

Old-Age Income Support in the 21st Century:

An International Perspective on Pension Systems and Reform

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THE WORLD BANK

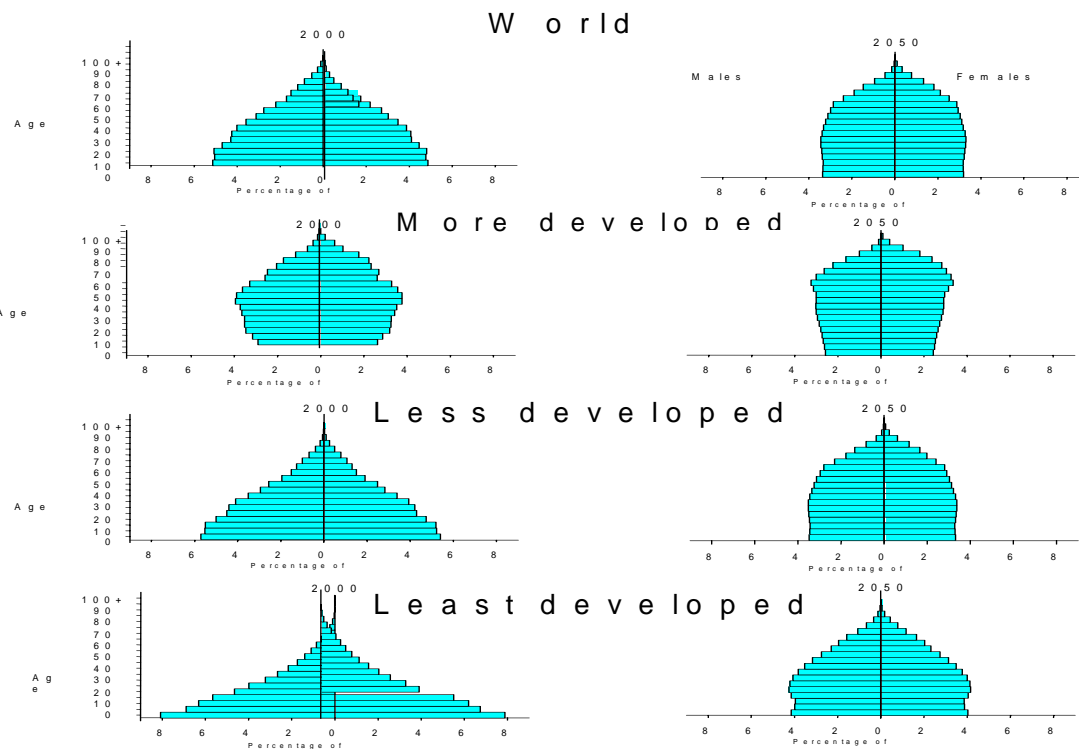
Why Pensions Are Now More Important Than Ever

