COMMENT TO
"DISAPPOINTING PERFORMANCE OF PENSION PRIVATIZATION IN EASTERN EUROPE"
BY NIKOLA ALTIPARMAKOV

*Lukas Reiss**

1 Introduction

In his very interesting and well written paper, Nikola Altiparmakov discusses a hot topic with several crisis-related aspects: the rising concerns about the viability of both private and public pension systems. While many private schemes have suffered under the stock market crash of 2008 and/or the current low interest rate environment, adjustment needs for public pension systems have arisen as a result of increases in trend unemployment rates and downward revisions of potential output estimates (on top of the implications from the ageing of societies).

Figures 1 and 2 show the gross replacement rates of public and private mandatory pension systems according to the OECD pension model (OECD, 2013). The figures indicate that mandatory[1] private pension schemes/second pillars are in place in many (but certainly not all) European OECD economies.

Interestingly, mandatory second pillars are to be found in two very different types of European countries, namely several economies from Northern and Western Europe with very high incomes and transformation economies from Central and Southeastern Europe.[2] However, the author points out that most of these transition economies "carved out" (gutted) "Bismarck-style" public pension systems by decreasing contribution rates to public systems (and introducing/increasing conributions to private systems), while countries like Denmark introduced a second pillar on top of a public "Beveridge-style" system ("add-on approach").

In the following I will try to complement the conceptual comparison of public and private systems (Section 2), and I will also discuss the authors' empirical work on pension funds' yields (Section 3.1) and the growth effects of having/introducing private systems (Section 3.2).

2 Comparison between mandatory second pillars and public pension systems

A substantial part of the paper is dedicated to the comparison of mandatory second pillars and public pension systems.

2.1 Public pension liabilities are not like explicit government debt, …

When contrasting public pension liabilities with explicit government debt (like bonds), one has to bear in mind that government balance sheets are quite different from corporate ones. While

* Oesterreichische Nationalbank (Economic Analysis Division) – Vienna, Austria. E-mail: Lukas.Reiss@oenb.at

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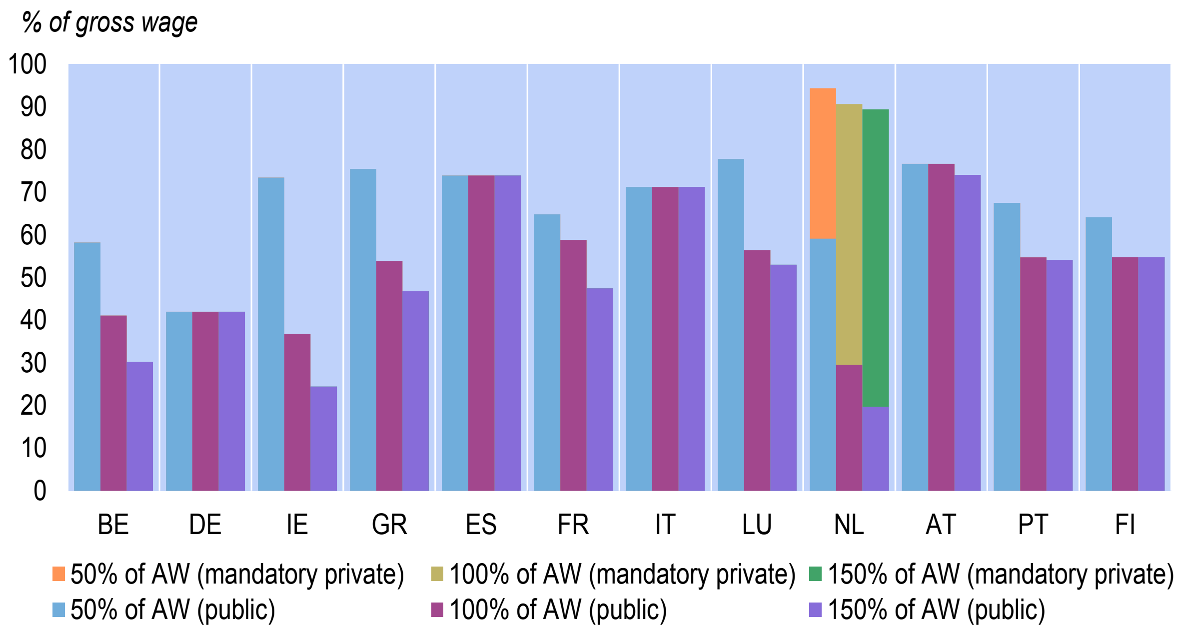
1 Several further European countries have voluntary second pillars (e.g., the UK); they are not further discussed in this paper.

