cast-iron pension guarantees suddenly looked vulnerable in the wake of declining stock markets. In the UK, estimates of the aggregate private pension deficit vary from £160 billion to £300 billion (Confederation of British Industry, 2003).

The visibility of this issue has attracted attention from policymakers. A recent report by the House of Commons Treasury Committee (2004) on restoring confidence in long-term savings concluded that 'It is widely accepted that a lack of consumer confidence in parts of the financial services industry is now deterring many households from saving as much as they might otherwise choose to' and that 'There is no scope for complacency when it comes to public trust in the solidity and solvency of savings institutions'.

This paper is about the problem of trust in public and private pensions. Trust is largely a problem of credibility and whether we can reasonably believe that pension providers (public or private) will provide a reliable context for long-term pensions planning. To understand this issue requires an analysis of governance arrangements – the framework in which pensions decisions are made.

Behind the problems of credibility lie two key facts about pensions arrangements. First, they are not 'spot market' transactions – they rely on fulfilment of obligations over significant periods of time. That need not, by itself, create any substantial difficulties. For example, the same is true in many other contractual arenas such as long-term leases and drilling contracts for oil. This is where the second key feature comes in. Pensions arrangements have been governed by highly *incomplete* contractual arrangements. In fact, pensions (almost everywhere we see them) are promises rather than contractual obligations. This greatly limits recourse to legal remedy in enforcing pensions rights. There may be possibilities to tighten the form of contracts in future. But there are very real difficulties in specifying exactly what obligations are required. It is for this reason that governance is important and will remain a key issue.

Our discussion should be seen in the context of three sources of risk in preparing for retirement. The first is the risk of non-performance of pensions due to events that are outside the control of individuals. This includes exposure to some types of financial market risk. In principle, these risks could be mitigated by having individuals save for old age in some form of private low-risk savings. However, returns can be expanded by exploiting standard risk–return trade-offs. Individuals are able to mitigate risks by some form of risk-pooling arrangement. But to be effective, this requires a richer contractual structure and greater reliance on the performance of other

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parties. For example, the guaranteed annuities offered by Equitable Life required risk-pooling across generations of retirees, which proved ultimately unsustainable.

Thus involvement of other parties in pensions arrangements creates a second source of risk – that due to agency problems. Unless suitable arrangements can be found to limit opportunism by these other parties and to ensure that they always act in the interest of beneficiaries, then retirement incomes are at risk.

A third source of risk arises in so far as individuals are poor judges of their own self-interest. This could be because individuals are poorly informed or else because of some defective decision-making capacity – short-sightedness or time-inconsistency.[2] Pensions are relatively complex arrangements and few consumers are highly knowledgeable.

Good governance is, in part, about finding effective means to deal with these sources of risk.[3] This is especially true in the case of agency risk, given the complicated network of agency problems that can be involved in sustaining pensions. Debates about pensions have paid remarkably little attention to governance issues. Discussions seem to be premised on a model of pension providers (whether public or private) as benevolent, even if they are occasionally misguided. Most of the focus has thence been on technocratic issues – for example, developing transparent and accurate projections or improved accounting. Comparatively little attention has been paid to understanding *incentives* to deliver on pensions promises. This blind spot explains, in part, why confidence in pensions is lacking today, since there are many unresolved governance issues that go to the heart of pensions policy.

Governance problems were largely masked for most of the post-war era by a series of propitious conditions. In the context of public pensions, population growth and economic growth helped to ease the burden of pay-as-you-go pensions. Meanwhile, many private sector plans reached maturity during a time of strong stock market performance.

The contribution of this paper is twofold. First, we develop a simple approach to thinking about governance issues in pensions arrangements which we can apply to public and private pensions. Second, we discuss how institutions can be designed to deal with problems of credibility that arise, in the hope of improving pensions credibility going forward.

