

## **Evaluation of World Bank Research**

### **Peter Diamond**

#### Pensions/Insurance Flagship Reports

I have reviewed the theoretical content in seven volumes:

- New Ideas about Old Age Security, 2001
- Income Support Systems for the Unemployed – Issues and Options, 2004
- Targeting of Transfers in Developing Countries, 2004
- Keeping the Promise of Social Security in Latin America, 2005
- South Asian Pension Systems, 2005
- Old Age Income Support in the 21st Century, 2005
- Pension Reform: Issues and Prospects for Nonfinancial Defined Contribution Schemes, 2006

I have not examined the empirical work – neither the data nor the empirical methods. I have asked two questions – whether the analysis is consistent with current theoretical thinking and whether the presentation is balanced (recognizing that to some degree balance is in the eye of the beholder). That is, I have reviewed these volumes as educational for policy analysis, not as advocacy pieces for some particular policy recommendation. This is consistent with the terms of reference, which includes an evaluation of whether the work “broadened the understanding of development policy.” The set of volumes includes two conference volumes, four study volumes of particular institutions, and one policy perspective volume. I review them in that order.

#### *Conference Volumes*

For the two conference volumes, I have not examined the entire content (although I was present at both conferences). Instead I asked whether the presenters were analysts with good reputations, whether there was a balance in the choice of presenters, including discussants, and whether the introduction or summary material was a balanced presentation.

#### *New Ideas about Old Age Security*

Edited by Robert Holzmann and Joseph Stiglitz

This volume grew out of a conference that I attended, and the volume contains a brief discussion by me. The topic is important and the coverage of issues is good. The volume contains material from many good pension analysts. And I recall that there were many instructive papers presented. For this review, I read only the part of the Introduction that did not summarize individual chapters. It seemed to me a balanced presentation.

#### *Pension Reform: Issues and Prospects for Nonfinancial Defined Contribution Schemes*

Edited by Robert Holzmann and Edward Palmer

This volume grew out of a conference that I attended, and the volume contains a brief discussion by me. The topic is important and the coverage of issues is very good. The volume contains material from a wide range of top pension analysts. And I recall that there were many instructive papers presented. Since the topic was relatively new for the research community, the timing of an early conference was very good. For this review, I read only the presentational parts (not the chapter summaries) of Chapter 1 – Introduction and Overview.

In explaining how NDC systems work, the chapter says, “Since the financial rate of return is generally expected to be higher than the rate of economic growth, NDC requires a higher level of contributions to achieve the same payout as an FDC scheme, and for this reason an NDC scheme is second best in economic terms.” (p. 4) How long will World Bank pension economists go on repeating this gross error? At this stage in understanding, this is appalling. It is well understood that decreasing funding raises the pensions of those receiving higher benefits financed out of the decreased funding. Thus, they can receive higher pensions than can be financed out of their own contributions, higher pensions that are paid for by lowering the pensions of those coming later. There is no general result that the distributional outcome with or without such transfers is better than the other. The following sentence mentioning transition costs does not offset the gross error in the previous sentence. And the follow-up sentence suggests that the comparison is an issue only with an ongoing PAYG system. But exactly the same issue arises with a new system – in the form of what to do with those near retirement at the start of a new system. If a new system is fully funded, those near retirement receive very small pensions. If a new system is less than fully funded, the resources that would otherwise be used for funding (for increasing later pensions) can be used to finance larger pensions for those near retirement.

The follow-up claim of fairness of NDC compared with a DB system is overblown. If tax rates do not change, then a system based on contributions has the same outcomes as a similar structure based on earnings subject to contributions. And while both systems give the same benefits to workers with identical earnings histories, workers with different histories that have the same financial PDV of contributions get different benefits. A DB system using a wage index has similar treatment of different workers as an NDC system using the same wage index for notional interest. Only by having a different (and with a shrinking labor force, lower) notional interest do they differ on this account. The claim that NDC rules are neutral with respect to the work-leisure decisions of older workers is again not quite right because the notional interest rate is below the market rate. The further claim that with NDC it makes no difference what country one is in is again wrong because different countries will generally have different notional rates of interest (unless one just collects benefits separately in all the countries). Don't get me wrong. I think NDC is a terrific innovation. I think overselling a good innovation is inappropriate for the World Bank.

Despite these criticisms of the introduction, this is a very good volume with a lot of good material.

