How Close to Best?

Appraising NDC Moving into Adulthood

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Yes, indeed, the new NDC family of siblings of pension schemes is a group of most promising youngsters in their teens. They are high potentials, holding promising prospects of further capture and development and of a bright future, unfolding multiple talents. Adolescent by now, NDC is uncontested as an innovative invention and a good practice. For many experts it is surely better a pledge than what most alternative approaches (DBs, fully funded FDCs, point systems) to old-age security usually offer credibly in terms of assurances.

What is controversial, though, is to what an extent nonfinancial defined contribution systems are „best" practices under all circumstances. Can they serve as a yardstick of performance - or even outperform all others in the long run in most relevant aspects of output and sustainability? Is NDC an „ideal" pension framework in general as Holzmann (2006, 225-265) suggests or is it as incomplete and abortive as any other pension system (as, for instance Barr, Diamond and Börsch-Suppan seem to tend towards to)? Can – and actually do - „well designed" DBs and point systems not successfully mimic NDCs without adopting them (as Whitehouse argues in Ch3)? Or is NDC, as I argued and continue to think, imperfect by definition and virtue of lived exercise as any human institution (from democracy over family to social insurance), but without viable better alternative so far? By implication, this would make NDC „close to ideal" or „close to best", depending on the specific molding and shape of its social security arrangement.

NDC will continue to be diffused but not be copied *tel quel* everywhere in this copy-cat world of globalizing inventions. Yet, it will remain a point of reference if not a – more or less silently – admired role model of institutional design for mature and advanced welfare regimes and a developmental perspective for low and middle income countries. The particular beauty of its special implementations – both in terms of efficiency and fairness or equity – will stay debated according to highly diverse public policy preferences and idiosyncratic tastes, due to irreversible histories and related political cultures and path dependencies. But the very base common to all notional defined contribution systems rests a simple, solid and sound robust rock of core organizing principles, implementation constraints and requirements of sustainability.

Sustainability, its single most important distinctive feature, is often powerful a rhetoric but poorly understood conceptually and rarely operationalized empirically in a convincing way. Sustainable pensions imply managing resource use so that it can meet demands of the present generation without decreasing opportunities for future generations. Its purpose is to minimize the closure of future options or maximize the range of future choices. This does not mean leaving old-age security as inherited, which is neither possible nor desirable in view of demographic and socio-economic challenges.

Sustainability is a constraint or limit on choices of developmental strategies („not everything goes"), but it does not compel any single policy (no „one best way", „one size fits all", „there is no alternative" to be enforced). There are multiple compatibilities of sustainable development, both of different NDCs and of other pension arrangements: highly divergent levels of sovereign debt, implicit liabilities, pension generosity, financing gaps, system dependency ratios, contribution or accrual rates, corresponding to widely different political and social values, all are compatible with sustainability.

Thus, sustainability is defined as a precondition for pension maintenance in a fiscal and social feasibility sense, and not as cultural, ehtical or political desirability. It is about a viable old-age security, not about an ideologically most desirable welfare system: several levels pension expenditures may be financially sustainable, but not adequate and socially acceptable for retired or active people – and, vice versa, massive and most popular pre-retirement practices (of up to 90% before the age of 65 in some European countries) may be self-destructive habits unsustainable even in mid-term time frames.

Intergenerational equity is central to sustainability, but this does not imply zero-sum conflicts between current and descendant generations. In contrast to (e.g. DB) uses of capital and credits for consumption à fond perdu, new knowledge and institutional inventions such as NDC and other human capacities passed on to the next generation are rather enhanced and not depleted by intensive current utilization. Investment in human development and social security, however, contributes to sustainability only if it is done at the expense of current consumption (including some legacy costs) and not of spending adding to future capacity.

In short: NDC has character (and style), in contrast to the many *bricolage* kind of hand-knitted, do-it-yourself homeworker DB pension edifices without building plan. They mostly result from painfully long series of patchy parametric repairs of often fundamentally flawed skeletal structures, most difficult to restore even by critical reconstructions. As successful reconstruction basically implies mimicing NDC within DB or points systems without adopting its overall architecture, as Whitehouse argues, why not taking over the entire institutional framework as a whole, as a total work of art of collective intelligence?