The remainder of the paper is organised as follows. In the next section, we lay a structure for thinking about governance and apply it to both public and private pensions. Section III then applies these ideas to ways of improving credibility and Section IV concludes.

[2]The literature in this area is now vast. See Rabin (2002) for a recent overview.
[3]See OECD (2000a and 2000b) for general discussion.

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II. Institution design

The key issue that concerns us here is whether it is possible to design institutional solutions that safeguard pension arrangements while still providing an attractive return to individuals. These are arrangements that solve the problems that arise via the variety of risks to which retirement saving is subject.

Experience suggests that adequate solutions are unlikely to rely exclusively on either public or private arrangements. It is necessary to understand public decision-making (political economy) and private decision-making in markets to strike the right balance.

1. Framework

We begin by outlining a simple structure for thinking about governance in pension plans in general. We then apply these ideas to different kinds of pension contracts. Pension arrangements have three key players: sponsors, beneficiaries and asset managers. These actors are responsible for making the main decisions that contribute towards a successful pension scheme.

The governance architecture of a pension arrangement is defined in terms of key *control rights*, i.e. the authority to make certain important decisions. We identify three main aspects of control rights: (i) contributions – how much to contribute to a pension plan and out of whose pocket; (ii) vigilance – taking responsibility for making sure that the plan is prudently managed (for example, matching assets and liabilities); and (iii) asset management – making portfolio choices. As we will show below, there are a number of ways to organise the allocation of control rights in a pension scheme. While schematic, this structure provides a useful first pass through a complex array of arrangements.

A final important idea is the issue of *residual claimancy* – who owns residual assets. This will shape the incentives that actors have for making certain decisions. We now show how public and private pension arrangements can be described in these terms.

2. Government pension plans

In the case of government pensions, the government serves as sponsor and asset manager. The beneficiaries are the citizens of the country who are eligible for benefits in the plan. Contributions typically take the form of taxes or special levies, although they may include some kind of voluntary component.

Control rights in public pension plans are geared heavily towards the government. Government sets contribution rates through the tax system and

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decides how to manage assets and liabilities. Government also takes responsibility for guaranteeing that any benefits that are promised are provided for adequately.[4] The rights of beneficiaries are limited to periodic elections over multiple issues, i.e. where pension policy is one of many things that are offered as part of political platforms.

State pension plans, including those in the UK, the USA and the largest EU countries, are normally financed on a pay-as-you-go (PAYG) basis. This means that current pension benefits are paid out of current contributions or taxes rather than accumulated assets. As a result, the asset management function in government pension plans is limited. The main activity is managing cash-flow control to ensure that there is sufficient income to cover current outlays.[5]

Most government pension plans are compulsory and monopolistic, i.e. there is little scope to choose between competing pension arrangements. These features could be rationalised on the grounds of adverse selection problems in annuity markets, i.e. individuals with different life expectancies are pooled together. However, the roots of public pensions are better located in two other concerns. First, there is a paternalist concern that individuals left to their own devices do not save enough.[6] Second, some provision needs to be made to finance an adequate retirement income for those who have earned low incomes during their working lives.

As we have already noted, governance in public pensions is via the general political process. The solvency of pension arrangements is backed by taxable capacity. As the policy history of the UK makes clear, it has been extremely easy for governments to make repeated policy changes that have an impact on the quality of public (and private) pensions. While governments may wish to phase these in over long time horizons, they have no obligation to do so. The ultimate sanction that voters have is to remove the government at the polls. It is, however, clear that this kind of governance mechanism cannot guarantee long-run predictability – the political process is sovereign and hence could, in principle, decide to change the pensions system at any future date.

The traditional view of political competition sees the median voter as gaining attention from politicians. But this is not particularly useful in

[4]In the UK, the fact that benefits are now decoupled from earnings allows benefits to be determined by fixing some kind of overall public spending budget. It is harder to do this in the continental European systems where benefits are explicitly linked to earnings.

