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Overview of the Issue

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This issue features four articles and a book review section. The first article in the issue is by Stefan Engström (Stockholm School of Economics) and Anna Westerberg (National Social Insurance Board) and examines "Which Individuals Make Active Decisions in the New Swedish Pension System?" The vast majority of empirical evidence on how individuals make decisions in defined contribution plans has been based on US experience and the unique choices available within 401(k) plans. Therefore, the paper by Engström and Westerberg, which examines the situation in Sweden where the institutional details and investment choices are somewhat different, is a most welcome contribution to the literature.

In the new Swedish pension system, there is a contribution rate of 18.5%, of which 2.5% goes to the funded defined contribution Premium Pension System (PPM) system that is the focus of the Engström and Westerberg study. The PPM offers considerably more choice than US 401(k) plans, with individuals able to choose between one and five funds fromover 450 funds available in the system. More interestingly, there is a publicly managed default fund that invests 90% of the portfolio in equity. This is distinct from the US market.

Engström and Westerberg focus on who makes active decisions in the Swedish system. Their results provide striking contrast to some results in the US literature on defined contribution decisions. Whereas in the US most individuals choose default options, this is far from the norm in Sweden. In addition, whereas in the US older workers are more likely to make active investment decisions, in Sweden it is the younger workers making active decisions.

While these findings represent important departures from those from the US, Engström and Westerberg confirm some findings from the US literature. Engström and Westerberg confirm the findings of Weisbenner (JPEF, 2002), who found that individuals who are more familiar with investments because they have choice in their pension plans over investment are more likely to actively invest elsewhere and hold stock outside their portfolios than other households. Their research also confirms the results of Huberman (2001), who finds a correlation between familiarity and active investment: those who are wealthier and have higher levels of education are more likely to invest actively. Individuals with significant private savings and who work in financial services are also less likely to choose the default option in Sweden. Whatever the reasons, these 'default behaviour' papers leave many interesting questions to explore and we encourage further research in this field.

The second article by Russell Cooper (University of Texas, Austin) and Thomas Ross (University of British Columbia) is "Protecting Underfunded Pensions: The Role of Guarantee Funds." The paper examines the role and design of guarantee funds for private pensions. Many private defined benefit pensions are significantly underfunded at present and therefore there is some concern about how to provide appropriate benefit security for individuals. The degree to which there are guarantee systems in place varies widely. Until recently there was for instance little protection for members in the United Kingdom. The United Kingdom government however announced in June 2003 it intends to introduce a guarantee fund along the lines of the US-based Pension Benefit Guarantee Corporation (PBGC).

Cooper and Ross start with a model with capital market imperfections that provides an explanation of why firms underfund pensions. They then show that in this environment it can be impossible for private guarantee funds to function and hence there is room for state intervention in the market. However, the structure of state guarantee funds is important as well. In particular, Cooper and Ross show that some types of guarantee funds can encourage underfunding and equity investment, hence potentially making the welfare of participants lower. Their paper is a timely addition to the literature given the discussion in the US regarding the large deficit that has developed within the PBGC in recent years, mostly due to companies who have effectively transferred their underfunded pension obligations to the PBGC.

The third article in this issue is by Andras Simonovits of the Institute of Economics, Hungarian Academy of Sciences. Simonovits' paper is on "Designing Optimal Linear Rules for Flexible Retirement". Early retirement is a significant problem across OECD countries and as a result the adjustment of benefits based on age at which they are first drawn is an important policy question. There has been some focus on measurement of early retirement incentives in the literature (the work of Gruber and Wise (1999, 2002) is an important example) but considerably less focus on related design issues.

Simonovits solves the problem of what disincentive for early retirement is socially optimal. The key conclusion of his analysis is that actuarially fair adjustments are not optimal. The optimal policy instead involves a benefit reduction that is less than actuarially fair. The intuition for the result is that there is correlation between retirement ages and mortality; individuals who will live longer retire later and are also wealthier and therefore their benefit increments should not be as large as those that follow from standard actuarial calculations.

The fourth article in this issue by Eduard Ponds of the Dutch pension fund ABP is entitled "Pension Funds & Value-Based Generational Accounting". In the spirit of Chapman, Gordon and Speed (2001), the paper focuses on conflicts between different stakeholders in a pension fund, including the sponsor and different classes of members. When pension funds choose investment strategies that do not match liabilities, the mismatch risk is borne by the sponsor as well as future generations of members.

Ponds presents a general framework for assessing intergenerational transfers in pension funds and therefore provides a tool to assess how the effects of different pension policy changes are distributed. The specific transfers that occur in practice

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depend not just on scheme designs but legal rules and the covenant which both protect member security and also divide up surpluses between different stakeholders. Ponds applies this intergenerational framework in the case of the Netherlands.

The issue closes with our book review section edited by Olivia Mitchell, executive director of the Pension Research Council at the Wharton School, University of Pennsylvania. The book review section contains four reviews and the editors wish to thank: Lori Lucas, (Hewitt Associates) Anna M. Rappaport (Mercer Human Resource Consulting) Alan Rubenstein (Morgan Stanley) and John Turner (AARP Public Policy Institute).

We hope you find this interesting issue of JPEF a valuable addition to your library. We certainly enjoyed putting it together. For related research news and other information about the OECD-administered International Network of Pension Regulators and Supervisors with which this journal is associated, we encourage you to go to the website http://www.inprs.org.

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