

Discussion of Orszag-Stiglitz paper for World Bank conference: New Ideas about Old Age Security - The transparency myth

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First, I agree with the paper on all 10 myths – the economic and political advantages of defined contribution individual accounts have been exaggerated. I agree one should compare politically plausible, well-designed DB and DC systems (as well as no economy-wide earnings-related system), where politically plausible varies across countries for both DB and DC systems. But one should not compare a well-designed system of one kind with a poorly designed system of the other. That sort of comparison may be the stuff of polemics, but does not belong in good policy analysis.

The politics of DB systems varies across countries and many countries have been less successful in good design than has the US. But DB systems can be improved and some of the worst features occur at the start of a system and are of little or no relevance to the question of reform. The politics of DC systems also varies across countries and the quality of design has already been worse in some countries than in Chile. Additional countries and future developments are likely to show more problems.

I want to use the time available to discuss an 11th myth – that DC systems are more transparent than DB systems and therefore more democratic. There are issues in pension design where alternative institutions do differ primarily in transparency – the extent to which information is made available and salient. However, in contrasting DB and DC systems it seems to me that the right vocabulary is that of framing, not of transparency. As we know from cognitive psychology, particularly the work of Kahneman and Tversky, framing has a very powerful effect on thought. It is not surprising that it also has powerful effects on political outcomes. Thus, DB and DC systems vary in the focus of what is transparent, not in the presence or absence of transparency.

DC systems make the financing of benefits particularly salient. This includes making redistribution particularly salient. However, DC systems make opaque the outcomes, measured by benefit levels relative to some measure of needs (replacement rates, measured in some way). Benefits depend on the returns on assets (which are stochastic and with the right stochastic process in dispute) and on the pricing of annuities (which is also stochastic and also subject to dispute about mortality trends as well as future rates of return). But, it is not just that individuals find it hard to tell what benefits they will receive conditional on future earnings. Also, the pattern of outcomes across different individuals is opaque. And citizens care about the pattern of incomes within a cohort.

In contrast, DB systems make individual annual benefits and benefit patterns visible, conditional, of course, on future earnings. That is, a DB system makes clear the outcomes of the system in terms of what the retirement income system is trying to do – which is to replace lost earnings. (The presence of a DB retirement system may also affect the DI program; indeed it is difficult to integrate well a DB disability system with a DC retirement system.) While DB systems will be adjusted from time to time, so actual benefits are stochastic, that adjustment takes place in the context of the salience of the benefit pattern. But DB systems make the connection between individual financing and individual benefits opaque. (This also is why benefits are related to earnings subject to tax not to taxes paid, another design feature that affects outcomes.)

It is interesting that the contrast in outcomes between public DB and DC systems also occurs in corporate pension systems. Giving past-service credits to long-term employees was common when DB systems were being set up in the US. Giving analogous lump-sums to similarly placed employees when setting up DC systems has certainly been rare in the US – I have not heard of a single one, although my search has not been exhaustive.

This tension is not unique to the provision of pensions. Every government expenditure has a benefit side and a cost side. While both sides are relevant for policy, no one has found a magical governmental institution that gives just the right salience to the two sides. The earmarking of payroll tax revenues for pension benefits changes the visibility

of financing and the distribution of cost-bearing, and so changes political outcomes. For example, pension benefits for Union Army veterans in the US were financed by tariff revenues. So supporters of these pensions were big fans of protection. Most analysts believe that the government spends too much on some programs and too little on other programs, although analysts disagree about which programs are which. So the connection between government institutions (both political and administrative) and the evaluation of outcomes varies across analysts.

In democracies, salience affects outcomes. The real question is how much one expects to like the political outcomes that come from different institutions. So the question here is to evaluate the different patterns of redistribution, within and across cohorts, that come with different pension institutions. The common wisdom is that DC systems are likely to give more to future generations and unified DB systems are likely to give more to the poor within each cohort. If true (and the pattern may be more complex since DC pensions automatically cut benefits for longer-lived cohorts and DB systems may include some elements that primarily benefit the politically well-connected), which is more important? That will depend on how well any particular country will do the two types of redistribution under the two different institutions. And it will depend on values.

As an example of how pension design may affect outcomes, let me contrast a unified DB system with a mixed DB/DC system with roughly the same funding and the same overall redistribution to begin. If there is a decline in growth, then the underfunded DB benefits will need adjustment. Some of the adjustment may come from taxes. Let us focus on the adjustment that comes on the benefit side. If, for example, the mixed system is like the PSA proposal in the US – a flat DB benefit with a nonredistributive DC system, then the response is likely to be a phased-in cut in the flat DB benefit. That is, every member of a cohort will have the same absolute cut in benefits. It seems implausible that a unified system with the same financial problem would choose that outcome. Thus, a mixed system puts more of the risk of the pay-as-you-go financing on the poor. On the other hand, a mixed system may put more of the rate-of-return risk on high earners if the unified DB system adjusts benefits in proportion rather than concentrating benefit cuts on

high earners. Of course a DB system can spread rate-of-return risk over many cohorts, possibly making that risk less of a concern.

It is interesting to consider the analog for Medicare. As a DB system, Medicare is described as giving everyone the same health insurance policy, with financing coming from payroll tax and general revenues. What if we set up Medicare as a fully payroll tax financed DC system? We could describe it as follows. Everyone is forced to save for his or her retirement medical expenses. Then, there are transfers from high to low earners, from healthy to sick and from short-lived to long-lived, in order to give each person the amount needed to finance covered medical expenses. This description does not seem to be more transparent, just focused on different issues. It risks losing sight of the apparent purpose of the system, which is to provide everyone with the same health insurance. It might result in a different uniform policy and it might result in transfers that do not give everyone the same policy. It might result in more funding and less use of pay-as-you-go. Framing can matter.

So too, individual pension accounts hide how the system provides income relative to past earnings. There is a tradeoff – making some aspects more salient, makes others less salient. Maybe highlighting who pays for redistribution is the most important thing that can be done. It seems to me that highlighting who has how much relative to their past earnings is highlighting what the system is, in its own terms, trying to do. In the US, there are individual account proposals that eliminate all redistribution in the system, except that coming from uniform annuity pricing. It is not accidental that people who oppose redistribution favor individual accounts – it would be hard to be taken seriously if one proposed to remove progressivity from the Social Security benefit formula.

Framing issues differently shifts salience or transparency and will often lead to different outcomes. It is simply wrong that one system is transparent and the other is not.