[5]This explains why the management of PAYG pensions is usually not outsourced. See, however, Valdés-Prieto (2003) for an innovative proposal to securitise the stream of future pension contributions, thus creating a PAYG pension asset, which could then be treated as the asset of a fully funded scheme. Asset management could then be delegated to external agents and tailored to the needs of individual beneficiaries. However, as the author acknowledges, securitisation can only occur once the government has overcome the issue of credibility.

[6]This could be true *because* they anticipate that the state will look after them in old age.

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thinking about pensions policy. For example, this model is difficult to apply to the analysis of pensions since there are multiple cleavages in the pensions sphere – young versus old, rich versus poor, etc. The strongest kind of evidence against a simplistic view of the political determination process is provided by Mulligan and Sala-i-Martin (2004a and 2004b). After analysing the features of public pension programmes in a cross-section of countries, they conclude that similar programmes emerge and grow under very different political systems. In particular, there is no discernible difference between dictatorships and democracies. We thus need to turn to more subtle political theories.[7]

In theory, the political process will pay most attention to pensioners' interests to the extent to which pensioners are swing voters, i.e. inclined to change their party loyalty in response to pensions policies. This in turn depends on how salient is the pensions issue compared with other cleavages among the parties. For example, if parties have similar policies on other issues, we might expect pensioners to vote on the basis of pensions policy. Otherwise, it depends on how they weigh up pensions policy against other policy and reputational differences that separate the parties. The numerical size of the pensioner group matters only when pensions are salient in this group. While the pensioner population is growing, it is less obvious that pensioners are becoming an important class of swing voters. Comparing data from the British Election Studies for the years 1992, 1997 and 2001 does not seem to show any less party attachment by retired voters compared with other groups in the population.[8]

When thinking through governance in the political process, it is useful therefore to think through two extreme cases. The first is where pensioners have little political power. Pensions policy is then determined mainly by the actions of bureaucrats, party elites and interest groups. While this may be relatively 'undemocratic', it could actually be conducive to policy stability to the extent that there is a long-run consensus among the relevant parties. The second case is where the pensions issue is highly salient and pensioners are weakly attached to parties. This will tend to make pensions policy more sensitive to electoral politics. If parties adopt divergent policies, then a greater role for politics could actually increase policy uncertainty. Moreover, pensions policy will tend to react to the current short-term interest of the currently retired.

The UK has traditionally been in the first of these two scenarios, where electoral politics has played little role in determining pensions policy. But this has not been a source of stability as there have been shifting views on

[7]For an extensive discussion of the political economy of pensions, see Persson and Tabellini (2000, section 6.2).

[8]We are grateful to Valentino Larcinese for giving us access to his data on this.

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the kind of pensions policy that is deemed desirable in the public sector. The UK began with a consensus on implementing a basic state pension that would provide a reasonable living standard to all retirees, but this has shifted increasingly towards state pension provision that is seen as a poverty alleviation device.[9] This political shift began in the Thatcher years, when pension increases were decoupled from earnings. There is now considerable effort by the main parties to attract pensioners, and the relative decline in state pensions has increased the salience of pension issues. Almost weekly, parties now compete by offering their own reform proposals, creating greater policy uncertainty. However, by creating greater political uncertainty, this is likely to reduce rather than to increase trust in state pensions.

Once we accept that public pension systems are the equilibrium of a complex dynamic political problem that includes the possibility of *ex-post* renegotiation, we must ask what determines the credibility of such a system. Boeri, Börsch-Supan and Tabellini (2001) analyse a survey of citizens' opinions in France, Germany, Italy and Spain.[10] The first thing to note (Table 1) is that in every country except Spain, a vast majority of citizens expect a serious pension crisis in the next 10 to 15 years. The response does not appear to be linked to demographic dynamics: the most pessimistic country, France, also enjoys one of the highest fertility rates in Europe, while the most optimistic, Spain, has one of the lowest.

