

# PENSION SAVING: FISCAL & INVESTMENT ILLUSIONS & LIES

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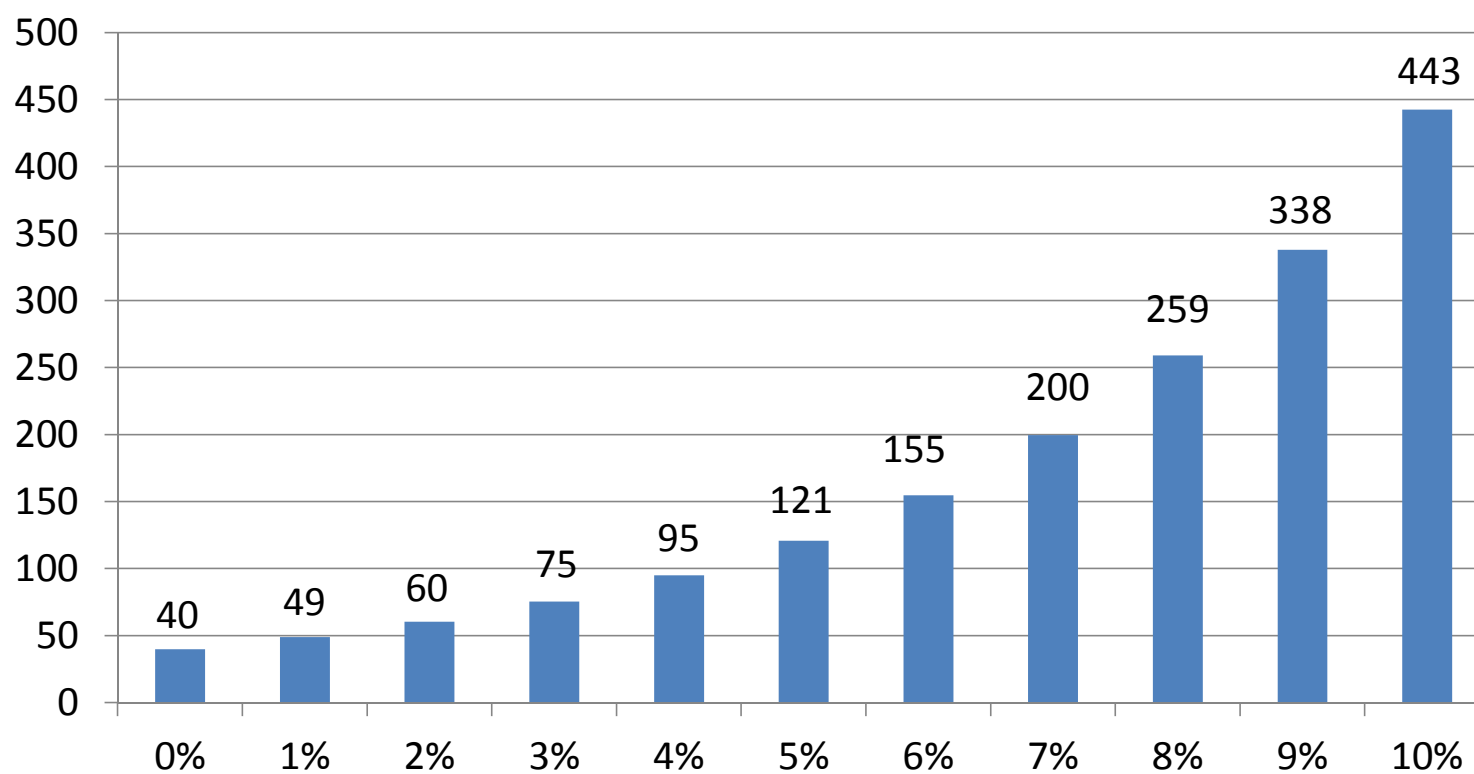
# Pension savings illusions and lies

- **Investment illusions**
  - New pension orthodoxy
  - Compound interest miracle
- **Investment lies**
  - Future investment returns
- **Fiscal illusions**
  - Lower contributions (higher pensions)
- **Fiscal lies**
  - Transition costs financing: VAT
  - Demographic costs

# New Pension Orthodoxy: Myths → NDC

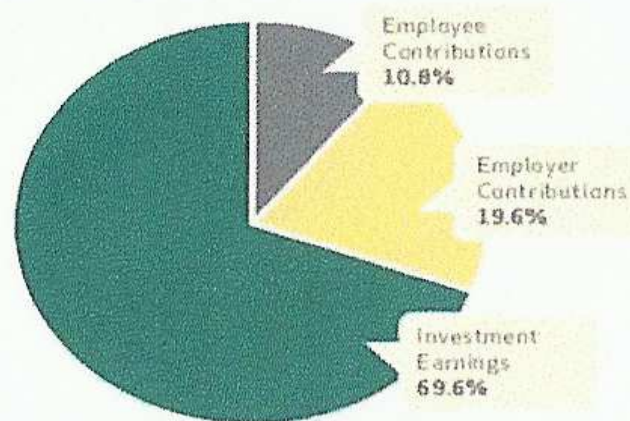
- **World Bank 1994: Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth**
  - Pushing through a full privatization of the public insurance schemes in post-Communist countries (2<sup>nd</sup> pillar: mandatory private savings)
  - 1999: “10 myths”
- **World Bank 2006: Pension Reform: Issues and Prospects for Non-Financial Defined Contribution (NDC) Schemes (eds.: Holzmann, Palmer)**
- **World Bank 2012: Nonfinancial Defined Contribution Pension Schemes in a Changing Pension World (eds.: Holzmann, Palmer, Robalino)**
  - Pan-European Pension System: NDC (core)
    - Wings: solidarity pillar, voluntary private pillar