- ❑ 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

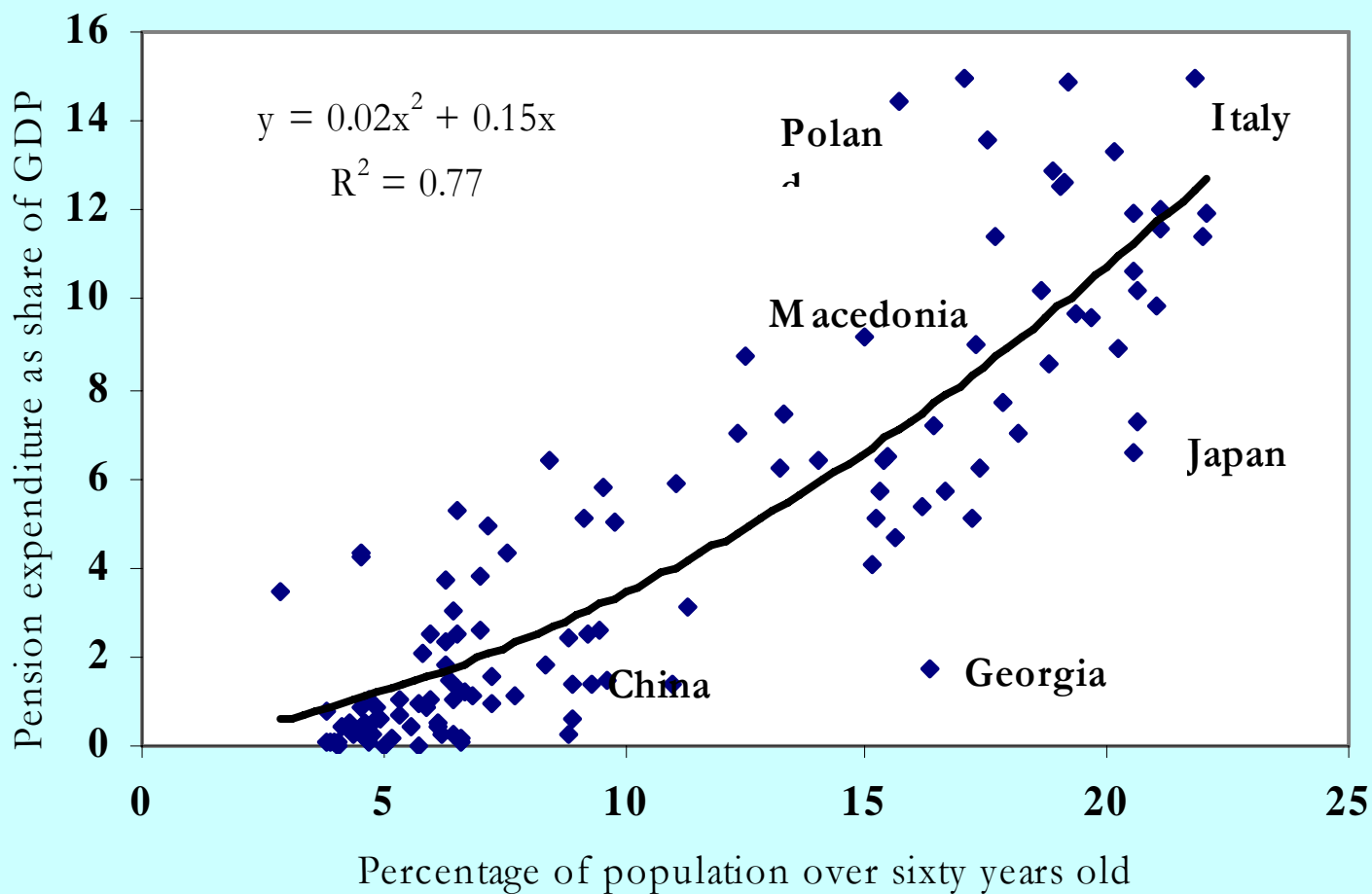
- ❑ Current pension systems do not deliver the expected coverage and benefit levels
- ❑ Uneven and unfair distribution of costs and benefits
- ❑ Unsustainable pension systems lead to the crowding-out of other social expenditures
- ❑ Unsustainable pension systems lead to macroeconomic instability (e.g.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

Population Pyramids: Age and Sex Distribution, 2000 and 2050



Source: *The Sex and Age Distribution of the World Populations: the 1998 Revision, Volume II*. The Population Division, Department of Economic and Social Affairs, United Nations Secretariat.

Public pension spending vs. % of population over age 60



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

Reasons For Voluntary Systems

- ❑ Supplementing Public Systems
- ❑ Diversifying Pension “Asset Portfolio”
- ❑ Enhancing Acceptance of Reforms
- ❑ Tool for Labor Market Management
- ❑ Increasing National Savings
- ❑ Catalyst for Savings/Financial Market Participation
- ❑ Facilitating Capital Market Development

Common Forms

- ❑ Occupational schemes
 - Company Sponsored (DB or Collective Investment)
 - Multiple Employer – Trade Union
- ❑ Mutual Benefit Society/Professional Associations
- ❑ Individual/Retail contractual savings accounts
 - Investment Products
 - Life Insurance/Annuity Products
- ❑ Hybrids (company + individual)

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

Funded Systems and Financial Market Development

- ❑ Extension of the Maturity of Financial Products
- ❑ Depth and Liquidity of Markets
- ❑ Product Innovation – e.g. Diversified Unitized Products, Annuities, Secondary Mortgage Market
- ❑ Financial Literacy and Savings Culture