

A Matter of Trust: Understanding Worldwide Public Pension Conversions

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The restructuring of public pension systems is one of the most far-reaching shifts in fiscal policy in the past two decades. At least 27 countries spanning five continents have converted at least part of their pay-as-you-go defined-benefit public pension systems to systems based on funded, defined-contribution accounts; and reforms appear imminent in several more countries.

While pension fund conversions from defined benefit to defined contribution plans in the private sector have been largely motivated by labor market mobility, this explanation does not hold for public pension systems since they are already portable across employers. In fact, the public plan conversions seem fairly puzzling at first. In a deterministic setting, the traditional public DB pension systems could, in theory, be designed to be as efficient as the newer DC plans. In the presence of economic and demographic uncertainty, however, traditional plans more easily allow for inter-generational risk sharing. Financial literacy, moral hazard and adverse selection seem only to buttress the case for the traditional design.

So why have so many countries moved, or are in the process of moving, away from unfunded DB plans toward at least partially funded DC plans? Adding to the puzzle is the fact that developing countries have typically embraced the most aggressive program changes, despite their facing less severe demographic pressures.

This study develops a model of “intergenerational trust” that helps to explain these worldwide trends. A central theme is that public pension conversions reflect a fundamental mistrust in the ability of the government to provide secure retirement resources. The exact nature of the distrust, though, differs systematically between developing and developed countries.

In developing countries, where reforms have been the largest, the distrust in the government provision of public pensions is conditioned on previous downward movements in benefits, misuse of retirement resources, and other risks and inequities in the former public pension systems as well as projections for the future. In particular, workers in many developing countries don’t trust the government to run even a strict pay-as-you-go system.

In developed countries, on the other hand, where reforms have been smaller, previous downward benefit adjustments and inequities have been less important. Instead, the primary objective in many developed countries is to pre-fund future benefits since many of these countries face more severe demographic problems. However, the government is not fully trusted to properly save or invest the resources that are needed to pre-fund some future benefits. So, in developed countries, the creation of personal accounts is a byproduct of attempts to increase funding.

The paper includes both theoretical and empirical components, building on a simple model of pension system trust. A pay-as-you-go social security system is an inter-generational struggle between median voters of successive generations. The median voter of each generation is “middle aged” and not yet retired. The median voter supports the continuation of the traditional system only if he believes that the next generation will do likewise – a so-called “trigger strategy.” Factors that undermine this trust will naturally lead to an unraveling of the traditional pension system, and pressures for reform.

The empirical work confirms how greater historic instability within a country is a statistically significant predictor of reform. For example, based on several estimation methods, we find that a change of one unit in the index of historic instability increases the chance of reform by as much as an increase of 1.25 to 1.5 percentage points of the population that will be above 65 in the year 2025.

The full working paper is available on our website www.nber.org/programs/ag/rrc/books&papers.html as paper NB08-15.

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