Paths and Forks or Chutes and Ladders?: The Dynamics of Pension Regime Change in Advanced Industrial Countries

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The Questions:

- How should we categorize national pension systems?
- How frequent is a major change in pension policy regimes?
- Do policymakers have significant leeway in shifting pension policy paths, or is there significant room for choice?
Models of Pension Regime Change
Unconstrained choice:

Regime Type 1

Regime Type 2

Regime Type 3

Regime Type 4

Regime Type 5

Regime Type 6

Regime Type 7
### Paths and Forks:

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<tr>
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**Cul de sac:**

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Chutes and Ladders:

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Mixed Patterns Across Regimes:

Regime Type at $t_1$  Regime Type at $t_2$

Regime Type 1
Regime Type 2
Regime Type 3
Regime Type 4
Regime Type 5
Regime Type 6
Regime Type 7
More choice at $t_1$:

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More choice at $t_2$:

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The Convention Wisdom on Pension Regime Change
Categorizing Pension Regimes:

• Welfare states can be divided into three categories
  – Universal/citizenship regimes (Scandinavia)
  – Social insurance “Bismarckian” regimes (continental Europe)
  – Residual regimes (U.K., Canada, United States, Australia)
The Frequency of Pension Regime Restructuring:

- Countries hardly ever change between the three broad categories of welfare state regimes: Pension regime change has been largely incremental (or “parametric”) rather than fundamental (or “paradigmatic”)
- Welfare states (including pension regimes) have survived economic/demographic retrenchment pressures relatively intact
Explaining Patterns of Pension Restructuring:

- Population aging and fertility declines
- Fiscal pressures
- Competitiveness pressures

Policy feedbacks:
- Policy regime
- Micro-rules
- Age of policy regime

Direction and extent of policy change:
- Retrenchment
- Refinancing
- Restructuring

Modified or new policy regime
Explaining Patterns of Pension Restructuring:

• “Positive policy feedbacks” limit the pension reform options of policymakers:
  – Constrain choice sets
  – Create constituencies who resist any change that would make them worse off

• Age and maturity of pension regime matter (e.g., “double payment problem”)
A Revised Approach
Categorizing Pension Regimes (1):

• Virtually all rich countries have multi-tier pension systems, organized in a variety of ways. E.g., Canada has:
  – OAS
  – GIS
  – CPP/QPP
  – Tax-advantaged RRP and RRSPs
Categorizing Pension Regimes (2):

- Esping-Andersen’s tripartite categories are overly broad and misleading, e.g.:
  - Residual category is overly broad mixture of
    - means-tested
    - “Bismarckian Lite”
    - mixed regimes
    with distinctive challenges and transition opportunities
  - New “Notional Defined Contribution” (NDC) pension has different challenges and transition opportunities from continental/Bismarckian regimes
Recategorizing Pension Regimes:

- Universal/citizenship regimes (New Zealand)
- Social insurance “Bismarckian” regimes (continental Europe)
- “Bismarckian Lite” regimes (U.S., Canada)
- NDC regimes (Sweden, Italy)
- Residual regimes (formerly Australia)
- Mixed regimes (U.K., Netherlands, Switzerland, Denmark)
- Privatized regimes (none among rich countries)
Pension Regime Transitions:


NDC
Bismarckian
Bismarckian Lite
Universal
Mixed
Residual
Privatized

Sweden
Italy
Germany
Austria
France
U.S.
Canada
N.Z.
Ireland
Denmark
Switz.
U.K..
Neth.
Australia
The Frequency of Pension Regime Restructuring:

• Pension regime change is fairly frequent
  – 9 of 14 countries in sample have at least one
  – Only two (Sweden and NZ) have more than one
  – Regime reversals (“Boomerangs”) are very rare
  – No shifts to privatized model

• Many recent changes are difficult to categorize (e.g., Germany, Sweden)
Pension Regime Restructuring—Regime Durability:

• Pension regimes differ significantly in their durability
  – “Bismarckian Lite” and mixed regimes are highly durable (cul-de-sac) in post WW II period
  – Universal and residual regimes virtually disappeared after World War II, with multiple destinations (paths and forks)
  – Bismarckian regimes were very durable until mid 1990s
Pension Regime Restructuring—Timing:

- Different types of regime transitions are concentrated in different periods:
  - Shifts to Bismarckian regimes pre-1973
  - Shifts to mixed regimes post-1973
  - Shifts from Bismarckian to NDC regimes post 1994
Feedback Effects and Explaining Pension Restructuring:

