Old-Age Income Support in the 21st Century:

An International Perspective on Pension Systems and Reform

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Focus of presentation

- Reasons for continued emphasis on pension reform
- Foundations and evolution of World Bank's Perspective on pension systems and reforms
- Key implementation issues

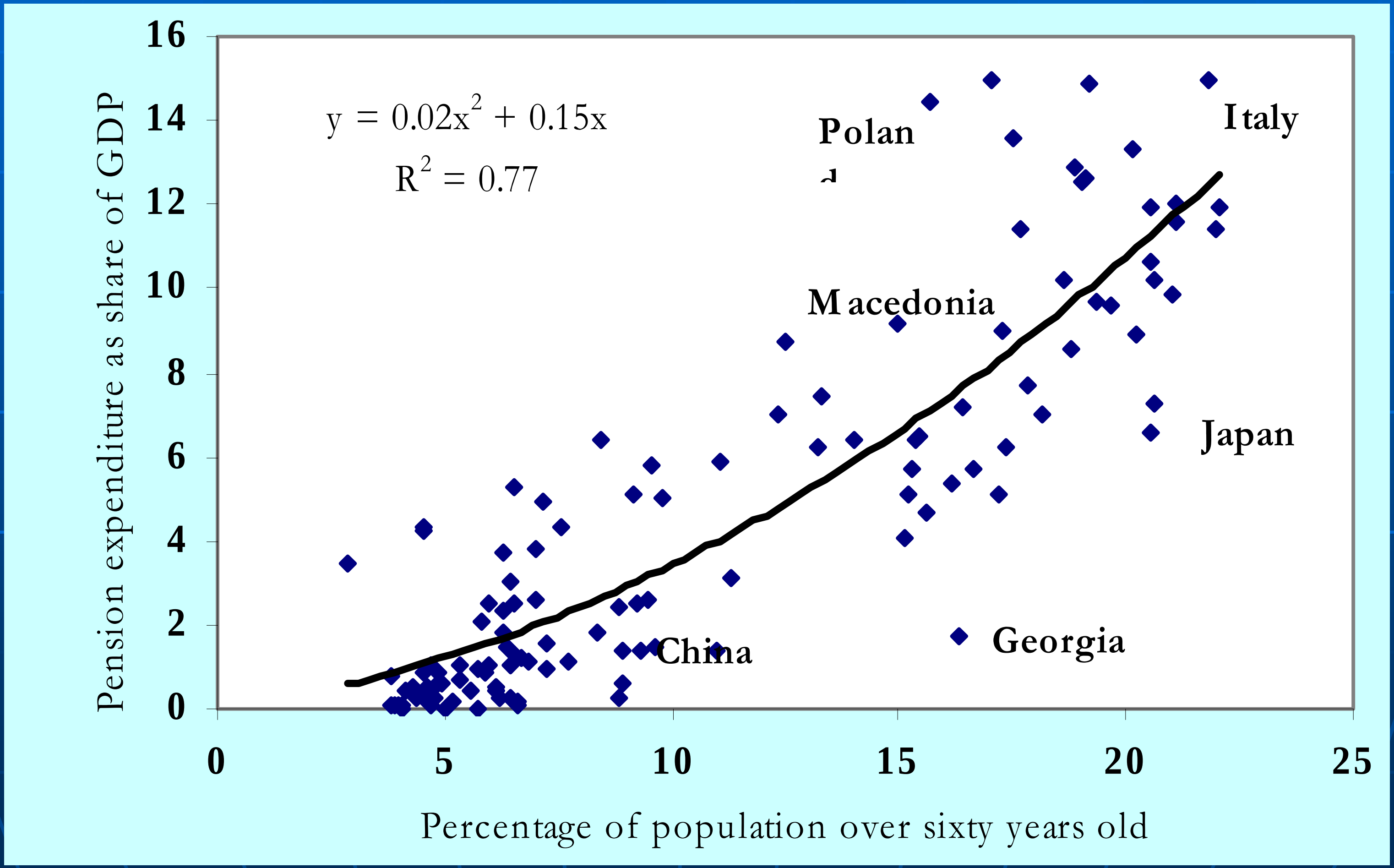
Why Pensions Are Now More Important Than Ever

- Traditional forms of old age security erode with urbanization and modernization
- Life expectancies are increasing – longer periods of economic inactivity/dependence
- Old age burden can make other social objectives unaffordable
- Economic development makes poverty alleviation among elderly possible
- Pension systems can impede or stimulate broader economic development