This is what Holzmann & Palmer („NDC in the Teens: Lessons and Issues", Ch1) recommend, and convincingly so: „go for an immediate transition to avoid future problems." The comprehensive analysis by Chlon-Dominczak, Franco and Palmer on „The First Wave of NDC Countries" (Ch2) provides ample empirical evidence as to the wisdom of this advice: Sweden, Latvia and Poland doing fast and mandatory and thereby best as against Italy trying to buy time and consensus by a slow, partly voluntary and minority transformation which „turned out to be the Achille's heel of the Italian NDC reform." As with justice, so reforms must not only be done but *seen to be done*. Italy's strategy of „disguised change", almost hiding the real agenda of far-reaching but long postponed 1995 reforms is somewhat self-defeating politically and technically, as the authors analyse in great detail (pp6 and 54 manuscript).

Sweden, in contrast, has demonstrated how best to use the *kairos* of a „demographic window of opportunity" (p9); but also to take the time it takes – including some years of political time-out – to reach the necessary broadest possible political consensus and over 80% of Parliamentary support by five major parties over 17 years 1994 to 2011, irrespective of government complexion. Distinguished Swedish communication strategies via famed „Orange Letter", „Orange Report" and user-friendly internet access allowing „individuals themselves to calculate possible pension levels at chosen retirement ages" (pp16) is certainly a „best practice" enabling such political success. But even less effective communication of NDC has not prevented its achievement: „The final conclusion is that NDC appears to have weathered the storm created by the deep recession 2009" - everywhere. (p56, and pp5,6)

The authors also show an impressive historical diversity and path dependency of NDC evolutionary patterns, far beyond a simple and uniform „one format fits all" device. Similar architectural design principles still allow for a great pluralism in NDC systems, ranging from different indexations of notional accounts (p14) to benefits (p55); over highly different patterns of explicit redistribution within a piggy bank framework, the settlement of legacy costs, the (non-)acceptance or existence of inherited special privileges, the coverage and exemptions within a fundamentally universal system (pp18,19), the greatly varying quality of law enforcement and administrative infrastructures (most problematic in Poland, pp14,15); much variation in transition models, the speed of transformation and the cohorts affected, ranging from those born 1936 till 1981 (pp20-24); a lot of diversity in build-up of individual accounts, whether concerning the calculation formula for the notional rate of return or other parameters, the handling of inheritance gains; or the multitude and diverging generosity regarding pension credits for many years out-of-work during working age, ranging from unemployment, sickness, disability over maternity and parental leave and care-taking to conscripted military service and even tertiary education credit vouchers (pp24-33). All NDCs resemble each other, but are as diverse as DBs, though much less arbitrarily and without violating basic sustainability requirements.

Despite significant variations of the share of contributions going to NDC (50% originally in Latvia, 63% in Poland, 86.5% in Sweden) as against FDC and of current contribution rates (12.22% in Poland to 33% in Italy), there is a most remarkeable convergence in expected gross replacement rates (60-68% for average workers, net rates varying more - 64-77% - due to different tax loads), implying highly differential effectiveness of pension system mixes in Italy and Sweden , for instance. These future individual outcomes should be adequate and broadly acceptable, in particular as they are comparable to other systems within EU-27, but come together with long-term financial and fiscal stability in contrast to hardly affordable rises in pension expenditures elsewhere in Europe.

Thus, in spite of all the technical and administrative constraints once an institutional NDC design has been set up and quasi constitutionalized, many most important and genuinely ethical and political choices have to be taken in design choice and implementation procedures. They may affect the distribution of legacy or adjustment costs between active and retired people (e.g. 2/3 to 1/3 in the Swedish „balancing index", managing the economic crisis after 2008); the conversion rules of transforming acquired pension entitlements into initial capital, where seemingly highly technical decisions (such as the choice of the G-value, the divisor used to calculate annuities) have severe distributional consequences along gender and generational lines as well as by age groups; or the phasing-out (or not) of special privileges for persons below the age of 55 and continuing exceptions from universal NDC coverage such as professionals in Italy or a long list of farmers, judges and prosecutors, military, police, prison wards, border guards, miners in Poland (pp 8, 18, 19, 54).