• Policy feedbacks may undermine as well as reinforce existing regimes
• Some policy regimes have higher “hazard rates” of exit than others
Prospects for regime change depend on:

• The balance of positive and negative *feedbacks* and the *challenges* they present

• The availability and efficacy of *incremental* (or “parametric”) *reforms* to address those challenges

• The availability of *paradigmatic reform options* (a/k/a “regime transition options”)

Public pension systems face common challenges of:

- Adequacy
- Equity
- Affordability/Sustainability

*Plus*
- Clarity and Transparency in Incentives and Retirement Planning
- Encouraging Work among Older Workers
- Limiting Investment and Annuitization Risk
- Political Sustainability
- Administrative cost and effectiveness
... but Policy Challenges, Incremental Reform Options and Regime Transition Opportunities differ:

- Over time (e.g., depending on degree of economic/demographic stress)
- Across pension regimes

![Figure 2-2. Changes in Old-Age Dependency Ratio Over Time](image-url)
Challenge and Change in Bismarckian Pension Regimes
Challenges for Bismarckian social insurance systems are severe:

- **Severe sustainability issues with aging**
- **Need to address problems of low labor market participation in 55-64 age group**

**Male Labor Force Participation Rates**

*age 60 to 64 c. 1980 and 1999 (approx.)*
Incremental reform options for Bismarckian social insurance systems are limited:

- **Payroll taxes perceived to hurt competitiveness**
Transition Opportunities for Bismarckian regimes are highly constrained (1):

- Shift to mixed (except as small “add-on”) or privatized regimes unlikely due to double payment problem.
Transition Opportunities for Bismarckian regimes are highly constrained (2):

• Can’t shift to universal, residual, or Bismarckian Lite regimes because of adequacy concerns
• NDC regime is only remaining regime transition option (single chute”)— and it is a recent innovation
Sweden in the 1990s—Policy Feedbacks in a Bismarckian System

- Universal pension
- Earnings-related pension on top
- Generous income-tested pension removes almost all seniors from poverty
Sweden--
Policy Challenges

• **Demography:** Very serious challenge in both short run and long run
• **Financial/Budgetary:** Severe fiscal crisis in early 1990s
• **Competitive:** Very high payroll taxes and overall tax burden

Incremental reform options

• Strong resistance to payroll tax increases
• Strong union resistance to visible benefit cuts

Regime Transition Opportunities:

• Shift to a Mixed System very difficult given high current commitments and payroll tax
• Shift to NDC system compatible with existing earnings-related system
Sweden Today—An NDC System with an Individual Account Add-On:

- Universal tier eliminated
- Benefits based on lifetime earnings
- Flexible retirement age with increased work incentives
- Stabilized contribution rate with 16% in state system and 2.5% in individual accounts
- Risk of poor economic performance and increased longevity shifted from state to workers
- Central management of individual account system
Germany—Policy Feedbacks in a Challenged Bismarckian system:

- Overwhelming reliance on social insurance tier
- Partial general revenue financing of pension system
- Generous early retirement programs
Germany
Policy Challenges

- **Demography**: Very serious challenge in short run and much worse in longer run
- **Affordability**: Very high payroll taxes and overall tax burden

Incremental reform options

- Strong resistance to further payroll tax increases
- Some political capacity for non payroll tax revenue increases
- Can address problems of low earners through addition of income-tested tier

Regime Transition Opportunities:

- Shift to a Mixed System very difficult given high current commitments and payroll tax
- Shift to NDC system compatible with existing earnings-related system
Germany Today—Still a Bismarckian system?

Multiple rounds of Retrenchment including:

- Multiple reductions in generosity of early retirement benefits, but still less than complete actuarial reduction
- Planned reductions over time in replacement rate

Refinancing:

- Increases in payroll tax
- Future increases in payroll taxes capped
- Eco-tax revenues dedicated to pension system
Germany Today—Still a Bismarckian system?

