

INNOVATION AND IMPERATIVES IN FINANCIAL SECURITY SYSTEMS

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Abstract

This paper is written for those aspiring to make a contribution to the structure of the financial security system in their country. It suggests a framework of justice, whereby we can evaluate what constitutes appropriate social and economic objectives and the principles to which they ought to conform. It applies the framework in turn to the role of state provided social security benefits, the design of employment based retirement funds, institutional investments and state regulation. The final section considers what actuaries, particularly, can contribute to build systems (both in public and private spheres) that will be more just, and meet people's needs more completely.

Key words: social security reform, justice, redistribution, defined benefits

1 Introduction

This paper arises out of my experience of contributing towards retirement fund reform in South Africa – in particular as member of the Taylor (2002) Committee. It lifts ideas and arguments from my other papers, particularly those related to that committee.

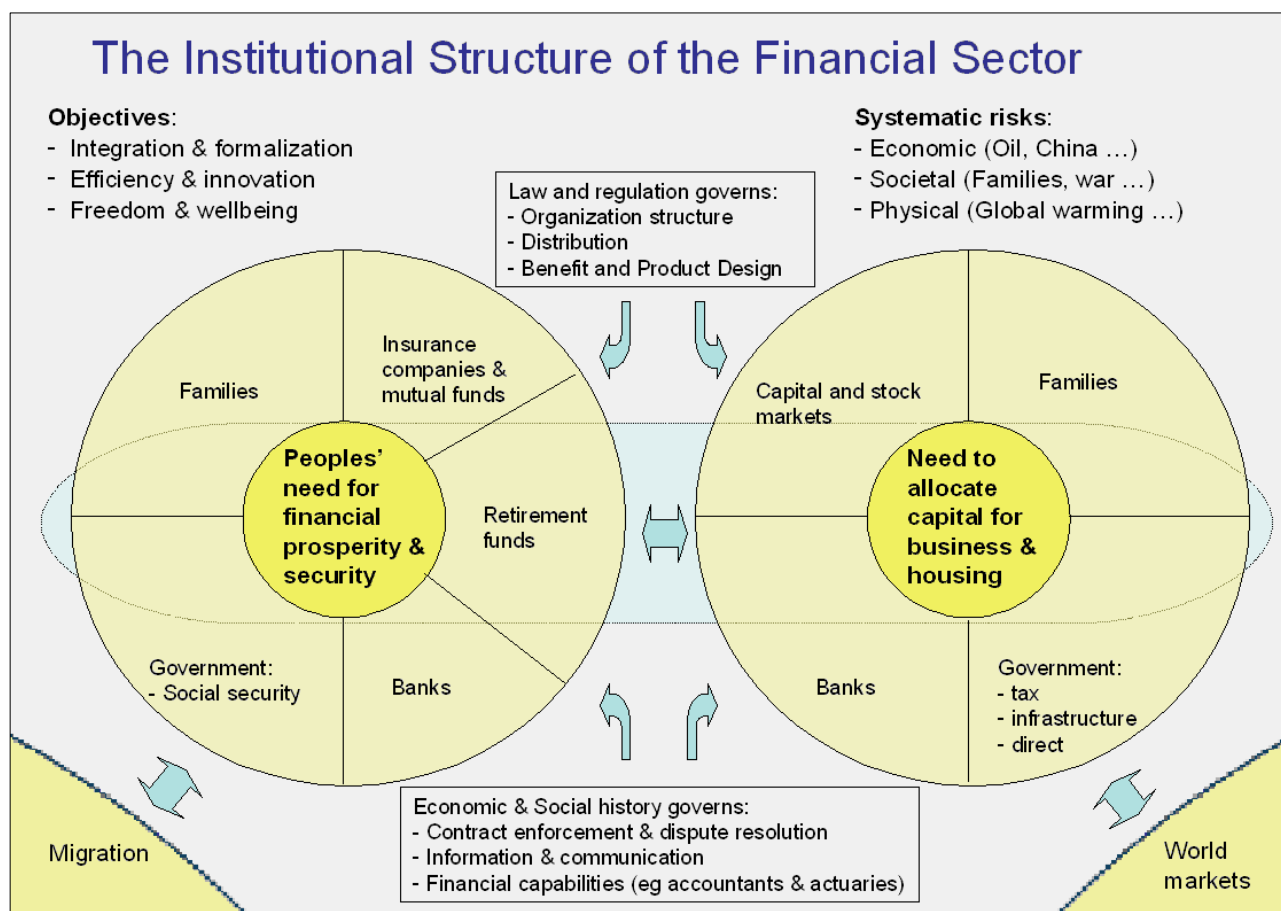
The ultimate question addressed is: what are the important changes we should be attempting to make to the financial security system in which we find ourselves? It is a personal question for each of us, but requires a view of the overall context: economics, politics, society and ethics. The final section is intended as an encouragement to readers – whether practitioners, regulators or researchers – to be even more active in working to make the financial security systems in which we work more just, and more capable of meeting people's needs.

The subject matter is vast and risks being over ambitious and controversial. I share the paper at this actuarial convention, however, because there are others who are making contributions to reform both in South Africa and elsewhere who may be interested, and perhaps encouraged.¹

Actuaries, particularly, can aspire to be the architects and builders of the financial security systems of their countries. While there are many other participants who are involved in designing and running financial security systems, the actuarial training, professional discipline and concern for the public interest fits actuaries for a particularly active role. As Trowbridge (1989) puts it: "Actuaries are those with a deep understanding of financial security systems, their reasons for being, their complexity, their mathematics, and the way they work." Such an understanding would seem pointless if it were not utilised to provide people with the financial security they really need.

2 Financial security systems

National financial security systems incorporate, as illustrated in the diagram below, the institutional structures required to meet people's need for financial prosperity and security on the one hand, and the institutions built to allocate capital for business and housing on the other.



The financial system should be considered as a whole because the parts interact with each other and the same principles apply throughout. The asset and liability spheres cannot be treated in isolation even if they are invariably managed separately. Most obviously, the generosity of the benefits depends on the yield on the assets. Less obviously perhaps, the control of the assets (and therefore of much of the capitalist economy) depends on the governance of the liabilities.

