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**Article**

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## RIESTER PENSIONS

PETER DIAMOND\*

While Hans-Werner Sinn has written extensively on pensions, I focus on a single, valuable contribution: ‘Why a Funded Pension System Is Needed and Why It Is Not Needed’, (*International Tax and Public Finance* 7, 389-410, 2000). The abstract includes: “based on explicit present value calculations, the paper criticizes the view that the PAYGO system wastes economic resources. In present value terms, there is nothing to be gained from a transition to a funded system even though the latter offers a permanently higher rate of return. ... Nevertheless a partial transition to a funded system may be a way to overcome the current demographic crisis ...”

The paper explains that many time series of contributions can pay for a given future benefit stream by having a present discounted value (PDV) equal to the PDV of benefits. By collecting more contributions earlier (and so less later), a system acquires funding. As benefits to earlier cohorts were greater than could have been financed by their own contributions, later cohorts receive benefits below what could be financed by their contributions. Sinn concludes that a higher rate of return on assets than on contributions comes from a distributional choice, not an inefficiency in PAYG.

Sinn considers partial funding as part of responding to the unsustainability of a pension system. That is, he thinks it distributionally worthwhile to collect contributions above the level that will just maintain PAYG from large cohorts who are having fewer children (to educate) per capita than their parents. In his words: “in the presence of the demographic crisis, burden smoothing implies partial funding: where human capital is lacking, and to the extent that it is, real capital could be used to fill the gap”.

\* The 2010 Nobel Laureate in Economics and Institute Professor Emeritus at MIT.

Sinn discusses risk when pension funding includes equities: “if the economy’s price of risk taking is appropriately taken into account, the mere fact that stocks have a higher [expected] rate of return than bonds does not imply that an increase in investment [in stocks] would be a welfare improvement”. Key is how well different designs for individual accounts can address the risks in individual portfolios. Two issues are the administrative costs of buying and holding stocks and the quality of the individual portfolios in terms of bearing risks.

I consider three methods of organizing defined contribution accounts. One is to let the private market provide the investment opportunities, subject to rules that apply to investment generally and some specific rules for this type of account. The German Riester pensions and the US IRA markets work in this way. Second is to allow only specialized firms subject to tight regulation, as pioneered by Chile and followed in several Latin American countries. And third is having a government provider offering limited portfolio choice.

Reliance on a wide variety of private providers is expensive and faces individuals with portfolio choices that many are ill-equipped to evaluate well. The importance of fees is often overlooked. Under plausible assumptions, over a 40-year working life, an annual administrative charge of 1 percent of a person’s pension accumulation will reduce the total accumulation by nearly 20 percent. It is estimated that Riester pensions cost 12 percent of lifetime contributions on average, but with huge variation and a lack of transparency. The high cost of IRA management in the United States has been recognized, but not seriously addressed.

A second issue is the financial sophistication needed to optimize portfolio choices over a lifetime, a sophistication widely missing in the general public. Compounding this problem are conflicts of interest for financial advisers and inadequate information provision. The Chilean use of a highly restricted range of alternative portfolios and tightly regulated competition between providers has held costs down and pro-

vided reasonable portfolios. But, higher costs in other countries with a similar approach show the importance of successful implementation. The design does greatly reduce reliance on the financial sophistication of savers.

Historically, provident funds – a single fund run by the government – did poorly in less developed countries, showing the sensitivity of results to the quality of governance. Bolivia uses the Chilean approach but without worker choice of provider. This has resulted in low costs but dissatisfaction with the quality of services. The Swedish Premium Pension has centralized administration which lowers costs while allowing very wide choice of mutual funds. Importantly, there is a government-run default which has low costs and a well-designed lifecycle portfolio and attracts over 98 percent of new entrants. The pension system for US federal government employees (the Thrift Savings Plan, TSP) has limited choices for individuals, very low costs and limited reliance on worker financial sophistication. While TSP covers over 3 million workers, a system for an entire country would have higher costs, but is likely to be considerably cheaper than reliance on a broad market.

Paying attention to costs and quality of actual portfolios is central for designing a system well. Key is the quality of implementation, including repeated thoughtful modifications of rules in response to poor outcomes, as has been done in Chile. Government competition with private providers, as in Sweden and in prospect in Chile, also appears useful. Riester pensions could readily be made much better for workers.