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PRIVATE OR PUBLIC PENSION INSURANCE?

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ABSTRACT

The most recent trends in population dynamics and increased longevity risk have provoked a rigorous debate whether the private or the public pension insurance system should be predominant. The public pension insurance is dominated by the state that guarantees its stability, but is often compared to a pyramid or a Ponzi scheme. The private pension insurance provides personal retirement accounts and proper ownership of the accumulated funds, but its sustainability during prolonged market crises and inadequate risk sharing are often questioned. In order to address the issue, this study analyzes and compares a large set of arguments and popular opinions in favour and against both pension models. As a result of the study, a conclusion is drawn stating that both types of pension insurance, despite of their positive and negative features have their essential role nowadays. This study is part of a growing set of articles on the feasibility of using a proper combination of the two pension models and will contribute to future research on the topic and might benefit policymakers in taking an appropriate decision.

JEL CLASSIFICATION & KEYWORDS

■ G20 ■ G28 ■ PUBLIC PENSION INSURANCE ■ PRIVATE PENSION INSURANCE

INTRODUCTION

Though it exists for more than a century, private pension insurance could not match the growth rate and scale of public pension insurance. A great variety and different participation rates of public and private sector are observed in the other domains of the insurance system. We can take health insurance as an example as it plays a major role in the USA and some other countries. Private investments flow into different sectors of the financial system at various rates having a leading role in some of them. This is valid for banking and insurance in the most of the economically developed countries around the world. Private investors are entering the market in the former “communist” states in Central and Eastern Europe at a fast pace as well. Only in the pension insurance sector, the leading role of the state is preserved almost anywhere in the world. The following interrelated questions come out in a logical manner: What is the root cause of this phenomenon and should this be the single or predominant type of pension insurance? If the above is true, is it necessary at all to develop the private pension system and is it beneficial for improving the effectiveness of social insurance? We will look for the answers of these questions examining the statements of some of the leading authorities working on the topic of social insurance.

In the specialized literature the opinions for private and public pension insurance are highly diverse and often polarized. They gravitate, on one side, to the full suspension of either public or private pension insurance, i.e. the development of only of the two, and on the other, to a balanced combination in the development of both types of pension insurance. Most experts defend the idea for the priority development of either one of the two types, looking for more arguments to justify their own preferences for the respective way of development of the pension insurance.

We can differentiate between several groups of authors. The first one comprises those who embrace the principle of solidarity in the organization and management and direct institutional participation of the state in pension insurance. Created along these patterns the system operates on a pay-as-you go basis. From technical point of view, it assumes that pensions paid to current pensioners that as a rule had already left the labour market are financed from contributions paid by current workers. There are only minimal or no reserves that are set aside in such a system. Major proponents of the idea for pension system fully organized and controlled by the state are Greg Anrig and Bernard Wasow (2004).

The second group of authors comprises those who defend the development of private pension insurance and deny both direct institutional participation and the principle of solidarity in the organization and management of the system. They accept only the fully funded type of pension system. From technical point of view, this principle assumes accumulation of funds financed out of the contributions that pensioners themselves made when they were working and capital income from the investment of these funds. This can be applied toward either a shorter or the whole period of the active working lifespan. The funds of every insured employee are separated in individual personal accounts. Thus, every person in any specific moment knows the accumulated amount in the account and the sum (pension) that can be received if it is decided to leave the system. In general, private companies take care for the management of these funds. The state can also be in charge of such activities, though, it is atypical for a country to deal with private investment management of pension funds. The management of the pension funds can be conducted at different levels, by various financial institutions fully or mostly privately-owned. This system is known as fully funded pension system. The main representatives of the group that supports only the private pension insurance include Jose Pinera (1996), Carlo Stagnaro (2004), and Georgi Angelov, Martin Dimitrov and Dimitar Chobanov (2006).

The predominating part of the authors proposes different combinations between public and private pension insurance, looking for the most effective way to manage the system. The most populous is the group of authors that favors the priority development of the state pension insurance over the private one. Among the other group, that favors the private pension system, are the names of Karl Borden (1995), Pavel Kohout (2005), Estelle James (2005) and others.

In the following paragraphs, I will outline the main arguments stated by proponents of the private pension insurance and comment on them.

Firstly, the principle of state financing of social security is challenged and perceived as incorrect. On the other hand, the principle of private financing of social security is considered completely fair.

The authors accept that the pay-as-you-go system functions as a pyramid, with the state being at the top of it. The revenue generated from social security contributions presents state obligation to the current employees. The state does not always recognize these obligations in their full size.

