Written evidence from Professor Nicholas Barr, London School of Economics [PPS0023]

Outline

Pension Freedom: Ignoring lessons from theory and practice[1]

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Summary

This submission starts with observed facts (section 1) and then discusses implications for pension design while a worker accumulates pension savings (section 2) and during drawdown (section 3). Section 4 sets out some wider considerations.

CENTRAL ARGUMENT.

[1] The analysis in this submission draws heavily on work with Peter Diamond (Barr and Diamond 2010, and a forthcoming book).

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- Pension design should assist choice by people who wish to make choices about saving and retirement.
- But the pension system should be designed to work well also for people who make no choice – and making no choice should be an acceptable option.

SOME FACTS. Many people make bad choices (section 1.1). People frequently:

- Save too little;
- Make bad choices of portfolio or adviser;
- Fail to realise the importance of administrative charges: **a 1 per cent annual management charge over a full career reduces a person's accumulation by about 20 per cent compared with what it would be without the charge**;
- Annuitise too little;
- Make bad choices of annuity provider.

SOME EXPLANATIONS. A large literature explains why these outcomes are no accident.

- Some suppliers exploit their superior knowledge to increase profits (section 1.2);
- Workers' choices are affected by the complexity of financial products, by widespread limited capacity to address that complexity, and by behavioural biases (section 1.3).

IMPROVING THE SAVING PROCESS. Those findings offer pointers for good design (section 2.1):

- Make pension saving mandatory or use automatic enrolment;
- Keep choices simple;
- Include a good default option for workers and pensioners who make no choice;
- Keep administrative costs low.

NEST pensions offer a good example of the application of these elements (section 2.2.)

PENSION FREEDOM: A SCANDAL THAT WAS PREDICTABLE (AND PREDICTED) (section 3.1). The NEST approach to accumulation is through a nudge in the form of auto-enrolment, a default, and highly constrained choice As the quote at the start of the main text makes clear, if that approach to accumulation is supported by empirical evidence and economic theory, then adopting the opposite policy of unconstrained choice of drawdown from age 55 cannot be right.

Alongside criticism of substance is criticism of the process of reform in 2014 – at short notice, with no public discussion, and no evidence of long-run thinking about the welfare of future pensioners.

BETTER WAYS FORWARD. Section 3.2 outlines three elements to improving drawdown:

- Improving choices about drawdown, in particular through advice and guidelines. Again, NEST offers useful suggestions.
- Improving choices of annuities by workers.
- Improving annuities, including introducing deferred annuities in which a worker aged (say) 70 buys an annuity that pays benefits starting from (say) age 85.

SOME WIDER CONSIDERATIONS (section 4). The section discusses:

- The benefits of achieving continuing cross-party agreement, to ensure that reform takes place within the framework of a long-run view of pensions.
- Indexing state pension age to life expectancy in some sensible way.
- Introducing options for flexible retirement, including the ability to combine partial pension with continuing work.

1. At the heart of the UK pension system is a fundamental incoherence:

> 'Unless the government beefs up guidance, new pensions freedoms could undermine auto-enrolment and leave us with a pensions crisis. *If the government was worried about obesity but simultaneously handing out free sweets, you'd have to question either their motives or their competence*.
>
> 'But that's exactly what the government has done with pensions. Auto enrolment largely exists because we believe that people are either incapable or unwilling to save for their future. At the same time, 'freedom and choice' makes the assumption that people are capable of making good decisions about retirement.
>
> 'It doesn't take a behavioural economist to tell you something's not right here. The two policies aren't just contradictory; they are underpinned by diametrically opposed assumptions about the way people think'.[3]

2. This submission makes the following argument:

- Pension products are complex.
- Many people make bad choices of financial products both while building up their pension savings and during drawdown.
- The policy direction that follows is twofold: pension design should assist choice by people who wish to make choices about saving and retirement; but the pension system should work well for people who make no choice – and making no choice should be an acceptable option.

3. Section 1 sets out some facts about the observed behaviour of savers and financial firms, and summarises the main reasons why those findings are unsurprising. Section 2 sets out the resulting lessons for getting accumulation right, with particular emphasis on the importance of NEST pensions. Section 3 looks at drawdown, explaining why pension freedom flies in the face of lessons from international experience and a large economic literature, and suggests better ways to organise drawdown. Section 4 briefly considers some wider considerations.

