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Protection of rights under private benefit plans

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1. Introduction

A wide range of benefits connected with age or health status may be privately financed, privately delivered and/or privately administered, prompting a similarly wide range of questions: under what circumstances are such schemes feasible; under what circumstances are they desirable; and how effective are they in protecting people against risk and uncertainty? While focusing mainly on old-age pensions, this paper attempts to sketch out at least some indicative answers for a wider range of benefits.

The paper is organized as follows. Section 2 sets out the risks facing pension schemes. The question, obviously, is whether private schemes are capable of addressing them. Section 3 discusses a series of prerequisites that private schemes must meet if they are to be viable: a country that cannot meet those prerequisites should regard private benefits as a future rather than a present option. Building on earlier discussion, section 4 discusses the role of the state in facilitating old-age security.

A number of background issues require discussion. First, what is the meaning of the word "private"? As so often, a seemingly clear term turns out to be slippery. Questions include:

- Is the scheme in question publicly or privately managed, i.e. is decision-making power vested in government, or in some private entity?
- Is the scheme publicly or privately administered? Many schemes that are *de facto* public are privately administered. Others are neither public nor private, for example schemes run by social partners.
- If the scheme is privately managed, is it for profit or not-for-profit? A private not-for-profit insurance scheme can be broadly identical to social insurance.

Discussion is restricted in several ways. I will talk mainly about retirement pensions and, within that, mainly about privately-managed funded pensions. The talk will be in terms of analytical principles, *not* in terms of specific arrangements in any particular country.

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[1] This paper draws on Barr (2002); for fuller discussion, see Barr (2001, chapters 6-9). Both sets of writing are based on work while a Visiting Scholar at the Fiscal Affairs Department at the International Monetary Fund (IMF) in Spring 2000.

2. Risks facing pension schemes

Pension schemes face risk and – separately – uncertainty. With risk, the probability distribution of potential outcomes is known or estimable, with uncertainty it is not. The distinction is central, among other reasons, because actuarial insurance can generally cope with risk but not with uncertainty.

Pension schemes face both uncertainty and risk: the future is an uncertain business, and no pension scheme can give certainty. Uncertainties are of at least three sorts.

a) Macroeconomic shocks affect output, prices or both. Since funding and pay-as-you-go are merely different ways of organizing claims on future output, it should not be surprising (Barr, 2002, pp. 7-10) that a fall in output has adverse effects on any pension scheme.
b) Demographic shocks also affect all pension schemes (*ibid.*).
c) Political risks affect all pension schemes because, as discussed in section 4, all pension systems are dependent – albeit in different ways – on effective government.

All pension schemes face these common shocks. Private funded schemes face further risks.

d) Management risk can arise through incompetence or fraud, which imperfectly informed consumers generally cannot monitor effectively.
e) Investment risk: pension accumulations held in the stock market are vulnerable to stock-market fluctuations. At its extreme, if a person is required to retire on his or her sixty-fifth birthday, there is a lottery element in the value of his/her pension accumulation.
f) Annuities market risk: for a given pension accumulation, the value of an annuity depends on remaining life expectancy and on the rate of return the insurance company can expect over those years. Both variables are subject not only to risk but also to significant uncertainties.

3. Prerequisites for private pensions

In considering the relative advantages of public and private benefits in addressing these risks and uncertainties, it is worth distinguishing two sets of questions:

- Which policy mix *should* a country adopt? This is an area beset by myths which are well covered (see, for example, Orszag and Stiglitz, 2001; Barr, 2002), and hence not discussed further.
- Which policy mix *could* a country adopt? This is a more modest question, which focuses on the range of options from which a country can sensibly choose. Clearly options are wider for countries with greater fiscal and institutional capacity, and vice versa, hence the issue of defining a choice set for a particular country – the subject of much of the rest of this paper – is a significant one.

All pension schemes, whether public or private, have significant institutional prerequisites.

