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Comments on Private pensions for Europe by Lans Bovenberg and Casper van Ewijk

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The paper

Private pensions can significantly improve intergenerational and international risk sharing.

As Defined Contribution systems are not optimal with regard to risk sharing,

the rules for the private pensions systems should be designed more intelligently.

For optimal risk sharing the government needs to step in by providing wage- (or GDP-) linked bonds.

Private pensions should be promoted by the governments by making them mandatory (this is necessary for eliminating moral hazard).

This way they would replace part of the public pension system, leading to a superior overall provision of pensions.

A parallel rationale for private pensions (1)

The following argument is based on intergenerational solidarity – it based on burden sharing with no reference to risks.

As the current (older) workers have had low fertility and will live longer than their parents, they should accept a combination of

- Higher retirement age
- Lower pensions benefits for a given retirement age
- Partial pre-funding (higher contribution payments for themselves for not postponing (all) the increase to the next generation).

This is basically a package that has been promoted at EU level since 10 years.

Note that 'pre-funding' can – in the context of general government - mean reduction of public debt – this is how it has been often (correctly) expressed.

A parallel rationale for private pensions (2)

Deduction 1: the size of pre-funding based on intergenerational solidarity/fairness depends on the two other policy prescriptions (retirement age increase and benefit decrease) and the demographic change.

The choice of the package may differ significantly across nations.

Deduction 2: prefunding can take place within the public pensions system or in a newly established mandatory private scheme.

This may depend e.g. on the trust in politicians vs. markets.

Design work to be done (1)

As the public scheme will remain important, improving its rules should have high priority.

- Automatic adjustments: retirement age and longevity determining the level of pension etc. (NDC = Notional Defined Contribution system – Sweden, Poland, Latvia…

- Retirement age increase must have the biggest role, and it requires a multitude of measures.

Design work to be done (2)

EU public finance rules (EMU) discourage moving towards private mandatory schemes.

- The deficit and debt rules exclude the mandatory private pensions scheme from general government accounts.
- “The cost of moving to multi-pillar schemes” is not fully taken into account.

Recently, these rules have induced reversing private schemes in some MSs.

This is not a time and place to take a view of what is right or wrong, but only to recognise this as a fact that follows from a complex set of existing EMU rules and the positions of various decision makers.

Design work to be done (3)

As the public schemes will remain important they should be reformed not only with regard to their redistribution (=solidarity) properties, but also wrt risk sharing.

As B&vE ask the governments to issue wage- (GDP-) indexed bonds for the private schemes to do their job, we should note that the government can and should adopt similar instruments for the public schemes: under wage indexed pensions (both for accumulation and payment phases) the government issues an implicit wage-indexed bond.

This can be made easily understood under NDC.

Comments on the paper (1)

The effect of the public pension rules on the optimal risk sharing properties of the private schemes is mentioned in passing, but it could be developed further.

The implication can be that, given the public pension rules, the young adults should take even more equity risk than indicated in the paper (equity much more than net financial wealth).

The authors dismiss borrowing for ‘equity’ as not likely.

This can be almost correct, but…

For example, one significant element in the portfolios of normal (middle income) people is housing wealth.

Housing prices correlate positively with equity. The young buy a house with a loan (the house as collateral). So, their risk exposure conforms to B&vE advice. If the government provides wage indexed housing loans, even better. All this is happening in real world.

Comments on the paper (2)

The governments hold financial assets, about 25% of GDP in the euro area (average). Source: USB Investment Research, Q-Series: European Monitor, 20 July 2011.

This is a risk portfolio that the government is managing on behalf of the citizens. To be taken into account overall analysis. (Maybe not so important quantitatively, but …)

As (or if) insufficient risk taking and long term investment is the problem, what can governments and private pension funds do? Pensions funds can be natural investors in long-term/infrastructure projects (also education?). These are often natural monopolies and therefore to be regulated for 'fair' returns.

This way pension funds are in the gray area between public and private.

Concluding with questions (1)

1. Is it most realistic to expect that public pensions will still be the bulk of pensions in the European welfare states?
2. Is the Merton-Samuelson model so relevant for peoples' behaviour? Should they trust the M-S more than various other simple and narrow microeconomic theories (which we know do not correspond to human behaviour)? – Maybe people are not very enthusiastic about following the M-S model as they may also be told that Robert Merton was on the board of the Long-Term Capital Management (LTCM) that had to be bailed out in 1998 to avoid even bigger damage (and they are also told that 'financial innovation' was behind the current crisis).

Concluding with questions (2)

3. **Is it not more plausible to think that the main rationale for an increase in private pensions is rather that there will be more prefunding and – as the people trust neither politicians nor the markets – a mixture is optimal. (And prefunding in mandatory private sector schemes will remain modest also for reasons related to EU fiscal rules for the time being.)**

4. **Should we concentrate on improving public pension system rules, i.e.**
   - **retirement age increase**
   - **linking benefit level to longevity**
   - **as a whole, keep costs (including health care) reasonable,**

   still recognising that privately managed pensions will be part of the picture?

Thanking the speakers

1. It is a well articulated paper on intergenerational and international risk sharing promoted by private pensions.

2. Its content and conclusions can be used in a broader context of reforming the pension systems in European welfare states, including the implications for reforming the public pensions.

Thank you for your attention!