1 Some facts

1.1 Many people make choices that do not suit themselves or their families

During accumulation

[3] 'Poor guidance could cause pensions crisis', *Pensions Insight*, January/February 2015, http://www.pensions-institute.org/reports/PI-Top50.pdf, p. 8, emphasis added.

4. MANY PEOPLE SAVE TOO LITTLE. A report by Scottish Widows (2014) includes the following data from YouGov:

- 19 per cent of adults in the UK had no saving;
- 55 per cent had savings between £1 and £50,000, the average being £10,200;
- 12 per cent had savings of more than £50,000;
- 15 per cent did not know how much savings they had.

5. Blake (2016; see also UK Pensions Policy Institute 2015) recommended 'a national retirement savings target of 15% of lifetime earnings … to avoid future pensioner poverty' (p. 28), considerably higher than the rate in most defined-contribution plans.

6. In addition to saving too little, errors are common in the ways in which people save. The following problems are well documented internationally.

7. DELAYED CHOICE OR NO CHOICE. In Sweden, where workers are supposed to choose from nearly 850 private mutual funds, in 2011 over 98 per cent of first-time choosers made no choice and so were enrolled in the default fund. Notwithstanding that some new entrants make a choice later, in 2016, 45 per cent of all participants were in the default fund.

8. MORE OPTIONS CAN IMPEDE CHOICE. A US study (Sethi-Iyengar *et al*. 2004) found that,

> '... if a plan offered more funds, this depressed probability of employee 401(k) participation …. The majority of the plans included in this data set offered between 10 and 30 options, yet … plans offering (fewer than 10 plans) had significantly higher employee participation rates' (pp. 88-91).

9. MAKING AN UNSUITABLE CHOICE. Examples are legion.

- Some people will choose actively-managed funds when cheaper index funds (also known as tracker funds) might be more appropriate. Some will choose a high-fee index fund when a similar index fund is available at a lower fee.

- Many investors do not understand how much administrative charges eat into their accumulation, for example a 1 per cent annual management charge over a full career reduces a person's accumulation by about 20 per cent compared with what it would be without the charge.[4]

- Some will hold an inadequately-diversified portfolio.

- Some may inappropriately choose and then stay with a pension provider on the basis of current inducements, for example a rebate in the first year.

10. TRADING TOO LITTLE, OR TOO MUCH, OR AT THE WRONG TIME. Some people rarely change their portfolio. Others trade a lot, taking insufficient account of transactions costs. Others trade at the wrong time, selling because the stock market has fallen and buying when the stock market is rising.

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[4] Barr and Diamond (2010, Box 7.2). See also Choi et al. (2010) and '9 in 10 Americans underestimate their hidden 401(k) fees', http://www.nerdwallet.com/blog/investing/2013/hidden-401k-fees-plan-retirement-account-study/ and, more fully, US Federal Research Division (2011).

During drawdown

11. Choices by individuals at the time they retire and in subsequent years display parallel problems.

12. ANNUITISING TOO LITTLE. Buying an annuity insures the pensioner against longevity risk. Relying fully on drawing down pension savings forgoes this insurance. Behavioural economics gives insights into why in a voluntary system people do not annuitise, or do not annuitise enough – known as the 'annuity puzzle'. Annuitising too little does not mean that mandatory full annuitisation is optimal. Uncertainty about future expenditures, notably the high costs of long-term care, as well as bequest motives imply that converting all savings into an annuity is not necessarily optimal.

13. MAKING A BAD CHOICE OF ANNUITY PROVIDER. The issues are the same as the choice of fund manager during accumulation.

> 'We estimate that … 80% of those purchasing an annuity from their existing pension provider would benefit from shopping around and switching. For standard annuities we estimate 79% could get a better deal on the open market, and for enhanced annuities the proportion is 91%' (UK Financial Conduct Authority 2014, p. 14).

14. DRAWING DOWN TOO FAST OR TOO SLOWLY. The problem can arise in multiple ways. The pensioner may spend too much too soon, particularly if he or she lives longer than planned for. Choices by an individual may take insufficient account of other family members. Or the pensioner may spend too little, either for fear of running out of money or out of a reluctance to 'spend the children's inheritance'.