Public-sector prerequisites

Fiscal sustainability of the state scheme. State pension promises have to be fiscally sustainable to ensure that public pension spending is compatible with economic growth. The emphasis on sustainability is not intended as an attack on pensioners, nor as a statement that state pension spending in the long-run should necessarily be minimized (as opposed to optimized).

Political sustainability has several essential ingredients.

- *Strength of political will.* If reform is envisaged, there must be sufficient political will to carry through the process. Thus it is important that the main drive for reform is domestic.[2]
- *Duration of political support.* A pension system is not static. It is subject to regular change. A system is not complete when legislation is passed, but needs continuing commitment from government, both for necessary adjustments and to sustain political support.
- *Depth of political support* is also important. A pension system must be supported and understood throughout government and administration. Without depth of shared understanding, a pension system risks being implemented badly or, at worst, actively subverted by lower levels of government or administration.

The achievement of fiscal and political sustainability requires government capacity of the following three sorts.

Administrative capacity to collect taxes and enforce contributions. Public pensions require government to collect contributions; private schemes require government to enforce contributions. A country which cannot implement even a simple payroll tax cannot run a pension scheme. The issue then becomes one of how to organize poverty relief, a topic with a large and separate literature (for a survey, Ravallion, 1996).

The capacity to maintain macroeconomic stability is necessary both to foster economic growth and to ensure the stability of pay-as-you-go finance. It is also of fundamental importance for private pensions, which are sensitive to unanticipated inflation.

Effective regulatory capacity. Effective regulation of financial markets is vital for private pensions, to protect consumers in areas too complex for them to protect themselves. This requires tightly drawn up regulatory procedures *and* a body of people with the capacity and will to enforce those procedures. The latter task is difficult: precisely because private pensions are such complex instruments, regulators need to be highly skilled – the sort of skills with a high price in the private sector.

These public-sector prerequisites are relevant, for the most part, both to state and private pensions. Private pensions have additional private-sector prerequisites.

Private-sector prerequisites

Adequate public understanding of and trust in private financial instruments. Private pensions require that government and citizens are well-informed about financial markets. This is not a patronizing remark about poorer countries: there is ample evidence of widespread ignorance even in countries like the United Kingdom and the United States. Alongside knowledge about private financial instruments is a separate issue of public trust. Specifically, does the public trust the private sector at least as much as it trusts government?

Financial assets and financial markets. Equally obviously, private schemes require financial assets for pension funds to hold and financial markets for channelling savings into their most productive use. One apparent solution is a blind alley. If pension funds hold only government bonds, this appears to address the lack of other financial assets. However, the resulting schemes are, in effect pay-as-you-go, since both the interest payments and subsequent redemption depend on future taxpayers. Thus there is no budgetary gain, no channelling of resources into productive investment, and considerable administrative cost.

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[2] See Nelson (2000) for discussion of the politics of reform in Hungary; see also Góra and Rutkowski (1998) on Poland, and Simonovits (2000) and Augusztinovics *et al.* (2002) on Hungary.

Another apparent solution is to use the pension savings of a poorer country to buy western financial assets. Bulgarian savings would go into (say) German firms, or Bolivian savings into firms in the United States. This approach, however, foregoes the growth of domestic investment and domestic employment which is part of the argument for private pensions. To get round this problem, it is argued (Kotlikoff and Seeger, 2000) that poor countries should buy low-risk western assets, offset by an inflow of western capital able to accommodate high-risk investments. The problem with this approach is the poor fit between capital inflows (frequently short term) and the longer-term investment needs of a poor country (for fuller discussion, see Barr, 2001, chapter 8). Thus the prerequisites of financial assets and financial markets really *are* prerequisites.

Private-sector capacity is essential, given the heavy administrative demands of private pensions.

