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Rethinking Pension Reform: Ten Myths about Social Security Systems

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Discussion of Peter Orszag and Joseph Stiglitz:
„Rethinking Pension Reform: Ten Myths about Social Security Systems“

Before coming to substance, a brief introductory remark: Although the paper claims to be deliberately provocative, I found only one really provocative statement in it, on the bottom of the first page, namely that the paper is „nuanced“.

"Nuanced" is certainly a matter of perspective. The paper's narrow-minded view may be helpful for a perspective centering on the United Kingdom or the United States where the development has gone far in the direction of private defined contribution (DC) plans. However, this is not the world, and this a World Bank conference. In fact, there are many parts of the world - actually a majority of the countries - which have only one monolithic public defined benefit (DB) system, and this paper does little to do justice to the many attempts of starting small moves towards more balanced systems which combine elements of public defined benefit and private defined contribution (DC) plans. A nuanced view would take at least a bit of a glimpse on the problems of those countries. I say this with quite a bit of frustration as a European, specifically as a German, where in spite of all kinds of serious troubles ahead the reform towards a more balanced system has been stalled over and again.

This brings me to my first substantive point.

1. Demographic constraints are serious

Demographic changes will increase implicit public debt in a way that is unsustainable even for rich countries. Thus, prefunding in the broad sense as defined in the paper by Orszag and Stiglitz is a simple necessity.

This is an important point! The paper misses this or at least its fundamental significance for the debate. The paper actually minimizes this fundamental political constraint by somewhat loosely referring to the illusion that the choice of prefunding or not is only a matter of “intergenerational trade-offs“. For many countries, this is simply wrong because the future payroll taxes will reach levels that are unsustainable and will not permit any tradeoff.

Again, the perspective is important. In spite of all the discussions in the U.S. congress, the U.S. demography is relatively harmless. The US expects to have a dependency ratio in 2030 that is as high as in many countries today. However, in those countries the dependency ratio will continue to double from this high level until the year 2030, seriously constraining policy options.

2. Corporate governance of public investment

Given that we need to prefund in the broad sense, the remaining core question is whether prefunding should be done publicly or privately. Orszag and Stiglitz advocate public investment. As opposed to the title of the conference, this is not a new idea. It has been done before with results which have been documented quite a few times. Examples are the provident funds in Asia which have rather low returns even after the correction done in the paper. Other examples are the partially funded systems in the Middle East where funds were frequently squandered in order to finance dubious public investment projects.

But there is a more subtle point, namely the question who should exert corporate governance. In order to answer this question it is important to get volumes right. Let me pick up the German example. In order to fund 50% of Germany´s pension claims, the fund would be about 1/3 of current gross fixed capital stock. The political economy of a government running such a significant share of the economy is well known and not favorable. There are plenty discouraging examples in France, Italy and Sweden, so I do not have to mention the many countries in the former East and in developing countries.

There is the illusion that the government can just passively invest in index fonds. This illusion is shared, by the way, also by a proposal put forwarded by Franco Modigliani recently. This will not work. Somebody has to enforce corporate governance – either the owner of the capital directly or her agents. Direct control is out of the question for most workers and pensioners. So the central question is what motivates the agent, in the case proposed by Orszag and Stiglitz the government. I do not see any compelling corporate governance mechanism that guarantees market rates of return in this case.

3. Political risks versus capital market risks

Belittleling political risks and being cavalier with political economy questions is another worrisome tendency in the argumentation of the paper by Orszag and Stiglitz. I find the discussion in Myths # 8, # 9 and # 10 on the political economy particularly troublesome. While it is quite correct that the regulation of capital markets is imperfect and subject to corruption and ignorance, it is by no means a logical conclusion that therefore one might as well leave all governance to the state. There is a clear hierarchy and a division of labor. It starts from day-to-day management, continues to the supervisory role of the governors, and finally end at the establishment of a regulatory environment by the government. The closer the state is to day-to-day management, the more problematic has it been, as has been proved over and over again in history all across the world.

Again, the discussion is very North American centered and misses the reality in most developing countries (but even in large parts of Western Europe) where a large share of GDP is government-related and deregulation is slow. Just to give some real life examples: In Germany, a board of state appointed but independent trustees overseeing a third of the capital stock, as proposed by Orszag and Stiglitz, is wishful thinking in the light of the fact that the social security actuaries have recently adjusted their demographic forecast to match the long-term budget limits of the public pension system. And Germany is not the only country (add certain non-government organizations!) in which demographic projections are treated as political, not scientific exercises.

