Are we getting it right on pensions?

JULIAN HODGE INSTITUTE OF APPLIED MACROECONOMICS

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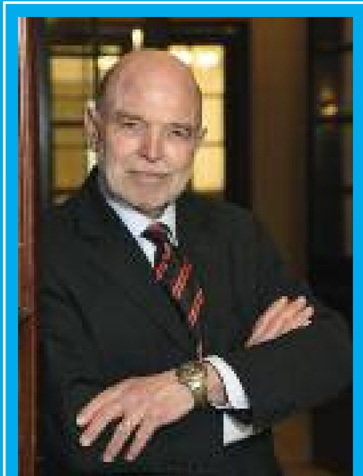

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Alongside his academic work is wide-ranging involvement in policy, including spells at the World Bank and the International Monetary Fund, and as a member of the World Economic Forum's Global Agenda Councils on Demographic Shifts and on Ageing Society. He has been active in policy debates, particularly on pension reform and higher education finance, advising governments in the post-communist countries, and in the UK, Australia, Chile, China, Hungary, New Zealand and South Africa. Recent activities include membership of the Presidential Commission on Reform of the Pension System in Chile. A range of academic and policy writing can be found on http://econ.lse.ac.uk/staff/nb.

JULIAN HODGE INSTITUTE OF APPLIED MACROECONOMICS

In May 1999, Cardiff Business School and Julian Hodge Bank entered into a significant collaboration, resulting in the establishment of the Julian Hodge Institute of Applied Macroeconomics. The main aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. The Institute's research work further extends across international trade, money and banking, international finance and econometrics, in a collaboration between around twenty academics, mostly in Cardiff, and some thirty PhD students. The institute's director since it was founded has been Professor Patrick Minford, of Cardiff Business School, who is also the Economic Adviser to Julian Hodge Bank. Apart from its research projects the institute carries on the forecasting and modelling work which Minford began at Liverpool University and has been based mainly in Cardiff for more than a decade, producing forecasts and policy analysis of the UK and other major economies.

Are we getting it right on pensions?

Nicholas Barr[1]

Good evening everybody. It's a great pleasure to be in Cardiff. Our younger grandchild was born here, so at some stage he is going to have to decide whether to play for Wales or for England.

As Patrick has indicated, my talk draws on my work with Peter Diamond, including some of the thinking that has come out of our advice to the government of China and our involvement in Chile. I want to start with some background matters and then talk about what we can learn from economic theory. Theory for pensions is quite complicated, but you can get an long way with relatively simple theory. I then want to talk about some lessons from international experience but also to make sure that I have time to talk about pensions in Britain -- what we are getting right and where we are making a mess of things. Sadly, we are making a mess of some things.

Background

OBJECTIVES. The primary objective of pensions is economic security in old age. That breaks down into different aspects. Consumption smoothing is redistribution from yourself in your younger years to yourself when you are older, so inherently a long run objective. Insurance against low income in old age includes annuities, but in different pension systems may also include insurance against low earnings during working life; the third element is poverty relief.

SOME INITIAL SURPRISES. There is something I call pub economics. Pub economics is something that is obviously right and everyone knows is right... but is wrong. We all know that the pensions crisis is caused by the baby boom – wrong! Pension systems face three long run trends: people are living longer, people are

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having fewer babies; and until recently there was a trend to people retiring earlier. Those are much more important than two more recent phenomena: the baby boom, and the increase in the scale of pension systems since World War II. Even if there hadn't been a baby boom, because of these long term trends there would be a problem paying for pensions. Sparing you the details, the diagram shows projected age pyramids for 2050 for China at the top, India and the United States. Until recently China had a one child policy; the US had a baby boom; India had neither. Three very different demographics, but if you look at these pictures, what do they tell you? The pyramids are all the same: they all say that there is considerably population ageing and it's the long run drivers, not the baby boom that are the cause.