## *Study Volumes*

For the study volumes, I have looked at the content, with a primary focus on chapters with theoretical content.

*Targeting of Transfers in Developing Countries: Review of Lessons and Experience*  
David Coady, Margaret Grosh, and John Hoddinott

Targeting of transfers is obviously important when addressing poverty. This volume gathers together a great deal of information on targeted programs in developing countries.

It reports statistics about individual programs and the descriptive content available from straightforward regressions on the available data set of programs. It is careful not to adduce causality to the regressions and careful to present a theoretical opening chapter (after the introduction) to frame how to interpret the data reported – and particularly the incompleteness inherent in the statistics reported.

My focus is on the quality of Chapter 2, “Targeting: An Overview,” and the comments later in the book that relate to the chapter. This is a good chapter, discussing both issues involved in having a well-targeted program and issues in trying to measure how well a program targets (and including references to relevant literature). Issues of measurement are important to help readers to learn from the rest of the book without over-interpreting the findings. To my taste, it could have been a bit better. A key element that may be missing is a discussion of the financing of the program. In the start of this chapter, the book appropriately assumes “a limited poverty alleviation budget.” There are two financing issues. One is the extent to which the poverty alleviation budget, while limited, is still influenced by the design of programs, an issue in political economy that would be impossible to incorporate in the type of data gathering done for this book, and one that receives a paragraph of its own. A second issue is the distributional pattern of the financing of the program, an issue that is particularly salient with an earmarked tax, but also relevant when financed out of general revenues. While earmarking is not important because few of the programs appear to be financed with earmarked taxes, it still would be worth mentioning, particularly with the presence of noncontributory pensions, which would be worth comparing to contributory ones. In addition, the discussion of what are labeled regressive programs needs to be placed in the context of financing, even if that is limited to the progressivity/regressivity of overall revenue sources. I note that financing does appear on page 79 in connection with financing of food subsidies. Thus a wider discussion in Chapter 2 would have been useful.<sup>1</sup>

In sum, I found this a valuable and well-executed book.

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<sup>1</sup> As a minor element that grated, I think it is not the best presentation to make a flat statement that is later contradicted. Page 6 states following: “The optimal transfer scheme is one that gives a transfer to all poor households only (i.e., those with income less than  $z$ ), with transfer levels equal to their individual ‘poverty gaps,’ that is, the distance between their original income and the poverty line,  $z - y$ .” My objection is to the word “optimal” because identification of responses to the program in the following section makes it clear that one does not define optimality in this way. As the book notes: “transfers that guarantee a minimum income irrespective of earnings are not considered desirable.”

*Keeping the Promise of Social Security in Latin America*  
Indermit S. Gill, Truman Packard, and Juan Yermo

This book contains detailed analyses of the workings of pension reforms in Latin America. Having the analyses of multiple countries gathered and compared is valuable and I learned a great deal reading the manuscript in the past. In addition to gathering considerable information, the book contains an intelligent discussion of the empirical findings on the impacts of reform on economic outcomes. And there is a valuable discussion of the impact of the reform on multiple dimensions of criteria, being wider than some earlier Bank assessments of pension reform, particularly with its attention to poverty.

Chapter 6 of this book contains a theoretical discussion underlying the policy recommendations in some of the other chapters. In a discussion to frame the size of the first and second pillars, there is a discussion of pooling in contrast to savings. These terms are not standard in the pension literature and as far as I can tell the analysis using them is badly defective. There is also a discussion of the basis for mandating savings, which is very far from a balanced presentation.

The analysis in Chapter 6 is related to a 1972 paper by Ehrlich and Becker. (This is clear in the section entitled Saving as the Mainstay of Old-Age Income Security on p. 112.) As much as it is true that saving is important for old-age security, the Ehrlich and Becker paper has nothing to say about the level of savings as a way of handling risks.

Ehrlich and Becker identify three approaches to risk – market insurance, self-insurance, and self-protection. Market insurance is a purchase in the market that results in a shift of income from a good state (lower marginal utility of income) to a bad state (higher marginal utility of income). Self-insurance is a non-market device for transferring income from a good state to a bad state. (And self-protection is lowering the probability of a bad state.)