2 Note that most European transformation economies which are not OECD members do have mandatory second pillars as well (e.g., the other countries mentioned in the paper, *i.e.*, Latvia, Bulgaria, Croatia, Lithuania, Macedonia und Romania) and that Hungary abolished its second pillar only relatively recently.

Figure 1

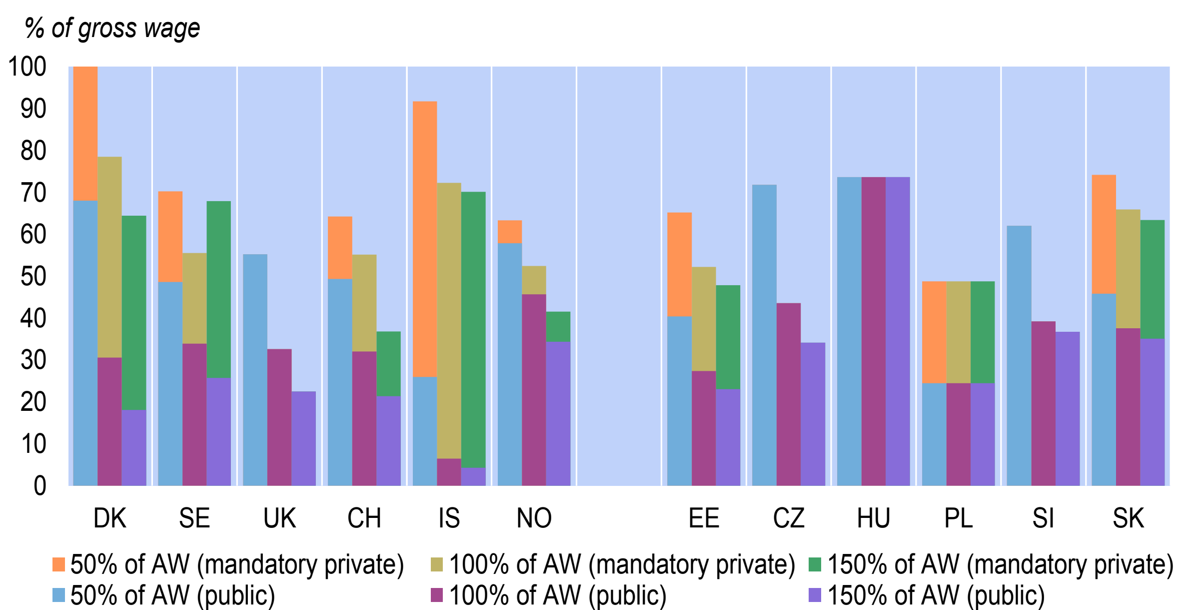
Pension Gross Replacement Rates in OECD Pension Model: EA-12



Source: OECD (2013).

Figure 2

Pension Gross Replacement Rates: Rest of (OECD) Europe



Source: OECD (2013).

implicit assets and liabilities may play some role for certain corporations (e.g., value of brands), they typically add up to immensely large amounts (typically exceeding explicit assets and liabilities by far) in government accounts. This is because of the right to tax reflected on the asset side and due to the vast amount of promises which governments give to their citizens (especially on the basis of entitlement spending legislation).

Theoretically, both high explicit debt and high "pension liabilities" (*i.e.*, high implicit debt) can be sustainable as long as tax revenue is high enough and the government/the system does not have to be shut down. However, there are several arguments why implicit debt may be less problematic from a government's viewpoint:

- Public pension liabilities typically cannot be withdrawn or traded (by "creditors"). Therefore, in contrast to explicit debt instruments, they are unlikely to cause situations with multiple equilibria where the perception of a higher default risk raises interest rates on explicit debt and therefore makes a default more likely.
- While explicit government debt instruments are mostly nominal and do generally not adjust to changes in real variables, pension liabilities adjust automatically to some extent (due to formulas for retirement age, indexation of pension payments and/or contributions to wage developments).
- Public pension liabilities are de facto "junior" to explicit government debt. While defaults on the latter have been rare in advanced economies after World War 2, there have been countless government "defaults" on pension liabilities over this time span. This includes not only major reforms, but also measures like (small) deviations from indexation formulas. While the latter may be considered as a standard consolidation measure in times of fiscal stress, "equivalent" measures on government bonds like a slight reduction of principal and/or coupons during a recession would be considered as a default.