The second surprise is it's not a crisis. When I talk to my students I always tell them that we all play by the same rules: you my students have as much right as I do to express a personal view, but you like me will be hung out to dry and publicly ritually humiliated for faulty logic. There is one exception: if you use the term 'the ageing problem' in your exam, you will fail. It is an ideologically unsound concept. There isn't an ageing problem. People are living longer, healthy lives – one of the great triumphs of the 20th century. The problem is not that people living too long, it's that they are retiring too soon. So we don't have an ageing problem, we have a retiring-too-soon problem.

Lessons from economic theory

The simple model is not enough

The previous discussion was by way of clearing out some undergrowth. I want to come on to what we can learn from economic theory. The key initial point is that the simple economic model is not enough. That model assumes that we are all well informed and behave rationally. That simple model, Economics 101, is useful as a benchmark in that it establishes the bullseye – what we are trying to achieve – but it's a bad basis for policy design.

What is needed is what economists call second best analysis. The first deviation from the simple model is imperfect information. This is addressed by the economics of information, for which the Nobel prize was awarded in 2001.

A second deviation from the simple model is the frequent failure of the assumption that people behave rationally. They don't. Non-rational behaviour is addressed by behavioural economics, for which the Nobel prize was awarded in 2002.

Incomplete markets and incomplete contracts, a third deviation, were cited in the 2010 Nobel Prize.

Finally there is distortionary taxation. If a pension system has poverty relief it redistributes from richer to poorer people. That is distortionary, a problem addressed by the literature on optimal taxation for which the Nobel prize was awarded in 1996.

Why am I banging on about these Nobel prizes? To make the point that what I am going to be talking about is not some weird peculiar, idiosyncratic Nick Barr view of the world, but rooted in really serious, heavy, top-rate theory.

Imperfect information and non-rational behaviour are pervasive

THE ECONOMICS OF INFORMATION. In pensions, as in many areas of social policy, the model of the well informed consumer does not hold. As an example, a survey of Americans found that 50% did not know the difference between a stock and a bond. Now if you are not clear about a distinction as basic as that, the idea that people can make sensible choices about old age security is a nonsense.

A second information failure is that most people don't understand that they need to shift from equities to bonds as they approach retirement if they want to use their pension accumulation to buy an annuity.

Third, few people realise the significance of administrative charges. The statistic I use is this. I always refuse to give people pension's advice with one exception: I say, look at your administrative charges; if your fund charges you 1% of your accumulation per year to look after your pension fund, then over a full career your accumulation is 20% smaller because of that 1% charge than it would otherwise be. At a conference in South Africa, the conference pack had advertisements from various South African financial outfits. One of them said that they were one of the cheapest pension providers in South Africa, charging only 1.8% a year. Now that implies that well over a third of savings go in administrative charges!

A failure to realise that is a serious information problem.

Or look at financial literacy. I knew it was bad but until I heard Olivia Mitchell presenting this material I didn't know how bad. She conducted an international survey, done to be comparable across countries, which asked people three questions. I am just going to pose the first one. You have £100 in a bank account; it pays 2% interest a year; how much would you have in the account after five years? £102? Less than £102. More than £102? The other two questions were of the same level of difficulty. In the United States about 35% of respondents got all three answers right, in perfectly sensible well-run countries like Sweden, Japan and New Zealand it was about a quarter, and in Russia it was 2%. What that says is that financial literacy is worse than we could ever have imagined.

NON-RATIONAL BEHAVIOUR. There are important lessons from behavioural economics. Conventional theory predicts that we will save: the youngsters among you will save voluntarily, and the older people will voluntarily buy the optimal amount of annuity when you retire. Ho ho ho! That may be true of people associated with the Cardiff University Business School, but it ain't the way people behave in practice.

- Bounded rationality arises where the problem is too complicated for people to know what they ought to do. It manifests itself in problems like procrastination (people delay making decisions), inertia (they stay where they are put), or immobilisation (they are frozen like rabbits in a car headlight and do nothing).
- Bounded willpower arises where people know very well what they ought to do, but do not do it, for example, they don't save or don't save enough.

