V. PENSION RIGHTS AND FINANCE OF FUTURE GROWTH ANTICIPATING THE DEREGULATION OF THE PENSION SYSTEM IN EUROPE – A RISK AND EXPERIMENTAL APPROACH

By Eskil Ullberg

Governments' dilemma in current risks, trends and future needs – Which one to drop?

Europe and other economic areas are currently facing challenges to deal with fundamentals of the welfare systems in relation to meeting future needs in at least three major areas: pensions, healthcare and education. These areas relate to the past, the present and the future of a society. Some research indicates that states will pay 15-35% of GDP in pensions in 2040 if no savings are done up-front. This equals about 1.5-2 times the healthcare costs and more than 2 times the educational costs. This poses a challenge to "drop" one of these from the state budget and/or regulation.

To pay for these challenging future needs, increased economic growth is obviously needed. Growth needs financing, infrastructure, etc. In Europe with its highly ambitious – some say "completely unrealistic" – Lisbon agenda to make Europe the world's most competitive economy by 2010, finance is undoubtedly a key issue. Transferring pensions from a state/regulated system to a *market based system* would provide the saved money to be reinvested[1]. Money would thereby be put back into the economy to better productive use than spending or, in many cases, pay-as-you-go schemes. Incentives would be created to invest at competitive returns at a wide range of risk levels, providing long term money for investments ranging from infrastructure to new ventures.

The issue seems to be a general problem in the world today but this article focuses on Europe's choices. Today's state pensions and most pension insurance schemes do not have *market prices*, are not *transferable* and are not treated as *private assets* and therefore not *traded*. Private insurance are assets, are transferable and have prices, for example in the form of funds. Even insurance contracts can through securitisation[2] be made more flexible and perhaps also more attractive as investable assets traded in capital markets, an area attracting a lot of interest in recent years.

Therefore *anticipating* the privatisation and deregulation of the pension system in Europe as a means of financing growth and get higher returns on savings (through more knowledgeable and discretionary investment decisions) would be a possible way to solve this overall equation of risks and needs. The proposal is to include a deregulation "option" as part of the framework developed in the Solvency II process. This process should be finished during 2006/2007.

Experimental economics[3], which studies what people really *do* in an economic and institutional context, may be used to provide experimental *facts* on efficient rules and incentive structures for such a market in pension rights (personal savings).

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[1] Here "the forth pillar", a concept I think originally proposed by Orio Giarini and others at Geneva Association, and now tried in Switzerland may come in. The forth pillar stands for part-time work and part-time pension. A new balance between capital and labor is introduced but not to loose out in this balance the money needs to be reinvested in new things otherwise the economy is shrinking or capital is destroyed by spending it on "things" that don't produce. There is also a special Geneva Papers issue on this issue, Vol. 30 Nr. 4 October 2005, and an article on future financial framework by Nikolaus von Bomhard and Clemens Frey , Vol. 31 Nr. 1 January 2006.

[2] Securitisation is a financial technique that turns assets into a tradable security using a highly solvent special purpose vehicle (SPV) to hold the securities. Through securitization the issuer can realise the present value of future cash flows and move the assets from its own balance sheet. With at lighter balance sheet there is less need for capital to meet solvency demands. The business focus then shifts from the "asset" side towards the "trading" side. Insurance companies become more "investment bank like".

[3] Prof. Vernon Smith, was given the Nobel Prize in Economics in 2002 for his work in Experimental Economics, an economic science where what people *do* is studied.

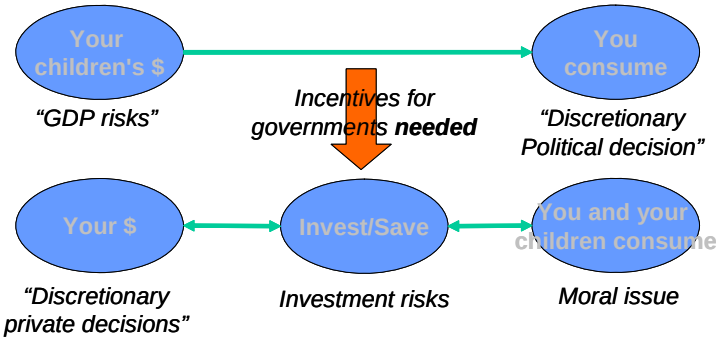

Fig. A simplification to illustrate a principle. You can't spend more than you grow.

Anticipating deregulation – strong private property rights may give the right incentives

Regulators need *perfect information* to do their job but who will *benefit* from this information in the end remains a *policy* issue. And there is one thing we can be sure about when it comes to governments – "they are always wrong". It is an impossible task for an agency to distribute the benefits to each individual's best. There has to be generalizations about the future benefit for individuals. Anticipating deregulation, what could we expect? Can theory and experiments help us here?

