Pension reform:

an analysis of the economic foundations of

private pensions

Sacha Vidler

PhD

University of Sydney

2003

Preliminaries

Table of contents

PRELIMINARIES **2**

TABLE OF CONTENTS 2
TABLE OF FIGURES 5
ACRONYMS 6
ACKNOWLEDGEMENTS 6
ABSTRACT 7

CHAPTER 1 INTRODUCTION **9**

1 NEOLIBERAL ECONOMIC POLICY 9
2 NEOLIBERAL PENSION POLICY 12
3 ECONOMIC ARGUMENTS SUPPORTING NEOLIBERAL PENSION POLICY 15
4 METHODS AND DATA 17

CHAPTER 2 SAVING **19**

1 INTRODUCTION 19
2 PENSION REFORM AND SAVING: THE OFFICIAL POLICY POSITION 20
2.1 Australia 20
2.2 Overseas 27
3 PENSION REFORM AND SAVING: ORTHODOX THEORY 31
3.1 The neoclassical life-cycle theory of saving 31
3.2 The LCT and public PAYGO pension systems 33
3.3 The LCT and private funded pension systems 36
3.4 Putting it together: the LCT and neoliberal pension reform 38
4 THEORETICAL AND EMPIRICAL CHALLENGES 40
4.1 Retirement saving 40
4.2 Empirical evidence 41
4.3 Saving offsets 49
5 SUMMARY 57

CHAPTER 3 INVESTMENT AND RATES OF RETURN **59**

1 INTRODUCTION 59
2 THE RECOMMENDED PRIVATE PENSION SYSTEM 60
3 PENSION RATES OF RETURN 66
3.1 Comparative historical returns 66
3.2 Intergenerational and intragenerational redistribution 74
3.3 Summary 81
4 PENSION FUND INVESTMENT 82
4.1 Pension fund investment and economic development 83
4.2 Governance 96
4.3 Summary 100
5 CONCLUSIONS 100

CHAPTER 4 ADMINISTRATION ... 102

1 INTRODUCTION ... 102
2 INFORMATION COST ... 103
3 PRODUCTS ... 105
3.1 Constrained provider choice ... 105
3.2 Product choice ... 106
4 PRICING ... 107
4.1 Complexity ... 107
4.2 Consumer skills and motivation ... 109
4.3 Marketing and selling - bias and cost ... 113
4.4 Determinants of price ... 116
4.5 Structural change and the cost of administration over time ... 120
4.6 Summary ... 123
5 ACCOUNT PROLIFERATION ... 123
6 NEGLIGENCE AND FRAUD ... 125
7 ALTERNATIVE SYSTEMS ... 127
7.1 Bolivia and Sweden - funded systems without consumer markets ... 127
7.2 A reformed consumer market for the Anglo-American countries ... 129
8 CONCLUSIONS ... 130

CHAPTER 5 LABOUR MARKETS AND INEQUALITY ... 132

1 INTRODUCTION ... 132
2 PENSIONS AND INEQUALITY ... 133
2.1 Defining poverty ... 134
2.2 Elderly poverty in OECD countries ... 137
2.3 Elderly poverty and pension systems ... 139
2.4 Modelling private pensions and poverty ... 147
2.5 Summary ... 152
3 PENSIONS AND LABOUR MARKETS ... 152
3.1 The neoliberal view: labour market distortion ... 152
3.2 Pensions and competitiveness ... 154
3.3 Pensions and early retirement ... 155
4 CONCLUSIONS ... 158

CHAPTER 6 POLITICAL ECONOMY ... 159

1 INTRODUCTION ... 159
2 PUBLIC PENSION SYSTEM CRISIS ... 160
2.1 Chile and Latin America ... 161
2.2 The Transition Economies ... 163
2.3 Africa ... 165
2.4 South-East Asia ... 166
2.5 OECD countries ... 167
2.6 Summary ... 169
3 INSULATION OF PRIVATE PENSIONS FROM GOVERNMENT ... 169
3.1 Private pension system reform ... 171
3.2 Economic and political crisis ... 172
3.3 Implied public responsibility for private pensions ... 173
3.4 Summary ... 174
4 PRIVATE PENSIONS - PRIVATE INTERESTS ... 175

4.1 Direct lobbying 176
4.2 IFI policy encouragement 178
5 CONCLUSIONS 180

CHAPTER 7 DEMOGRAPHY AND FISCAL SUSTAINABILITY 182

1 INTRODUCTION 182
2 NEW ZEALAND SUPERANNUATION (NZS) 183
3 MODELLING SUSTAINABILITY 184
4 APPLYING THE MODEL 186
4.1 Australian demographic conditions 186
4.2 Other OECD countries 187
5 CONCLUSIONS 188

CHAPTER 8 CONCLUSIONS 190

1 SUMMARY OF FINDINGS 190
1.1 Saving 190
1.2 Investment 192
1.3 Administration 196
1.4 Labour market distortion and inequality 197
1.5 Political economy 198
1.6 Sustainability 199
2 SOME IMPLICATIONS OF THE FINDINGS 200