Evidence shows that people have a high discount rate in the short run, much lower in the long run. There is a famous experiment: as you came in today you signed up for your snack for next week's lecture: two thirds of you chose fruit salad because that's the healthy option, and a third of you chose chocolate; but as you came past the table to pick up today's snack, two thirds of you chose chocolate. That says that we are all rational for the future -- rational long run economic man and woman -- but not for the present. The trouble is that when the future arrives it becomes the present so the short term wins. You have got 'time inconsistency'.

There have been studies: sort of 'economic theory meets hard neuroscience'. They asked people questions when under a CAT scanner. As you probably know our brain has different parts: the mesolimbic is the old part of the brain, the animal part, the me, me, me, now, now, now - eat now this may be the last meal I get. The pre-frontal cortex is a much newer part of the brain, it is patient and rational. Experiments under the scanner show that short-term decisions are made by the mesolimbic system and longer term by the pre-frontal cortex. And we have only to introspect to see that life is a constant fight between the two parts: we know we need to lose a bit of weight, we know we need to go on a diet, but today's a bad day, there is a lecture and there is a dinner afterwards, and I will start dieting tomorrow. We know we should quit smoking, but it's coming into

exam season, stressful for students, and it is not a good time to give up! So those sorts of results call into question the simple model of long-term rationality.

IMPLICATIONS FOR POLICY. What do these information problems and non-rational behaviour tell us about how to design pensions sensibly?

The first lesson is that limiting people's choice can be part of good policy design. In the face of bounded rationality, giving people more choice can reduce their welfare. A second problem with choice is that it is costly: one of the reasons for high administrative costs is that choice is expensive to administer. Thus it is desirable to constrain people's choice of pension provider. It is also desirable to constrain their choice about how much to save; if you leave it to individual choice, bounded rationality means that many people won't know how much they need to save to achieve a given standard of living in old age, and bounded will power means that, even if they are told, they won't necessarily save enough. So a savings mandate is desirable.

The second lesson is that it is mistaken to overestimate what financial education is capable of achieving. Financial education is enormously important and should be part of the national curriculum, but there are limits to what can realistically be expected. Financial education doesn't make us well-informed choosers of financial products- I will give you an example in a minute.

Lesson three: choice and competition is the wrong model for pensions. Pensions are complex, and choosing from competing private pension providers creates information and behavioural problems and high administrative costs. That is not a condescending remark from an elderly professor of economics; the problem is very real. In the private part of the pension system in Sweden workers have to choose a pension fund from nearly 800 funds. I was asked to write a report for the government of Sweden on their pension system. The night before I presented the report, I was having dinner in Stockholm with two old friends, the person who, in essence, ran their pension system and one of the people who had been intimately involved with creating it. I said to them, 'if I were a Swedish worker I wouldn't have a clue about which fund to choose, I would be in the default fund'.

And my friends looked at me, and they laughed, and they said 'we're in the default fund'. So the real experts realise that they can't choose well, or maybe they can choose well but they prefer to do better things with their life. As an analogy, none of us is allowed to go into Boots to buy any pharmaceutical drugs we like, the reason being we don't know enough to be able to choose well. In my view, choice and competition is the wrong model for pensions: it uses a first-best model in second-best circumstances. I am not attacking pension funds, but criticising the model.

Lesson four: incentives matter. Work by Jonathan Gruber and David Wise shows that if you give people dumb incentives about retirement they will do dumb things. I am not saying that incentives don't matter, but that one should not exaggerate how rational people's responses will be. My example is 401(k)

plans in the United States. Many employers make matching contributions, workers put in money, get the employer match, and from age 59½ can make penalty free withdrawals. So I am 59 and anything I put into my employer's fund will get an employer match, so I put the money in which I can take out in six months' time, tax free with the employer match – so obviously everybody puts in as much as they possibly can as they approach 59, don't they? No they don't! They know about it, but it just doesn't happen! So the fourth lesson is: incentives matter but people respond only to very powerful incentives: the idea of adjusting things at the margin and people responding as the simple theory predicts is not what happens.

