Credible Pensions*

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1 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 sectors. 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 public pension programs had offered pensions that were not sustainable in financial terms at current tax levels.[1] This lead to degree of smugness in those parts of the world, such as the Netherlands, U.K., and U.S., that had encouraged 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 and Wireless and corporate scandals such as Enron and Parmalat have dented confidence in the governance of private money. 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 to 300 billion pounds (CBI 2003).

The visibility of this has issue has attracted attention from policy makers. A recent report by the House of Commons Treasury Committee 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

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

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, pensions arrangements are not "spot market" transactions – they rely on fulfillment of obligations over significant periods of time. That need not, by itself, create any substantial issues. For example, the same is true in many other contracts – for example 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.

There are three distinct sources of risk in saving for retirement. The first concern problems of non-performance of pensions due to events that are outside the control of individuals. This includes exposure to some risks in financial markets. 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. There are also some opportunities to mitigate risks by some form of risk pooling arrangement, which require a richer contractual structure and greater reliance on the performance of other parties.

However, the involvement of other parties creates the second source of risk: agency problems. Unless suitable arrangements can be found to prevent opportunism in such contexts, individuals may considerable risk.

A third source of risk arises in so far as individuals have failings in judging their own self-interest. This could be because individuals are poorly informed or else because of some defective decision making capacity – short-sightenedness or problems of time-inconsistency.[2]

In all these cases, there is a premium on finding arrangements that mitigate risks and allow individuals to make high quality investment and savings decisions. Governance arrangements are a key part of this.[3]

Debates about pensions policies and pensions arrangements have paid remarkably little attention to governance issues. Policy discussions seem to be premised on a model of government as a benign (although occasionally misguided) social planner. Most of the focus has thence been on technocratic issues – for example developing transparent and accurate projections or improved accounting. Comparatively less attention has been paid to understand government incentives to produce high quality public pensions.

This lack of attention to governance issues is even more striking in the context of private pensions. Incentive problems have received very little attention. This may be due to the fact that the maturity of many private pensions was reached during the bull run of the 1990s.

The contribution of this paper is two-fold. First, we will develop a simple approach to thinking about governance and apply it to public and private pensions. Second we discuss how institutions can be designed to deal with these issues in the hope of increasing the problems associated with governance.

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

2 Institution Design

The key issue that concerns us here is whether it is possible to design institutional solutions which safe-guard 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.

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

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.

2.1 Framework

In this section, we discuss 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 key 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); (iii) asset management – making portfolio choices. As we will show below, different types of pension arrangements find ways to allocate control rights. While the detail matters – for example the relationships between pension sponsors and trustees can be quite complex, as a first pass this is a useful framework.

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

2.2 Government Pension plans

In the case of government pensions, the government plays the role of sponsor and asset manager. The beneficiary in this case are the citizens of the country who are eligible for benefits in the public pension plan. Their contributions are typically in the form of taxes although they could include some kinds of additional voluntary contributions.

Control rights in public pension plans are geared heavily towards the government. In general, they set contributions rates through the tax system and they decide how to manage assets and liabilities and responsibility for guaranteeing that any benefits that are promised are provided for adequately.

The rights of beneficiaries are confined to periodic elections over multiple issues, i.e., where pension policy is one of many things that are offered as part of political platforms.

Typically, state pension plans, including those in the UK, US, and the largest EU countries, are 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, asset management function is rather different in funded pensions schemes, the main activity being cash-flow control to ensure that there is sufficient income to cover current outlays.[4]

Most government pension plans are compulsory and monopolistic, i.e. there is little scope to choose between competing pension arrangements. These features could be rationalized on the grounds of adverse selection problems in annuity markets. However, the roots of public pensions are better located in two things. First, the paternalism concern that individuals left to save for themselves will do inadequately. Second, the need to find some way of financing an adequate retirement income for those have earned low incomes during their working lives.