2.2 … hence 2nd pillars investing in government bonds do not necessarily qualify as "disguised PAYG"

However, and this is one small point of disagreement with the author, this implies that the phenomenon of pension funds heavily investing in government bonds is not necessarily "disguised PAYG" as government bonds are typically nominal and tend to be "senior" to PAYG pensions. In theory, PAYG pension liabilities could be made equally "senior",[3] but this is usually hampered by lack of trust by citizens and/or lack of (legally possible) commitment by governments.

In general, there are good reasons for such a lack of trust, especially so for younger generations: While sustained deteriorations in the present value of net pension liabilities are often not immediately reflected in measures on pension systems, fiscal space is occasionally used to give goodies to the elderly (like temporary early retirement schemes, extended by Austria in 2008 or introduced by Germany in 2013). Therefore, in a world of imperfect commitment it may make sense that pension funds invest into domestic government bonds.

2.3 Low trust in government and insurance against shocks to public finances are arguments for 2nd pillars (especially in emerging economies) ….

Arguments in favour of a mandatory second pillar are somewhat stronger for small emerging economies like the countries covered in this paper. At least according to a Gallup survey in 2011, trust in government (both absolute and relative to the financial sector) in the EU transition

[3] The underlying indexation in PAYG systems to price and/or wage developments may be considered as an advantage of PAYG anyway.

economies tends to be lower than in the rest of the EU. Furthermore, at least from the perspective of its citizens, there are good reasons to make returns to the pension system not only related to potentially volatile domestic economic developments.[4] Most EU transition economies are relatively small, and several of them have witnessed a long pre-crisis boom followed by a prolonged recession since 2008/09. Foreign investments of pension funds could reduce uncertainty concerning future returns to pension contributions.

2.4 … but arguments for public systems are still compelling[5]

Notwithstanding these arguments, there many good reasons not to gut "Bismarck-style" pension systems:

- The adjustment cost from gutting the public pension system (*i.e.*, the shortfall in government revenue) is simply massive. The potential benefits of second pillars can be easily outweighed by the increased vulnerability due to higher explicit public debt.
- If management fees and contribution fees are as high as in several of the countries analysed by the author, the efficiency loss compared to a public system is very large.[6]
- If there are so many requirements for the design of pension insurance plans (sufficient insurance against longevity, relatively high return with low administration cost, inflation-protection …), the government may just provide it itself.

3 Some further minor comments

3.1 The choice of benchmark for yields of pension funds (in transition economies) is tricky

The analysis of yields is one of the most interesting parts of this paper. Both the differences to other institutions' estimates and the poor performance of funds in some countries are striking. However, the author may set a somewhat too ambitious benchmark for these funds by comparing their yields to domestic GDP growth. While the latter may be seen as an appropriate target in a closed economy or a high-income country, due to the reasons stated in Section 2.3 these funds may (or should) invest abroad; and (pre-crisis) GDP growth in the advanced economies was lower than in the analysed countries.

3.2 Direction of causuality is a big issue when assessing the implications of pension reforms for GDP growth

The author also provides an analysis on the macroeconomic effects of changes to private pension systems (*i.e.*, introduction, changes in contribution rates) and finds no positive effects on GDP growth. However, the interpretation of coefficients is hampered by the fact that several of the included variables are likely to influence each other. This is not only an issue for the control variables: While one would have to assess in detail how big a role short-term growth considerations played in introducing mandatory second pillars, such considerations definitely contributed to the (partial) reversion of these second pillars after the beginning of the crisis.

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[4] In theory, these investments into foreign assets could be also carried out by governments (like the sovereign wealth funds of certain oil exporting countries).

[5] Note that neither Serbia (country of author) nor Austria (country of discussant) has a mandatory second pillar.

[6] In any case, strict regulation of fees may be needed as fixed costs of running a fund and the large importance of reputation hamper free entry of pension funds.

REFERENCES

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