# Compound interest miracle (40 periods)



## Aggregate Contributions by Source, 1993-2006

# Financing of State and Local Pension Plans



Aggregate Contributions by Source,  
1993-2006



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# Investment lies

- **Neo-liberals lie about the effectiveness of public and mandatory private pensions**
  - High investment returns cause higher private (than public) pensions
  - (Semi)mandatory private pensions save public expenditures in the long run
- **Full costs of the (semi)mandatory schemes are much higher than the direct administrative costs of pension funds**
  - OECD: average for 8 countries for 25 years before 2007, balanced portfolio, in real terms
    - Gross investment return **7.3%**
    - Net investment return: **5%**
    - Return used in pension models: **3%**
- **Negligible costs of public insurance schemes**



## Es. Cost of pension funds vs Life Insurers (Research of the Dutch Central Bank)

|                      | Life insurers     |             | Pension funds     |             |
|----------------------|-------------------|-------------|-------------------|-------------|
|                      | % of contribution | % of assets | % of contribution | % of assets |
| Administrative costs | 12,9              | 1,27        | 4,4               | 0,15        |
| Profit               | 11,0              | 1,08        | -                 | -           |
| Total                | 23,9              | 2,35        | 4,4               | 0,15        |

AEIP

# Rescaled rate of return and replacement rate (OECD, 2009)

Table 3. Distribution of simulated future investment returns: balanced portfolio

|                    | Percentile of distribution |      |      |      |      |      |       |       |       |
|--------------------|----------------------------|------|------|------|------|------|-------|-------|-------|
|                    | 10                         | 20   | 30   | 40   | 50   | 60   | 70    | 80    | 90    |
| <b>Market data</b> |                            |      |      |      |      |      |       |       |       |
| Rate of return     | 5.5                        | 6.1  | 6.6  | 7.0  | 7.3  | 7.7  | 8.0   | 8.5   | 9.0   |
| Replacement rate   | 54.8                       | 63.7 | 72.3 | 80.2 | 86.9 | 96.7 | 104.9 | 120.4 | 138.6 |
| <b>Rescaled</b>    |                            |      |      |      |      |      |       |       |       |
| Rate of return     | 3.2                        | 3.8  | 4.3  | 4.7  | 5.0  | 5.4  | 5.7   | 6.2   | 6.7   |
| Replacement rate   | 32.2                       | 36.8 | 41.2 | 45.2 | 48.6 | 53.5 | 57.6  | 65.3  | 74.2  |

Note: Based on unisex mortality rates of the OECD average projected for 2040. Assumes a contribution of 10% of earnings over a 40-year term. Balanced portfolio is invested 50% in equities and 50% in bonds.

Source: OECD pension models and OECD analysis of Datastream information.



# Future investment yields?

- **Long term decrease of rates of return (inflation adjusted)**
  - Before the crisis
  - Future expectations
- **OECD pension models (private schemes)**
  - Till 2012: 3 or 3.5%
  - 2013/2014: 1%
    - Sensitivity analyses: 0%, 2%
- **Aaron rule**
  - Return on pension savings
  - Growth of wages

# Great pension lie: large pension reform is necessary due to demographic reasons

- **Misusing dependency ratio of seniors (relation of number of people 65+ and number of people 20-64 years)**
  - „Replacement ratio could fall by up to 50% over the period of 30 to 40 years“
- **Correct indicator: relation of people drawing on old-age pensions and people paying contributions**
- **Small pension reform solved basically this problem on a long-term basis: only demographic waves remain**
  - **Correct indicator:**
    - 2:1 in 2012
    - 1.63:1 in 2050
    - 2.2:1 in 2100
  - **Demographic loss 2012-2060: equivalent to 0.5% loss in real investment return**

# Public funded system?

- **Low public pension overhead costs**
  - 1% of contributions = **0.05%** of assets
  - Kotlikoff: zero costs
- **High private pension overhead costs – incl. annuity provision**
  - 40% of contributions = **2%** of assets
- **OECD investment yields for corresponding public funded schemes (?!)**
  - **1% + 1.95% = 2.95%**

# Fiscal illusion: pension „deficits“

- **Deficit of „pension account“ increases substantially every year → large pension reform is necessary**
  - No law regulates this „pension account“ (balance of pension expenditure and pension insurance premiums)
  - Declines in public revenues result from adverse economic development: responsibility of government
- **Czech public pensions are pure public expenditure programmes, pension insurance premiums are current budget receipts**
  - Solidarity elements of the public pillar should be financed from taxes, not from insurance premiums

# Fiscal illusions and lies

**„Full“ pension: net replacement rate ca. 40%**

- **Necessary contributions (% of wages):**
  - NDC social insurance **16%**
  - FDC private saving/insurance **12%**
  - FDC social insurance **8%**
- **Transition costs are to be added to**
  - FDC private saving/insurance
  - FDC social insurance
- **Transition costs: VAT financing?**

# Conclusions

- **Privatization of public pension schemes: investment and fiscal illusions and lies**
- **Demographic loss in Czechia: 0.5% of assets**
- **Public funded systems might be efficient in the future**
  - **2.95% - 0.5% = 2.45%**
  - **Transition costs to be deducted!**

Thank you for your attention!

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