When asked whether they would like to opt out of the public system altogether, the answer depends on the alternative. If opting out means getting cash and a reduced pension benefit in the future, the majority are opposed (Table 2). If, however, the alternative consists of diverting the contributions that are currently going into the state system into an

TABLE 1

'Some people speak of a possible crisis in public pension systems, which would mean that, in ten/fifteen years time we would not be able to enjoy public pensions at their actual level. Do you agree with this opinion?'

	France	*Germany*	*Italy*	*Spain*
Don't know / No answer	14%	6%	7%	23%
Of those who answered: Yes	82%	81%	72%	43%

Source: Boeri, Börsch-Supan and Tabellini, 2001.

[9]In fact, the state pension has now reached the point that additional targeted transfers are needed to deal with pensioner poverty.

[10]While the findings that follow are interesting, it should be borne in mind that the historical and institutional circumstances do differ from the UK's in at least two important ways. First, the surveyed countries do not have extensive experiences with private defined benefit plans. Second, they have relied on earnings-related state-funded plans whereas the UK has had only limited participation in such schemes – public sector workers and the second state pension being the main exceptions.

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TABLE 2

'Suppose that you were offered the following "less contribution – less pension" deal. Namely, you were offered to reduce your contributions to <national public pension system> by one half (e.g., rather than paying 30 per cent, you pay 15 per cent <adjusted by country>), and receive this amount in your pay slip. When you retire, you will get a lower pension as if you had worked at 50 per cent of your salary from tomorrow onwards. Would you accept such a deal?'

	France	*Germany*	*Italy*	*Spain*
Don't know / No answer	6.5%	4.3%	6.6%	7.5%
Of those who answered: Yes	24.4%	47.2%	46.9%	18.9%

Source: Boeri, Börsch-Supan and Tabellini, 2001.

TABLE 3

'Consider a slightly different proposal: The compulsory contributions rather than being put in your pay slip would be put in an investment fund of your choice. You would be free to cash in from that fund only upon retirement. Would you accept such a deal?'

	France	*Germany*	*Italy*	*Spain*
Don't know / No answer	11.8%	4.3%	9.7%	13.2%
Of those who answered: Yes	49.7%	71%	67%	63%

Source: Boeri, Börsch-Supan and Tabellini, 2001.

investment fund of their choice, the vast majority of citizens are in favour, except in France, where they are equally split (Table 3).

Boeri et al. obtain further insight by examining the characteristics of the individuals who wish to switch to a private system. The most likely to want to switch are the young, the males, the better educated and those who have better information about the pension system (the level of information was obtained in earlier survey questions). Surprisingly, income is only marginally significant. Another interesting fact is that a majority of the respondents who would accept an unconditional opt-out would save all the additional income for old-age provision.

While the picture that emerges from the survey is still blurred, there are already some clear patterns:

- *The credibility of the classical European PAYG system is low.* People expect a crisis in the not-too-distant future. Mistrust is high even in a country such as Italy, which has seen radical pension reform in the past decade.
- *Most people want to opt out of state pensions.* They wish to leave the state pension system, not to enjoy the additional income now, but to invest in alternative saving schemes that they presumably deem more reliable.

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- *Information plays an important role.* Mistrust in the public system is higher in those individuals who know it better. As information about pensions improves, we might expect a greater demand to increase private provision.

It is difficult not to conclude that the European PAYG model faces serious problems, at least from the point of view of credibility. At the root of the problem lie the excessively generous promises that were made in past decades. In the 1960s and 1970s, governments guaranteed large pension entitlements to the then working-age generations at the expense of the future ones (who were under-represented in the voting process). This is a warning signal to any country, such as the UK, that is considering expanding the role of the state in pension provision. The experience in continental Europe teaches us that it is difficult to have PAYG provision that is both generous and credible.

In the UK, these issues manifest themselves in the context of pension plans for public sector workers. Such income-related schemes are financed by taxpayers on a PAYG basis. The government is currently engaged in an effort to roll back the generous commitments that have been made to such workers to avoid a future funding crisis. This gives a further vivid illustration of the absence of credible commitments to pension rights.