1.2 Some suppliers exploit their superior knowledge to increase profits

15. A competent and well-motivated firm gives good advice. However, the financial crisis was a firm reminder that biased advice is a continuing problem, and so is fraud.

16. THE WRONG PRICE. A seller may charge an inflated price either by selling an unsuitable high-cost product, for example, an actively-managed portfolio for a small individual account, or by abusing market power to charge a price higher than would emerge in a competitive market.

17. It is ancient history that there is an obvious incentive when advice affects the income of the person providing advice.

> 'That any sane nation, having observed that you could provide for the supply of bread by giving bakers a pecuniary interest in baking for you, should go on to give a surgeon a pecuniary interest in cutting off your leg, is enough to make one despair of political humanity' (George Bernard Shaw, *The Doctor's Dilemma*, 1911).

More recently,

> 'The sting operation had the trappings of a Wall Street thriller, except that it was run by a team of Harvard and MIT economists. In an audacious experiment, the professors dispatched a squad of undercover operatives across Cambridge and Boston to pose as middle-class investors and ask retail brokers for investment advice.

> 'Nearly half the brokers … steered clients toward actively managed mutual funds. Those funds — which sometimes beat the market but most often don't — carry higher fees that enrich brokers and fund managers but, critics say, stunt the growth of middle-class nest egg'[5].

18. THE WRONG PRODUCT. Misselling is an extreme case of biased advice. The total cost of compensation after the 1988 misselling scandal exceeded £10 billion. It might be thought that the lesson had been learned. Not so. In 2018, with awful predictability,

> 'Politicians' scrutiny of the British Steel Pension Scheme saga — and the [regulator's] response to it — came after more than 2,000 current and former steelworkers, spooked by the restructuring under way at the Tata Steel plant in Port Talbot in Wales, transferred out of their final-salary schemes after receiving allegedly unsuitable advice.'[6]

19. In the words of a deeply respected commentator,

> 'With the "right" fee structure mediocre investment managers may become rich as they ensure that their investors cease to remain so' (Martin Wolf, *Financial Times*, 18 March 2008).

1.3 Some explanations

20. Bad choices by workers and pensioners are not surprising for at least three sets of reasons:

- The underlying problem is complex;
- Many workers and pensioners lack the technical skills to make those choices well ('can't'), and some with the necessary technical skills do not devote sufficient continuing attention to the management of their pension savings ('won't').
- For many workers and pensioners choices are hampered by behavioural biases.

There is a large literature – the subject of multiple Nobel prizes – on the economics of information and behavioural economics, of which the following paragraphs are the briefest of summaries.

21. COMPLEXITY. Choices about saving and drawdown over the course of a lifetime are inherently complex because of uncertainty and because financial products are not simple.

22. To illustrate, a worker making choices about saving faces multiple uncertainties:

- Future needs are heavily influenced by how long a person and his or her family will live; by family circumstances; by the duration of a marriage and the options after a divorce or death of a spouse; by the number, ages and experience of children; and by medical expenses including – importantly – whether a person will face the costs of social care in old age.

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[5] 'Financial firms lobby hard against stricter protections' *Boston Globe*, November 16, 2014, http://www.bostonglobe.com/news/politics/2014/11/16/rules-protect-middle-class-investors-face-tough-fight-obama-final-two-years/kEzo0lm4qvt4wNIMIQMdVJ/story.html). See also Pool *et al*. (2015).

[6] 'UK's FCA to probe thousands of pension advisers after Port Talbot crisis', *Financial Times*, 12 January 2018, https://www.ft.com/content/7e383ad9-f411-3ceb-ace5-a248cdc662a2

- Future earnings: people are uncertain, about the level and time path of future earning opportunities, which will depend, *inter alia*, on the state of the economy at different times and the demand for workers with particular skills.
- Future asset returns.
- Future annuity prices, which will be heavily influenced by future interest rates.

23. LIMITED CAPACITY TO ADDRESS COMPLEXITY. Many financial products are complex, and making choices requires a good understanding of financial concepts. Many workers and pensioners lack the technical skills to make those choices well, and end up with products that are not a good fit for themselves or their families.

