Old age income support in the twenty-first century: The World Bank Report

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Outline

- Background.
- Conceptual Foundations of the World Bank's Perspective.
- Goals and criteria that define the World Bank's perspective.
- Design of the reform.
- Readiness, regulatory and financial market issues.

The Need for Reform

- Fiscal pressures.
- Inadequacy of current systems.
- Socioeconomic changes.
- Need to pay attention to economic effects of pension schemes owing to globalisation.

Contours of Promising Reform Directions

- Have well defined retirement income objectives and reform criteria.
- Cater to three main groups: lifetime poor, informal sector workers, formal sector workers.
- Keep the formal and earnings-related system small, simple and universal.
- Allow for diversification of systems and resources to enhance stability and security of retirement income.
- Pay more attention to process in addition to design issues.
- Take account of country circumstances.

Target audience

- Lifetime poor.
- Non poor informal sector workers.
- Formal sector workers.

Arrangements

- Informal.
- Public.
- Market-based.

Goals of a pension system

- To provide retirement income that is
  - Adequate,
  - Affordable,
  - Sustainable,
  - Robust.
- While seeking to implement welfare-improving schemes in a manner appropriate to the individual country.

Adequate

- Absolute level preventing old-age poverty.
- Relative level replacing sufficient life-time earnings.

Affordable

- Financing capacity of individuals and society.
- Direct costs: higher costs for individuals.
- Indirect costs: higher incentives for evasion by engaging in informal activities.
- World Bank experience indicates that mandated contribution rates in excess of 20% are detrimental.

Sustainable

- Financial soundness of the scheme in the present and future.
- Capacity to provide promised benefits without unduly displacing other claims on future resources.

Robust

- Capacity to withstand major shocks and to remain viable in the face of unforeseen conditions and circumstances.
- Capacity to sustain income-replacement targets in a predictable manner over the long term.

Contributing to economic development

- Minimise negative impacts (labour market distortion, macroeconomic instability).
- Leverage positive impacts (increasing national saving, promoting financial development).

Reform criteria

- Does the reform make sufficient progress toward the goals of a pension system?
- Is the macro and fiscal environment capable of supporting the reform?
- Can the administrative structure operate the new pension scheme efficiently?
- Have steps been prepared to establish the regulatory and supervisory arrangements?

Political economy of reform

- Long term credible commitment by the government.
- Consensus building through local buy-in and leadership.
- Sufficient capacity building and implementation.

Options for reform

- Parametric reform.
- Notional defined contribution reform.
- Market-based fully funded defined benefit or defined contribution reform.
- Public prefunding DB or DC.
- Multi-pillar reform.

Parametric reform

- Leave the existing structure unchanged but adjust the parameters of the scheme.
  1. Lengthening assessment period.
  2. Actuarial increments for earlier retirement.
  3. Reducing the annual accrual rate, increasing retirement age.
  4. Changing from wage to price indexation of benefits.

Problems with parametric reform

- Never fully implemented.
- Many distortions likely to remain.

Notional defined contribution reform

- Changes the benefit structure to DC but retains the unfunded nature of the system.
- Makes the underlying financial relationship more explicit and transparent.

Problems with NDC reform

- Can be hijacked to less-than-optimal system designs.
- Buffer fund may get emptied.
- Requires high administrative requirements.

Full market-based reform

- Changes the manner of funding (unfunded to prefunded).
- Moves from public to private administration.
- Has the potential to produce higher replacement rates.
- Reduces distortions on labour supply and retirement decisions.

Problems with market-based reform

- Transition might be difficult because of the explicit debt.
- Requires a sound, well-regulated and well-supervised financial sector.

Public prefunding

- Centralised funding of DB/DC systems.
- Reduces the fiscal burden on future governments.
- Improves risk pooling and lowers administrative costs by the use of one central fund.

Problems with public prefunding

- Requires a sound governance structure.
- Danger of producing a loose fiscal stance as government has easy access to funds.

Multi-pillar system

World Bank 1994

Pillar 1 Mandated unfunded system of flat or means-tested benefits, that is publicly managed and seeks to alleviate poverty.

Pillar 2 Mandated fully funded (usually DC), that is privately managed and seeks to replace income.

Pillar 3 Voluntary funded retirement provisions.

Multi-pillar system reviewed

Pillar 0 Basic pillar to deal more explicitly with the poverty objective.

Pillar 4 Nonfinancial pillar to include the broader context of social policy, such as family support, access to health care and housing.

Choice of reform option

- Existing pension scheme.
- Special reform needs of the scheme.
- Then (enabling or disabling) environment.

Choices for design of a basic pillar

- Expanding the contributory system.
- Integrating programs to address elderly poverty with the general safety net.
- Universal basic pension.
- Means-tested basic pension.

Basic pillar

Contributory system leaves out informal sector workers; lifetime poor; requires huge administrative capacity.

General safety net could create adverse incentive effects on the labour market.

Universal pension fiscal affordability; opportunity cost.

Means-tested pension cost of service delivery.

Contributory pillars

- **Pillar 1** Flat benefit; proportional/progressive earnings related benefit; or a DB in the form of a non-financial DC; benefits based on lifetime earning.
- **Pillar 2** DC; market based investment; life-annuity.
- **Pillar 3** Voluntary investments for more generous retirement benefits.

Other issues

- Designing disability pensions.
- Designing survivor pensions.
- Financial sustainability.

Administrative issues

- Administrative preparedness and institution building.
- Contribution collection.
- Taxation.
- Fee structure and levels.
- Annuitisation.

Reforming public pension funds

- Moving to an unfunded PAYG system.
- Moving towards a market based and decentralised system.
- Improving the governance structure of the existing fund.

Funded pillars: the issues

- Can funded pensions be introduced with rudimentary financial markets? What are the conditions?
- What are the good or best regulatory practices that typical client countries should follow?
- What are the good or best supervisory practices to be applied?
- What are the options for countries with small systems?

Minimum conditions for a funded pillar

- Presence of a solid core of sound banks and insurance companies.
- A long term commitment by government to pursue sound macroeconomic policies.
- A long-term commitment to financial sector reform.

Controversial regulations

- Controls on market structure and choice.
- Funding, investment and portability rules.
- Legal investment limits versus the prudent-man principle.
- Limits on commissions and switching.
- Profitability rules and guarantees.

Controversial rules

- Creation of a single-purpose or dedicated supervisory agency.
- Establishment of effective collaboration with other regulators.
- The best way to guarantee independence of the supervisory body.
- Oversight and accountability of the supervisor.

Options for small countries

- Develop financial markets.
- Create systems with neighbouring regions.