4. Incentive effects on participation and internal rates of return

In the sake of time, let me be very brief on Myths # 5 and # 6, related to economic incentive effects. Orszag and Stiglitz are very right that labor supply disincentives are not necessarily implications of public DB plans. But this is theory. In practise, two significant effects - participation effects and early retirement effects - dominate almost all existing public defined benefit plans, even if they are partially funded.

Concerning participation incentives, evidence in many countries shows that participation declains as soon as public DB plans become voluntary. “Opting out” has been overwhelming in Hungary, the United Kingdom and the Latin America reform countries. In a similar fashion, public opinion policies on public DB plans yield miserable grades.

The negative incentive effects on participating in public DB plans are governed by the perceived rate of return differences vis-a-vis capital market returns. The paper by Orszag and Stiglitz is quite correct in dismissing superficial comparisons, particularly if transition costs are ignored. But this does not leave rates of return under PAYG DB plans and fully funded DC plans equivalent. Again, I am missing a more subtle (may I say “nuanced”) approach to this question. The equivalence of maintaining the PAYG system and a transition to a fully funded system shown by Breyer (1989), Brunner (1994), Fenge (1995) and others only holds in very simple economies that work frictionless (e.g., perfect capital markets) and have a fixed technology. If there are liquidity constraints, diversification constraints, or if the technology changes because productivity is affected by changes in the pension system (Cosetti, 1994), these results do not hold and provide room for a genuine difference in the rates of return.

5. Incentive effects on early retirement and the political economy

In terms of early retirement, it should be stressed that the United States is an outlier. Most other countries in the Gruber and Wise (1999) volume have not managed, or did not want, to make their defined benefit plans actuarially fair. This is not by chance but has systematic reasons, namely a link to unemployment policies - the false belief that reducing old age labor force participation will reduce unemployment because labor is a fixed lump - and pork barrels politics - because in many countries the elderly are the largest special interest group among votes, Mulligan and Sala-i-Martin (1999).

Getting quarrels such as about actuarially adjustments out of the day-to-day special interest politics into the realm of actuaries and insurance managers is an important reason to move away from pure public DB plans – may be not all the way. Here are exactly the nuances missing that the paper claims to deliver.

6. Political risks versus capital market risks, revisited

This brings us back to the question of political risks. In being so one-sided, the paper also misses the point that defined benefits are not defined benefits anyway. It is simply a myth that defined benefit plans carry no risk. And it is simply a myth that any pension system can be risk-free. Public DB plans have an enormous political risk. Social security benefits have been changed up and down for all kinds of reasons in the major EU countries as can be studied in the many institutional comparisons available. Once again: This paper should have left the U.S. perspective to include the European, Latin America or North African experience.

Two examples: In spite of being “defined benefit” plans, in most countries it is not possible to get an official statement of what these defined benefits are for a specific individual. This includes my own country. And taking another example from Germany: during the last eight months future pension benefits have been increased and reduced again by 15% when laws were revoked and administrative rules changed to fit budget requirements.

On top of this, indexation to inflation is discretionary and subject to pork-barrell politics in most developing countries and even some European countries. Of course, it is not a necessary feature of public DB plans in theory. In reality, however, governments are rare by binding themselves. The historical evidence quite clearly shows that governments prefer to keep their ability to make discretionary policy.

I do not want to belittle the risk inherent in private DC plans. All things considered, this very much speaks for a multi-pillar system in which one part is run by the state and might be pay-as-you-go or funded, another part are individual funded accounts. Very obviously – since capital market and political risks are unlikely to be perfectly correlated – a combination reduces overall risk. The balance between political risk and capital market risk is not only country-specific (as the paper points out quite correctly and repeatedly) but will also vary within countries from rich to poor and according to preferences. It is thus important to give the people some choice of how much the second pillar is investing in public bonds or private equities, very much along the lines of Tony Blair´s stakeholder pension idea.

7. Whom to Trust?

The fundamental disagreement in our debate is on which choices to leave the people, and whom the people should trust. If we take the historical evidence, in most countries – maybe the U.S. is an exception - governments have had a rather bad track record when they were trusted with running large funds. We have to bite part of this bullet for redistributional tasks because there is no way to organize this differently but through the state. However, it is not necessary to bite all of this bullet, in particular for the non-redistributive bulk of the old-age insurance as this paper – with much too few nuances – suggests.

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Biographical Note

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