Restructuring

- “Voluntary” quasi-mandatory tax advantaged individual account tier added to make up for planned future declines in public system replacement rates
- Sustainability factor added to lower future pension payouts
Challenge and Change in “Bismarckian Lite” Pension Regimes
Challenges for “Bismarckian Lite” social insurance systems include:

- Developing adequate mechanisms to deal with senior poverty
- Adapting to changes in supplementary occupational and personal pension sectors
- Addressing long-term pension funding problems in the absence of an immediate funding crisis
“Bismarckian Lite” pension regimes contain room for refinancing without restructuring
“Bismarckian Lite” pension regimes have multiple incremental reform options, including:

- Incremental payroll tax increases
- Increased income-testing at upper end
- Improving tax incentives for private sector pensions
“Bismarckian Lite” pension regimes have multiple transition opportunities:

• Can shift to Bismarckian regime only before demographic crisis hits
• Can shift to mixed regime (especially if “add-on”) with higher contributions
• Can shift to NDC regime
• Can’t shift to universal or residual regimes because of adequacy concerns
• Shift to privatized regimes unlikely due to double payment problem

But also have less need to shift
Canada Policy Feedbacks: A Bismarckian Lite System with a Generous Minimum

- Old Age Security
- Guaranteed Income Supplement
- Canada Pension Plan / Quebec Pension Plan
Canada: Policy Challenges in 1990s and Beyond– A Scorecard
Due to OAS-GIS floor for most recipients

Adequacy: A-

Elderly Poverty Reduced Through Universal and Social Insurance Plus Income-Related Transfers


NB: Australia has no social insurance-based retirement system for the elderly and in Sweden the effect of private pensions cannot be separated from social insurance
# Affordability: B

PENSION EFFORT IN SELECTED OECD COUNTRIES, 2000 AND PROJECTED FOR 2050

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Encouraging continued labor force participation: C+

Male Labor Force Participation Rates
age 60 to 64 c. 1980 and 1999 (approx.)

Encouraging continued labor force participation: C+

Female Labor Force Participation Rates
age 60 to 64 c. 1980 and 1999 (approx.)

Political risk: A-

• Good governance structure for CPPIB, although likely to be increasing pressures with more active investment policy
• Will an income-indexed OAS be sustainable over time—and will bidding wars break out?
Canada:

Incremental reform options
• Increased income-testing at upper end
• Possibility of increased payroll taxes to fund CPP

Regime Transition Opportunities
• Shift to a Bismarckian regime blocked by affordability issues
• Shift to a mixed system blocked by weakness of adequacy and affordability challenges—and for political reasons
Canada Today: Still a Bismarckian Lite system

- Retrenchment in Old Age Security universal program
- Increase in payroll tax
- No serious consideration of individual accounts
United States: Policy Feedbacks in a Bismarckian Lite System

• Overwhelming reliance on social insurance tier (Social Security)
• Very small means-tested tier (SSI)
• Large but changing occupational and personal sector
United States: Policy Challenges

- **Demography**: Moderate challenge in short run and relatively modest in longer run
- **Financial/Budgetary**: Severe fiscal pressures in early 1980s and post 2017
- **Adequacy**: High poverty rates for older women have not been on the agenda

Incremental reform options
- Increased income-testing at upper end
- Increased payroll taxes limited by Republican opposition

Regime Transition Opportunities
- **Shift to mixed system** inhibited by financing unless new revenues added
- **NDC system** possible but inhibited by internal cross-subsidies unless new revenues added
United States Today—
“Bismarckian Lite” Stability:

Social Security in the U.S.:
• Parametric reform in 1977 and 1983
• Virtually no policy change since then
• Efforts by Bush II to get opt-out reform on the agenda failed
Challenge and Change in Mixed Pension Regimes
Challenges for “Mixed” Pension systems:

• Integrate public and private tiers and provide transparency, equity and universal coverage
• Provide adequate minimum pension
• Control administrative costs and market and annuitization risks in private tiers

are serious but usually not regime threatening
A variety of incremental reform options are available for Mixed regimes:

- Improve benefit minima
- Increase regulation to address administrative cost and investment/annuity risk concerns
- Subsidize accounts for low-earners
Transition Opportunities for Mixed regimes are highly constrained (Cul de sac):

- Can’t shift to universal or residual regimes because of adequacy concerns
- Shift to Bismarckian or Bismarckian Lite regimes unlikely due to affordability concerns
- Shift to privatized regimes unlikely due to adequacy and risk concerns
- Shift to NDC regime unlikely due to low affordability challenge
U.K. Policy Feedbacks: A Mixed System

- Quasi-universal flat-rate basic pension
- Opt-out from state earnings-related scheme into occupational or personal pensions rather than as add-on to state scheme
- Substantial reliance on income-tested benefits among the elderly
U.K. Policy Challenges