Precautionary saving is appropriate in a risky world. And the optimal level of savings depends on the riskiness of the world, the presence of insurance opportunities, and the nature of preferences. But saving today in non-insurance products transfers resources from today to tomorrow. If the return on the assets held is stochastically independent of the outcome of the risk determining whether the saver is in a good or bad state, then it does not transfer resources between the good state and the bad state. One might find assets to hold that have a return correlated with the realization of a bad state, but that is not primarily a saving issue but one of portfolio choice. The literature on the impact of uncertainty about future income on the optimal level of precautionary savings is an old one, going back at least to Leland (*Quarterly Journal of Economics*, 1968), a much-cited paper. So the underlying theory behind the framing of their approach does not apply to the uses they make of it. To be clear, providing better savings opportunities is very important in its own right and as a way of helping people cope with uncertain future

incomes. That is, the ability of precautionary savings to do well at smoothing consumption in the presence of shocks depends on the expected return, volatility of return, and liquidity of savings (and access to borrowing) as well as correlations between returns and risks. Recognizing the importance of better savings vehicles seems to me right on target. It is the analysis used to underpin consideration of better savings vehicles that I object to, not the basic focus.

Chapter 6 also contains a discussion of the sizes of second and third pillars in a section entitled Justifying Mandatory Saving-Individual Welfare, starting on page 115. The chapter states that it examines “the possible rationale for *mandating* this saving, relying on a paper commissioned for this book.” (p. 116, italics in original.) The quoted sentence has a footnote: “See Valdés-Prieto (2002b). This reliance notwithstanding, the views expressed in this chapter are not necessarily those of the author of this background paper.” Indeed, as I have confirmed with Valdés-Prieto, the basic policy conclusion is not that of the author.

The Valdés-Prieto paper discusses “the five rationales that are most frequently given for introducing a mandate,” concluding that “only improvidence [a systematic mistake by workers in assessing the length and cost of their old age until they are too old to make good this mistake at a modest cost] can be justified as a rationale and thus I propose this as a plausible basis for benevolent policy.” (abstract) The paper does not explicitly state the sizes of second and third pillars that follow from this conclusion. But it does refer to the “massive prevalence of this psychological problem” and sees a role for both a “mandate to save for old age (a second pillar) and fiscal incentives to save for old age (a third pillar) ... during a transition period that may last a further century.” (p. 26) The paper does recognize that in some countries the prevalence is low enough that “there is no justification for second pillar plans or for third pillar plans.” (p. 26) And the paper recognizes “there exists an iron bound on the size of the social and individual costs of second and third pillar programs that is reasonable to accept.” (p. 26) The paper does not state a condition for such a bound, but it appears to be related to the prevalence of under-saving, not the need to offset the free-rider problem created by the 0th or first pillars.

However, Chapter 6 of this volume follows its presentation of the conclusion in the Valdés-Prieto paper with the statement: “Even pro-mandate or interventionist interpretations based on individual behavior imply a second pillar that is relatively small, with savings only enough to allow purchases of annuities that yield the same level of benefits as first-pillar pensions. The main rationale for the large second pillars that we observe in the countries that have adopted multi-pillar reforms must then be the existence of *oversized first pillars*.” (p. 116, italics in the original)

The Valdés-Prieto paper lays out its analysis clearly and thoroughly. I disagree with its dismissal of myopia as a basis for policy in both its time-consistent and time-inconsistent forms and some of the analyses in the paper, but this does not lead me to a very different policy position. I think reliance on a single background paper was not appropriate and the project should have commissioned at least two papers from authors from whom it expected divergent views.

The dismissal of the conclusion of the Valdés-Prieto paper without discussion and the assertion of an extremist view of the role of second pillars, without discussion, is appalling. While the basis for mandated savings in Chapter 6 reflects one view of the role of mandates in a democratic society, it is a highly controversial view, one that is disputed by many analysts (including Valdés-Prieto). It is simply presented as an appropriate basis for policy discussions without signaling the controversial nature of the conclusions, indeed while implicitly claiming it is not controversial. There is no place for such extremist views without a careful presentation of alternative views in such a book.

My conclusion is that this chapter in its current state is totally inappropriate for a World Bank book meant to inform readers in a balanced way about pension issues.