Markets are based on property rights that can be transferred[4]. In this case strong private pension rights would create a market for pension savings. A market would also be possible in derivatives of these rights or other financial instruments to "slice up" the risks into tradable assets like, for example, securitisation of bundles of rights. Individuals holding these rights could then buy and sell them as a new instrument for long term savings at the same time providing long term finance to companies, infrastructure projects, etc. This requires a highly precise definition of such a right but the basic idea is that it is related to an individual's pension and has access to the capital markets (is tradable). Without strong property rights, the risk of owning these rights would be high and less attractive for holders or investors. Legal rights to new private pension rights therefore remain the basics for this deregulated/ privatized market.

In contrast to a state/regulated system managed by regulators, market participants *do not need* perfect information. This is the Hayek hypothesis (1937, 1945), which states that markets are economizers of information. This means that a market participant can benefit from all the information from all market actors through the publicly available *price* and therefore needs very *little* information to pay the right asset price. And as we know "markets are always right". Therefore, who will benefit becomes a *knowledge* issue. One has to be aware of what offers are available in the pension rights market and understand how they will be beneficial for my pension on the desired (long term) horizon. The market therefore also encourages a greater competition of offers, thus fostering development of more individually targeted offers. The greatest advantage of the market can be seen in the innovation and development it gives incentive to, not primarily in a price advantage[5].
Arrow's case for state insurance (=redistribution of tax revenues) was built on the fact that there were no markets in these rights. Today such markets may well be envisaged, especially if one looks at the pension *funds*.

[4] The earliest property rights in law are found in the Bible:"You shall not steal", which establishes private property rights and thereby markets (1450 B.C.)

[5] William Baumol argues that the consumers have benefited from markets not primarily though lower prices (price competition) but through routinely making innovative products (innovation competition), "*The free market innovation machine*", Princeton University Press, 2003.

A fundamental benefit in my view of a future market in pension rights is that markets do a better job in *pricing* risk when the consumers are on the buying side ("investors") not on the selling side (tax payers) of the saving equation. A market in pension rights will create an economic equilibrium between risk and return, buyer and seller, limiting each others' options of actions putting the focus on the most "valuable" offers. This is painfully lacking in many state/regulated systems where the consumers are both "buyers" and "sellers".

Anticipation and the proposed regulatory framework

Could the *Solvency II* agenda possibly accommodate a framework for markets, thereby minimising insurance company regulations (anticipatory)? There is a chance now this year (2006) while the framework is to be decided.

Enforcing new and defined private pension rights would enable the state to step out from pensions. The framework could create a special long term asset in this area. Governments are then forced to rethink strategically since the funding of pensions will not be passed through the state budget.

A framework could give incentives to privatize/deregulate on a national basis (since *national* state schemes). Financing "old pensions" could be done by a "buy out" pension debt from governments with government bonds. Then an incentive is created for governments to act sooner than later while credit ratings are up. Later, when pension payments get closer to the 15-35% of GDP, that may be more challenging. Risk is transferred from political uncertainty (people anticipate that already) to the private side (the market *institution*) where the state institution focuses on *protecting* these rights rather than funding them. (Such a concept does not exclude other state/private solutions for the poorest, but lets financial markets, in price and innovation competition, take care of the money earned by the people contributing.)

Could we find the right incentive structure?

Could we define a market institution with rules that give the right incentives for an efficient market in private pension rights, giving socially acceptable outcomes? Prior to 1962 this was not done. Post 1962 a new field, experimental economics, began to develop. Experimental economics allows for *laboratory* experiments in controlled economic systems, generating experimental *facts*, varying the economic environment and/or the market institution rules. Real people could interact in the experimental private pension rights market as pension rights holders (buyers) and companies or private individuals as sellers.

Many years of experimenting in this area have shown that incentives can be tested and market efficiency evaluated. Examples are the deregulation of electricity markets, emission permit trading and gas pipeline capacity pricing. The "amazing" thing is that people in the experiments do not *do* what economic theories predict. Some theories are validated (like the Hayek hypothesis) others are challenged (like rational choice) and new are "discovered" (most fundamentally the process by which the competitive equilibrium price is found – where there is no theory!). A concrete proposal here could be to test incentive schemes for trading private pension rights and learn from the lab experiments what economic system design to apply, what benefits to expect and what problems to avoid.

Summary

In summary, the proposed anticipatory solution combines:

1) Incentives created for profit seeking based on discretionary decisions under risk at individual level; risks spread better
   - Demand side gets strategic buying power based on *their* cost of capital and knowledge
   - Risk is transferred from GDP and spread over international markets
2) Finance for future growth – Lisbon agenda

3) Market institutions provide rules and incentives to discipline free riders, nullify market power, etc.
4) Property rights for pensions declared, which is a *moral* issue, the rights of the people who worked and contributed and a way to give next generations a debt free future.

Incentives for governments to get out of state/regulated pension schemes:

1) Declare pension rights – the government has to stand up to its promises
2) Governments issue bonds to pay for the privatization
3) There is an incentive to issue bonds while a good credit rating.

The "pension problem" is turned into a "who is best to manage the risk problem": the state or millions of private market actors with incentives to learn. The pension savings can therefore be *organised* privately through international markets rather than centrally through national economies.

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