Systems can vary quite dramatically as a result of their social, economic and legal history. The World Bank (2008) emphasises the role of "initial conditions" and makes the point that "country-specific options do not imply infinite possibilities." That document calls for government commitment to reform, the buy in of local political and technical leadership and emphasises "capacity-building and support for implementation arrangements." More particularly it requires individuals from public and private sectors to invest their technical,

social and political skills and capital. It is hoped that this paper may contribute to the clarification of values and objectives and support such a buy in.

The primary concerns here are benefits provided by government social security and employment based retirement funds. Life insurance companies are often involved in the retirement fund industry; their individual policies are surrogates or supplements depending on whether the policyholder is lucky enough to be a member of a retirement fund. All the design issues discussed can be applied to such policies.

Banks have a wider role than financial security, but their involvement in housing plays an important role in the financial lifecycle and therefore in financial security. This role is not however considered in this paper.

3 Principles

Recognising that there are different initial conditions, and that different electorates have different preferences, there are nevertheless universal principles and imperatives that apply to the design of financial security systems. This section attempts an outline of these.

3.1 Justice²

Justice is the standard against which we measure the exercise of power by individuals, and agreements and laws that exercise power over our lives, and particularly all elements of government intervention. It is also the standard by which we should measure our own actions and their consequences. It is especially concerned with protecting the powerless against the powerful.

There is an ancient consensus that justice can be defined as giving to each his due.³ What is due to people subjected to the power of others? If anything, it must be related to their essential dignity: to their ubuntu (humanness), flowing, for some, from our resemblance to the Creator. This dignity seems to provide sufficient basis for the recognition of certain principles or what are sometimes called basic human rights: to life, equality, liberty, the provision of basic needs and the recognition of just deserts. Efficiency is also included as a principle because it creates some of the resources without which the other principles may need to be sacrificed.

There are good reasons to recognise the absolute value of these principles, in the sense that they always have value and that an attempt must be made to satisfy each of them as much as possible. While it is frequently necessary to compromise one to meet another, the thrust of the traditional consensus is that such compromises must be taken reluctantly.

This differs from the "rights-based" approach to social objectives, which attempts to set minimum levels in law (but begs the question of why), and a "needs based" approach, which underemphasises criteria other than need. Justice is rather seen as wider and more process-based, and why there is a recognised need for judgement and reason in the process.

Justice can alternatively be seen as the application of the golden rule to the relationship between rulers and the ruled. Its foundation in human dignity gives the lie to claims that the solidarity it provides allows those with authority in a community to be immune from criticism. On the contrary, their position of power means that they are subject to an even higher standard of behaviour.

3.2 Indignation

While these principles have some ability to inspire, real motivation to action (and real dangers in its direction) is more likely to be found in our response to injustice. As Adam Smith (1759) has it on the topic of indignation: "Resentment seems to have been given us by nature for defence, and for defence only. It is the safeguard of justice and the security of innocence".

The risk is to allow our indignation at injustices – or even to an apparent overreaction of others to an injustice – to blind us to the value of one or other of the principles, or – worse – to the value of other people. This framework of justice frequently illicit strong responses from people holding either the idea that justice is an entirely subjective and personal matter or that justice is not relevant to society. Equally strong objections can come from the view that one of the principles (often equality or desert) is not relevant. If readers find that they respond in one or other of these ways, the appendix explains the framework in greater detail.

There is one sense in which indignation is particularly personal, and that is where it represents a call to action: to turn our anger at unfairness – wherever it is found – to constructive reform and innovation.

3.3 The locus of power and responsibility

An important corollary for institutional structures is the concept of "subsidiarity", coined apparently by Catholic social teaching but used extensively in Europe. "It is an injustice, a grave evil and a disturbance of right order for a larger and higher organization to arrogate to itself functions which can be performed efficiently by smaller and lower bodies." (Pius XI, 1931) Not only should power be located at the smallest and lowest level consistent with efficiency, the principle means that we should strive to prevent individuals from domination by others at every level.

3.4 Differences with the World Bank

Some of these principles are at odds with the World Bank's primary criteria (adequacy, affordability, sustainability, equitability, predictability and robustness), and with their secondary criteria (removal of labour market distortions, promotion of savings and developed capital markets). While there is a significant overlap: the World Bank does address needs (under adequacy), equality (equitability) and efficiency, specific consideration could also be given to:

- Limiting government's role in activities that can be provided by the private sector, and more positively encouraging democratic participation in institutional structures
- Actuarial equity (where the expected value of benefits equals the present value of contributions), which means people get their just deserts, and which provides the basis for the overlapping criteria of affordability, sustainability, predictability and robustness, while also providing arguments against greater protection from unfair cross-subsidies and arbitrary rulings
- Ensuring that peoples' minimal needs for protection against financial risks are met, and that options are created that allow for them to meet more than their minimal needs
- Removing the distortions in financial markets created by government intervention or monopolistic practices, rather than the more ambitious objective of developing financial markets and savings. The objection to distortions in markets is as much on grounds of the infringement of liberty, as to their contribution to economic inefficiency. There is also little reason to prefer savings over consumption given that there is no evidence that savings promotes growth.

4 State funded minimum benefits

There is almost universal support for governments to provide a minimum level of benefits to those who cannot provide for themselves: widows, orphans and the disabled – whether from sickness, accident or age. There is, however, differences in to the level of support, how it should be funded, and the extent to which it should be tailored to the particular needs and means of the people concerned.

4.1 Redistribution⁴

Looking first at the level of support and funding, we are brought to the issues of the justice, politics and mechanics of redistribution.

The debate can be found in the literature of economics, politics, law and the social sciences, and is one of the central political issues of our time. Key words are solidarity, distributive justice, welfare and public or social choice.

From a framework of justice, a redistribution policy should attempt to achieve the following.