The further discussion relevant for considering a savings mandate includes the following: “In the case of underconsumption or underproduction of something good—for example, vaccines against tuberculosis or automobiles that run on solar energy—the usual solution proposed is to subsidize its production or consumption. This “rule” arises from the principle that quantity restrictions are more distortionary in terms of unintended effects than interventions to manipulate prices. When an activity is mandated by societies (e.g., compulsory enrollment of children in basic education), the government is generally expected to provide this service at a lower price than could be asked by the market.” (p. 115)

There is a sizable literature on price interventions compared with quantity interventions going back to Weitzman (*Review of Economic Studies*, 1974). There is not a general result that price controls are always better, as suggested. Moreover, this literature has focused on externality-generating goods and has not had much discussion of alternative bases for quantity interventions. For example, in addition to savings mandates, the wide use of mandates on the types of goods that can be sold, particularly with issues of product safety, which are quantity controls, has not been seriously questioned as inferior to price controls.

The insurance analysis in Chapter 6 is cited on page 205 in broadly dismissing (apart from politics) the distinction between 0th and first pillars, a dismissal that ignores the significantly different impacts on labor markets.

In sum I found this a book with some very valuable content, but one marred by the very poor theoretical presentation and biased advocacy.

*Income Support Systems for the Unemployed – Issues and Options*  
Milan Vodopivec

This was a very interesting book for me to read. It contains a great deal of information about programs in different countries that address unemployment in different ways.

There was also extensive reference to relevant literature, with brief statements about findings in the literature. I am not familiar with most of the literature cited, but found accurate references for the few pieces I do know. I also found the framing of issues and discussion of the bases for different policy conclusions in different country settings to be intelligent and plausible.

Nevertheless, I did find some issues of theoretical accuracy and balance of presentation.

The largest theoretical failure is the reliance on Ehrlich and Becker to draw conclusions about precautionary savings. Since I discussed the inappropriateness of basing conclusions about precautionary savings on a model of self-insurance above, I do not repeat it here. Beyond this shortcoming, my browsing of the book, in light of my limited knowledge of the literature, still turned up some presentational issues.

Box 4.4, “Should Assets Be Held by the Government or in Private Accounts?” (p. 113) has the following key sentence: “What is the likelihood that mismanagement or high administrative costs will eventually lead to the reduction of benefits under the two options?” This is a key question. But the discussion is all about mismanagement without comparable discussion of administrative costs. Given my flagging of this box, I turned to the cited Smetters paper to see if the discussion there covered both issues, but the paper cited must not be the relevant Smetters paper.

Box 6.2, “Benefits and Costs of Introducing Unemployment Insurance” (p. 156) raises the issue of who benefits from the program. This issue seems to me to depend critically on the source of financing, which comes immediately to mind for a public economist like me, but is not discussed in the box. I note that inadequate attention to the source of finances was an issue in one of the other volumes.

In sum this is a valuable and informative volume. Apart from the misplaced presentation of Ehrlich and Becker, it seems very sound, with only a few nitpicks from my reading.

### *South Asia Pension Schemes for the Formal Sector*

This book describes pension systems for civil servants, mandatory systems for private workers in the formal sector as well as the framework for voluntary systems for private workers. It makes the case that there is much scope for improvement in the countries discussed and spells out the importance of choosing suitable systems for different countries, particularly reflecting the administrative and regulatory capacities of the countries. The descriptive material is useful and the discussions of reform are very sensible.<sup>2</sup> What is missing in the book is a presentation of underlying conceptual issues that would help readers in these countries to think through the design of reform relative to their countries’ needs. For example, not discussed is the issue of how expectations of ongoing employment should affect treatment of existing civil servants, as opposed to new

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<sup>2</sup> There is a typo – the contribution numbers for Sri Lanka are not the same on pages 18 and 20.

hires. This is a particularly sensitive issue for civil servants and one that I have not seen addressed in the literature. Such an underlying discussion would have added to the book.

Similarly, issues about portfolio investment abroad could have been discussed. The lack of an overarching theoretical framework also results in considerable repetition in the book.

One issue that I did not see discussed (and may have missed) is the role of pre-retirement death in system design. This is a difficult issue under any circumstance, but the importance is larger where mortality rates are higher at pre-retirement ages. Another issue that received little attention is the natural tension between backloading pensions to retain employees and the implied negative impact on labor mobility. Trying to get the balance right between these two issues is not easy and the choice could have been framed. More generally, in an economy with limited financial market development, the role of early access to retirement funds and simultaneous receipt of pensions and continued employment (possibly with a different employer) are subtle issues. Comments on these two issues appear without suitable framing.