This is even more surprising as there was „an extensive public discussion of the principles...of the reform" and „the simple message of linking benefits to contributions and pensions to life expectancy had „popular" appeal to Poles" (p7), in contrast, for instance, to Greeks or Austrians. Still, narrow sectional interest protection prevailed and Polish „bridging pensions" are a dunning remnant and reminder of „cashing in" on non abolished special rights, i.e. of structural corruption of an authoritarian past extending far into a neat future. But it remains an exception among NDCs, whereas clientilism and rent-seeking of potentially „dangerous" or otherwise critical interest groups seem to be widespread among DBs, and far beyond the countries with an authoritarian (Communist or Fascist) past such as practically all Mediterranean and (South)-Eastern and some Central European countries.

One last remark on Chapter 2. The authors justly state that „given the actuarial link between benefits and contributions, in NDC systems there is no need to set a fixed retirement age" – and „people's desire for flexibility and freedom of choice" are indeed among the crucial non-monetary assets of NDC. Unfortunately, instead of exploiting this innovative and libertarian competitive edge over all other mandatory public pension schemes, they stick to a traditional benevolent paternalism: „setting a minimum age from which pensions can be paid to protect people from myopic decisions leading to low pension benefits and higher risk of poverty at old age" is very conventional indeed and not up to the most important potential of the new paradigm. „The debate on the age of retirement" (pp10-12), fully dispensable within NDC, is well understandable in view of the heavy historical legacy in Italy, Latvia and Poland, starting their reform process with very low (and gender-unequal) legal and actual retirement ages. I am also well aware of the important signalling function of minimum and reference ages, but they could be variable in function of account endowments and fixed (higher) age thresholds should be restricted to poverty relief measures (such as „guarentee pensions") or converting disability into old-age benefits (in Sweden both at age 65) or the age up to which people „have the right to retain their employment" (currently 67, to be raised to 70 in Sweden, as in France).

But the truly innovative potential of NDCs still to be explored is that they could – and should – be used not just as old-age but also as a kind of lifetime social security accounts. Here, people (after a significant contribution and vesting period, i.e. from midlife onward) could withdraw financial means for Sabbatical-like time-out periods up to a year every seven or X years during working life, at the expense of correspondingly less accrued pension benefits in old age, or of later retirement. In order to prevent moral hazard it is sufficient to make sure that drawing out money from lifetime accounts can only be done with coverage assets effectual to assure life annuity above the poverty level. Without optional, elective retirement age and full liberalization of lifetime social security accounts by flexible choice, the liberating, choice enhancing effects and „utopian potential" of NDCs fall largely short of their re-assuring „you get what you paid for", stabilizing force. The persuasive power neither of system maintenance, financial stability and sustainability by design nor of social insurance and personal freedom of choice should be abdicated to each other.

Ed Whitehouse (Ch3) identifies four major areas of economic concern and observes „parallel lines" between „NDC and the direction of pension reforms in other OECD countries": „benefits based on lifetime earnings, rather than a subset of „best“ or „final“ years pay“; „each extra year’s contribution...give rise to an additional benefit“ and there is „no ceiling on the number of pensionable years“; an actuarial bonus-malus system for later and earlier retirement; and „benefits should be reduced as life expectancy increases“.

His bold summary statement „that most (pensions systems) have already achieved most of these objectives, but without adopting NDC“ may sound quite plausible at first glance. It also seems in line with some apparent OECD Social Policy Division disposition to play down the innovative character of the Swedish and other NDC reform countries in aid of of either Anglo-Saxon („Britain abroad“) demogrant models or of Franco-German point systems or even traditional DBs. But already a second glimpse at his own evidence reveals that his interpretations may have been all too hasty and contradictory, and the conclusions overly favorable to ongoing DB reforms.

„Most (systems) have...achieved most...objectives“ is hardly half true according to the evidence presented by Whitehouse himself: almost 40% of the DB systems still have no lifetime earnings calculation, many countries stay far below the optimum standard, including the US, Canada, Spain, France and the Czech Republic, whereas others which do reform adequately in principle such as Austria take many decades of transition before fully implementing this core requirement. 73% of the countries permit early retirement, 10% without any and 80% with (partly much) less than actuarial reductions/increments in accrued pension benefits with early/later exit. Early pension ages average 60.4 years or 4.7 years earlier than normal retirement age, the earliest one - according to Whitehouse – being 61.8 years, obviously ignoring the different and lower retirement age for women even in OECD- or EU-countries such as Austria, the Czech Republic, Lithuania, Latvia, Estonia, Romania, Bulgaria, Slovenia, Italy, Poland, Turkey and the United Kingdom (not to speak of the almost twenty UN-European countries outside OECD and EU-27, such as Russia, Belarus, the Ukraine, and many countries between the Western Balkans and Central Asia).