As far as governance is concerned, pensions use the general political process. The solvency of pension arrangements is backed by taxable capacity. As we have seen in the U.K. it has been extremely easy for governments to repeatedly make 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. This kind of governance mechanism cannot guarantee long-run predictability – the political process is sovereign and hence could, in principle, decided to change the 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 thinking about pensions policy. For example, this model is difficult to apply

[4]This explains why the management of PAYG pensions usually not outsourced. See however Valdés-Prieto (2004) for an innovative proposal to securitize 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, securitization can only occur once the government has overcome the issue of credibility.

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 (2004b). After analyzing the features of public pension programs in a cross-section of country, they conclude that similar programs 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.[5]

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 to 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.

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 maybe relatively "undemocratic", this 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 pensions 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 current short term interest of he currently retired.

The U.K. has traditionally been in the first of these two scenarios where the role of 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 the kind of pensions policy that is deemed desirable in the public sector. The U.K. began with a consensus on implementing a basic state

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

pension that would provide a reasonable living standard to all retirees, but this has shifted increasingly towards state pension provision that are seen as a poverty alleviation device.[6] This political shift began in the Thatcher years when pensions' increases were decoupled from earnings. There is now evidence that pensions are becoming a more attractive group of swing voters principally because the relative decline in state pensions has increased the demand among the currently retired for pensions increases. Almost weekly, parties now compete by offering their own reform proposals creating greater policy uncertainty. By creating greater political uncertainty, this is likely to reduce rather than 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 (2000) analyze a survey of citizens' opinions in France, Germany, Italy, and Spain. The first thing to note (Table 1) is that in every country, except Spain, a vast majority of citizen expects a serious pension crisis in the next 10/15 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.

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

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

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 is opposed (Table 2). If, however, the alternative consists of diverting the contributions that are currently going into the state system into an investment fund of their choice, the vast majority of citizens are in favor, except in France, where they are equally split (Table 3).

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%

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

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 educated, and the informed (the level of information was obtained in previous 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 that 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 so distant future. Mistrust is high even in a country like Italy which saw 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 savings schemes that they presumably deem more reliable.

- *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 should expect an even greater wish to move to private provision.

It is difficult not to conclude that the European PAYG model is a failure, 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 60's and 70's 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, like the U.K., 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.

2.3 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 define contribution and we discuss each in turn. Before entering into detailed discussion, it merits observing that private pensions arrangements are also subject to significant public governance risk. First, the whole macro-economic and financial climate is dependent on good financial management by government. Second, a raft of government policies affect the operation of private pensions. These include, in particular the structure of tax reliefs which created the pensions industry as distinct savings vehicle. The performance of private pensions is intertwined with these policies.

2.3.1 Defined Benefit Plans

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

To illustrate, consider the case of Hermes which is the pensions plan for British Telecom (BT) in the U.K.. 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.[7]

One overriding 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 over funded 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.

[7] See www.hermes.com for more details.

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 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 scrutinize actuarial projections.[8]

The main governance problems that have arisen in DB plans are as follows. First, there are problems of under-funding. 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 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 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 since 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 organizing collective action in the work place and the decline of trades unions, there is a governance deficit which requires serious thought.

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

The data show that defined benefit plans are now on the wane in the U.K. which is now following a trend established in the U.S. some years ago. Many schemes are closed to new members. As workers retire, the relative importance of DB keeps decreasing. Until the beginning of the Eighties, in the US DB schemes accounted for over half of the amount contributed to private pension schemes. By 1999, they accounted for less than 20% and the trend is still negative. There is some indication that the UK has taken the same route. Unless there is a surprising reversal, in a couple of decades DB schemes will play a negligible role for active private sector workers (but not for retirees).

A combination of factors has brought about the demise of the DB plan, such as the increase in labor 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 under-funding of the Nineties 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 make light of 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 realize 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 capitalization. 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 binding. Companies would have then be encouraged to ensure proper funding, perhaps at the cost of lower promises or higher contributions.

