Uncertainty and Pension Policy

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Abstract

The balance between pension revenues and expenditures is subject to considerable uncertainty because pension “contracts” span extremely long periods. Under pay-as-you-go or partial-reserve financing, a major source of this uncertainty relates to demographic projections. Small deviations in projections of fertility rates, mortality rates, and other relevant variables can cause enormous imbalances. These imbalances are of the same general magnitude as those resulting from deviations in economic results from initial assumptions. In the case of deficits, such imbalances necessitate large and politically divisive changes in pensions. Many nations have indexed pensions for prices and wages to avoid the need for large adjustments. Yet none has adopted similar automatic adjustment provisions for deviations in demographic outcomes from initial assumptions. This paper explores the size of possible demographic surprises that might arise from reductions in mortality rates arising from the current biomedical revolution and indicates their possible effects on pension costs. It reviews various possible forms of “indexation” for such demographic “shocks” and concludes that each is problematic and concludes that ex post adjustments in response to demographic events is probably optimal.