Risk sharing in pensions is central and often overlooked

The future is an uncertain business, so any pension system is going to face risks. The right question to ask is how should those risks be shared? As we know, different designs share risks differently. In a pure Defined Contribution (DC) scheme all the risk falls on the individual worker. In a pure Defined Benefit (DB) final salary scheme the risk falls on the plan sponsor, usually the firm -- think BHS, think Tata. In a public pay-as-you-go scheme that is not allowed to run a deficit the risk falls on workers; and with a public plan that includes at least some tax finance, risk falls on taxpayers and hence, via government borrowing, can be shared across generations. This question - how should risk be shared? -- isn't asked enough.

One of the things that Peter Diamond and I are trying to make clear is that, though we don't have a theoretical model, there are powerful arguments for arguing that exposure to risk should decline with age. Even if old people have the same utility function as they had when they are younger, they are less able to adjust as they get older. Workers can adjust by saving more, by working harder, by working longer, or by retiring on a smaller pension, or any mix of those. Older workers still have the same margins, but less time to adjust; and pensioners have fewer margins on which to adjust. These considerations suggest that pension systems should offer risk protection that rises with age. That doesn't mean pensioners should not be exposed to any risk, but that pensioners should be exposed to less risk than younger people.

Some pension systems obey this advice. The province of New Brunswick in Canada has a system which says: here's the career average that we will try to pay, but if things go badly here is how we are going to adjust things; and the adjustment includes some of the risk falling on pensioners, but less on pensioners than workers. That seems to make a lot of sense.

Risks can be shared in the design of an individual element or shared across the system. To take a simple example, if there is a non-contributory pension of a million pounds per year and a small defined-contribution pension, of course the worker faces risk on the defined-contribution bit, but for the system as a whole risk is not important because of the large non-contributory pension. Alternatively, as in the USA, the risk is shared by having a redistributive element in their social security pension.

In New Zealand risks are shared by having a generous non-contributory pension with automatic enrolment into individual savings. By adjusting the relative sizes of those two elements it is possible to share risk in different ways.

No single best pension system for all countries

Peter Diamond and I intended to write a quick short book; we failed on both counts. It took us four years and it was a very long book! Its bottom line was there are sound principles of pension design but no single best pension system for all countries. The reason is straight forward. There are multiple objectives -- consumption smoothing, insurance, poverty relief and perhaps also redistribution -- and multiple constraints -- fiscal capacity, institutional capacity, and empirical values of behavioural parameters of things like labour supply. The reason there is no single best system is that the different objectives will have different weights for different policy makers at different times and in different places, and the pattern of constraints will differ across countries. So if the objectives differ and the constraints differ, the optimum will generally differ.

That is why what is optimal will differ across countries and over time, and that is why pension systems vary widely across sensible, well run, democratic countries -- and that is as it should be. There is a problem for pension portability for internationally mobile labour but the idea that there is a single optimal pension system that is imposed on all countries is the wrong model.

So those are some -- I think quite potent -- lessons from economic theory.

Lessons from international experience

I want now to come to what we can learn from international experience. Having just said that there is no single best system, what I am going to talk about is not something that is definitively right, but discuss four directions that are interesting and useful: non-contributory pensions; later and more flexible retirement; how to design simple savings and annuities; and the idea of a notional defined-contribution pension system of the sort in Sweden.

Non-contributory pensions

Non-contributory pensions, also known as social pensions, are awarded on the basis of age and residence, but without a contributions test. The Netherlands has a system like that. If you have lived in Holland all your life, when you reach pension age, you get a non-contributory pension. Where does the idea come from?

The starting point is that the world has changed. Social policy in Europe and North America in 1950 was based on a series of assumptions: independent nation states; employment was generally full time and long term; there was limited international mobility; men and women got married and stayed married and the man earned the money and the woman looked after the children; and skills once acquired were lifelong.

Those assumptions were not strictly true even then, but were true enough to be a realistic basis for policy. But you have only to articulate them to see how totally they fail to apply in today's world.