I fully agree with Whitehouse that „the key difference between NDC and the two other types of earnings-related pensions is the automatic link between changes in life expectancy and the value of benefits..... So, pensions will be lower if people live longer“, at long as they are not also „working longer to compensate“. NDCs – and automatically NDCs only - provide what I call *„lifetime indexing“* against „age inflation“(Marin 2011), i.e. an automatic coupling of the pension entitlements formula with gains in life expectancy in order to make it fail-proof when key parameters change significantly.

Whitehouse recognizes this unique selling proposition as a distinctive feature of NDCs, but again plays down their decisive comparative advantage over all forms of DBs an point systems. „Nearly half of the OECD countries – 13 out of 30 – now have an automatic link between pensions and life expectancy....A decade ago, only one country had such a link. The spread of this policy has a strong claim as the major innovation in pension policy in recent years.“ Although I completely agree with the innovation claim in principle, the impression created of an innovation glass almost half full is fairly misleading. According to the data provided, the credit goes in 69% of the cases only to the new NDCs and / or to „DC plans as a substitute for all or part of their public pensions“ and *not* to traditional schemes being reformed accordingly.

Rather, only less than 17% (5 out of 30) of OECD countries have started to introduce an automatic linkage between life expectancy an pensions into their public DB or points systems, either to benefit levels (Finland, Germany, Portugal) or to qualifying conditions. In contrast to the fully operating DC and NDC schemes, lifetime indexing in the few DB countries adopting it will be partly implemented far into the future, and partly linked to sub-optimal parameters (contribution years in France, instead of pension age in Denmark). The „automatism“ of lifetime indexing foreseen in a coalition government programme has been defeated by agitated protest and stolid resistance against the supposed „tyranny of soulless computers“, bringing down government and provoking snap elections in Austria in 2008.

Thus, in the overwhelming majority of cases of DB and point systems, the most required lifetime indexing adjustment so far does *not* work, not only not automatically: it does not work at all in 83% of the OECD domain, and where it starts to do so it does not work instantly, consensually, properly and as fully as needed. Consequently, in most OECD countries pension systems continue (in his own words) to „distort decisions to work and save... to encourage people to leave the labour market“ early, they „give rise to substantial inequities between different individuals“, „penalise people who do not retire at the earliest possible opportunity“, etc. While not all countries display all or most of these undoubtedly bad practices, Whitehouse' reasoning that there are „only four OECD countries – Belgium, Greece, Luxembourg and Spain – whose pension schemes fall significantly short of best practice in at least two of the areas analysed“ and that „many OECD countries have retirement-income systems to which NDC principles are simply not applicable: Australia, Denmark, Ireland, the Netherlands, New Zealand and the UK“ sounds quite unconvincing in view of his own empirical evidence and his candid concession that „NDC schemes are an example of good practice in all these areas.“

Though it is a – purely tautological - truth that „well designed pension schemes of the alternative types – DB or point systems – share these characteristics“, he can not even raise let alone answer the query why this happens so rarely as he does not recognize its rarity in his own data but rather defines away failures. Thus, a critical review of his reasoning in favor of reforming DBs and point systems and the evidence provided for it turns out to be the single best – outcome and process - argument in favor of Holzmann & Palmer's (Ch1) key commendation to „go for an immediate transition to avoid future problems", a most rapid advent of paradigmatic NDC instead of parametric DB reforms.

Other Ch1 recommendations are equally pertinent. In view of the above observations on Chapter 3, the first suggestion of the priority policy research agenda is most imminent: „(i) Assess the outcome of NDC schemes compared to the primary goals of pension systems, and compared to alternative scheme designs", in order to guarantee some better informed and more objective appraisal. Regarding the partly heavy historical legacies and transformation problems as discussed in Chapter 2, Holzmann & Palmer's referral „identify and finance the transition costs as they will hit you otherwise" is most topical. And, apart from two recent more general volumes on women and pensions (James, Edwards, Wong 2008 and Marin, Zólyomi (Eds.) 2010), this is the first time that the gender dimension of pension reform with NDC has been looked at by five papers from leading experts in the field more systematically, with good indications for promising further research and productive political discourse.

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