3. Private pension plans

We now turn to private pension plans and how they try to solve the problems of credibility. The issues that arise are different depending on whether the plan is defined benefit or defined contribution, and we discuss each in turn. Private pensions operate in a context of an array of tax and regulatory policies and hence are subject to significant public governance risk. First, the whole macroeconomic and financial climate is dependent on good management by government. Second, it is possible for government to change the tax laws that govern pension contributions and benefits. This is not just a theoretical issue – the current government changed the tax treatment of assets in private pension plans through the abolition of advance corporation tax relief in 1997, with a significant reduction in the implicit tax relief in private pensions. Moreover, it did so with limited phasing-in.

(a) Defined benefit plans

In a defined benefit (DB) plan, the employer is the sponsor, being responsible in the first instance for collecting contributions from employees and safeguarding these. Asset management and vigilance are more complicated and vary a great deal. However, most plans work on the basis of appointed trustees who retain a fiduciary duty to the beneficiaries. These

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trustees have responsibility for assessing the adequacy of assets against liabilities and frequently employ consulting actuaries to assist in this task. Large funds typically use some system of delegated asset management. The beneficiaries then negotiate with the sponsor over contributions to the fund. The degree of separation between the management of the pension fund and the corporate sponsor varies somewhat, particularly in the extent to which the trustees are also active in the sponsor's business.

To illustrate, consider the case of Hermes, which is the pensions plan for British Telecom (BT) in the UK. Hermes is governed by the BT Pension Scheme Board of Trustees, which comprises four member representatives, four company representatives – two from BT and two nominated by BT – and a Chairman, whose appointment is agreed by all the Trustees. The Board delegates management responsibility of Hermes to its Chief Executive, Chief Investment Officer, Chief Operating Officer and Head of Business Development.[11]

One important feature of DB plans is that the sponsor is a residual claimant. This can entitle a sponsor to take a contributions holiday or even wind up an overfunded pension scheme. While this was historically thought of as a problem of distributing surpluses, in recent years the key issue is how the sponsor becomes liable for pension fund deficits.[12]

It is apparent from this description that the governance of DB plans is via a nexus of complex agency problems. By placing the notion of fiduciary duty at the heart of governance, the hope is that the interests of beneficiaries will figure centrally in all aspects of funding, asset management and vigilance. But equally this rests on trustees exercising their duty of care and their duty of loyalty in a satisfactory manner. This is not an issue of incentives in any straightforward sense. Trustees are not rewarded based on their performance, and, for the system to work, they have either to care strongly about their reputations (implicit incentives) or else to work altruistically on behalf of beneficiaries.

The fiduciary model also raises issues of competence. There has been a great deal of recent attention on whether trustees have sufficient expertise – for example, to scrutinise actuarial projections.[13]

The main governance problems that have arisen in DB plans are as follows. First, there are problems of underfunding. Given that sponsors have only loose legal obligations, it has been feasible for plans to become underfunded and hence to walk away from their pension obligations. Second, there are related problems of risk management. Sponsors may have

[11]See www.hermes.co.uk for more details.

[12]The link between firm performance and pension fund performance is an interesting and comparatively unexplored area. There is evidence that CEOs manipulate pensions returns assumptions (Bergstresser, Desai and Rauh, 2004).

[13]See Myners (2001) and Robinson and Kakabadse (2002) for discussion.

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poor incentives to manage risk optimally on behalf of employees if they have too much say in governance. For example, plans that are approaching insolvency encourage risk-taking as a form of 'gambling for resurrection'.

However, at the core of the DB plan is an attractive risk-sharing benefit – the ability to smooth risk across successive generations of employees and to mitigate adverse selection in annuity markets. However, on the downside, such plans are unattractive to mobile labour. Moreover, there are few possibilities to introduce competition between pension plans – since jobs and pensions are bundled in the market place.