I will talk about only two assumptions – employment and the structure of the family. It used to be true that people had long term, full time employment. Today, patterns of work are much more diverse: full-time, part-time, full-time, self-employed, out of the labour force, getting training, etc. So there are problems for the coverage of benefits where contributions are tied to employment. In the United Kingdom in 2004, when it still needed over 40 years of contributions to get a full national insurance pension, only 85% of men had enough contributions for a full basic pension and only 35% of women. That is not because we are incapable of collecting contributions or maintaining records. It's not an administrative problem. It's not a policy design problem. It's a problem of the fit between the labour market and pensions.

Turning to the changing nature of the family, family structures are more fluid: people get married but they may get unmarried, or they may not get married at all. Separately there is rising labour market activity by women, not just paid work but full careers. So the idea of basing a woman's pension on her husband's contribution, not only sounds bizarre in today's world but doesn't work. Arguably it did work in 1950 but it doesn't work today.

What that says is that if you want a pension system to deliver poverty relief, the contributory system is a bad way of doing so, because with today's labour markets and family structures, you can't rely on people having complete contribution records.

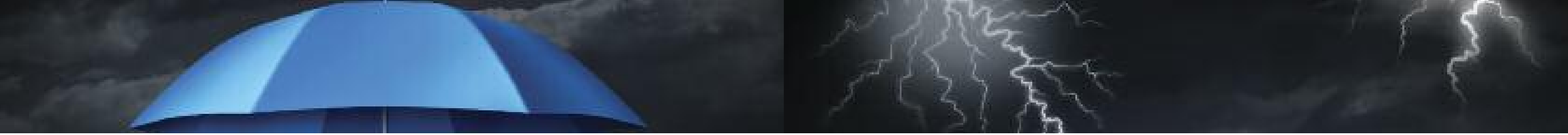
Thus the case for social pensions is that they strengthen poverty relief in terms of coverage, adequacy and gender balance, since women generally have poorer contributions records because on average earn less than men and work for fewer years. Thus a non-contributory element benefits women more than men. Non-contributory pensions have considerable advantages: they are a good way of sharing risk; they can fit different budgetary situations, they are more robust in the face of shocks than benefits based on financial markets, and they make fewer demands on institutional capacity than contributory systems. For a non-contributory pension it is necessary only to establish a person's age; there is no need for a contributions record or earnings records. Countries that have non-contributory benefits include Australia, Canada, Chile, the Netherlands and New Zealand, and an increasing number of developing countries.

Later but more flexible retirement

The argument for later retirement is obvious: longer healthy life, combined with a constant or declining retirement age means that pension spending per person will get larger and larger, and eventually finance will blow a gasket. As I have said, the problem is not that people are living too long, but that they are retiring too soon. Thus the solution is that pensionable age should rise in a rational way as life expectancy increases. Of course there are complications. If the only demographic change is that people are living longer, raising retirement age is a fairly complete solution. If in addition there is declining fertility, the problem cannot easily be solved just by raising pension age; it is necessary also to increase savings. But, however you look at it, with people living longer, healthy lives, they should work longer.

The 'lump of labour' fallacy is another example of pub economics: politicians always and everywhere know if you raise the retirement age, you cause youth unemployment. It's obvious… and it's wrong. If it were true, countries with higher retirement ages would have more youth unemployment; what you observe tends to be the reverse: it is countries with low retirement ages that have more youth unemployment. Youth unemployment is a labour market problem, not a pension problem. With well-functioning labour markets, if retirement age goes up over time, other things equal the number of workers goes up, therefore wages rise more slowly than would otherwise be the case and more jobs are created. So countries with well-functioning labour markets can accommodate rising retirement age. The problem of youth unemployment is a truly horrible problem but not raising retirement age is not a solution.

Later retirement is a pretty obvious policy direction. What is often overlooked is that we need not only later retirement but also



more flexible retirement, in other words, people should be given choice over how they move from full-time work to full retirement. When pensions were invented in the late 19th century, their economic purpose was to get doddering, unproductive workers off the factory floor and the farm yard where they were lowering the productivity of younger workers. It's like me coming into your office and saying, 'can you help me turn on my computer', or fiddling with your keyboard and losing the document that you haven't yet saved. If the objective of pensions is to clear out dead wood, it makes sense to say that retirement should be mandatory and complete. You turn 65 (which in the late 19th century was really old), and on your 65th birthday you must retire and must retire completely.