- i) Social security benefits and tax payments should be seen as part of a single system and be consistent with each other.
- ii) Redistribution should include the provision of a basic package of benefits that can be justified by human need.
- iii) In order to be vertically equitable, the marginal rate of tax and claw back of benefits should increase with income.
- iv) The system as a whole should be progressive, contributing as much as possible to equality of outcomes. It is not necessary for every element of the system to be progressive. It must be seen as a whole.
- v) Tax and means testing should not be overly intrusive, and should be set at a level that they do not undermine the principle of just deserts nor the incentive to work.

Means tests for pensions are a particularly objectionable infringement of these principles. Inconsistencies in the tax system create vertical inequities, an unjustifiable intrusion into the life of the beneficiaries, and discredit to government arising the impossibility of their administration (Asher, 2006b).

Other justifications for redistribution

While redistribution can be justified on grounds of equality, there are other approaches that may be persuasive.

- It can be held that social security systems are based on the ideas of solidarity and social cohesion.⁵ The consequence of mutual support is that people are able to identify more positively with their society.
- Redistribution also represents an equal division of the common goods that can be regarded as belonging equally to all members of society. This would include access to land and water, taxes from mineral and other wealth, the excessive rents earned by monopolies, and the return on state assets.
- At least some portion of income differentials is the product of random effects. The wealthy might deserve some of their wealth because of their extra efforts, but at least a portion can be ascribed to simple good fortune. Poverty, on the other hand, frequently arises through uninsurable catastrophes, of which those created by apartheid government interventions in South Africa are an example. Redistribution can therefore be seen as an insurance mechanism: taking from the lucky, and giving to the unfortunate. This is one way of viewing Rawls's (1991) arguments for greater equality.
- Progressive taxation can also be justified in that richer people gain proportionally more from some state services, such as higher education and security. They can also, of course, afford to pay more.

Limitations

There are, however, reasons to limit income redistribution. These are mainly arguments stemming from efficiency and desert.

- Income differentials can be justified to the extent that they reflect differences in the effort expended, unpleasant and dangerous working conditions and income from earlier investment (in education, for instance, which requires additional expenses and a deferral of income). Most people would consider it unfair to eliminate these.
- The successful operation of the market requires differences in remuneration to signal relative demand. Redistributive taxes can lead to the wrong signals being given in the market, to the emigration of skilled workers and to a flight of capital.
- The disincentive effects of increasing taxation may also lead to a reduction in output, so impoverishing everyone in society. Research results on this score are ambivalent. Higher taxes can encourage increased work output as people attempt to replace lost income.⁶
- In third world countries particularly many people operate in a non-monetized economy (i.e. they do not earn a salary, but grow and make what they consume) and so incomes are not easily comparable.
- Some also apply the principle of "self-sufficiency". Wherever possible, people should make whatever advance provision they are able to, as a contribution towards their own future needs, rather than be expected to rely on support from society.⁷

Redistribution also includes a consideration of intergenerational equity. This is achieved if each generation passes on to its successors the net wealth it receives from its predecessors. This should include allowance for physical and human capital investments, state borrowing – and appropriate allowance for depletion, or the enhancement, of natural resources.

These principles allow for a wide range of acceptable benefit levels, which will depend on the government of the day and the relative weight placed by public opinion on equality, desert, needs and efficiency.

4.2 Social security benefits

Benefits are addressed to different needs.

4.2.1 Universal pensions

Equality and need together call for benefits to be first provided to those who are least able to fend for themselves. This justifies a universal pension for orphans, and those incapable of earning a living for themselves, whether through sickness, accident or age.

4.2.2 Disability benefits⁸

In developed countries particularly, disability income payments can be very significant. An OECD report⁹ shows a variation from 1.3% of GDP in Canada to 5.6% in Norway. This variation suggests that it is possible to make expensive errors in the design of a system of insurance: either denying needy claimants, or overpaying those who could be working. This section attempts to outline a sensible and compassionate approach to issues that cry out for reform.

Rehabilitation

Tate (1992) confirms that return to the workforce and “normal” life is often a possibility, and often the best cure. Rehabilitation may require special equipment and other provision, and needs special effort from family, employers and insurance providers. It is difficult, painful and sometimes humiliating for the disabled person. It is however superior from a human point of view and appears ultimately to be less costly.

Heterogeneity

It was particularly clear from representations to the Taylor Committee that there are distinct categories of need amongst the disabled, and that the disabled are neither homogeneous nor uniformly represented. It seems that disabilities fall into four main groups.

- **Physical disabilities**

Disabled people from this group were the only ones to make representations directly to the Committee. With help, they expect to be able to make a full economic contribution to society. Some of the groups even argued that the disabled should not be paid income replacement benefits at all, as the benefits would tend to marginalize them. Benefits to fund the cost of rehabilitation are necessary.

- **Backache and depression**

This group includes people suffering from non-specific backache injuries and some types of depression: painful conditions that make many aspects of life and work more difficult, but do not prevent working. Claims in this category fluctuate dramatically with economic and social change, and can represent more than half of all disability

expenditures¹⁰. There is evidence, particularly for chronic backache claims, that insurance cover for these conditions is largely misconceived. NACHEMSON (1999), in his review of the medical research, suggests that the diagnosis rather than the condition is the cause of most claims, and that “compensation prolongs symptoms and disability”. He continues: “In our efforts to be kind to people, politicians and physicians perhaps have been doing the wrong thing. We are perhaps making people sicker by some insurance schemes.”

- **Intellectual and mental conditions**

This grouping includes people of working age with intellectual shortcomings, the severely mentally-ill, and some people addicted to drugs and alcohol. Noble (1998) confirms that there are people, with these conditions, who will not be able to participate in workplace without ongoing expert, or at least informed, assistance, which sometimes should be delivered in an institutional setting. Their families are often not able to cope on their own. The idea that such people should be looked after in the community is meaningless unless there are appropriate social structures to embody the concept. If structured care is not forthcoming, people in this category can be disruptive: occupying and defacing public spaces, and possibly being a physical danger. Benefits should in many of these cases be paid to third parties and subject to appropriate controls.