The DB model was the dominant form of pensions arrangement for two generations. Such plans survived, in part, because governance problems were comparatively rare. It is now clear that there have been significant governance issues, which were masked largely by high asset returns. But the picture is far from universally bleak – there are many examples of successful schemes. That said, it is clear that employees should not take the security of DB plans for granted and, given the difficulty of organising collective action in the work place and the decline of trade unions, there is a governance deficit which requires serious thought.

Data show that defined benefit plans are on the wane in the UK, which is now following a trend established in the USA some years ago. Many schemes are closed to new members. As workers retire, the relative importance of DB plans keeps decreasing. Until the beginning of the 1980s, DB schemes accounted for over half of the amount contributed to private pension schemes in the USA. By 1999, they accounted for less than 20 per cent, and the trend is still downward. There is some indication that the UK is following a similar path. Unless there is a surprising reversal, in a couple of decades DB schemes will play a negligible role for active private sector workers (if not for retirees).

Various factors have brought about the demise of the DB plan, such as the increase in labour mobility and the appearance of user-friendly financial products. From our viewpoint, the key consideration is the lack of credibility of DB arrangements, at least in the UK. The systematic underfunding of the 1990s and the wind-ups of the past years have created a general awareness that defined benefits are not as 'defined' as workers used to think. To shed light on the situation, the government imposed a more transparent market-based standard (FRS17), which led to a more precise, and unfortunately more worrying, picture of the funding gap. Companies realise that restoring credibility would entail large contributions to pension funds and they are reluctant to do it. For instance, the estimated funding gap of British Airways is roughly equal to half its market capitalisation. With hindsight, the DB crisis could have been avoided by imposing stricter accounting standards on DB schemes from the beginning and by making the DB pension promises

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binding. Companies would have then been encouraged to ensure proper funding, perhaps at the cost of lower promises or higher contributions.

An important role in ensuring the credibility of DB schemes should have been played by the actuarial profession. Actuaries advise trustees about the long-term viability of their pension scheme by comparing existing and future assets with existing and future liabilities. This exercise involves making assumptions on unknown variables, such as future interest rates or equity returns. In the 1990s, actuaries tended to make optimistic assumptions on future financial returns, which resulted in lower contributions and helped create the current funding crisis. According to the Morris Review of the Actuarial Profession (Morris, 2004), UK actuaries can been criticised on three grounds:

> first, failing to allow adequately for the persistently downward path of inflation and interest rates in the 1990's; second, failing to allow adequately for the subsequent precipitate fall in the stock market; and third, more generally, for not questioning sufficiently the prevailing orthodoxy at the time that high equity returns could be expected to provide healthy long-term returns but with a degree of confidence only appropriate to bond investments.

The Morris Review highlights an important source of conflict of interest for actuaries, who advise both the trustees of the DB schemes and the management of the sponsoring company. The optimistic actuarial assumptions made in the 1990s tended to reduce contributions from the sponsoring company to the detriment of the long-term prospects of the plan. To restore trust in the actuarial profession, we must find a way to resolve this potential conflict of interest and ensure that actuaries are seen as acting purely in the interest of the plan beneficiaries.

The government is now trying to restore the credibility of DB schemes by providing partial insurance through the Pension Protection Fund (PPF). The fund, which is modelled after the US Pensions Benefit Guaranty Corporation, will be financed through contributions levied on DB schemes and will provide protection to workers in schemes that become insolvent. This begs the question of whether the PPF is itself credible. What happens if a sufficient number of DB schemes fail (for instance, because of a severe drop in stock prices) and the PPF becomes insolvent?

The government portrays the PPF as a self-financing insurance scheme and is adamant in offering no guarantee that it would bail out the fund in case of default. If we take the government's denial at face value, this means that the credibility of the PPF as a whole derives from the sustainability of the bulk of the DB plans, which, as we have seen above, is highly questionable. Moreover, the introduction of insurance will worsen the moral hazard problem on the part of sponsors: the temptation of trying to devise ways to shed their pension promises will be even greater than it is already.