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We can look for arguments supporting the above statement in the functioning mechanism that the government uses to manage its accounts. According to this mechanism, some portion of these obligations remains unsecured and therefore there is no guarantee that in the future they will be repaid. There have been drawn parallels between state social security and a Ponzi scheme. In a Ponzi scheme, the early investors are paid greater returns using the money of subsequent investors, who receive less or nothing at all. The subsequent investors remain largely unsecured because there is limited number of new investors to cover for their obligations before the system collapses. This collapse happens because there is no real growth involved. The illusion of growth increases in the begging along with the number of entering investors, but decreases when the count of new investors dwindles. This scheme is completely illegal and forbidden by the national legislations in over 60 countries.

Are the abovementioned shortcomings of the state unfunded pay-as-you-go system surmountable? According to the authors that perceive the principle of state financing of the system these shortcomings cannot be avoided in the long-run. They consider that only some changes made in the pension benefits, pension contributions, and retirement age will have a positive, but short-term effect. In the long run the system is predetermined to fail, mainly because the construction of the state pension system is built on an unsustainable basis.

Despite of the abundance of such statements almost any country in the world possessing developed social security system continue to maintain its state funded pensions and in several countries these are the only existing pensions. Why? The answer to this question can be sought in the coexistence of the following three facts:

a. The system can be kept solvent with minor corrections in the minimum retirement age and thus in the time period when the funds will be used. Such correction can be done either at the entry of the system by an increase in the monetary contributions or at the exit mainly through withholding or decreasing pension payments, generating long-term sustainability. The proof of this is the adoption of such by almost all countries that face a severe demographic crisis. They are implementing the corrections cited above in order mitigate the consequences of such demographic crisis. The hypothesis that the population ageing will follow an everlasting upward trend is implausible. Approving this or similar hypothesis means that we are accepting the fact that in a moment of time the whole population of a given country will disappear, which is really preposterous.
b. Whenever there are some urgent payments, while the system is underfunded, they can be temporarily subsidized by the state. This measure can also be applied permanently if regular transfers are made from the government budget to the budget of the social security system. More specifically, the pensioners can participate in financing their own pensions through taxes. This occurred, for instance, in Bulgaria, but is a regular practice in many other countries as well.
c. The pay-as-you-go system is much less affected by unfavorable downturns in financial and credit system. In the context of a crisis, almost every time workers, who their money into the private pension system, lose unexpectedly part of their savings, because for almost all of them the crisis itself begins “almost unexpectedly”. We can easily prove that by taking a look at any country that is experiencing the negative effects of the current financial and economic crisis.

Secondly, it is atypical for the government to form and manage a genuine trust fund

There are some serious grounds to take this statement as substantial and trustworthy. The role of the state in the context of market economics is actually limited regarding the management of genuine trust funds.

Private institutions are those that deal with management of trust funds. When the economy is rising, financial markets are able to add considerable growth to the portfolio for a certain degree of risk. But what happens when a crisis comes, stock prices fall down and all the employees that make regular contributions to the private pension institutions see a substantial decrease in the value of their pension saving assets. In most cases, all these private institutions start looking for the government to bail them out. If the crisis is an exception that can be otherwise avoided, we should accept the arguments of those who defend only the existence and development of the private pension insurance. They, though, have put on their pink glasses and see a glamorous future for the economic system. This has naturally given them the basis to formulate one more conclusion defending their stance on developing only the private pension insurance.

Thirdly, the rate of return on employees’ savings will increase, therefore the accumulated amounts in their individuals accounts will increase as well.

It is considered that while the employees receive an annual return of less than 1% from the traditional social security system (the public one), they will receive a return between 8 and 10% from the private pension insurance if their funds were invested on the stock exchanges in the USA. Approximately similar value of average annualized yield of 8.5% is suggested by another author.

The given rates of return are to a certain degree incorrect and misleading due to several reasons, amongst the most important are:

a. The estimates are based on an improper assessment of the investment risk for the investors in the private pension funds. There is no serious investment risk involved in the state social security risk as investments, if any, are quite limited and short-term, i.e. all else equal they bear considerable less amount of risk. Moreover, the investment risk in this is case will be dispersed between the society as a whole, rather than solely between the members of a given pension plan.
b. The investors in private pension schemes will not have the ability to fully benefit from the increased rate of return on their pension assets. This is evident, because both a part of their initial contribution and a part of the positive realized return will be deducted as remuneration for the company managing the plan. The total rate of return for the participants of the plan will thus equal the average of their individual accounts and the collective account.
c. The rate of return from the state pension security system, in countries where it does accumulate funds is not so low, though, most state pension systems around the world function as purely pay-as-you-go schemes and do not accumulate funds. According to Gary Burtless (1999) the expected average rate of return for the public social security system in the US will be about 1 – 1.5% no matter whether an increase in taxes or a decrease in benefits for the pensioners will be necessary to restore the solvency of the system over the long term.