But two things have happened since then. People are living longer, healthier lives which means they should retire later, but we are also richer as societies, which means that we can afford to give people a period of leisure at the end of their working life. But that means that the purpose of pensions has changed: it is not only about getting rid of dead wood, but a social invention for dividing adult life between working years and leisure years; and that means that it is a good idea to give people choice about how they move from full-time work to full retirement, partly as a response to demographic change, but also as a response to individual preferences. Thus it would be desirable to have more flexible retirement even if there were no problem of paying for pensions.

Simple savings and annuities

AS discussed earlier, choice and competition is the wrong model for pensions because (a) choice is administratively expensive and (b) consumers don't do a good job of choosing because of imperfect information, bounded rationality and bounded willpower. What does that tell us about pension design? First, people should not have much choice about saving: either have a savings mandate, or if that is politically not possible, auto enrolment. A second lesson is to keep choices simple: highly constrained choice is a deliberate and welfare-enhancing design feature. Third, even if you give people simple choices, people won't necessarily make a choice, so it is necessary to have good default option. In a system where people must buy an annuity, the default should have life cycle profiling (i.e. should automatically move a person's pension savings from equities into bonds as she/she approaches pension age). If people have the option to draw down their pension saving over time, rather than buy an annuity, you might want to do things differently.

A fourth lesson is to keep administrative costs low in two ways: first, through less choice, and secondly by decoupling two aspects of administration. One is record keeping, the back-office stuff, the other is deciding which financial assets should go into the portfolio. The back-office tasks should be centralised to exploit economies of scale. Fund management – the investment decisions – can be arranged either on a wholesale competitive basis (as in the US Thrift Savings Plan, discussed shortly), or by government through a sovereign wealth fund (the closest example being Norway).

A practical example of this approach is the Thrift Savings Plan, the US savings plan for federal civil servants. The plan was initially voluntary but now has auto enrolment, with 5 funds from which workers can choose. The plan has centralised account administration and wholesale fund management. The way fund management works is that private investment firms bid for the right to manage tranches of civil servants' savings; so supposing the Thrift Savings Plan managers invite bids to manage $50million tranches, any private firm that bids has to run an identical portfolio for their private clients to insulate from political interference.

A further point is that the people who choose who manages the portfolio are not individual members, who don't usually have the capacity to make that choice, but the people who manage the Thrift Savings Plan – and in-house they have people with the necessary information and skills to choose good fund managers.

The system being introduced in the UK, the National Employment Savings Trust (NEST pensions) is similarly based on arguments about information problems and behavioural issues, including automatic enrolment into NEST or a similar occupational plan. When fully phased in, NEST pensions has a minimum contribution of 8% divided between worker, employer and taxpayer, choice is from a small number of funds, account administration is centralised, and fund

management organised on a wholesale basis.

The US Thrift Savings Plan has unbelievably low administrative costs: they claim costs of 6 cents per $1000, which I don't believe. I think some of the costs must appear somewhere else in the federal budget. I'm not saying that they are telling porkies, just that since it's a government scheme there are economics of scale that I don't think are fully captured in the quoted administrative costs. For NEST pensions the target is to emulate costs of the private system in Sweden, which caps charges at 0.3%. I expect that there are people here who know vastly more about how NEST pensions are actually operating and whether that low costs is being achieved, but that is the thinking behind the plan. Both the Thrift Savings Plan and NEST pensions respect the lessons from the economics of information and behavioural economics, and both keep administrative costs low.

Notional defined contribution pensions

But -- there is always a but -- any fully-funded pension can share risk only among current participants, whereas a partially funded plan can share risks more widely. So the fourth lesson from international experience that I want to discuss is the idea of notional defined contribution (NDC) pensions. Because they are pay-as-you-go or partially funded they have the potential to share risk more widely than a fully-funded scheme. Let me explain how they work, though I am sure you know about them.