The report says: “Moving toward funded pension schemes opens opportunities for strong synergies to arise between these schemes and local financial markets.” (p. IX) While the direction of interaction is normally positive and there is evidence supporting a positive link and, more importantly, a further link to growth, the magnitude of the impact on growth and the conditions under which the synergy will in fact be positive are not well worked out in the literature. A lot more caution on this statement would have been appropriate. For example, in Gill et al: “the evidence that pension reform contributes to capital market development is tenuous, as we explore in the next chapter.” (p. 49)

In sum, I found this a valuable book for its identification of pension design elements that are badly in need of correction and presentation of sensible reform ideas. It could have been a more valuable book with greater conceptual and theoretical framing.

***Policy perspective volume:***

***Old Age Income Support in the 21st Century***

Robert Holzmann and Richard Hinz

This volume was written “to explain the Bank’s perspective on pension reforms to other Bank staff and the outside world.” (p. vii) As such, I think it is particularly important that the analysis meet the goal of a balanced presentation that enhances understanding. I was one of the outside reviewers of one, and part of a second, iteration of the manuscript that became this book. I stopped being part of the review process because I found that my critical comments did not result in changes that were adequately responsive. This assignment was an opportunity to review some of the final product. My focus is on the presentation of the case for mandatory funded individual accounts, although I do comment on a few other matters that caught my eye. To state my view, I think that such accounts have been a success in Chile, compared with the previous system. They are

suitable policy in some settings, not suitable in others, and subject to debate in yet others, where other options may be more attractive. My complaint about the volume is in both the presentation of the case for funding and the recommendations to include funding in reforms (which are hedged in a way that does not seem completely consistent).

The volume uses a vocabulary that recognizes five separate pillars:

- 0...Noncontributory system providing minimal protection for all
- 1...Contributory system linked to earnings
- 2...Mandatory system “that is essentially an individual savings account”
- 3...Voluntary arrangements providing retirement income
- 4...Informal arrangements providing both financial and nonfinancial support.

I find this way of organizing discussion of the various routes to supporting old age helpful. I do not think there is any serious dispute about having a 0th pillar, although there are many issues in choosing among the very different ways of organizing it.

Similarly, no one proposes preventing informal arrangements or prohibiting voluntary financial arrangements, although there are issues of regulation, supervision, and tax treatment. The dispute that has generated the most heated discussion is about the choice relative to the first and second pillars. The volume notes “a near-religious war about the virtue of funded versus unfunded provisions, and the merits of defined-benefit versus defined-contribution plans.” In this context, I have read carefully the parts referring to these issues, while not looking closely at other parts of the book.

As stated in the Introduction and Executive Summary, the study includes the conclusion that “a system that incorporates as many of these elements as possible ... can, through diversification, deliver retirement income more effectively and efficiently.” The omitted material is “depending on the preferences of individual countries as well as the level and incidence of transaction costs.” The intent of the volume seems clearer with the excision, although the book certainly recognizes settings where funding is not recommended. I think the book does not do a balanced job of presenting the issues for evaluating a proposal for mandatory funded individual accounts, and will try to document that conclusion, with particular focus on pages 42-53.

A typical pay-as-you-go first pillar is subject to demographic risk. The mandatory second pillar is described as subject to “demographic risks if they require some mandatory annuitization.” (p. 43) Someone who plans on a given level of savings with which to start retirement is subject to demographic risk (interpreted as cohort-wide risk, not individual risk conditional on cohort-wide risk) whether annuitizing (at prices that vary with cohort life expectancy) or not. If not annuitizing, a retiree has to select a level of consumption designed to last for anticipated life expectancy. How this selection and a suitable level of planned retirement wealth should be chosen are both affected by demographic risk. Changes in life expectancy occurring during retirement make the experience thereafter stochastic. Thus a mandatory second pillar is subject to demographic risk whether annuitization is mandatory, voluntary, or unavailable.

Third pillars are described as subject to agency risk, without mentioning that second pillars that invest with the same fund management companies as do third pillars are also subject to agency risk.