- **Other conditions**

Those in this category require income replacement. Included are people who are bedridden or housebound.

4.2.3 Frail care

In their final stages of life, there are few alternatives to state-provided care. Means tests in this context represent relatively little additional intrusion into the lives of the people concerned, and are efficient in providing incentive to family members to limit state-subsidised care. The means tests should probably include the family home and apply to children, but the approach taken appears to differ from country to country.

4.2.4 Unemployment

There is a considerable overlap, conceptually, between unemployment and disability benefits both of which arise because of a mismatch between capabilities and the needs of employers, and both of which require rehabilitation, and benefits for both of which face difficult moral hazards.

The arguments in section 4.2.2 above can be extended to suggest that support for the unemployed should be in the form of support for education, finding jobs or subsidised employment, rather than as cash. It is especially unfair to expect young people, who bear the brunt of unemployment, to create their own jobs. Their need, the objective of equality and the desire for efficient use of otherwise unemployed resources provide the justification for such support.

4.2.5 Benefits in kind

Arguments from need can also be used to justify medical insurance for emergencies and other

essentials. They can also be used for the provision of minimum requirements for other necessities such as housing, water, power and food. As an example, most South African municipalities provide free basic water with higher tariffs for greater consumption.

4.2.6 Road accident and workers' compensation

Such reasoning cannot however be used to justify the generous benefits provided in many countries for road accident and workers' compensation. It is entirely just to ensure that the road users and employers should pay for the harm that they cause to others. Justice does not however appear to be served by the very unequal benefits accorded to beneficiaries of these schemes – compared to those suffering from accidents or diseases not covered by these compensation arrangements.

Such schemes can be abolished, and the while the premiums should continue to be collected, they should be folded into general taxation.

5 Employment based benefits

If government provides minimum benefits for everyone, there is considerable scope for supplementary employment based schemes. The critical question in this area is the level of government involvement. Private provision for those who ought to be able to provide for themselves – with state oversight as necessary – is consistent with greatest liberty and subsidiarity, and does not apply scarce government resources to provide benefits to the wealthy. Sections 5.1 to 5.3 spell out the consequences of this view.

5.1 PAYG DB vs Private DC

This debate is particularly relevant in South Africa in that a national career average pay-as-you-go defined benefit (PAYG DB) scheme has been proposed¹¹.

The argument for private DC arrangements can be summarised as follows:

- PAYG "Notional defined contribution" (NDC) schemes are superior to PAYG DB schemes:
 - Firstly, the benefits are actuarially fair – ie related directly to the contributions. Even a re-valued career average DB provides invisible retrogressive subsidies from low earners to high earners because their salaries peak earlier in their working lives. Low earners also have shorter life expectancies in retirement. The differences are unacceptably large, and can be as much as 40% between different classes, and even more between individuals.
 - Secondly, NDC arrangements are also self correcting, and do not need disruptive political intervention when retirement ages need to increase.
- DC schemes holding marketable government debt are superior to unfunded PAYG NDC schemes because they properly account for the costs of providing the benefits. Reporting the size of the government debt makes it more difficult for irresponsible populist governments to buy votes by hiding the costs of benefit improvements. This is good accounting practice and increases the security of the benefit (Asher, 1997).
- Privately run, compulsory, DC schemes better meet the criteria of subsidiarity than one central government scheme – if they are sufficiently large to benefit from economies of scale. Asher (2007d) suggests that South Africa's private sector funds are civil society treasures contributing to industrial peace and democracy – by the enforced cooperation of labour and management, and the encouragement of industrial democracy.

5.2 Investments and guarantees

If privately run DC schemes are to be preferred, one is then left with the question of the desirability of state or employer guarantee of the investment returns – either explicitly or implicitly.

5.2.1 State investment guarantees

One approach is to require privately run DC funds to invest in government debt. In order to

ensure that costs are transparent and fair and there are no hidden subsidies, the investments should yield market consistent returns. If this is the case, and to ensure that it remains so, the investments should be available to other market participants.

For similar reasons, the retirement funds themselves should be able to invest freely. Given the normal size of the equity risk premium, it is quite likely that they will take investment risks in order to enhance expected returns and benefits. While this does lead to an increase in the costs of investment management, these are likely to be covered by the additional return and can be justified socially as necessary for efficiently allocating capital.

Prescribed assets also offend against the principle of liberty, while allowing retirement funds to invest freely should improve the efficiency of capital markets and thus contribute to economic growth. If there are reasons to tax or subsidise some people, then the amounts should be readily quantifiable in order to avoid powerful lobbies from extracting invisible political rents.

If funds have the freedom to invest, there is a massive moral hazard in government's offering minimum investment guarantees. It is difficult to see how such guarantees, which benefit a group of wealthier pensioners who have taken investment risks presumably in the hope of higher returns, should take precedence over an increase to the minimum state pension.

5.2.2 Employer investment guarantees

DB funds can also incorporate employer guarantees of investment returns, although often of a discretionary nature. The discretion can be used productively to support needy or deserving cases. They can, however, also be abused to benefit powerful individuals. On balance, discretions should not be permitted to employers or trustees, and any contingencies included in an employer guarantee should be contractual and free of moral hazard. Contracts might, for instance, make good a shortfall in a retirement fund from a proportion of the employer's profits – if they are any. Such an approach could work for single or multiple employer funds.

5.2.3 Smoothing investment returns

The same risk of moral hazard applies to smoothing of investment returns where there are discretions and unallocated reserves. There is too great a risk of manipulative deferral and subsequent expropriation. It is possible to create smoother payouts by alternative investment strategies that require no discretion (Asher, 2007a). Some of these approximate closely to traditional actuarial discretionary approaches – without discretions and moral hazards.

5.3 Compulsion

The other element of state involvement is of mandating contributions, requiring them to be preserved until some retirement date, and then ensuring that they are paid as annuities.

The main argument made for compulsion is that people are myopic, but this needs to be balanced against the loss of liberty – and the obvious question: how do we know that those who make the rules are less myopic?