24. In a famous international study of financial literacy, Lusardi and Mitchell (2014) asked participants three questions:

- Interest: you have $100 in a bank account paying 2% interest a year. How much would you have in the account after 5 years: less than $102? equal to $102? more than $102? don't know?
- Inflation: suppose that the interest rate on your bank account is 1% a year and that inflation is 2% a year. After one year, with the money in this account, would you be able to buy: more than today? the same as today? less than today?
- Risk. True or false? Using $100 to buy shares in a single company usually provides a safer return than buying $100 of a unit trust (i.e. something that holds a wide range of shares)?

In the USA, 35% of respondents answered all three questions correctly; in many OECD countries only about 25% of respondents did so. The implication is that many people do not understand simple interest, let alone compound interest, let alone the concept of present values which underpin sensible decisions about annuities.

25. In the context of pensions:

- A survey, 50% of Americans did not know the difference between a stock and a bond.
- Most people do not understand the need to shift from equities to bonds as they age if they hold an individual account.
- As noted, few people realise the significance of administrative charges.

26. As indirect UK evidence of the extent of limited financial literacy, consider the stature that Martin Lewis rightly has as a campaigner for financial literacy and consumer financial rights.

27. LACK OF EFFORT. Even where an individual is financially literate, it does not follow that he or she will devote the necessary attention to managing and adjusting their pension affairs. To see the extent of inertia, one has only to note how many people fail to move money from bank accounts with lower interest rates to ones paying higher rates. Note that this type of maintenance is a continuing process over working life and during retirement, not a one-off event like buying a car.

28. BEHAVIOURAL BIASES. Alongside complexity and limited capacity to address complexity, a large recent literature discusses behavioural biases (for non-technical

discussion, see Thaler and Sunstein 2008, Kahnemann 2011 and Thaler 2015), of which 'nudge' has been prominent in public discussion. Behavioural biases can usefully be divided into two sorts

29. *Bounded rationality* arises where a problem is too complex for someone to know what they should do, even when presented with the relevant information (many medical problems have the same characteristic). Manifestations include:

- Procrastination: people delay making decisions.
- Inertia: people stay where they are; in theory it should make no difference whether the system is opt in or opt out – in practice, automatic enrolment leads to higher participation .
- Immobilisation: faced by complex choices, many people do nothing.

30. *Bounded will-power* arises where a person knows what he or she should do, but does not do it, the clearest example being not saving enough (or not losing weight, getting more exercise, etc.)

1.4 A large but usually unasked question

31. These explanations are well known. What is rarely discussed is an equally important issue: even if none of the problems outlined above is significant, choice and regular monitoring of pension savings take time and energy, raising the question of whether a pension plan that requires such efforts by each individual is welfare-enhancing.

2 Accumulation: Getting it right

2.1 Implications for pension design

32. The preceding discussion suggests a number of pointers for good design of defined-contribution pensions.

1. Make pension saving mandatory, or use automatic enrolment, thus turning inertia to people's advantage: once automatically enrolled, most people will stay with the plan.
2. Keep choices simple, for example offering only a small number of clearly differentiated funds. Offering less choice can increase participation. In complex areas, offering less choice is a deliberate and helpful design feature.
3. Include a single default for workers who make no choice. A good default will automatically reduce exposure to risk as a worker approaches pension age (so called lifecycle profiling).
4. Keep administrative costs low by decoupling account administration (i.e. record keeping) from fund management (i.e. decisions about the choice of assets in a pension fund).

33. In employer plans a further option is to design policy so that people commit now to action in the future, thus using procrastination to assist policy. People are often willing to promise to save more in the future, as in the 'Save More Tomorrow' plan of Thaler and Benartzi (2004). The essence of the arrangement is that people commit to save a given

fraction of their salary, but starting only with the next pay increase; the fraction is initially small but, unless the individual takes explicit action, rises with each successive pay increase.

34. Barr and Diamond (2017, 2018), in evidence to an Inquiry by the Australia Productivity Commission, argue for a design with a single default, a simple choice architecture within the default, one pension account per person (to avoid 'lost accounts' and erosion of small pots via administrative charges), centralised record keeping, and a level playing field for competition between a centrally-run default and multiple private providers.

