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Pensionomics

On the Role of PAYGO in Pension Portfolios

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Pensionomics

On the Role of PAYGO in Pension Portfolios

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Pensionomics puts forward a portfolio perspective on the combination of funded and unfunded pension arrangements. In a second-best type argument it is formally shown that a Pay-As-You-Go pension system can substitute the tradability of human capital: if risk-averse investors were able to directly invest into the present value of future labour income, they would allocate their pension portfolios in both human and physical capital. While this ideal form of diversification can not be implemented due to the imperfection of capital markets, one can design a typical Pay-As-You-Go system in such a way that it allows for the same intertemporal consumption allocations as the first-best solution. This replication works regardless of the demographic development.Therefore, PAYGO should play a key role in optimising the risk-return combinations for old-age savings.

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