A more satisfying argument than myopia is to see the group provision of retirement and risk benefits as a common or public good. Common goods are those where marginal costs exceed marginal benefits unless there is common provision – and free riders are not permitted. Free riding would be more likely to be felt in local communities, where people may feel obliged to support their relations and friends that have fallen on hard times – or feel guilty if they do not. Such support is likely to be unsatisfactory if entirely *ad hoc*; while as soon as thought is given to an appropriate structure, it becomes clear (in terms of just deserts) that people should make their own contributions.

Compulsory contributions are popular – not least because people want help in making savings decisions – but it is always dangerous to base policy on the assumption that rulers are wiser than the ruled. Governments should be encouraged to facilitate the development of institutions providing common goods, but not to extend their powers.

Compulsory annuities do, however, make it easier to ensure that wealth is allocated fairly between different generations and between spouses. In particular, the failure to provide adequate (joint) pensions falls heavily on elderly widows, and undoes much of the legislative effort of the past century to ensure that women receive a just share of family earnings. Men should be required to contribute to a pension for the sake of their wives – who for equality's sake should contribute too.

There are two groups who should be exempted from mandatory contributions:

- Contributions should be delayed (or reduced at younger ages) so that young families particularly are not overly burdened with mortgage repayments as well.
- Attempting to include the informal sector is likely to be inefficient and to impose more of a burden than a benefit (Asher, 2006a). It can be noted that the World Bank (2008) agrees.

5.4 The benefits¹²

Whether or not they are compulsory, providing retirement, death and disability benefits within a single employment based scheme saves costs and allows for greater coverage.

Cost savings can arise from economies of scope (collecting one premium, etc) and scale (bigger accounts).

Insurance charges can also be reduced because pre- and post-retirement benefits can be offset against each other. The offset arises because pre-retirement death and pension benefits are mutually exclusive and disabled people are likely to have shorter retirements. People subject to higher rates of mortality and disability therefore need to save less for retirement as their life expectancies are lower. The offset also means that there is a reduced requirement for underwriting – saving further costs and increasing coverage.

It is therefore a pity that there are legal obstacles to this integration in some jurisdictions.

5.4.1 Annuities

All benefits (death, disability and retirement) should be structured as annuities – as the objective is to replace income. Allowance can be made for some commutation to repay debts. Even if not invested in inflation protected bonds, the annuities should be priced so as to allow investment profits (when they arise) to increase the payments to allow for inflation.

5.4.2 Disability

The discussion in 4.2.2 applies also to the private provision of disability benefits. In the absence of a sufficiently active state sector, private provision could lead the way. There may perhaps be a special role for private insurance where people pay lower premiums on the understanding that they will not claim for chronic backache or depression, pre-committing to the possible pain of working with these conditions.

5.4.3 Long term care

Provision for frail care might be incorporated into retirement fund benefits. As an insurance benefit, however, it would be subject to moral hazard: family members will be given less incentive to provide the necessary care. The incentives are perhaps better aligned if frail care was funded by a savings component that allowed for some money to be left over for bequests if it was not used. The amount required to pay for care is however be large, particularly when compared to smaller pensions. It is difficult to envisage retirement funds withholding such amounts from relatively poor pensioners for what may be decades between retirement and entry into frail care.

5.4.4 Unemployment

Unemployment would appear to be subject to too much moral hazard to be insurable privately – except perhaps after retrenchment and for a short period of cover. There are strong arguments, however, for allowing withdrawals from retirement funds during periods of unemployment – especially in countries with limited or no unemployment insurance. Integrating payments made from retirement funds during periods of voluntary and involuntary unemployment could reduce the moral hazards associated with unemployment insurance.

There is even an argument for making higher payments into retirement accounts, so that they can help fund periods of unemployment. Those making less use of such withdrawals would have the option of earlier retirement.

5.5 Pricing

Employment based schemes are not appropriate vehicles for redistribution. They can at best have marginal impact as the poorest and most needy are not employed; may have the perverse impact of reducing employment by increasing the cost of lower wages and often create anomalies because they are subject to capture by the powerful.

Not so obvious, but more pernicious socially, they create islands of relative privilege amongst

employees of more profitable and capital intensive employers. In Africa at least, it is government employees who most enjoy this privilege (Asher, 2006a).

This implies that insurance and annuity premiums should be accurately differentiated for heterogeneous groups – where it is cost effective to do so.

This idea can offend people indignant at income inequalities, so needs a little more justification. The main point is that the offset between pre- and post-retirement benefits means that the lifetime cost of the proposed package of death, disability and retirement benefits is much the same for all people. Any differences in cost depend on the shape of the mortality and disability curves – and the age at which people have children and the number of children – rather than on the level of the curves. The argument from equality therefore has much less force, and can be used as a smokescreen for vested interests. Other reasons to make the more obvious distinctions are:

- transparency, particularly that differences due to lifestyle (smoking particularly) continue to receive emphasis
- better financial management in that there more accurate projections of future cash flows are no unexpected profits and losses from transferred benefits

5.6 Choice of fund

If the best arguments for compulsion arise from the nature of retirement funds as common goods, choice of retirement fund undermines the benefits (Asher, 1999):

- Economies of scale are more difficult to achieve and there is a need to spend money (often considerable amounts) on marketing;
- Universal insurance cover and annuitisation is more difficult to achieve as underwriting becomes necessary;
- The protection offered to less involved members of retirement funds by their sophisticated fellows is removed as the more sophisticated gravitate to funds offering better value and more choice.

Where choice has already been given to people, it may be difficult to unwind – although the options are being rolled back in South America and elsewhere. Employers and employees could however be given the option of removing choices from their place of employment (for new members at least).

To recognise the loss of liberty that members of group retirement funds must sacrifice in losing their choice, benefits should be limited to the minimum level likely to be needed by all (or at least the overwhelming majority) of members.

6 Institutional Investment

This section scans some of the issues that arise when funds do have freedom of investment.