35. Of these elements, a single default is perhaps the most relevant in the UK context. Australia has multiple funds each with a default. New Zealand has designated nine default providers selected on the basis of competitive bidding. A worker who makes no choice is allocated to a fund in what is sometimes called the 'cab rank' principle. A major problem with multiple default accounts, however organised, is that diversity of accounts will result in diversity in realized returns between workers of the same age, which is likely to generate dissatisfaction and possible political hostility. Having multiple default plans is like a Post Office with 10 windows and 10 queues, so that queuing time is random luck of the draw; a single queue for all 10 windows is widely regarded as fairer.

36. Having a single default:

- Avoids the problem of diverse returns.
- Provides a simpler picture for a worker of the consequences of not making a choice.
- Reduces costs by avoiding complexity in policing multiple defaults and, in a system of industry plans each with a default, the repeated need to relocate assets for workers using a default who move across industries.

2.2 NEST Pensions

37. THE DESIGN. NEST pensions ((http://www.nestpensions.org.uk/) are based on a strategic design suggested by the excellent Turner Commission (UK Pensions Commission 2005), which took heavy account of the findings of behavioural economics and of the similar design of the Thrift Savings Plan (www.tsp.gov) introduced in 1985 for US federal civil servants.

38. The elements of the plan exactly match the pointers for good design outlined above.

39. *Automatic enrolment*. Since 2012, on a phased basis, employers without any other approved pension plan have been required to automatically enrol workers in NEST, the idea being that employers should have access to a high quality, low charge path through which to discharge their obligations.

40. *A default*. The default is a target-date fund, using state pension age as the target. The fund has with three phases:

- A foundation phase (the first 5 or so years) is a novelty in pension design. Losses in early years are profoundly discouraging, so the strategy during this phase seeks to avoid reducing the value of the nascent accumulation.
- A growth phase adopts a less conservative approach. NEST's aim is to produce a long-run average annual net real return of 3 per cent.

- A consolidation phase starts to de-risk the portfolio in order to crystallise the gains as a worker approaches state pension age.

41. *Limited choice*. Alongside the default, a worker has the option to choose from five funds: a higher risk fund, i.e. potentially higher growth; a lower risk fund; an ethical fund; a Sharia fund; and a pre-retirement fund. And a worker can choose to have part of his/her pension savings in the default fund and part in (say) the higher risk fund.

42. In addition, a worker can choose a target date different from the default. A worker may choose a later date than the year in which he/she will reach state pension age, either because of an intention to delay the start of retirement or to slow down the move from equities to bonds, thus choosing to take more risk in the hope of higher returns. Or a worker could choose an earlier date, thus de-risking sooner.

43. *Centralised account administration*. NEST maintains all individual records.

44. *Wholesale fund management*. NEST decides in-house on overall exposure to building block funds and asset classes, manages some parts of the portfolio itself, outsources other parts to the private sector, and publishes quarterly updates.

45. ASSESSMENT. The NEST approach is a good design for accumulating pension savings. It respects the lessons from the economics of information and behavioural economics

- The design simplifies choice for workers, including working well for a worker who makes no choice, who goes into the default fund.
- It keeps administrative costs low.
- It locates competition in the right place. The important purpose of fund management is to allocate savings to productive investment use. That task is carried out more effectively with competition in the right place, i.e. between fund managers and NEST plan managers, hence both sides of the market are well-informed, rather than between well-informed fund managers and individual workers, who are generally not well informed.

46. NEST can be thought of as a 'Marks and Spencer' pension (a mass produced standard product of reliable quality with prices to match), rather than a 'Savile Row' pension (individually tailor-made and expensive), the latter being more suitable as a niche product than as the standard design.

3 Drawdown: Getting it wrong; and fixing it

3.1 Pension freedom: A scandal that was predictable (and predicted)

47. In March 2014 the then Chancellor of the Exchequer, George Osborne, abolished the requirement to convert pension savings into an annuity, and in September further relaxed the rules by allowing complete freedom over the timing and speed of drawdown from age 55.

48. There are grounds for criticising those reforms in terms both of policy and process. The reason offered was that annuities offered consumers a bad deal, and the findings in section 1.2 offer some support for that diagnosis. But the prescription does not follow. The

Chancellor argued that ‘people should be allowed to do what they like with their own money’, which is good as a sound bite but ignores the realities described in section 1. As the quote at the start of this submission makes clear, if the NEST approach – auto-enrolment, a clear default and highly constrained choice – goes with the grain of international evidence and economic theory, then adopting the opposite policy of unconstrained choice from age 55 cannot be right.