The idea is that NDC pensions mimic individual funded accounts but on a pay-as-you- go or partially funded basis. Thus your contributions this year as younger workers pay for my pension, i.e. pay-as-you-go. The government keeps a record of your contribution and at the end of this year it adds this year's contribution to your accumulation at the end of last year and attributes to the total accumulation an interest rate. That interest rate is not the market rate but a notional interest rate related to the performance of the economy. It could be the overall rate of growth, or more typically either the rate of wage growth or the rate of growth of the wage bill. At the time a person retires, the government computer has a number which represents his/her cumulative contributions plus interest. That total is converted into annuity whose value depends on (1) the size of the person's notional accumulation and (2) the remaining life expectancy of his/her birth cohort. From the point of view of the individual worker the arrangement is simple: it is centrally administered so it has low administrative costs; it avoids much of the risk of fully-funded individual accounts, because it is partially funded so it can share risk more widely than a fully funded plan; and it doesn't require the institutional capacity to manage a funded plan – an aspect which is not relevant in European countries but is in some developing countries.

A further advantage is that increased savings isn't always the right policy. It is in most countries, but when Peter Diamond and I were asked to advise the government of China in 2004, the savings rate in China was 52% of GDP – China needed more savings like it needed a hole in the head! So we argued that fully-funded individual accounts was the wrong approach for China, at least at that time. The system in China of a pooled element plus individual accounts was a perfectly good strategy, but we argued that the individual accounts did not have to be fully funded, but could be notional. So our recommendation was to keep to a system with a pooled element together with individual accounts, but to organise the individual accounts as notional accounts rather than fully funded.

Countries with NDC systems include Sweden, Poland and Latvia. So this is a system that can work. When the financial crisis struck, workers and pensioners in Sweden took a hit, but a much smaller hit than in fully-funded accounts.

UK pensions: What's wrong, what's right, what's missing?

So let me come onto the UK.

What is wrong?

First of all we reform far too often: we have a pension reform every three weeks (I exaggerate, but not as much as you might think)! Pensions are a long run instrument, this is ridiculous! The social security pension in the United States is recognisably the same as that introduced in the 1935 Social Security Act. Sweden, similarly, reformed after much thought and discussion in the late 1990s and the system has been maintained since then.

A second problem with our system is complexity: my suspicion is that very few of you could give a good description of the British pension system, and if you can, to be honest, you are a sad human being. Those of you who have seen recent editions of my book The Economics of the Welfare State will see there is no a description of the British system in it: that is not an accident- life is too short! The system is absurdly complex.

The third problem is pension freedom. Politicians say 'People should be allowed to do what they like with their own money'. Now it should be clear from what I have said earlier that my problem with that is that it is first-best economics: it assumes rational behaviour and hence ignores lessons from information and behavioural economics. As I have said we don't use the same argument for pharmaceutical drugs -- the extent of choice should be optimised, not maximised.

What has happened? In March 2014 George Osborne abolished the requirement to annuitise on the grounds, he said, that annuities were bad value. That was the right diagnosis but the wrong prescription. We know why annuities are bad value, and there are things we can do to improve matters. We can complete the private market, for example if the government were to issue longevity bonds, about which I suspect a lot of you know a lot more than I do; or there is the Swedish approach, with a single monopoly seller of annuities, the government; the government can pool risk and can take a long run view of interest rates etc. The predicted problem of abolishing the requirement to annuitise is that there is a potential for mis-selling of non-annuity products and for high charges.

The second reform, in September 2014, was to give people freedom over how they draw down their pension. Once you turn 55, you can spend your pension pot as you like. Problem 1: some people will draw down too fast; Steve Webb referred to this as buying a Lamborghini. That problem is obvious.