6.1 Investment market efficiency

Justifications for the investment of retirement fund assets in private capital markets are liberty, subsidiarity and efficiency. The efficiency argument is that free and efficient capital markets will drive greater economic growth. While this is an attractive argument theoretically, the countries where private retirement funds play a significant role in capital markets do not appear to have obtained any real economic benefits. One can, for instance, compare the Netherlands with Belgium, or the United Kingdom with the larger continental economies.

One explanation is that there are other ways of creating efficient capital markets; the other is that retirement funds have not played a sufficiently active role in capital markets to have made any difference. It may be that they have been passive providers of funds to whoever has approached them with the most attractive sales pitch.

There may be some truth in the latter:

- As major providers of capital, Asher (1998) suggests that retirement funds have been insufficiently active in monitoring boards and management, and that the main moral imperative they face is to perform this social function more effectively – not least for the benefit of the members they are serving.
- Retirement fund managers may also have been less than diligent in ensuring that they have received a sufficiently good deal from investment managers, stock brokers and investment banks. The first step would be a more active measurement of the costs of investing, see Asher (2007b).

In both papers, I attempt to make the case for fundamental analysis as the proper foundation for institutional investments – and a necessity if investment markets are to fulfil their social responsibility of allocating capital effectively. By fundamental analysis, I mean an attempt to determine the value of an investment by analysis of all readily available information with a bearing on the value of asset – as against technical analysis that is concerned only with the price and its movements.

Rusconi (2008) finds much to question in South African investment markets, but they are unlikely to be unique. The call is to those in positions of influence to be more active in ensuring that investment markets work more efficiently.

6.2 Other social criteria

This is not to argue, however, for the compulsory introduction of other social criteria into the choice of investments. Institutional investment should preferably not be a vehicle of redistribution, nor to provide for the needs or just deserts of those that are being treated unjustly – and more than any other organisation should be required to subsidise some of its

customers. These objectives should be funded transparently by general taxation.

Individuals, or funds, can of course elect to use their powers of investment to achieve legitimate collateral goals, or achieve common goods by collaborating with each other. Asher (2005) considers how this is done by the Community Growth Fund (a South African fund that applied social criteria), and suggests that the costs to investment returns of more altruistic goals can be relatively small – but are much more difficult to measure than commonly supposed.

6.3 Choice of investments

Giving members choice of their underlying investments is justified on grounds of liberty, but Asher (1999) argues that the burden of choice in most instances outweighs the benefits. Making informed investment decisions is costly – probably not possible for the amateur. Choice undermines the benefits of collaboration in the choice of investments, in the monitoring of investment service providers, and in the management of companies in which the fund invests.

Given that most people appear to remain within the default option, this may not be a particular obstacle to appropriate investment management. There remains however the risk that some members will be panicked into making serious allocation errors when investment markets are at extremes – as raised in Asher (2007b).

7 Governance and regulation

One of the benefits of privately run funds is that government can focus on reviewing the private sector rather than attempting to provide both management and review.

7.1 Elected trustees

It seems that the boards of employment based funds – as envisaged above – should be elected. On grounds of equality, the current and potential beneficiaries – active contributors, pensioners and spouses – should all have a voice. The employers should have no direct financial interest in the fund, and therefore should not need any powers or direct representation. On the other hand, managers could usefully have some representation on the boards of trustees because they often have access to greater financial expertise, and, as equal members of the board, interact on an equal basis with employee representatives, which can contribute to better industrial relations.

Another governance question, raised in Asher (2007c), “relates to representation of members and the level of expertise of the governing bodies. There are some, such as Myners (2001) who suggests that funds should have some professionally trained members of their governing body. This has apparent advantages, but clearly weakens the position of the lay trustees in board meetings. If trustees want independent advice, they would be advised to contract for it rather than to surrender some of their powers. The Taylor Committee recommended that lay trustees continue to control South African retirement funds, as reflected its preference for democratic rather than technocratic governance.”

One reviewer also pointed out that the legal onus on elected trustees should not be such that they defer to professional service providers out of fear.

7.2 Regulation

The need for just regulation is primarily concerned that ensuring that everyone gets their due – protecting the weak and ignorant. It should, therefore, focus on two areas:

- First it should ensure that trustees fulfil their fiduciary duties, which is apparently required by law in all countries - although in different guises. First and foremost of these is the law against secret profits, so regulators should ensure that there is full and appropriate accounting of all costs and particularly that trustee and advisor remuneration is disclosed. Secondly there is the need to ensure that no parties are making decisions as to their own remuneration or reward. See Asher (2008).
- The other area of regulation is one of assisting members make appropriate financial planning decisions. It could alternatively be described as education, although many people seem reluctant to become involved, preferring to be given an acceptable default option. Regulation, therefore, involves ensuring the setting of appropriate default benefit and investment options. It includes ensuring that investment returns are appropriately reported to trustees and members, and providing regular illustrations of projected retirement benefits. See Asher (2007b).

There is also a need to ensure that the market in administration services and insurance is not dominated by monopolistic or other unfair market practices, but this is not unique to the financial security system – in spite perhaps of its recent prominence in the economy.

7.3 Self regulation

It is relatively easy for government review to descend into government regulation in great black letter detail. This is neither respectful of the capability or freedoms of the regulated, nor particularly effective or efficient. Only self-regulation can be really effective, and this requires what Braithwaite (2002) calls responsive regulation, that uses both carrot and stick - aiming to get the best out of the people, but prepared on occasion to use the “benign big gun”.

8 Personal implications¹³

If the principles outlines above include persuasive moral imperatives, or the gap between the current system and what could be achieved gives rise to feelings of indignation, or the reader is looking to make a contribution in this field, this last section makes a few suggestions – for researchers, practitioners and regulators.

For researchers, the main thrust is that there are enormous possibilities for connecting economic and social research into how people are behaving with actuarial knowledge of what the financial services industry does and how it might be changed. Research could be much more orientated to what people should be doing: comparing successful and unsuccessful life trajectories within different systems being a particular area of interest. Such research needs to be based on panel studies, the data for which takes many years to accumulate (Asher, 2006a).

