

Social protection: Lessons from economic theory and international experience

Nicholas Barr

London School of Economics

<http://econ.lse.ac.uk/staff/nb>

Committee of the Whole on Crisis Responses:
Social Protection

Geneva, 8 June 2009

Social protection: Lessons from economic theory and international experience

1 The backdrop

2 Policies aimed primarily at poverty relief

3 Policies aimed primarily at consumption smoothing

1 The backdrop

- ILO social security development staircase
 - The floor: four guarantees
 - Income security for the elderly and disabled
 - Income security for children
 - Assistance for the unemployed and poor
 - Access to essential health care for all
 - Mandatory social insurance/social security
 - Voluntary insurance
- I will talk mainly about income security for the elderly, with brief discussion of what we have learned about the design of second-tier pensions
- Talk draws heavily on Barr and Diamond (2008)



Reforming Pensions

*Principles and
Policy Choices*

Nicholas Barr
Peter Diamond

Key message: No single best pension system

- Objectives: consumption smoothing, insurance, poverty relief, redistribution
- Constraints include
 - Fiscal capacity
 - Institutional capacity
 - Empirical value of behavioural parameters
 - Shape of the income distribution
- No single best system because
 - Policy makers attach different relative weights to the different objectives
 - The pattern of fiscal and institutional constraints differs across countries
- Thus
 - What is optimal will differ across countries and over time
 - Pension systems look different across countries; this is as it should be

2 Policies aimed primarily at poverty relief

2.1 Non-contributory basic pensions

- What?
 - A public pension paid at a flat rate, on the basis of residence rather than contributions
 - Also referred to as a social pension or a citizens pension
- Why?
 - The contributory principle assumed workers with long, stable employment, thus coverage would grow
 - History has not sustained this argument

The world then

- Social policy in 1950 was based on a series of assumptions
 - Independent nation states
 - Employment generally full time and long term
 - Limited international mobility
 - Stable nuclear family with male breadwinner and female caregiver
 - Skills once acquired were lifelong
- Though not true even then, true enough to be a realistic basis for policy

What has changed?

- Increasing international competition ('globalisation')
- **Changing nature of work, with more fluid labour markets ('post-industrialisation')**
- Rising international mobility
- **Changing nature of the family**
 - More fluid family structures
 - Rising labour-market activity by women
- Shorter half-life of skills ('information age')
- Thus the drivers of change are
 - More diverse patterns of work: thus there are problems for coverage of contributory benefits tied to employment
 - Increasingly fluid family structures: thus there are problems basing women's benefits on husbands' contributions

Arguments for non-contributory basic pensions

Non-contributory basic pensions:

- Strengthen poverty relief in terms of
 - Coverage
 - Adequacy
 - Gender balance
- Improve work incentives relative to income-tested benefits
- Provide effective targeting (age is a useful indicator of poverty)
- Can assist international labour mobility through pro-rata arrangements
- Act as a stabiliser during economic turbulence by providing a floor

Containing costs

- Adjusting to match budgetary constraints: three instruments
 - The size of the pension
 - The age at which the pension is first paid
 - Perhaps also an affluence test
- Offsets against costs
 - Savings in spending on income-tested benefits
 - Social gain (non-quantifiable) from reduced poverty *and* reduced uncertainty

Country examples

- UK: illustrates problems of coverage, hence
 - Reduced contribution requirements, i.e. move towards a non-contributory basic pension
 - Ability to buy extra years
- OECD countries with non-contributory basic pensions
 - The Netherlands
 - New Zealand
 - Australia (includes an affluence test)
 - Canada (includes an affluence test)
- Other examples
 - Chile: a non-contributory pension was introduced in July 2008
 - South Africa

2.2 Child benefit

- Benefits for children are generally well-targeted
- This is no accident:
 - Parents are young hence not at the peak of their earning power
 - The arrival of children often reduces second-earner income
 - For life-cycle reasons, families with children *systematically* have low income relative to needs
 - Pointing to exceptions is like arguing that heavy smokers who live into their 90s disprove the ill-health effects of smoking
- Separately, benefits targeted via the mother can have broader social benefits
- Examples: UK, South Africa
- Most of the gains from a non-contributory pension are equally applicable to child benefit