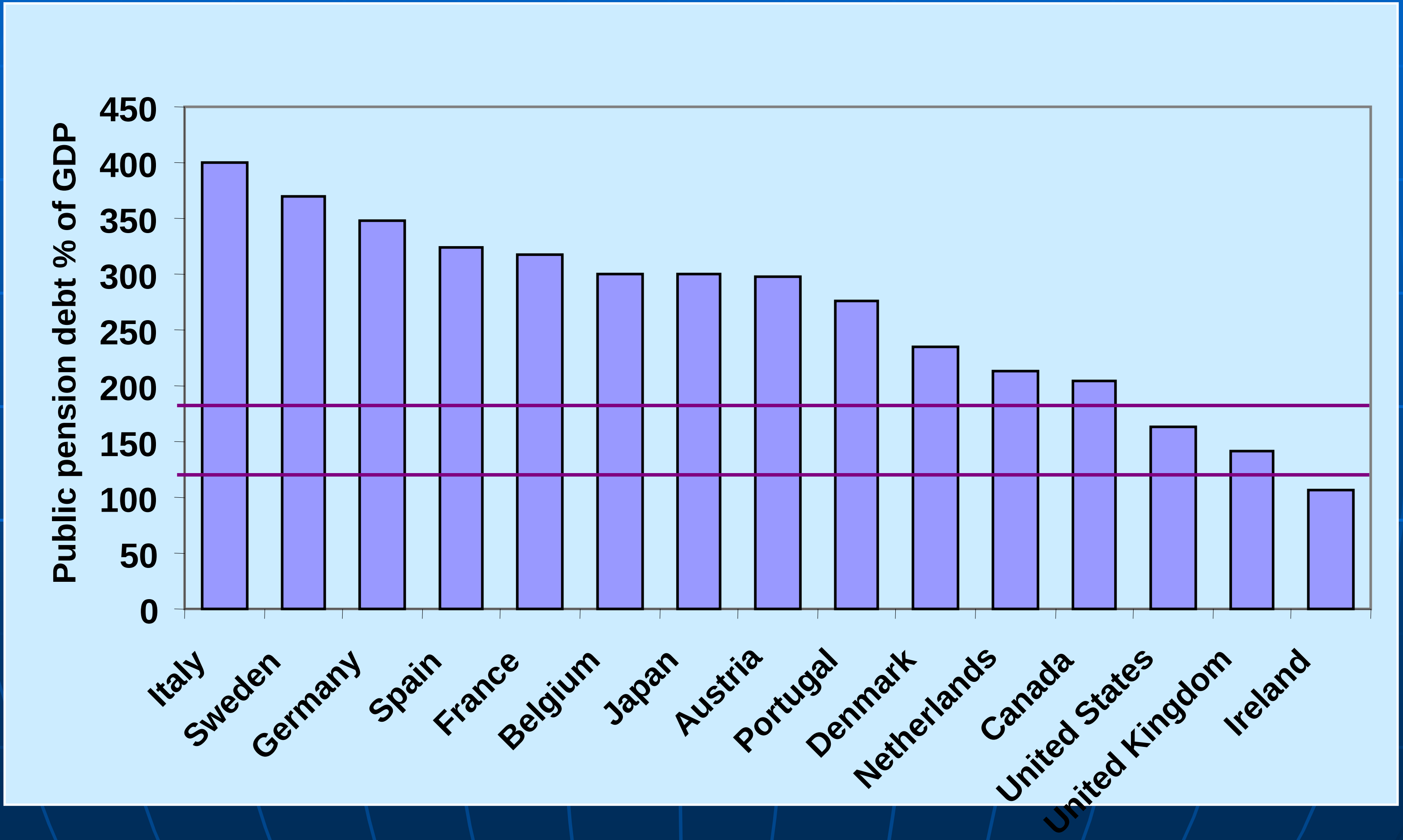
What Is Wrong With Existing Pension Systems

- Current pension systems do not deliver the expected coverage and benefit levels
- Uneven and unfair distribution of costs and benefits
- Unsustainable pension systems lead to the crowding-out of other social expenditures
- Unsustainable pension systems lead to macroeconomic instability (e.g. Brazil 1998)
- Most pension systems exhibit major labor market distortions
- Public management of assets has poor track record

Public pension spending vs. % of population over age 60



Implicit pension debt



Development of World Bank Position and Policies

- Publication of "*Averting the Old Age Crisis*" in 1994
- Active participation in pension reforms of many types throughout the world
- Coordinated research and evaluation effort
- Assessment of experience and evolution of policies and priorities

Evolution of Perspectives on Reform

- Experience with realities of the “political economy” of reform
- Increased understanding of challenges to reach the “lifetime poor”
- Recognition of importance of initial conditions and cultural context of reform
- Appreciation of interactions with capital market development and administrative costs
- Inclusion of non-financial aspects of old age security

Current Perspectives on Pension Reform

- Reforms to be evaluated primarily in the context of ability to achieve objectives and meet criteria and not structure of new system
- Initial conditions and path of reform are as important as the ultimate form of the system
- Flexibility and diversification of risks through multiple pillars more important than the number of pension elements
- Need to consider some form of social safety net in most circumstances
- Funding remains important benchmark

Goals of a Pension System

- Primary goals: provide adequate, affordable, sustainable and robust old-age income
  - Adequacy – both in absolute and relative levels (i.e. poverty alleviation and income replacement)
  - Affordability – financing capacity of individuals & society
  - Sustainability – financial soundness of the scheme, current and future
  - Robustness – capacity to withstand major shocks, including economic, demographic & political risks
- Secondary goals: create developmental effects
  - minimizing negative impacts, e.g. labor market distortions
  - leveraging on positive impacts, e.g. financial market development