These various prerequisites are not intended to be applied mechanically, but to offer a checklist to policymakers. It was precisely because of the demonstrable failure to meet the prerequisites for private pensions that in 1998 the World Bank – courageously but correctly – withdrew its support for proposals to bring in mandatory second-tier private pensions in Russia. Reference to the same criteria calls seriously into question reforms in Kazakhstan which introduced private, funded pensions based largely on government bonds.

4. Pension design: What role for the state in facilitating old-age security?

What do the risks and uncertainties set out in section 2 and prerequisites discussed in section 3 imply for the role of the state in protecting rights under private benefit plans?

Government is essential for all types of pension scheme

A clear conclusion is that it is a myth to imagine that a move to private pensions will get government out of the pensions business. The importance of government to the efficient operation of the private sector is now (finally!) recognized by the "Washington consensus".

> "Capitalism is revealed to require much more than private property; it functions because of the widespread acceptance and enforcement in an economy of fundamental rules and safeguards that make the outcomes of exchange secure, predictable, and of reasonably widespread benefit. Where such rules and safeguards, such institutions, are absent, what suffers is not just fairness and equity, but firm performance as well...." (Nellis, 1999, p. 16).

Effective government is essential whichever approach to pensions is adopted. Government failure is most obvious with pay-as-you-go schemes built on fiscally irresponsible promises. But private pensions are also vulnerable: fiscal imprudence leads to inflation which can decapitalize private funds; and inability to regulate financial markets creates inequity, and may also squander the efficiency gains which private pensions are intended to engender. As Lawrence Thompson (1998, p. 22) put it in the book he wrote for the ISSA's Stockholm Initiative:

> "It is ... too early to know how effectively the new systems based on the defined contribution model will be insulated from irresponsible behavior. Politicians are not the only people who are prone to promise more than they can deliver. The defined contribution model requires sophisticated oversight and regulation to ensure that one

> set of problems resulting from public sector political dynamics is not simply traded for a different set of problems derived from the dynamics of private sector operations."

Two other issues should be considered. It is sometimes argued that funded schemes are safer from government depredations than pay-as-you-go pensions. This is not necessarily the case. Governments can, indeed, break their pay-as-you-go promises; but equally they can reduce the real return to pension funds, either by requiring fund managers to hold government financial assets with a lower yield than they could earn on the stock market or by reducing any tax privileges the fund might have (the July 1997 budget of the United Kingdom is an example of the latter).

A separate argument considers the role of government if things go wrong. It is argued that political pressure on government to repair ravages to a state scheme will be stronger than those to put right adverse outcomes in private schemes. This argument cannot be taken as always and everywhere true: the more people have private pensions, and the greater the fraction of pension income deriving from private sources, the greater the pressure on government in the face of disaster.

Effective government is therefore critical:

- to ensure macroeconomic stability, which underpins well-run pay-as-you-go schemes, and which is necessary to protect pension accumulations, which are sensitive to unanticipated inflation; and
- to ensure regulatory capacity in financial markets for reasons of consumer protection.

In short, there is an inescapable role for the state in pensions – public and private – even if one distrusts politicians.

Protection of rights under private benefit plans

Let me now (as a good student should) try to answer the question posed in the title. The state has a major role in at least the following ways.

Regulation, including

- Maintaining the legal infrastructure necessary for a market economy to flourish.
- Effective regulation of financial markets.
- Effective regulation of pension schemes, e.g. to prevent misselling.

Maintaining macroeconomic stability to ensure that pension fund accumulations are protected from unanticipated inflation. Note that a burst of high, unanticipated inflation at any time during the long life of a person's pension experience (e.g. from starting to contribute aged 21 to death 60 years later) can decapitalize her fund.

A wide-ranging policy overview. A government genuinely dedicated to old-age security will not allow private pensions on anything but the most modest scale (and probably on a voluntary basis) until the public *and* private prerequisites are in place. This leads naturally to the next question – what is the link between (a) pension design and (b) institutional capacity?

What type of pension scheme?

Though conclusions should not be overstated, a number of messages should be clear.