Practitioners in the pension and life insurance industry are given a range of suggestions on how benefits could be better designed to meet the real needs of members. The most common response to suggestions of this sort is that there is no demand from clients for the new products. It is difficult however for people to appreciate what new products can do for them, so this is not entirely surprising. Product innovations are also risky, but as Drucker's (1977) magisterial book on management has it: "the main purpose of business is innovation".

Sometimes the response is informed by the assumption that the purpose of business is to make a profit, and that this is most easily achieved by meeting the obvious demands of the market in the most efficient way. This is reductionistic; Drucker suggesting that the function of management is to know: what is our business? The business is to meet particular needs of customers and potential customers. The needs are met by creating new products and services, and the profit is made by showing customers that their needs are better met by buying the new products. This is an aspect of business that can be particularly exciting, creative and remunerative.

As for the duty of regulators, theirs particularly is the prevention of injustice: the abuse of power. Regulators include those in compliance roles within companies, especially statutorily appointed actuaries and auditors, and including outside directors, as well as everyone employed by industry and consumer bodies, and government. Injustice is to be found in civil servants who manipulate pension and tax rules for their own benefit – and not just in Africa. It is to be found in the profession and industry groups that lobby for concessions and compulsion that distorts markets and social structures. Executive management manipulate their income to many times their market value. The most apparently proper of trustees and their professional advisors can extract large rents from those they are supposed to serve in a fiduciary capacity. Academics and those in international organizations play with theoretical models and ignore egregious wrongs in the industries they research. Even volunteer activists fired with justifiable indignation ignore important issues and interests that do not suit their agendas.

Making a contribution requires expertise, collaboration and particularly courage to take what can be an unpopular line. It is however possible to be overzealous, and there are warnings not to embark on an adversarial course without adequate personal support. Jos *et al* (1989), for

instance, describe the significant costs paid by those who whistle blow. Luke's beatitudes¹⁴ provide a model: listen, weep and hunger before risking oneself, and then private rebuke before open opposition: “the wrath of man does not produce the righteousness of God.”¹⁵

Another warning is against the propensity to become more concerned with injustices perpetrated by someone else. Against this, Eliot Spitzer provides a model and a warning. He¹⁶ has been proved to have feet of clay, yet made a significant impact on US financial services, clearing out conflicts of interest that had become entrenched in what appeared to be the most reputable of banks and insurers. It seems likely that the integrity of any system depends as much on thousands of smaller decisions to eschew or confront injustice – as on the occasional energetic attorney-general. I am grateful to have worked with many people who have quietly, and not so quietly, made some of these courageous decisions and so protected us all.

Researchers, practitioners and regulators also have an educational role. Three particular areas stand out. The first is to explain the need for appropriate savings and insurance; the second to reinforce good investment theory - the value of fundamental analysis; and the third for the centrality in matters of governance of the principle that conflicts of interest must be avoided.

Finally, we can ask whether the financial sector is that important in a world of devastating poverty, vicious war and global warming. Perhaps not, but those of us who labour in this sector can perhaps take some encouragement from the end of the first chapter of James: “Pure and undefiled religion before God and the Father is this: to visit orphans and widows in their trouble, and to keep oneself unspotted from the world.”

Acknowledgments

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10 APPENDIX: Some expansion on my understanding of justice¹⁷.

While the principles of justice are hotly debated, they are not novel and would have to be mentioned in any serious application of moral philosophy to financial or social questions, as they are in chapters 7, 9, 10 and 11 of Hausman and McPherson (1996) - for instance.

Discussions on the relevance of justice frequently bring forward the arguments that the concept is personal and that it is irrelevant to the way people behave. Neither is entirely true.

10.1 Personal

People certainly place a different personal value on the different elements of justice. Europeans appear to place a much greater value on equality and a lower value on liberty than North Americans (Alesina *et al*, 2004). Union members usually place more emphasis on equality than managers - and less on just deserts. MacIntyre's (1988) different intellectual traditions of rationality and justice provide different rationalizations for this variety, but it would be a mistake to see the variety as proving that our views of justice are entirely personal with no wider application. Without the idea of justice, government could be based only on the whims of the powerful. There is also widespread agreement on the procedures required to attain it, and much on its constitution. There is near universal agreement of what constitutes gross injustices: corruption, theft, exploitation etc.

Tyler and Smith (1995), in a review of the social science literature on justice, show that people are often more concerned with just procedures than just outcomes. The argument being made here is that each of the criteria has an absolute value in the process: *ceteris paribus* it is never wrong to value people's needs, create greater equality, efficiency and liberty or give people their just deserts. The subjective personal differences arise partly from the compromises that practicalities force on us, and partly from our individual experiences of injustices – both to ourselves and to others.

In another paradigm, justice gives to each person a set of minimum human rights. Our indignation is justified if the criteria or the rights are not considered in the process.

The critical issue is the process rather than result: one might justifiably consider a criterion or right and decide to modify and even override it in particular circumstances.

10.2 Relevance

The view that justice is irrelevant to people's behaviour can only be sustained by a cynicism that not only holds that people exclusively pursue their own self-interest, but that they are not prepared to compromise for the common good.

While this view may have some traction in the economics literature as justified for instance in Stigler (1982), it finds minimal acceptance in other disciplines. In politics and philosophy, justice provides the rules that allow for the production of the common goods of security and the other benefits of good government. As Lucas (1980) puts it: "Justice is the bond of society, ... the condition under which I and every man can identify with society, feel at one

with it, and accept its rulings as my own." Even the most self-interested must take note of it if they are not to be excluded from society.

From the other social sciences, Tyler and Smith (1995) confirm that: "People's actual behavior is also strongly linked to views about justice and injustice. A wide variety of studies link justice judgments to positive behaviors such as willingness to accept third-party decisions; willingness to help the group; and willingness to empower group authorities. Conversely, other studies link the lack of justice to sabotage, theft, and on a collective level, to the willingness to rebel or protest. In other words, how people feel and behave in social settings is strongly shaped by judgments about justice and injustice."