Criteria for Evaluation of Reform Proposal

- Four primary content criteria
  - Does the reform make sufficient progress toward the goals of a pension system, and meet distributive concerns?
  - Is the macro and fiscal framework capable of supporting the reform?
  - Can the administrative structure operate the new pension system?
  - Have steps been taken to establish regulatory and supervisory arrangements and institutions to operate a funded pillar?
- Three primary process criteria
  - Is there a credible commitment by government
  - Is there local buy-in and leadership
  - Does it include sufficient capacity building for implementation

Many Types of Reform Can Meet These Criteria

- Parametric – Change provisions of existing system
- Transformational – Transforming PAYGO defined benefit to Notional Defined Contribution
- Privatization
- Pre-funding
- Diversification – additional pillars

Multi Pillar Pension Framework

- Zero Pillar – Non contributory social assistance for lifetime poor
- 1st Pillar - Publicly financed and managed PAYGO system to provide basic income protection
- 2nd Pillar - Mandatory funded individual account system creating direct linkage between contributions and benefits
- 3rd Pillar - Voluntary retirement savings, individual or occupational
- 4th Pillar – Family and inter-generational support for elderly

A Flexible Model

- Appropriate combination of pillars depends on conditions and history
  - Successful system with only Zero and 3rd Pillar or mainly 1st and 2nd
- Success depends on ability to align characteristics of elements with needs and objectives
- Strength of multi pillar approach is in diversification of risks and ability to align elements with specific policy objectives

Some Key Principles

- Most should consider a social safety net to address poverty among the elderly
  - Challenge: who is most vulnerable, fiscal capacity, eligibility criteria and delivery mechanism
- If conditions are right, some pre-funding for economic and political reasons and can happen in any pillar
  - Challenge: balancing benefits and costs, best organization and management
- A mandated and fully funded pillar provides a useful benchmark
  - Challenge: evaluation of the proposed reform design

Why Funding Remains Important

- Makes pension debt explicit – diminishes potential for default
- Political economy of reform – strengthen the sustainability of a reform
- Portfolio diversification by individuals – wage versus capital market returns
- Potential behavioral and savings effects
- Developmental effects

Some Key Design and Implementation Issues

- Taxation of pension schemes
- Costs and fees of funded and privately managed pillar
- Regulation and supervision of private pillars
- Retirement products: Can the private sector deliver?
- How best to reform the unfunded pillar – Is NDC a truly viable alternative
- How to improve the performance of centralized pension funds – guidelines for governance
- How to assess poverty among the elderly and introduce social pensions

How to Tax Pension Schemes

- Pensions should not be tax free
- A consumption-type taxation is favored over a comprehensive income-type taxation
- A back-loaded approach (EET) is favored over a front-loader approach (TEE)
- Voluntary and supplementary schemes may be tax favored, but within limits

Costs and fees: How to contain?

- Comparison of fee levels requires a life-cycle type approach in which all types of fees are considered
- Savings on administrative expenses through use of central clearing house (such as in Sweden)
- Limiting of marketing costs through blind accounts or switching constraints
- Limiting of asset management fees by restrictions on individual choice and, passively managed accounts, employers choice in provider, or competitive bidding of restricted number of asset managers

How to regulate and supervise private and funded pillars?

- Basic and largely uncontested regulation to be applied from the beginning
  - Appropriate licensing and capital requirements
  - Full segregation of pensions assets from other activities
  - Use of external custodian and transparent asset valuation rules
- Other more controversial rules
  - Market structure and portfolio choice
  - Minimum funding standards for DBs
  - Minimum rate of return guarantees

Regulation and Supervision (cont'd)

- Non-controversial rules of supervision
  - Need of independent, proactive, well-financed and professional staff in supervisory body
  - Vetting of application for licensing
- More controversial rules and questions
  - Single purpose (pioneered in Chile) or integrated supervisory agency
  - Decision about range of institutions permitted to offer retirement products

How to provide retirement products?

- Focus so far on accumulation phase gives way to investigating the capacity of private sector to deliver appropriate retirement products (phased withdrawal, annuities, ?)
- Joint work program of Financial Sector and Social Protection to review conceptual issues and experience
- Is there a demand-side problem to explain annuity puzzle such as
  - Underestimating (remaining) life expectancy
  - Strong bequest motive
  - Incomplete insurance markets for other risks increase the marginal value of traditional (non-insurance) assets

Retirement Products (cont'd)

- Is there a supply side problem due to investment or longevity risk as satisfactory hedging mechanisms do not exist?
- Can private sector fully insure investment and longevity risks at reasonable/competitive prices?
- Is there a need to share the risk between individual and provider?
- Does the government need to assume both main risks and be the final provider of annuities?

- What type of providers should be allowed to offer annuities?
- What kind of products should be allowed?
- When must the private annuity market be ready?
- Should there be price indexation of annuities?

Summing-up

- Pension reform issues are now a fully multi sector issue at the Bank, from safety net type to social insurance to financial sector provisions
- Major progress and adjustments in the Bank’s understanding in pension issues. Result of constant re-evaluation, re-thinking and internal discussions
- Many conceptual and operational challenges are remaining, such as provision of social pension and providing private sector annuities