Chapter 8

TOWARDS AN OPTIMAL PUBLIC PENSION SCHEME

Use the Insurance Principle to protect against longevity risks. Treat each cohort independently and adopt the Fully Funded Pension Principle for each cohort. Build in any redistributive elements explicitly and collectively as desired.

1. INTRODUCTION

Economists around the world are by now quite familiar with the pitfalls of a pay-as-you-go pension system. An aging society coupled with the prospect of increasing longevity is causing financial strains in public pension schemes from Europe to America. (See Table 1) Calls for pension reform are heard everywhere. In the industrial world quite a few authors are talking about privatization of public pensions (Roberts, 1995; Dornbusch, 1995). A favorite model of pension reform is privatization Chile style. This is an option (dubbed "personal security" in contrast to social security) considered in the recent report of President Clinton's Advisory Council on Social Security (Businessweek, Jan. 20, 1997, 26-27). Yet the superiority of this model is not unquestioned. Note, for example, MIT economist Peter Diamond's conclusion in 1993:

We have come to think of privatization as a route to greater efficiency and lower costs. Thus, perhaps the most surprising aspect of the Chilean reform is the high cost of running a privatized social security system, higher than the "inefficient" system that it replaced. (NBER Working Paper, no. 4510, 1993)

It has been pointed out that the administration costs of public pension plans are likely to be under-reported (James and Palacios, 1995). However, under-reporting is unlikely to account for the huge gap between the administration costs of public and private plans (Mitchell and Zeldes, 1996,
p.11). The U.S. Social Security Administration reported administration costs at less than 1 per cent of annual benefits while those of the life insurance industry are known to range from 12 to 14 per cent of annual benefits (Diamond, 1993, p.7). Economies of scale of management, economies of supervision, as well as economies arising from the dispensing of much of marketing costs, are likely to provide important cost savings attributable to the central administration of public pensions.

Equally important, a "private social security system" is a contradiction in terms. Under such a system, each worker has his own account. Each worker and his employer are to contribute a percentage of the monthly salary into this account, and the funds accumulated are managed privately and the total amount inclusive of investment returns is repayable upon retirement. The only aspect that is "social" about a purely private system — the Chile model *not* being a true example because the government does guarantee a minimum pension and because it mandates a minimum requirement of annuitization — is that it is mandatory. A true Mandatory Private Provident Fund (MPPF) scheme — one that allows individual account holders to opt for lump-sum payment or to buy an annuity in the market place from voluntary underwriters, such as recently introduced in Hong Kong (Hewitt Associates LLC and GML Consulting Ltd., 1995, para. 33) — *either* fails to pool longevity risks (Eckstein, Eichenbaum, and Peled, 1985), *or* fails to deal with the high cost of voluntarily purchased annuity plans (Abel, 1986). It is also doubtful that workers stand to gain from employers' contributions. In a highly competitive world how much can be spent in compensation for labor is dictated by the market. Workers' pay and/or other benefit are likely to fall, thus offsetting employers' contributions. The set-up will not expand the real opportunity set open to workers.

On the contrary, employees see their opportunity set reduced because they are required to contribute the stipulated percentage of their salaries towards their retirement plans. From this perspective, if the plan has any merit at all, the merit must be founded on the assumption that citizens do not know what is best for themselves (the assumption of *myopia*) or the assumption of *moral hazard*, namely that some citizens overconsume before their retirement, intending to take a free ride on public money to bail them out after they have retired. As we will see, even if the myopia and the moral hazard assumptions are valid, the MPPF is not necessarily the best option.

Abel (1986) has demonstrated the welfare enhancing property of "Fully Funded Social Security." With compulsory participation, fully funded social security overcomes the problem of "adverse selection." Adverse selection is the phenomenon of private, voluntary, insurance plans attracting "bad risks." Compulsory participation, through diluting the risks to the average level of those of the population, allows the rate of return to become higher than that on