The diversification advantage of having as many pillars as possible is related to a lack of perfect correlation of outcomes across pillars. This is also stated as follows: “Because wage growth and financial returns are not perfectly correlated, the efficiency gains from diversification across the two ‘asset categories’ can be readily demonstrated.” (p. 43)

The inadequacy of these statements follows from consideration of the process of initiating funded individual accounts. Doing a steady-state analysis, it has been shown that with plausible coefficients, the best steady-state expected utility is achieved with a mix of PAYG and funded pensions (assuming no other source of consumption than the two parts of the pension system). However, this does not imply that it is socially optimal to convert part of a PAYG pension to a funded pension. Doing so requires lowering the consumption of some cohort or cohorts in order to generate the assets that go into standard funded individual accounts. Thus, there are gains for some cohorts and losses for others and a social evaluation can go either way. (The converse is different – with only a fully funded individual account system, there is a double gain from converting a suitable part to PAYG – increased expected utility of steady-state cohorts and a transfer to early cohorts because less funding is needed.) It is true that the diversification gain is available in principle from an asset swap – creating wage bill indexed assets and swapping them for capital rate-of-return indexed assets. But this is not the type of individual account creation the book is talking about.

If individuals hold assets other than the two pension accounts, then allowing workers to acquire some equity by giving up some PAYG return (as in the proposal of the Bush administration) does nothing for optimizing workers already holding diversified portfolios outside the pension system because the marginal return from the change is perfectly correlated with marginal changes previously available. Such a swap can be beneficial for workers without outside assets. But the assertions in this section do not recognize the nature of the argument – merely asserting a lack of perfect correlation. If mandatory funded individual accounts are added to a mandatory PAYG system, then the normative evaluation must consider the issues arising when a mandate is put in place to do something that was available on a voluntary basis. Again, it may be worthwhile, but such a conclusion cannot be reached by the type of argument presented.

Further down page 43, it is asserted that “The risks of earnings volatility and employment dislocation that underlie voluntary employment-based third pillars are significantly offset by first- and second-pillar arrangements.” The ability of a first pillar to ease the earnings volatility risk of voluntary accumulation depends on the rules determining benefits, which can indeed smooth benefits for some stochastic processes (but do not necessarily do so). In contrast, the type of funded individual account considered here (without explicit redistribution) does no such thing – it merely reproduces the volatility in benefits that would follow from individual savings at a fixed rate.

On page 44 the issue of fiscal transition costs is seen as a possible offset to the gain from funding “(when replacing an unfunded scheme).” But exactly the same issue is present when choosing between starting an unfunded scheme and starting a funded scheme for a country that has no mandatory pension system. Starting a less-than-fully funded scheme frees up resources that are commonly used for those nearing retirement at the time of creation of the scheme. Starting instead a fully-funded scheme has the opportunity cost of passing up the transfers available (and standardly used) when starting a less-than-fully funded scheme. This is not to claim that funded is necessarily inferior, just to claim that the economic issues have the same general character as with an existing system and it is wrong to draw a sharp distinction on economic grounds between circumstances with existing schemes and those without. Of course, other differences are likely to be present as well.

The book goes on to consider three scenarios. Scenario I is an advanced country like Denmark or the United States. In this context, the book asks: “Would any of these countries be better off if it were to replace its established funded system by enlarging the size of the unfunded system? The answer would likely be an almost unanimous no from politicians or economists, regardless of their political perspectives.” (p. 45) This assertion is somewhat vague. Suppose the established unfunded system needs to adapt to increasing life expectancy after retirement, as does the United States (I do not know about Denmark). This can be done by cutting benefits, raising taxes, or doing a combination of the two. Is any increase in the tax an increase in the size of the system? Compared with just cutting benefits, it is likely to result in less accumulation in the third pillar, so including some tax increase appears to fit the category of enlarging the unfunded system and replacing some of the funded system. Not only has this been recommended by some economists (including me), but polls of the American public show overwhelming support for including some tax increase as at least part of adjusting Social Security for increased life expectancy. And the UK Pensions Commission also recommended increased public spending as part of its package, which presumably would displace some of the funded private pensions.

Further down the same page, it is asserted that funding can increase national output through the mechanism of lowering labor market distortions. But the increased taxes needed to finance the funding, if collected through a payroll tax (the so-called double burden of transition) increases market distortion during the transition. This may be worth doing for the lower distortions following from the need for lower taxes later, or for the lower distortions that may follow from altering the link between earnings subject to tax and benefits. But the distortions from a temporary tax increase need to be recognized.

