The Scandinavian Journal of Economics / Volume 102, Issue 3 / p. 395-417

The Financial Stability of Notional Account Pensions

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First published: 17 December 2002
https://doi.org/10.1111/1467-9442.03205

Abstract

A number of European countries are reforming their pension benefit formulas by adopting 'notional' accounts. These accounts are used to determine individual benefits, but pay-as-you-go financing is retained. This paper addresses the belief that by choosing adjustment rules cleverly, notional accounts can provide automatic financial equilibrium in the short run. If this were true, it would be a valuable advantage in terms of insulating the government budget from demographic pressures, while insulating the pension budget from fiscal pressures. It is shown that notional account benefit formulas cannot provide automatic financial equilibrium in the short run. The paper also suggests that if indexing rules are chosen in a particular way, and shocks revert rapidly to a mean, the pension institution may achieve financial stability in the *long* run. However, long-run stability is unlikely to be valuable because political interference occurs in the short run.