Countries with mature pay-as-you-go systems which face population ageing should adopt policies that directly address the problems of pay-as-you-go finance, to whit, policies that:

- increase output and/or
- reduce the living standards of workers and/or
- reduce the living standards of pensioners and/or
- reduce the number of pensioners by raising the retirement age.

Prefunding could be one element in the policy mix.

Countries with large, unsustainable pay-as-you-go systems have very little choice: the only solution is to make the pay-as-you-go system sustainable, by reducing benefits, by increasing contributions or by a mix of the two. Since privatizing a pay-as-you-go scheme is much more expensive when it is bloated, making the scheme sustainable is essential whether or not policy makers wish aggressively to pursue a move towards private, funded arrangements.

Countries with very limited institutional capacity also have little choice. There is a significant element of progression: in the poorest, administratively weakest countries, the issue is how to organize poverty relief; as taxable capacity increases the next step might be a tax-funded citizen's pension; growing public administrative capacity makes it possible to implement a contributory system; with rising income and growing private administrative capacity, private pensions become an option.

A country with a small public system and relatively solid public and private administrative capacity has the greatest potential choice. Provided it meets the prerequisites discussed earlier there is a genuine choice of balance between pay-as-you-go and funded arrangements. I have argued elsewhere (Barr, 2001, 2002) that from an *economic* point of view there is no dominant policy. That being the case, the best choice for a country is that which accords best with its values and political situation.

What other role in respect of private benefits?

Finally, what role might government play in respect of private benefits other than pensions? Each of the benefits mentioned below is worth a book in its own right, so I shall make only a few – deliberately provocative – remarks.

Private disability benefits. Long-term disability is in principle an insurable risk. The problem is somewhat easier than pensions, since this year's premium covers the risk of becoming disabled this year (in a funded pension scheme, in contrast, this year's contributions pay for benefits in the future). However, disability benefit, once awarded, may be payable for many years; and the contract (in particular the definition of "disability") may be complex. For both reasons, to protect the rights of beneficiaries, governments must be able to regulate insurance markets effectively and over an extended period.

Private medical benefits. It is well-established that pervasive information failures in private insurance markets make private *finance* of medical care problematic. The United States is

alone in relying on a private-insurance paradigm,[3] and the problems of the resulting system are entirely predicted by economic theory (Barr, 2001, chapter 4). The role of the private sector in the *delivery* of health care is potentially much greater; many successful systems rely partly or mainly on privately-organized medical services. As with pensions, however, reliance on the private sector is likely to require *greater* public capacity than is needed for mainly public systems (for example, the capacity to impose a global budget constraint). These arguments are well-known and well-documented.

Financing long-term care. This, in contrast, is a neglected topic and one which will become increasingly important. With fragmenting family structures an increasing number of elderly people require care from non-family members either in their own home or a residential establishment. Since (a) only some people require care, and (b) the duration of such care is on average relatively short (in the United Kingdom, currently about two years), this is a risk against which people could in principle insure. Again, actuarial insurance faces major technical problems, not least the fact that the risk is one that will eventuate, if at all, only a long time in the future; thus insurers do not have a precise estimate of the probability of the insured event, making the problem one of uncertainty rather than risk. I have argued elsewhere (Barr, 2001, chapter 5) that this is a suitable case for social insurance.

Financing post-school education and training. A major function of pensions is consumption smoothing, i.e. redistribution from my younger to my older self. Financing education and training when (as increasingly) financed through student loans is exactly the same thing – redistribution from a person's older to his/her younger self. Though a long way from the focus of this conference, the topic is logically part of the picture (see Barr, 2001, chapters 10-14).

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[3] Countries like Germany and Switzerland have systems that are organized in the private sector; but (a) premiums are not based on individual risk and (b) nobody is excluded on the grounds that he/she is high risk. For both reasons, such schemes are, in effect, decentralized social insurance. The contrast with the United States is stark.

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