There is no question that taxes can decrease labor supply and some traditional pensions have been designed in a way that does that to the detriment of the economy. But when discussing this issue, the book cites Prescott (2004) without citing Blanchard (NBER WP 10310, 2004), who objects to Prescott’s assumed large elasticity of labor supply, which lies behind Prescott’s finding. And Blanchard points to the weak cross-country correlation in Europe between the decrease in hours and the increase in tax rates.

This sort of selective use of the literature is inappropriate, even when the underlying point has validity, although with not as large an effect as the citation suggests.

The following suggestion is on page 48: “The difference in recent growth experience of the United Kingdom and the United States compared to France and Germany can be related to differences in the state of financial market development and in the importance of funded pensions.” The absence of any mention of labor regulations with sizable employment protection as being relevant for the comparison is surprising given how much of the macro literature has been devoted to analyzing the effects of employment protection and arguing for reducing it in Europe.

I see no basis for the assertion on page 48 that funded pillars provide more flexibility in retirement ages. This is true if the funded pillar being considered is voluntary and true if the mandatory system has poorly designed access rules. But I see no basis for a distinction between funded and unfunded systems that can have the same age of earliest entitlement to claim a retirement benefit that is then followed by actuarial adjustment in benefit levels. (This can be done by an unfunded system even if the level of benefits at the earliest entitlement age is not actuarially balanced, as it will not be.)

Nor do I see a basis for the claim on page 49 that funding facilitates mobility across professions – a single national pension system has that mobility whether funded or not.

This page also contains the following assertion: “A (partially) funded scheme should also provide a higher rate of return than an unfunded system (especially where there is no tax burden to fund transition costs, as in this scenario).” First, I do not understand how replacing an existing unfunded system (as exists in this scenario) with some funding has no transition cost. And second, the higher rate of return in steady-state as would happen with a newly created funded system compared with a newly created unfunded system ignores the fact that the transition generations enjoy higher rates of return without funding, while those coming later have lower ones.

In Scenario II, referring to France, Germany and Italy, the adjustment of benefits to fit with what can be afforded with existing taxes (with no cut in taxes) is described as an increase in funding. This appears to be an implicit claim that these governments support the kind of recommendation discussed here to create a funded pillar. But such a claim would have no apparent logic. One would not refer to the benefit decreases that happen in fully-funded defined contribution systems from increased life expectancy as a decrease in funding.

Scenario III starting on page 51 refers to the typical client country. Here the assertion: “These countries are in dire need of national savings,” ignores China, where there has been encouragement to have a funded account system, which was legislated but has not been implemented. Here is the claim that “the argument regarding transition costs is less relevant for these countries.” As argued above, the absence of an existing unfunded system does not remove the implicit transition cost from foregoing the opportunity to increase benefits for those nearing retirement. The tradeoff in benefits across different

cohorts remains highly relevant, possibly even more so in light of possibly rapid wage growth making older cohorts more needy than younger ones. It is true that the absence of unfunded liability may make it easier to issue more debt, as might happen as a consequence of funding while also trying to help older cohorts.

Having reviewed this much of the volume and concluding, as I did when reviewing draft manuscripts, that the presentation is not balanced, I did not go on to consider the rest of the volume. Here are some further comments on the earlier material that are not so narrowly focused on funding.

The volume recognizes that “a key issue in determining whether advance funding is advantageous is the extent to which it results in net additions to national savings.” (p. 5) This is correct but incomplete in that in some countries it may not be advantageous to increase national savings, for example a country with a very high savings rate and an anticipated rapid growth in average earnings, as is the case in China. Thus, missing from the volume is a discussion of the determinants of an optimal level of national savings (which of course requires a discussion of whose consumption goes down to save more and whose goes up later in consequence of the increased savings). Thus I think it is inadequate to simply refer to an increase in the national savings rate as a positive externality, as is done on page 14.

The positive view of the expression of “the need for the closest possible link between contributions and benefits” (p. 35) is contradicted by the basic theory that with asymmetric information, the provision of insurance (here against poor realizations in the worthwhile length of working life) requires an implicit tax wedge between contributions and benefits. A call for the closest possible link does not recognize this interaction.

Similarly, the goal should not be “to minimize distortions in the labor market” (p. 35), but to sensibly balance distortions with worthwhile insurance and redistribution. Indeed the book contradicts this view on page 39 by indicating that redistributions “are bound to have economic distortions.” Thus the underlying theory calls for having distortions as part of balancing insurance, redistribution and labor market distortions.