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If instead we believe that, *ex post*, the government will consider bailing out an insolvent PPF, then we should apply a political economy model. But trying to predict today whether and how the government would intervene is a guessing game. It will depend on the economic and political climate at the moment when the default happens.

The PPF is unlikely to reach its stated goal of reducing the level of uncertainty surrounding DB schemes. Whether one believes in the no-bailout promise or not, the introduction of the fund offers no clear solution to the DB credibility issue. It dodges the issue of how to reduce the huge aggregate gap between assets and liabilities and it adds new potential sources of agency problems.

(b) Defined contribution plans

The other form of private pension arrangement is that organised by defined contribution (DC). In the limiting case, the individual is the beneficiary, sponsor and asset manager. But in reality there is some delegation. For example, employers are sponsors in several respects. First, they play some role in selecting a 'preferred' provider, which may also result in favourable management terms. Second, by making direct contributions (often with a matching element), employers promote workplace saving. Third, employers may also play a role in monitoring the ongoing quality of the plan – especially when it is a preferred provider. That said, it is clear that such plans rely much less on solving agency problems than do DB plans.

In a broad sense, the agency problem at the heart of DC plans concerns the individual involved. In making asset management, contributions and vigilance decisions, the beneficiary has to act in the best interest of his/her 'future self'. The recent literature in behavioural economics has attached a lot of weight to personal agency problems which could lead to poor decision-making in any or all of these dimensions. It is not easy to be motivated to read the detailed reports when there are other distractions. There is pervasive evidence to boot that consumers are very poorly informed about pensions issues. Indeed, it is inefficient to have everyone in the economy well informed about the pensions market – delegation to a benevolent expert would clearly be better.

Thus, DC plans replace external with internal agency problems. This exposes beneficiaries to a different kind of governance risk. This is on top of the fact that DC plans offer little direct means to insure against market fluctuations that – with inflexible retirement dates – can expose individuals to currently undiversifiable risk. DC plans also create adverse selection issues in annuities markets (see Finkelstein and Poterba (2002)).

On the upside, competition can play a more important role in the market for DC plans since it is relatively easy for individuals to switch between

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providers. In principle, this should lead plans to invest more in pleasing their customers and allow individuals to diversify their risk across plans.

DC plans have been extremely successful in the USA: 401(k) plans, which were started in 1980, are now the most common form of private pension provision in the USA. Their success is probably due to their simplicity. They are individual plans that workers can take with them if they change jobs. Typically, workers can choose among several classes of investments and several providers within the same class. There is evidence that the introduction of 401(k) plans has led to the accumulation of large levels of private pension assets (Poterba, Venti and Wise, 2001).

In the UK, too, DC is fast becoming the dominant form of pension arrangement. Evidence from the Pensions Commission (2004, chapter 3) showed, however, that the typical level of contributions going into DC plans is lower than the level of contributions to comparable DB plans of a few years ago. This is suggestive (although far from definitive evidence) that personal agency problems may be important. But simplifying agency relationships (even if they are not entirely eliminated) is an arguable advantage of the switch from DB to DC, especially if attention is paid to creating financial instruments that limit the resulting risk exposure.

III. Enhancing credibility

We now explore how specific initiatives may be possible to enhance the credibility of pensions in either the public or private sector.

We begin with policy credibility. We have argued that governance based on periodic elections cannot easily deliver the kind of long-term commitment that underpins credibility. One possibility is to delegate policy analysis and recommendations to an independent body. The UK Pensions Commission is a case in point. There is clear value in the clarity of thinking that can survive more easily outside the political process. However, it is also apparent that the political process is ultimately needed to comply in finding solutions. To date, a preliminary report (Pensions Commission, 2004) has raised important issues but may create a climate of even greater policy uncertainty ahead of the next election. The key issue is whether the final report of the Commission can generate the kind of political consensus needed to create greater stability and hence credibility. The timing of the report means, however, that there is a lost opportunity to provide this consensus during the coming election cycle.