• **Demography**: Moderate challenge in short run and relatively modest in longer run
• **Affordability**: Moderate payroll taxes and low overall burden on the state
• **Administrative effectiveness**: very high costs
• **Clarity**: multiple pensions make predicting pensions difficult

Regime Transition Opportunities

• **Shift away from mixed system** inhibited by barriers to all alternatives and imbeddedness of private pensions
U.K. Today—Still a Mixed System

The U.K. retirement system has been subjected to frequent tinkering with individual tiers:

- Shift to price indexing under Thatcher
- Cutbacks in SERPS under Thatcher
- Shift from SERPS to State Second Pension (SSP)
- Shift from Minimum Income Guarantee to Pension Credit
- Introduction of stakeholder pension
- Ad hoc changes in Basic Pension
- Proposed Turner Commission reforms

But no fundamental change
Conclusions
Some conclusions (1):

• Tri-partite conceptualization of pension regimes is inadequate
• Amount of pension regime change over last fifty years has been substantial in OECD countries
• Pension regime feedbacks can be transition-encouraging as well as regime-reinforcing (e.g., affordability of Bismarckian regimes)
Some conclusions (2):

• Amount and direction of pension policy regime change depends in large part on:
  – Policy feedbacks and the challenges they create
  – Incremental reform options available to policymakers—and whether they have been exhausted
  – Regime Transition opportunities available to policymakers
Some conclusions (3):

• Feedback effects are insufficient to explain why:
  – Some Bismarckian systems (e.g., Sweden) shift to NDC while others do not
  – U.S. has not followed Canada’s lead in addressing pension funding
The menu of incremental and fundamental reform options for pension systems is evolving.
1. New mechanisms for automatic stabilizers in public pension liabilities as populations age

- NDC reforms in Sweden, Italy, etc.
- Sustainability mechanism in Germany
- Failsafe mechanism in Canada Pension Plan

But....

- Unclear that shifting all demographic and economic performance risks to the benefit side will be sustainable
2. Centralized management of some DC individual account functions

- Collecting contributions
- Transferring to fund managers and managing fund-switching
- Communication with fund holders

...can produce major savings in administrative costs but...

But much work needs to be done on:
Increasing transparency and lowering information costs associated with fund choice

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<td>907 683</td>
<td>Banca Etska Sverigefond Pension Banco Pensionsfonder AB</td>
<td></td>
<td>Min 90% svenska aktier. Ettika alkohol-, tobaks-, och vapenbranscher.</td>
<td>36</td>
<td>0,8</td>
<td>- - - - - - - - - - - - - - - - - 1,2</td>
<td>-</td>
</tr>
<tr>
<td>738 366</td>
<td>Carlson Sverigefond Carlson Fondförvaltning AB</td>
<td></td>
<td>Fonden placerar i svenska börsbolag.</td>
<td>710</td>
<td>1,0</td>
<td>25 39 61 -7 -14</td>
<td>126</td>
</tr>
</tbody>
</table>

* Avgiften varierar beroende på fondens resultat. * Avgiften varierar beroende på fondens förmögenhet. * Avgift inkluderar alla kostnader, dvs är dennesamma som TMA och fastställs på förmån. All information i tabellen graderas på information från fondmarknaden.
Educating workers on the need to work later....

<table>
<thead>
<tr>
<th>Age</th>
<th>Without Growth</th>
<th>With 2% Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>61</td>
<td>8,900 kr/mån</td>
<td>12,700 kr/mån</td>
</tr>
<tr>
<td>65</td>
<td>11,100 kr/mån</td>
<td>17,700 kr/mån</td>
</tr>
<tr>
<td>70</td>
<td>16,000 kr/mån</td>
<td>28,200 kr/mån</td>
</tr>
</tbody>
</table>

Din allmänna pension vid 65 års ålder och noll procents tillväxt (11 100 kr/mån) består av: 9 300 kr inkomstpension och 1 800 kr premiepension (beräkningsantaganden för premiepension, se Prognos i ordförklaringarna).

Source: Prognos för din allmänna pension ‘04
...and goals and design of a default fund

"People who do not have a Fund Manager, for whatever reason, should receive the same pension as others - that is our goal."

--Seventh Swedish AP Fund
3. Governments can pre-fund general revenue financed public pension programs

(Source: McCulloch and Frances, Governance of Public Pension Funds: New Zealand Superannuation Fund)
The End