The government is now trying to restore credibility by providing partial insurance of DB schemes through the Pension Protection Fund (modelled after the US Pensions Benefit Guaranty Corporation). 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 question-able. 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 higher than it is now.

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 at this stage 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-bail-out promise or not, the introduction of the fund offers no clean 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.

2.3.2 Defined Contribution Plans

The other form of private pension arrangement is that organized by defined contribution (DC). In the limiting case, the individual is the beneficiary, sponsor and asset manager. But in reality there is some delegation. First, employers are sponsors in several respects. First, they plan some role in selecting a "preferred" provider which may also resulting in favorable management terms. Second, by making direct contributions (often with a matching element) employers promote workplace savings. Third, employers may also play a role in monitoring the on-going quality of the plan – especially when it is a preferred provider. That said, it is clear that such plans really 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 concerned. 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 behavioral economics has attached a lot of weight to personal agency problems which could lead to poor decision making on 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 ensure against market fluctuations that – with inflexible retirement dates – can expose individuals to currently undiversifiable risk. They also create adverse selection issues in annuities markets (see Finklestein and Poterba (2004))

On the up-side competition can play a more important role in the market for DC plans since it is relatively easy for individuals to switch between 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 US: 401(k) plans, which were started in 1980, are now the most common form of private pension provision in the US. Their success is probably due to their simplicity. These 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 showed, however, that the typical level of contributions going into to DC plans is lower than contributions to comparable DB plans of a few years ago. This is suggestive (although far form 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.

3 Enhancing Credibility

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

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. Whether delegating policy analysis and recommendations to independent bodies such as The Pensions Commission in the U.K. enhances policy credibility is moot. There is clear value in the clarity of thinking that can survive more easily outside the political process. However, it is also clear that the political process is ultimately needed to comply in finding solutions. Moreover, flagging issues without proposing solutions as has been done in the preliminary report (The Pensions Commission (2004)) seems to have created a climate of even greater policy uncertainty. The decision by the current U.K. government to postpone policy proposals until after the next election has only exacerbated this problem. Past policies in the U.K. have ensured that pensions are more fertile political territory for policy pronouncements. Hence, a return pension policy largely overseen by technocrats is not an option. Thus, to enhance policy credibility requires instead an element of political consensus on key aspects of pensions policy now and in the future. Moreover such a consensus would be most valuable when an election is looming.

Public pensions credibility could be enhanced by delegating policy decisions rather than only analysis and recommendations. This is the thinking behind the move to create independent authorities such as the Bank of England. But this model has clear limitations and is not feasible in the context of pensions. First, contributions to pensions are essentially taxes and delegating tax authority in this way raises difficult issues of reconciliation of these 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 as body could draw a list of principles for pensions policy to which all major political groups consent and will agree to abide by over the next twenty years. While full commitment is not possible, the symbolic force of such a compact could play a role in convincing those making long range planning that there is an important element of political consensus.

In the context of the private sector, there are three 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 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.[9] 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

[9]See, for example, the proposals in OECD (2002).

practice.[10]

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 programs. There is some evidence from the U.S. that these programs have 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 of this to government is the answer here either. It is arguable that employers have a comparative advantage. To be effective pensions intermediaries need to be credible – i.e., independent and farsighted. This is a challenging problem of institution design that gets little attention. But without it, seems hard to see how the problem of pensions credibility can be resolved.

4 Concluding Comments

The issues that we have discussed here are central to designing an adequate pensions system. Recent experience has revealed severe problems with public and private management of pensions arrangements.

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 means-tested), (iii) DB schemes (run in the workplace) and (iv) DC schemes (run partly through the work place and 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 public and private governance problems (political in the first case, and corporate in the second). These problems of credibility suggest shifting to a mix of means-tested state pensions and individual DC schemes. 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 U.K. policy has been edging in the direction that we suggest. But there would be huge benefits from making clear that

[10] This is the thrust of a recent set of six core principles put forward in OECD (2004).

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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