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Financial market lobbies and pension reform

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ABSTRACT

We develop a model in which firms in the financial market lobby the government to lower compulsory contributions to the public pension system. Firms lobby in order to increase demand from households for their old-age savings products. We conclude with a comparison of two major pension reforms in Europe exemplifying the influence of financial market lobbies on pension policies.

1. Introduction

Within the last two decades a range of OECD countries launched major pension reforms. Among those reforms the implementation of (mandatory) defined-contributions plans played a key role. In these schemes workers typically have individual accounts managed by private financial-services companies. Workers pay contributions into these schemes and receive a stream of income once retired. Concomitantly, most governments have reduced the level of public pension benefits of the pay-as-you-go (PAYGO) system (OECD, 2005; Whiteford and Whitehouse, 2006). Workers are nowadays more and more forced to contract with private agents for old-age provision.

In this article we address the reasons why public pensions were retrenched in some countries and not in others. We argue that countries that host politically powerful financial markets are more likely to conduct pension policy reforms that strengthen private savings components. The reason is simple: financial-services companies that typically manage defined-contributions schemes profit from these reforms; with this vested interest, firms in the financial market should be eager to lobby governments to conduct such pension reforms.

We formalize this argument using theoretical models of interest groups' influence on pension systems (see, e.g., Verhoeven and Verbon, 1991; Breyer, 1994b; Grossman and Helpman, 1998; Neugart, forthcoming). An interest group model may be particularly suited for studying pension policies as it depicts more accurately than median-voter models some of the characteristics of representative democracies (Mulligan and Sala-i-Martin, 1999). The government does not only take into account the decisive

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voter's policy preferences but also has to balance contradictory claims from various societal actors. We extend the existing formal approaches analyzing pension policies by introducing financial-service companies that lobby the government. These lobbyists try to push governments to reduce the contribution rate to the PAYGO system. This induces more private savings from households and increases the demand for products of the financial-service companies.

We motivate our argument by looking more closely at time and cross-country correlates of net-replacement rates of pension systems, the scope of the financial markets, and pension reforms for OECD countries. These descriptive statistics prompt us to analyze more deeply the interplay between financial market lobbies and governments' pension policies. We focus on a causal mechanism that has hitherto been somewhat neglected, namely that governments distort policies in favor of the financial market interests in exchange for some sort of favor that they receive from these lobbyists. To support our formal approach on governments' pension policies empirically, we present two case studies for the U.K. and Germany. Both of these case studies show how financial market lobbies shaped the policymaking of the governments to various degrees at those times. A better organized financial market lobby having better access to the ruling parties can explain the stronger shift towards private components in retirement provision in the U.K. than in Germany.

The literature on the political economy of pension systems has usually focused on other factors than financial markets to explain characteristics of social security systems (see, e.g., the surveys by Breyer, 1994a; Galasso and Profeta, 2002). In this literature, changes in the generosity of public pension schemes are, for example, explained on the basis of demographics which have shifted the median voter (Sinn and Übelmesser, 2003), inequality in the electorate and the quest for redistribution (Tabellini, 2000), or the ability of the older generation to effectively organize their interests (Profeta, 2002). Recently, Conde-Ruiz and Profeta (2007) focus on a more complex design of pension systems. They build a model to explain both the generosity of public pension systems and their redistributive characteristics. They argue that middle income voters face lower returns from private savings in the financial market than high income voters which, depending on income inequality, may lead to different coalitions of voters supporting either a Bismarckian or a Beveridgean type of pension system. However, as for the general role of the financial market normative assessments of pension reforms prevail (see, e.g., the survey by Lindbeck and Persson, 2003). The political role of financial markets goes largely unnoticed. This is remarkable given the commonly held belief that financial markets benefit greatly from the introduction of privatized mandatory pension schemes (see, e.g., World Bank, 1994).

Empirical studies on pension reforms based on micro-data highlight the fact that voters are more likely to accept reforms if they are better informed about the costs and particularities of the pension system (Boeri and Tabellini, 2005). Using aggregate data, Perotti and Schwienbacher (2007) present some evidence for their claim that the degree to which the middle class participates in financial markets explains the initial choice of the type of the pension system. A higher concentration of wealth among a small group of the society will shape, as they argue, the preferences of the decisive middle class towards a more redistributive public pension scheme. Brooks (2002) finds that problem pressure measured as implicit public debt and political variables such as democracy or the effective number of parties exert an effect on the likelihood of a reform. There is also evidence that countries learn from the reform processes of other countries (Brooks, 2005). Finally, case studies by Immergut et al. (2007) and Myles and Pierson (2001) reveal the role of political party competition and of institutional veto players in recent privatizations of pension systems in Europe.

In the following section we start with some stylized facts on public vs. private pension systems in the OECD world. Next, we set-up an overlapping-generations model in which financial-service companies lobby a government's choice of the contribution rate to a PAYGO system. Then we test the validity of our claims by comparing two cases of privatization of pension systems: the United Kingdom in 1986 and Germany in 2001. The last section concludes.

2. Pensions, reforms, and financial markets

We start with some stylized facts about the relationship between public and private old-age provision in OECD countries. Public pension systems vary in many different ways (OECD, 2005), but arguably the most important parameter for the generosity of the system is the replacement rate. Scruggs (2004) calculated net pension replacement rates for PAYGO pension systems for various household types for 18 countries. It is the most reliable measure for international comparisons with a comparatively broad coverage. The OECD, for instance, only recently started to look into net replacement rates and reports historical series only for gross rates. Replacement rates reflect the underlying individual contributions better than the official contributions rates since governments use various means to finance pensions. For example, standard contribution rates seriously underreport the generosity of public pension schemes whenever governments use taxes as an additional source to finance pensions (Adema, 2001).

Simple correlations of net replacement rates and proxies for the strength of the financial market indicate a strong negative relationship, see Table 1. To calculate these correlations we gathered a pooled data set comprising up to 25 OECD countries from 1970 to 2002.[1]

One measure for the scope of the financial market is assets held by institutional investors in percent of GDP. This measure yields a correlation coefficient of −0.45 which is significantly different from zero at a p-value lower than one percent. Thus, we observe over some 20 countries and roughly the last two decades that higher net replacement rates from PAYGO pension systems coincide with lower prevalence of the institutional investors. Similar results can be found for the size of the private insurance industry, measured by gross premiums as percent of GDP, and the number of employees working in the financial sector as a ratio of all

[1] For individual time series, however, the data coverage is much smaller as the summary statistics in the Appendix show.