10.3 More on the principles of justice

I have found that some of the principles require some explanation:

- Liberty. This is perhaps the easiest criterion to deal with. In general, people do not like to be told what to do. Intervention of government in the lives of people is undesirable *per se*.
- Needs. Meant by needs is the wherewithal for a minimum acceptable standard of living. This too is universally accepted – although sometimes reluctantly –and the level of needs that have to be met is certainly controversial.
- Equality. Equality refers in this case to equality of welfare, interpreted broadly, of income and of status. Equality can be variously justified as desirable for its own sake, as maximizing society's total utility from the widely observed fact that marginal utility tends to decline with income; for its impact on improved health (Wilkinson, 2005); for its contribution to the development of mutual trust and social capital so discouraging crime (Uslaner, 2002); or because it leads to greater happiness (Layard, 2005) - although Alesina *et al* (2004) suggest that this does not apply universally. Tyler and Smith (1995) refer to extensive documentation of how feelings of relative rather than absolute deprivation underlie much social unrest: it is the inequality that seems to provide the spark. Further arguments for equality can also be found in section 4.1, which discusses redistribution.

It should be emphasized that the argument here is that – if there were no other considerations – everyone should, morally, have an identical amount of money to spend. This is clearly a fundamental assumption of those who would incline to the political left. It is also, just as clearly, not recognized by some on the political right. The consequence of the model of justice used here is that failing to recognize equality as a principle is wrong. (Having considered the desirability of equality, however, one might however make a just decision that does not promote equality.)

Equality should incorporate both horizontal equity, which means like people are treated in the same way, and vertical equity, which means that differences in treatment are proportional to the differences between the people concerned. In terms of taxation, horizontal equity requires those of equal income to pay equal amounts of tax. Vertical equity requires that the rate of tax applied to people of different income increases smoothly with their income and requires increasing marginal rates of tax.

Christians not persuaded of the importance of equality are referred to Paul's express desire in 2 Corinthians 8:13 that his efforts at aid would lead to equality, and to the

parable of the workers in the vineyard in Matthew 20, who were all paid the same full day's wage even though some had worked shorter hours.

- Efficiency. Efficiency is taken to include lower costs of administration and the provision of productive incentives. Efficiency is not normally explicitly considered as an issue of justice, but it must often be considered in order to make a balanced evaluation of policy options. It is argued here that it should function as a criterion of justice. The question to ask is whether it would be unjust to fail to meet one of the other criteria because of cost considerations? If not, then efficiency would appear to act as one of the components of justice.
- Just deserts. This covers both the rewards that do, or should, directly follow effort, creativity or personal sacrifice, and the penalties that do, or should, follow destructive or exploitative actions. Narrowly interpreted, justice can describe the process of ensuring that other people are not negatively affected by our behaviour.

While more traditional authors, such as Lucas (1980), regard desert as “pre-eminent” in a consideration of justice, modern academics such as Rawls (1991) and Sen (2009) find it unnecessary. While giving people their just deserts has the considerable benefit of providing appropriate incentives to do good, it is even more important in recognising the value of each individual and their actions. Telling me that I am to have the same benefits, and be treated in the same way, regardless of what I do, is patronising or oppressive – and insulting.

Christians needing persuasion as to the place of just deserts can consider Matthew 25, where Jesus tells of the different judgement awaiting the sheep and the goats, and Paul's argument for his entitlement to a reward for preaching even if he elects not to receive it in 1 Corinthians 9:4ff

10.4 Party spirit

Differences in opinion and different vested interests reinforce each other – and find expression in political parties and lobby groups. The differences extend to the two major international organisations involved in social security arrangements. The World Bank tends to encourage the role of markets, and be more concerned with efficiency. The International Labour Organisation (ILO) leans more towards solidarity and equality. The two do not seem to communicate particularly well.

The divide between the main protagonists of equality, solidarity and greater state-involvement – the parties on the left – and those advocating reduced state-involvement and less redistribution – on the right – is not, however, a simple one. In particular, the European Christian Democratic parties – largely regarded as more to the right but under the influence of various papal encyclicals¹⁸ – have been builders of social security systems with significant redistributive elements. Most countries recognise the need to adopt compromise positions, as social security programmes that are changed frequently create instability and destroy the certainty they are meant to promote.

A party spirit that fails to try and understand the views and arguments of alternative views, and expresses its frustrations by caricature and repetition, is a temptation we should attempt to avoid. I believe that this framework of justice can help.

¹ *The opinions expressed are mine, and should not be ascribed to my employers – past or present.*

² *Adapted from Asher (2007d) – without quotation marks for ease of reading*

³ *See Thomas Aquinas's Summa Theologiae Part II – II Question 58*

⁴ *Taken largely from Asher (2003)*

⁵ *Hutsebaut M (1996) The Financing of Social Protection in Europe: Achieving the Impossible? Unpublished paper 3*

⁶ *Polachek & Siebert (1993), chapter 5*

⁷ *Stanton & Dapr  (1995) 14.*

⁸ *This section is taken from Asher (2007c), which provides more detailed reasoning.*

⁹ *From Marin B & Prinz C (2003) 36*

¹⁰ *As reported in Berkowitz M (2002) Designing an Early Intervention Demonstration to Return Applicants for Social Security Disability Benefits to Work www.dri.uiuc.edu/research/p01-01c/final_report_p01-01c.doc and by Conti et al (2006)*

¹¹ *In various "Feasibility Studies" published by the South African Department of Social Development*

¹² *This section is also taken from Asher (2007c), which provides more detailed reasoning.*

¹³ *Taken largely from Asher (2007d)*

¹⁴ *Luke 6:20-23*

¹⁵ *James 1:20*

¹⁶ *In Eliot Spitzer (2005) Business ethics, regulation and the "ownership society" http://www.oag.state.ny.us/press/statements/Business_Ethics.pdf*

¹⁷ *Taken from Asher (2006b) without quotation marks*

¹⁸ *See John Paul II (1991).*