Fourthly, national savings and future economic growth will be stimulated. We can find proofs for that in the facts summarized by the father of the Chilean pension model – Jose Pinera (1996). According to the economist Klaus Schmidt-Hebbel (1998) "the growth rate of the Chilean economy increased from 3.7% annually in the period between 1961 and 1974 to 7.1% annually in the period between 1990 and 1997, out of these addition 3.4% annual growth about 0.9% can be attributed to the pension reform in the country, or more than a quarter of the total growth". He also argues that "the reform has contributed for 3.8% percentage points from the total growth of 12.2 percentage points in the savings during this period, or 31% of the total growth".

Even if all the assumptions are correct and the calculations precise, the increase in the national saving will be observed when the national economy is in its growth phase. What if the economy is in crisis and recession? Will the increased amount of savings will lead to a faster way out of the crises. The answer to these questions is negative, because both theory and practice have unarguable proven that the increase in savings have not always led to an increase of the investments in the economy.

Fifthly, there are political benefits in practice compared to the reforms in the existing public programmes that depend on an increase in taxes or greater accumulation of public pension reserves.

In a 2004 article, Margo Thorning and Pinar Cebi from the International Council for Capital Formation pointed out that when the population is ageing, the political influence of the people in retirement age increases and impedes any change in the rules of the game – even provided that the pensioners will be immunized against any reform.

This conclusion is absolutely correct. The question which system is more suitable, in the context of ageing population, still remains open. If we assume that this is the private (fully funded) system, we must prove that, it is the more sustainable and independent system given the constant increase in the average life expectancy and ageing population. If we assume that this is the public (unfunded, pay-as-you-go) system, we must prove that it is more sustainable given the decreasing number of real investors pouring funds into the system – the people in working age.

The private system distributes to all its possessions to its contributors. Benefits are distributed proportionately to what a person has deposited over the course of the years of employment and has been accumulated in the retirement savings account. Following the increase in life expectancy, payments from the private pension system are expected to decrease with a certain proportion. This can generate social tension, provided no other alternative sources to maintain the purchasing power of the present and future beneficiaries of the pension system are sought after.

The ageing population negatively impacts the revenue of the state pension system, basically because the number of people expected to provide contributions for the system (the investors) is decreasing. In order to maintain the sustainability of the system it will be necessary to either increase to contributions, or to decrease the benefits (the payments) from the system or to increase the retirement age. Another opportunity is a viable combination of these three options to successfully reform the system.

It becomes clear that in both cases the system might remain solvent only if there is an intervention leading to an increase to the available pool of funds necessary to pay out the current amount of benefits.

The main conclusions that can be drawn from the comparison between the public and the private pension insurance are:

Firstly, both types of pension insurance are built upon and function along different underlying principles. The opponents of any of the two types of pension insurance criticize the other type of organization and management of the pension system and defend the one that they support.

The opponents to the principle of solidarity that functions as a foundation of the state pension insurance system, tend to put solidarity against the interest and responsibility of the single individuals that make contributions to the system. They consider the state to be incapable and inefficient owner and manager, unable to properly manage and invest the funds that come from the contributions. This is why they regard this principle as incorrect.

The opponents of the principle of capital management of accumulated funds, on which the private pension system is based, deny the possibility for considerable accumulations in the private pension system and claim that major losses might be incurred whenever the economy falls into recession. At the end of the day, if private pension schemes become insolvent they will seek government support to bail them out.

Secondly, it cannot be accepted that the two approaches are typical for two entirely different models for managing the entire economy. It is true that in the context of centrally planned and managed economy there is exclusively state pension insurance, but it is also true that in various countries having developed market economy public pension insurance exists as well, being the more dominant form of pension insurance. The countries in which the private pension system was developed at a later stage (Latin-American and post-communist states) have their economies managed in a similar manner as the rest of the countries (USA and the economically developed Western European states). Therefore, the social security system, including the pension system, is not affected by the type of institutions that establish it – public or private or whether their ultimate goal is to realize a profit or not from this activity. In a similar way we can think of the matter for financing the entire social security system. It should not be affected by the type of the institution that organized and manages the insurance process.

Conclusion

The main conclusion is that there is enough room for both types of pension insurance with each of them having its positive and negative features. Thus, neither one of them should be overestimated nor the other one underestimated. Only the symbiosis between them would let the pension system be organized and managed effectively.

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