49. A separate criticism is the process of reform, which was:

- Driven by the Chancellor of the Exchequer;
- With little or no consultation (reportedly blindsiding the highly-knowledgeable Pensions Minister, Steve Webb), and
- With no evidence of any long-run strategic thinking and no discussion of how annuities and/or rules for drawdown might be improved.

50. As discussed in section 1, some providers exploit the fact that many people lack the expertise for making good choices during drawdown. The resulting problems, which were utterly predictable, are of two sorts.

- Scams and scandals such as Port Talbot make the headlines, aggravated by the option to hold pension savings as a Self-invested Personal Pension (SIPP).
- However, the problems are much wider, including high administrative costs and charges (correspondingly reducing pensioners' net benefit), and biased advice, so that the savings of some pensioners are held in a form that suits the provider better than the pensioner.

3.2 Better ways forward

50. Three strategic directions are useful: improving arrangements for drawdown of pension savings; assisting better choices by workers about annuities; and improving what annuity products are offered.

Improving choices about drawdown

51. THE BARE MINIMUM. At a minimum, it would help pensioners if they were offered guidelines for drawdown, possibly including a tax penalty where someone withdraws less than an annual minimum or more than a maximum. As an example, 401(k) plans in the USA include a Required Minimum Distribution each year after age 70.5, enforced by a tax penalty for not doing so. Australia has a similar arrangement. An additional option could be to offer greater freedom for pension saving above a fairly high limit.

52. NEST pensions take a wider-ranging approach with three elements.[7]

53. CURATED DRAWDOWN. The approach aims to help retirees avoid drawing down too fast or too slowly by advising on what drawdown trajectory, given market conditions, is most likely to provide a sustainably steady income indexed to price inflation. A member can choose to follow that guidance but retains the flexibility to withdraw a higher (or lower) income – although drawing more reduces the size of the fund and by extension his/her future income prospects.

54. That approach includes a default portfolio (NEST use the term 'core approach'). The central idea is the same as during accumulation, namely to make sure that the system works in a sensible way for an individual who makes no choice.

55. A LIQUID CASH COMPONENT. This element is intended to allow for unexpected expenditures without jeopardising a member's long-run income stream.

> 'To be highly liquid so it can be used by members for unexpected events without impacting their core income stream. If market conditions are good then this pot can be topped up with additional lump sums. This would be a fund from which members could move money in ad hoc lump sums into their bank account to use as they like'.[8]

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[7] https://www.nestpensions.org.uk/schemeweb/nest/aboutnest/investment-approach/retirement-solutions.html#:~:text=Nest%20has%20designed%20a%20blueprint,research%20and%20analysis%20by%20Nest.

[8] https://www.nestpensions.org.uk/schemeweb/dam/nestlibrary/the-future-of-retirement-pdf.pdf

56. A DEFERRED ANNUITY. As an example, a 70-year old worker could use part of his pension saving to buy an annuity that would pay his pension from the age of (say) 85. Thus he could plan to draw down the rest of his pension saving with a 15-year horizon, knowing that his pension from age 85 was taken care of. Deferred annuities are relatively cheap because (a) the annuity seller in this example has the entire accumulation for 15 years before it has to pay benefits and (b) not everyone aged 70 reaches the age of 85.

57. While an immediate annuity purchased with part of the accumulation is a good option, NEST pays particular attention to deferred annuities. In this element, which is a work in progress, money is set aside to buy a deferred annuity at a given age,

> 'This would remain refundable up to a certain age, at which point that money is locked in to ensure a secure income is available for the remainder of a member's life to protect against the risk of running out of money before they die.'[9]

Where a worker has no other annuity, a requirement to buy a deferred annuity is a policy option worth considering.

Improving choices about annuities by workers

58. INFORMATION ABOUT ANNUITIES. Providers of annuities should be required to provide directly comparable price and design details. In Chile, this activity is organised through a government-run information website.