Less obvious, but possibly even more important, is the opposite – that people will draw down too slowly. I know that this is the big worry of Martin Lewis, the founder of the consumer information and campaigning site MoneySavingExpert.com. Why might people draw down too slowly? 1) They can't do the sums they need to spread their money out well; 2) They worry about living too long; and 3) (it occurred to me thinking about this on the way here), I can remember my Mother saying to my brother and me, 'I am sorry that I am spending your inheritance' (we both said a rude word to her and said 'that's absolute baloney, it's your money, enjoy it'). But there will be pressure on Mum not to redecorate the house and certainly not to get a new car because her pension pot will become yours if she doesn't spend too much. I think that is a truly horrible situation. The point in economic theory is that if someone is risk averse, insurance (i.e. an annuity) dominates self-insurance (i.e. drawing down pension saving). If people don't insure and aren't required to insure and there is no instrument to insure, that reduces their welfare.

The third reform, in March 2015) is the freedom to convert an annuity back into lump sum. Again the problems are of drawing down too fast, or too slowly, or potential mis-selling of non-annuity products, high charges etc.

Why do these things when they fly so much in the face of economic theory? I have two explanations; there may be more.

One is ideology: people should be allowed to do what they like with their own money. It sounds good and by and large I agree with it. We all agree in principle: it's great for smartphones and cars and computers and things like that. It is much less clear that a simple argument like that is good for pensions, indeed I think it is wrong.

The second possible explanation is very cynical. If you give people freedom to draw down and a significant number draw down more quickly than they otherwise would they will pay more tax more quickly than they otherwise would, creating a tax windfall for the Treasury. I hope that is not the case – that ain't the way to run a pension system.

What is right?

The Report of the Pensions Commission, the Turner report, published in 2005 is a rare shining example of a stunningly good government report, beautifully argued, beautifully written. It has led indirectly to the single tier state pension and directly to NEST pensions. The single-tier state pension, which has aspects of a non-contributory pension, is very much a move in the right direction and the design of NEST pensions, similar to the US Thrift Savings Plan, is important because it gives workers a simple, reliable, cheaply administered way of saving.

What is missing?

What is missing above all, is long-term cross party agreement. Sweden reformed in 1998, with the reforms agreed by all the political parties. I am told that if you want to murder someone, all fourteen of you should stick a dagger in the body; that way no-one knows who has killed the person. This is the principle in Sweden: all the political parties signed up for the reform, so they are all in it together. They have managed to maintain cross-party political support, which made me feel very wistful when I look at the way pensions politics works in this country.

The second thing that is needed is indexing earliest pension age to life expectancy in some sensible way. They have done that in Denmark. It is good that we are starting to raise state pension age, but it is done on a fairly ad hoc basis. It would be better to have some sort of rule.

There should also be improved options for flexible retirement. In Sweden, when a worker reaches minimum pension age, she can choose whether to take 100% of her pension, 0% of her pension or 25, 50 or 75% of her pension. If she takes half the pension and carries on working, she carries on paying pension contributions on her earnings, and the half of her pension that she hasn't drawn down grows actuarially so that when she retires fully there is a second part of pension which is larger than the initial part.
It is also desirable to have better options between part time work and full retirement.

Fourth, it is desirable to have better designs for risk sharing, including age related exposure to risk. One approach is

what is sometimes call a Defined Ambition plan. An example I mentioned earlier is the plan in New Brunswick with career average benefits as the aspiration, but with explicit rules that apply if the fund runs a deficit, specifying where the costs of that deficit should fall in terms of higher contributions by workers and/or lower accrual rates for workers and/or or less generous indexation of pensions, or in the extreme even some fall in the nominal pension.

Fifth, completing the annuities market: index-linked gilts already exist, but consider also longevity bonds. At a very minimum, if nothing else is done, introduce sensible rules for draw down, including a tax penalty if people withdraw less than a minimum or more than a maximum amount in any one year. There are plenty of good examples in other countries of minima and maxima, and you can allow some flexibility around those for good reason.

Finally, long term care: I have not had time to discuss the topic this evening, but have argued elsewhere that it is a suitable case for social insurance.

So my bottom line: there are good ways of designing pensions but basing policy on choice and competition between multiple providers is not the way to do it. There is much to talk about. I'll be happy to take questions. Thank you very much.

The first Julian Hodge Institute of Applied Macroeconomics Lecture was delivered in 2000. Since this time the lecture series held in Cardiff has included some of the world's leading economists.

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