Public pensions credibility could be enhanced by delegating policy *decisions* and not only analysis and recommendations. This is the kind of thinking behind the move to create independent authorities such as the Bank of England. But this model is not feasible in the context of pensions.

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Contributions to pensions are essentially taxes, and delegating tax authority in this way raises difficult issues of reconciliation of pensions commitments with others that are financed through taxation.

However, even if direct policy delegation is unlikely, there is scope to create a cross-party standing body as the guardian of consensus on pensions issues. Such a body could draw up a list of principles for pensions policy to which all major political groups consent and will agree to abide by over the next 20 years. While full commitment is not possible, the symbolic force of such a compact could play a role in convincing those making long-range plans that there is an important element of political consensus.

In the context of the private sector, there are two main issues. First, the process of tightening up on governance in DB plans, defining the role and responsibility of trustees, is important. In the sphere of corporate governance, the Cadbury and Higgs Reports[14] have resulted in codes of good practice which are now adopted on a 'comply or explain' basis. Similar codes are needed in the sphere of pension fund governance with the same common-law status.[15] While the OECD has played a leading role in developing principles for governance, the thrust of many of these is to suggest regulations rather than relying on systems of self-regulation through voluntary adoption of good practice.[16] But this pushes the credibility problem back one stage further, onto the regulatory system.

The second raft of measures need to be aimed at dealing with personal agency problems. There are two routes. First, we could create 'better consumers' through education programmes. There is some evidence from the USA that this has an impact (see, for example, Bernheim and Garrett (2003)). Second, greater thought is needed about the role of collectives in DC provision. It is socially inefficient to have every citizen be an expert in vigilance and asset management. Society needs workable arrangements that provide this good collectively. It is not clear that delegation to government is the answer here either. It is arguable that employers have a comparative advantage. To be effective, however, pensions intermediaries need to be credible, i.e. independent and far-sighted. This is a challenging problem of institution design that gets little attention. But without it, it seems hard to see how the problem of pensions credibility can be resolved.

IV. Concluding comments

The issues that we have discussed here are central to designing an adequate pensions system. Recent experience has revealed severe problems with

[14]Committee on the Financial Aspects of Corporate Governance, 1992; Higgs, 2003.
[15]See, for example, the proposals in OECD (2002).
[16]This is the thrust of a recent set of six core principles put forward in OECD (2004).

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public and private management of pensions arrangements. The UK faces governance issues that are in some ways unique. By encouraging contracting out of the second state pension, it has avoided the kind of problems that confront many other PAYG systems, except perhaps for pension provision for public sector workers. However, this privatisation is no panacea when it comes to governance.

At the risk of excessive simplification, there are broadly four types of system that can be envisaged: (i) Bismarckian PAYG (where benefits are roughly proportional to earnings with little demand for private alternatives); (ii) Beveridgean PAYG (where pensions benefits are paid at a flat rate or are means-tested); (iii) DB schemes (run in the workplace); and (iv) DC schemes (run partly through the workplace and partly via private initiative). Our analysis casts light on the relative merits of each from a governance perspective.

Experience has taught us that both Bismarckian and private DB schemes suffer from serious credibility problems rooted in their governance arrangements (political in the first case and corporate in the second). These problems of credibility can be mitigated by shifting to a mix of means-tested or flat-rate state pensions and individual DC plans. The first component would guarantee a minimum income to all pensioners and is credible in any democratic society, while the second will help people smooth consumption over their life cycle.

It is interesting to note that UK policy has been edging in the direction that we suggest. But there would be huge benefits from making clear that this is part of a longer-term strategy and that the institutional foundations will be put in place to make such a system work effectively now and in the future.

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