APPENDIX A. DETAILED REPRESENTATION OF FIGURE 5.6 202

SOURCES 203

Table of figures

Figure 2.1 Superannuation coverage by type of employee 23
Figure 2.2 Assumptions and implications of the life-cycle theory of saving 32
Figure 2.3 The Hump-Shaped Age-Asset Profile 42
Figure 2.4 Age-asset profile of a single cohort 43
Figure 2.5 National saving versus private pension assets 47
Figure 2.6 National saving versus public pension spending 48
Figure 3.1 System dependency and public PAYGO accounting 76
Figure 3.2 Passive investment and herding 87
Figure 3.3 Venture capital and the dot.com stock boom 95
Figure 4.1 Negative impact on final accumulation of different annual asset-based fees with different annual gross returns 108
Figure 4.2 Range of administration charges per member by size of fund 118
Figure 4.3 Asset-based charges, by size of account (medium expense investment options) 119
Figure 4.4 Net annual contributions to Australian superannuation 122
Figure 4.5 Aggregate internal operating costs for Australian superannuation 123
Figure 5.1 Elderly People in Relative Poverty in Selected OECD Countries 138
Figure 5.2 Gender Breakdown of Elderly Population in Australia in Relative Poverty. 139
Figure 5.3 Public pension spending versus elderly poverty (50% of median income) - Selected OECD Countries 140
Figure 5.4 Public pension spending versus elderly women living alone in poverty (50% of median adjusted income) - Selected OECD Countries 141
Figure 5.5 Private pension assets versus elderly poverty (50% of median income) - Selected OECD Countries 142
Figure 5.6 Summary of provisional modelling of the potential for ordinary and low-income earners to avoid poverty in retirement in funded pension systems 151
Figure 7.1 A model of sustainability applied to Australian demographic predictions ... 187
Figure 7.2 The NZS-style model applied to other OECD countries 188

Acronyms

APRA	Australian Prudential and Regulatory Authority
ASFA	Association of Superannuation Funds of Australia
ATO	Australian Tax Office
CEPR	Centre for Economic Policy Research (Italy)
ENEPRI	European Network Of Economic Policy Research Institutes
FSA	Financial Services Authority (UK)
ICI	Investment Company Institute (US)
ILO	International Labour Office
IMF	International Monetary Fund
NASVF	National Association of Seed and Venture Funds (US)
NBER	National Bureau of Economic Research (US)
NPR	Neoliberal pension reform
OASDI	Old Age, Survivors, and Disability Insurance
OECD	Organisation for Economic Co-operation and Development
OTRC	Office of the Retirement Commissioner (NZ)
PAYGO	Pay-As-You-Go
RBA	Reserve Bank of Australia
RIM	Retirement Income Modelling (RIM) Taskforce (Australia)
UN	United Nations
VC	Venture Capital
WB	The World Bank

Acknowledgements

I would like to thank Evan Jones, my supervisor, for unflagging support and patience.

Sarah Wentworth, my partner, provided the initial motivation to attempt this research and has supported me throughout the exercise. Sarah also provided valuable improvements while proofing.

Andrew Buckland gave excellent feedback on a late draft.

Tom Brennan, Paul Ireland and David Money gave interviews which shaped the early approach. I have also benefited from discussions at various stages with Tom, Paul, Andrew and Declan Moore.

Abstract

The dissertation investigates support by economists for the global policy shift away from unfunded public pension schemes towards funded private pension schemes. Influential economists and institutions, including the World Bank, present a suite of economic arguments that suggest that this shift will have positive effects on national economies, particularly in the context of aging.

The arguments may be categorised according to their relation to the operation of three sets of institutions: capital markets, labour markets and political systems.

In capital markets, the transition is purported to increase private and national saving, increase the quantity and quality of investment, and provide more efficient private administration. In labour markets, it is claimed that the shift will reduce labour market distortions associated with public pensions, which inhibit competitiveness, produce unemployment and encourage early retirement. According to the World Bank, public pensions systems cause these distortions *without* achieving their stated objective of reducing inequality. In the political sphere, the shift is purported to insulate the pension system from political pressures, which otherwise inevitably lead to crisis.

The thesis provides evidence which refutes these claims. The best research, including studies by orthodox economists, indicate that the shift does not increase savings or investment, or improve the quality of financial investment. The main effect of tax concessions associated with private pension systems is to divert to private pension funds savings that would occur in any case via other mechanisms. The tax concessions are also regressive, even in systems with compulsory elements. Private administration of pensions, particularly in a plural consumer market setting, is highly inefficient, with customers at a disadvantage in dealing with providers due to the complexity and opacity of products and pricing.

A negative relationship is found between public pension spending and levels of elderly poverty, suggesting that reducing public pension spending increases levels of elderly inequality. Public pensions are found not to explain differences in economic growth between regions. Elements of system design which distort labour markets,

such as by encouraging early retirement, can easily be adjusted. However, such elements are explicit government policy in several countries.

A review of public and private pensions finds that examples of public system crisis are associated with instances of economic and political collapse, rather than system design. Private funded systems are found to be more vulnerable, not less, to the same external influences. Relatively generous universal public pension systems are found to be financially sustainable despite demographic change, assuming modest levels of economic growth.