2.3 Later and more flexible retirement

- Longer healthy life + constant or declining retirement age creates problems of pension finance
- The solution: pensionable age should rise in a rational way as life expectancy increases
- Thus people can retire later but still have a longer retirement than their parents
- This is all the more the case since most work is less physically demanding than in the past

Also more flexible retirement

- Mandatory full retirement made sense historically, but no longer
- Increased choice about when to retire, and whether fully or partially is desirable
 - To promote output growth
 - To stabilise pension spending over the medium term, thus also strengthening their robustness in the face of short-run crisis
 - As a response to individual preferences, and thus desirable for its own sake

Country examples

- USA: age for full pension of 65 (men and women) rising over time to 67
- UK: state pensionable age for 65 (men and women) will rise to 66 in 2024 and thereafter by one year each decade
- Norway: retirement age is already 67 (men and women)
- Not before time, retirement age is now a proper topic for polite society

3 Policies aimed primarily at consumption smoothing

3.1 Problems to avoid

Problems with simple model of worker choice from competing providers of DC individual accounts

- Lessons from economics of information and behavioural economics
 - The usefulness of the model of competition and rational consumer choice should not be overstated
 - Incentives to voluntary saving will not be fully effective
 - Financial education is an incomplete solution
 - High charges continue, despite competition
- Very limited risk sharing

3.2 National systems: NDC pensions

- Mimic individual funded accounts, but on a Pay-As-You-Go basis, i.e. actuarial Pay-As-You-Go
- Workers' contributions this year pay this year's pensions
- The government keeps a record of individual contributions, each year attributing a notional interest rate to each worker's accumulation
- When the worker retires, his/her notional accumulation is converted into an annuity
- In a pure NDC system benefits are actuarial; the system can also incorporate redistribution, e.g. minimum benefits or pension credits for caring activities

Why might NDC be advantageous?

- Simple from the point of view of the worker
- Centrally administered, hence low administrative costs
- Avoids much of the risk of funded individual accounts, since avoids volatility of capital markets
- Does not require the institutional capacity to manage funded schemes
- Saving may be the wrong policy (China), or people may not want to save
- In either case, NDC can be the basis for a future move to partial or full funding; thus may have advantages as a starting point if financial market turbulence continues
- NDC or funded accounts? Solid economic principles for informing the choice (Barr and Diamond 2008)

Country examples

- Sweden
- Poland
- Latvia

3.3 Occupational pensions

- Many options
- Particularly interesting
 - Hybrid arrangement in the Netherlands, agreed by trade unions, employers and government
 - Introduces a DC element into occupational DB schemes so as to share risks between workers and pensioners in an orderly way
- The importance of the arrangement is that it explicitly addresses risk sharing

3.4 Individual pensions

Lessons from the economics of information and behaviour economics

- Use automatic enrolment
- Keep choices simple
 - Highly constrained choice is a deliberate and welfare-enhancing design feature
 - But one of the options can be to allow individual choice (Marks and Spencer or Saville Row)
- Design a good default option which includes life-cycle profiling
- Decouple account administration from fund management
 - Centralised administration
 - Fund management: wholesale, competitive

Example: the US Thrift Savings Plan

- The system (www.tsp.gov)
 - Initially voluntary for federal civil servants, now auto-enrolment
 - Workers choose from five funds
 - Centralised account administration
 - Wholesale fund management
- Comments
 - Simplifies choice for workers, respecting information constraints
 - Keeps administrative costs low
 - The new system of personal pensions in the UK is similar

References

Barr, Nicholas and Diamond, Peter (2008), *Reforming pensions: Principles and policy choices*, New York and Oxford: OUP.

Barr, Nicholas and Diamond, Peter (2009), 'Reforming pensions: Principles, analytical errors and policy directions', *International Social Security Review*, Vol. 62, No. 2, 2009 (also in French, German and Spanish)

Barr, Nicholas and Diamond, Peter (forthcoming), *Pension reform: A Short Guide*, New York and Oxford: OUP.

US Thrift Savings Plan (<http://www.tsp.gov>)