One example of misusing existing literature occurs on page 38: “Davidoff, Brown and Diamond (2003) suggest that full annuitization may not be optimal when markets (for other risks) are incomplete; this incompleteness of markets can lead to zero annuitization and the holding of financial assets only.” The article does indeed explore models where the conclusion of the optimality of complete annuitization for own consumption with complete markets (and a suitable structure of a bequest motive) does not follow when markets are incomplete, as they are. The thrust of the analysis is the optimality nevertheless of a significant fraction of one’s financial assets with suitable annuity options. An example of a zero level of optimal annuitization was presented to show that there is not a general theorem requiring some annuitization. But the example was chosen to make a mathematical point, not to present something with possibly wide empirical applicability. Citing it in this way does not convey its implications accurately.

There are a few other issues I want to flag. On page 11: “In high-coverage situations, redistribution, especially for funded systems, can and should be provided by budgetary transfers.” If by budgetary transfers is meant transfers from general revenues rather than transfers within the pension system, then this conclusion seems to me to not necessarily hold. Political economy reasons may make it better to do redistribution within the system, as, for example, has been proposed by Kotlikoff in the context of fully funded individual accounts.

The definition of financial sustainability is “the payment of current and future benefits according to an announced path of contribution rates without unannounced hikes in contribution rates, cuts in benefits, or deficits that need to be covered by budgetary resources.” (p. 12) This means that an automatic indexing system that cuts benefits and/or raises taxes in response to realizations of economic and demographic variables is fiscally sustainable. But a system that is in anticipated balance and will likely receive new, possibly reasonable, legislation if economic and demographic realizations drive the system out of projected balance is not financially sustainable. I think there is much scope for automatic adjustments in pension systems, and it is critical to keep pension finances out of the annual budget process. However, I do not think one can conclude from this that probabilistically relying on legislative changes in the future is necessarily worse than automatic indexing. Both the economics of the ability to respond in a more complex way than would be legislated in automatic indexing and the politics of reviewing many aspects of the system from time to time seem to me to be attractive in some settings. This is not to claim that government will always get it right, but that there is a positive potential that depends on the quality of future government. But then the ability to set up and maintain a good automatic system also depends on the quality of government.

In sum this volume contains some very good and clearly presented material but is badly marred by its tendency for its advocacy to get in the way of accurate use of theory and a balanced presentation.

### *Summary*

I have reviewed two conference volumes, both of which represent real contributions, particularly the second, with its focus on NDC programs and gathering information about them.

The four study volumes collected information on programs (relating to targeting the poor, Latin American pensions, the unemployed, and Asian civil servant pensions). I found all four volumes interesting and educational to read, real additions to the literature. In terms of the quality of theoretical presentation to help readers trying to think about these issues, I found that one did a very good job, two had the same fundamentally flawed basic structure, and one did not try. There is clearly room for improvement here.

The seventh volume was a statement of a policy perspective and suffers from a presentation that is subtly and not-so-subtly, in part, an unbalanced policy advocacy piece. I do not consider that suitable for this type of volume.

In addition to my comments directly on the content of these volumes, it may be useful for me to comment on my overall experience interacting with World Bank economists on pension issues. There are good economists and good analyses being done at the World Bank. I have felt two concerns. One is that there has been too much advocacy at the cost of more balanced, and so more educational, presentations. As noted above, the Holzmann and Hinz volume refers to “a near-religious war about the virtue of funded versus unfunded provisions, and the merits of defined-benefit versus defined-contribution plans.” It should be recognized that the Bank’s economists set (and sustained) the tone for these interactions. Overselling first the value of funded privately-managed individual accounts and then of NDC systems does not serve the Bank’s central role in broadening the understanding of development policy, a role stated in the charge for this report. Indeed repeated analytical errors associated with overselling policy views casts doubt on the World Bank’s pension role.

Second is a concern that Bank analyses, particularly empirical ones, do not receive adequate evaluations. In academe, evaluations arise through submissions to refereed journals and, when passing the publications hurdle, through reexaminations by other economists as part of the ongoing research process. For the empirical work on which Bank analyses rely heavily, I think an effort should be made to find comparable outside vetting, instead of relying so much on inside evaluations. This could be done by submissions to refereed journals, by commissioning detailed referee reports of individual papers being heavily relied on, and by arranging with graduate programs to use reexamination of World Bank papers as part of econometrics and/or development economics training.