Mitchell's Musings 9-3-12: Maybe Not a Good Choice

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One of the axioms of classical economics is that choice can make you better off and certainly can't make you worse off. It seems logical. Imagine you go into a restaurant and there are five choices on the menu. Then the waiter comes along and tells you there is a sixth item as a "special" available. You might prefer the special selection to the other five so you are now better off. If you don't like the special, you don't have to choose it and you can stick to the five on the menu. So you are not worse off even if you don't like the special.

Actually, that may not be the whole story. There is a cost to the restaurant in offering the additional special. The more items that are offered, the more difficult it is to plan to have just enough food on hand so that excesses don't have to be thrown away and that you don't run out of items your customers might want. There may be training costs for the staff as you add more dishes to prepare. So by offering more choice, all prices at the restaurant might have to be a bit higher than would be the case for fewer selections. There is more to be said about having a choice, in short, even in this simple restaurant case.

Choice can be more complicated when it comes to insurance. Much of the debate about alternative universal health insurance proposals turns on choice and adverse selection. If we were simply to mandate that anyone can choose to buy health insurance whenever he/she desired and do so at some community rate, the rational consumer would buy only when illness occurred or threatened. The result would be a disproportionate sample of bad risks buying insurance and, therefore, escalating premiums. That why - in one way or another - something limiting choice is a component of all universal health care proposals.

Everyone needs to be in the pool all the time for such a plan to work. The more you allow the choice of opting out of having insurance, the more the plan is likely to break down. You can mandate that everyone be in the pool (no choice at all). Or you can tilt the game against choosing to opt out, either by penalizing those who make that choice or bribing them sufficiently not to make it. In effect, although there is a choice in either of those two situations, you are making an offer that can't (rationally) be refused.

So far, however, we are analyzing a condition of rationality. Marketers and advertisers have long known, and behavioral economists are increasingly discovering, that human choice is often not rational in the classic economic sense. In particular, people are not very good at appraising risk and they are not good at long-term planning (both of which are elements critical to areas such as retirement saving and insurance). One example is the finding that when employers offer tax-preferred savings plans such as 401ks, the default condition when you are hired matters. If the default is that when you are hired, you automatically go into the 401k unless you check a box that opts you out, you are more likely to go in and stay in than if the default is non-participation and you have to check the box to go in. Since box checking is essentially costless, under simple rationality, the choice should be the same regardless of the default. But empirically it isn't.

All of this background is prelude to something I read in a recent issue of the *Daily Labor Report* about GM and Ford offering already-retired salary workers a choice of continuing to receive their monthly defined-benefit pensions or cashing them out with a lump sum.[1] The apparent rationale for giving pensioners this choice – which they didn't have before – is that if workers take the lump sum, the firms will have less debt. While that is true, they – or their pension plans - will also have less cash, since there must be cash from somewhere - presumably from the pension fund – to make the lump-sum payment.

Let's first start with the classical economic assumption of rationality for the pensioners. Pensioners presumably know something about their health and longevity prospects, probably more than the pension fund managers do. To put it bluntly, given the new choice, you should cash out if you know you are your deathbed. The stream of future monthly pension payments for you will be short. But the lump sum is likely to be based on some average expected longevity of all those in the pension pool, a longevity which you expect to be longer than yours. Under rationality, it is likely that the pensioners – offered the choice – will game the system in a form of adverse selection. Those on their death beds will cash out and leave the lump sum they receive to their heirs. Those who can expect to be Methuselahs – based on their current health condition, the longevity of their parents, etc. – will choose to continue their lifetime pension annuities. Both choices tend to drain the plan.

Given the possibility of adverse selection and gaming, why is the choice being offered? The likely answer – the only rational answer I can think of on the assumption that the pension fund managers are rational (which may not be correct) – is that the managers' expectation is that retirees won't be rational. That is, they must be betting that long-lived retirees will be smitten by the prospect of a large one-time payout. That is, the Methuselahs won't realize that they are making a bad selection relative to the present value of the future annuity payments they would otherwise be owed. If the Methuselahs – with longer-than-average life expectancies – opt out of the plan and those on their deathbeds stay in, the plan clearly comes out ahead – but only because those retirees making the choice are choosing to accept bad deals.

There is still another element to be considered. A pension annuity is an insurance contract. If you simply start retirement with a lump sum, you might live longer than you expect and run out of cash. The contract protects you from that risk since you will receive the payment for as long as you live, even if it turns out to be much longer than you might have thought. It is difficult for individuals to insure inexpensively against that risk. Yes, you can take a lump sum of cash to a private insurance company and buy an annuity as an individual. But the costs of that annuity have to be high, since the insurance company knows you must believe (and perhaps with good reason) that you have a longer-than-average life expectancy. And it knows that you would not be in the market for an annuity if you believed the opposite.

[1] "GM, Ford offer lump sums to retirees, but some question whether others should," *Daily Labor Report*, August 6, 2012, pp. A7-A8.

Large pension plans, however, can deal with averages when it comes to longevity because they cover a large population sample. So they can make actuarial projections and count on those who live a long time to be paid for by those who die comparatively young. They can deal with longevity risks much better than individuals. However, they can do so only *if* they don't start offering opportunities for adverse selection to appear, as the GM and Ford plans seem to be doing, or if retirees aren't rational.[2]

Simple economic theory – with its assumption that everyone is rational – tends to endorse any market transaction as win-win. Obviously, both parties to the transaction must think they are better off making the deal, else why would they have made it? Both sides had a choice of not transacting. But in the case of the pensioners at GM and Ford, is sure is hard to come up with a win-win story.

GM and Ford are reported by the *Daily Labor Report* to have two of the largest defined-benefit pension plans in the country. But they are in the private sector which is rapidly pulling out of defined benefit pension plans and offering defined contribution plans instead. In the public sector, there is much agitation about defined-benefit pensions which are still common in government, and particularly there is agitation about underfunded plans. Some jurisdictions – the City of San Diego, California is a recent case – are moving to defined contribution for new hires and trying to push existing employees in that direction. If high-profile GM and Ford offer lump-sum cash outs to existing annuitants, you can expect some folks in the public sector to start thinking along those lines, regardless of whether it is good policy. If that happens, remember that you read it here first. And remember how hard it was to provide a win-win rationale for offering retirees that "choice."

[2] The pension experts interviewed by the *Daily Labor Report* seemed puzzled by what GM and Ford were doing. They seemed reluctant to recommend such arrangements to other clients and had difficulty coming up with a rationale for the GM and Ford approach.