59. SURVIVORS' PENSIONS. Decumulation, whether from a lump-sum or as an annuity, should take account of family circumstances, with a particular focus on preventing poverty for a surviving spouse, most often the wife. Such poverty has multiple roots.

- There are economies of scale in household formation. A single survivor of a couple typically needs about 65-70 per cent of the couple's income to maintain a broadly constant standard of living. Thus, if spouses are the same age and have identical earnings histories and identical pension benefits, the death of one may lower the living standard of the other. This is part of the reason why poverty is more frequent among widows than among married older women.
- Older women on average have had lower earnings and/or less complete contribution records than men, as well as having longer expected lives.
- If benefits are not fully indexed, the longer the retirement the more the pensioner falls behind current living standards – again, a problem that particularly affects women.

60. For both reasons, survivor pensions are important for preserving the living standards of the elderly. A worker's accumulation could be used to buy a joint-life annuity. In a two-earner couple this could be done by both partners.

Improving annuities

61. The policy directions outlined thus far could be introduced fairly quickly. Other reforms have a more medium-term horizon

62. PUBLICLY-PROVIDED ANNUITIES. In Sweden workers are required to convert their entire accumulation into a publicly-organised annuity.

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[9] *Ibid*.

63. IMPROVING PRIVATE ANNUITIES: LONGEVITY BONDS. The seller of an annuity faces uncertainty about future asset returns, future rates of inflation and future life expectancy. For technical reasons, private markets face problems offering insurance against inflation and against uncertainty about the remaining life span of a cohort of (say) 65-year olds – these are what economists call incomplete markets. For example, if official figures consistently under-estimate increases in life expectancy, annuity providers make losses and either leave the market or price future annuities conservatively.

64. The state already helps to complete the market by selling indexed government bonds. It could improve matters further by offering longevity bonds for annuity providers to buy. In this arrangement, in (say) 2030, an insurance company would sell an annuity to an individual aged (say) 70 priced on official estimates of the remaining life expectancy of a 70-year old in 2030. If the cohort of annuitants lives longer than the 2030 projection, the taxpayer finances the resulting extra cost through the longevity bonds. Thus the insurance company takes on the risk, the taxpayer the uncertainty. This is a sensible division of labour. The role of government is to complete the market.

65. DEFERRED ANNUITIES. As discussed above, work on deferred annuities is an unfinished agenda. Further work developing such products is highly desirable.

4 Some wider considerations

66. Though the focus of the Inquiry is to improve options for drawdown, some wider considerations of pension design are directly relevant, summarised here only briefly.

67. RESPONSES TO THE PANDEMIC. Pension freedom might include some flexibility on the contributions side as a time-limited response to the Covid-19 pandemic. The argument is that it might be better to include an option to skip some contributions if the only other choice for a worker is to opt out. To ensure that the added flexibility is only temporary the relevant legislation should include a sunset clause.

68. ENDURING CROSS-PARTY AGREEMENT. Pensions are a mechanism to assist people planning over their life course, and should therefore be managed and reformed with a long-term perspective. Sweden reformed in 1998, with the reforms agreed by all the political parties. It is said that if you want to murder someone, all fourteen of participants should stick a dagger into the body so that nobody knows who was the killer. This is the principle in Sweden: all the political parties signed up for the reform, so that they are all in it together. Through that design, Sweden has managed to maintain cross-party political support and hence a capacity to take a long-term view. The comparison with the UK makes me feel very wistful.

69. INDEXING STATE PENSION AGE. Increasingly, countries are linking pension age to life expectancy in some sensible way. Countries that have done so include Denmark, Finland, Italy, the Netherlands and Portugal. It is good that the UK is starting to raise state pension age, but that is done on an ad hoc basis. It would be better to have a rule.

70. 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 has not yet drawn down grows actuarially so that when she retires fully the second part of pension is correspondingly larger. It is also desirable to have better options for part-time work.

5 Conclusion

71. Realistic perception of retirement opportunities and decisions implies that pension design cannot simply rely on markets and individual choice. Pensions are more like pharmaceutical drugs than like smartphones – the outcomes are highly important and the choices complex, difficult to get right and difficult to judge whether they are on track. Thus there is an essential role for the government, and that fulfilling that goal, the government needs to pay attention to the differences between an idealized solution and the actual outcomes documented at the start of this submission.

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