2008

Reflections on Pension Reform in the Americas: From 'Averting the Old-Age Crisis' to 'Keeping the Promise of Old-Age Security' and Beyond

Estelle James

Truman Packard

Robert Holzmann

Chapter 6

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Estelle James, Truman Packard, and Robert Holzmann

On 'Averting the Old-Age Crisis'

Estelle James

If you are fortunate enough to write something that people actually read, you may find that the message you think you are sending and the message readers receive are quite different. What you have written becomes part of the public domain and you cannot control how it is interpreted and used after that. Twelve years after *Averting the Old Age Crisis* was released (WB 1994), and after much controversy about its recommendations, I would like to dispel some of the myths about what *Averting the Old Age Crisis* said, what it did not say, and what it all means.

The basic message of *Averting the Old Age Crisis* and the reasons behind the message still hold. In fact, many more people accept this message today than when the book was published in 1994; it seems almost self-evident and uncontroversial now. In essence, the book says that old-age security plans should have two mandatory parts. One component is responsible for handling workers' savings, resulting in income smoothing over their lifetimes. This part should be funded, with the funds privately managed, and would usually be a DC system. The second component has a redistributive and poverty-prevention objective, transferring lifetime income from high earners to lifetime low earners who cannot save enough in prime age to support themselves in old age. This part would be PAYGO or tax-financed and publicly managed, and would usually define the benefit in such a way as to set a floor on old-age income. This division of responsibility provides fiscal sustainability and national savings that result from shifting away from a complete reliance on PAYGO as populations age, as well as a labor market advantage by establishing a close link between contributions and benefits, for the consumption-smoothing objective. It also addresses the empirical evidence that governments are not very efficient at allocating a country's capital and that the private sector has no motivation to provide a safety net to keep people out of poverty.

Aside from stating these fundamental principles, *Averting the Old Age Crisis* does not provide a precise blueprint for how countries should set up their systems. Rather, it provides several options about how the public and private pillars (the funded and tax-financed pillars) *could* be organized. It was up to each country's policymakers to determine which variation to implement. Although many have accused the book of directing policymakers to copy Chile's plan, those who have read *Averting the Old Age Crisis* know that this is not the case.

Many countries have adopted multipillar systems over the years that have passed since the publication of *Averting the Old Age Crisis*. Their experiences have clarified some implementation issues. A sequel to *Averting the Old Age Crisis* would concentrate on these issues, particularly low coverage, high administrative costs and fees, payout issues, and pitfalls in financing the transition. I address these issues below.

Low Coverage and Low Density of Contributions

The private pillar, which manages workers' retirement savings, is based on contributions. Retirees eventually get a benefit based on their contributions. Much of the discussion in Latin America today concerns the low coverage rate or low density of contributions in the new privatized systems. While many people belong to the system, they do not contribute much over their lifetimes, which will result in low pensions. However, this situation is not surprising, occurring as it does in low- and middle-income countries. *Averting the Old Age Crisis* shows the close correlation between coverage rate and the state of a country's development. Although the old-age schemes are mandatory—many people, due to myopia, do not voluntarily postpone their consumption sufficiently—it is difficult to enforce in low- and middle-income countries because self-employment and small firms dominate, the informal sector is large, women are less likely to be educated and work in the market, and the government's capacity is limited. This is true whether the contributory system is old or new, DC or DB.

To some extent, the family system provides old-age support in these countries. However, if the family system is failing and the government cannot enforce contributions, greater coverage in the mandatory formal system can be achieved through the public pillar and must be financed out of general government revenues. That is, coverage must be part of a noncontributory plan. Of course, for many of the same reasons these countries experience difficulties enforcing their mandatory contribution systems, they also have limited capacity to collect taxes. Policymakers must therefore carefully analyze the desirability of greater coverage through general revenues. Another reason for financing old-age programs through earmarked contributions rather than general taxes is that people may be more willing to contribute incremental amounts that they will eventually get back as benefits. Thus, difficult trade-offs with other public goods and services are avoided. If government cannot collect these earmarked contributions, then general revenue finance is the only way to go and the difficult trade-offs are unavoidable.

Each country's government must address these policy questions. Should resources be shifted from other public services toward old-age pensions? Should the government attempt to raise taxes—and will it be able to do so? Whose taxes should be raised and whose services cut? If we are looking at pensions only, it would seem that more benefits and greater coverage are always preferable. However, if we are looking at the economic priorities of the country as a whole, as we must, then the right policy is much more country-specific and difficult to determine. If the elderly are especially poor and no better way to get them out of poverty is feasible, then the argument for a universal, tax-financed public benefit is compelling. However, in many countries poverty is not concentrated among the elderly. In many countries, young families with children may be poorer, and key public goods such as education and health services underfunded. In these cases, a universal, tax-financed old-age program may not be a top priority.

Averting the Old Age Crisis is agnostic on the question of whether the redistributive public benefit should be for contributors only and financed out of payroll taxes or universal and financed out of general revenues. It is also neutral on whether the benefit should take the form of an MPG, a means-tested benefit for all, or a flat benefit. The book is agnostic because the authors believed that each option had pros and cons and that the answer, therefore, would depend on a country's individual conditions and priorities. However, a sequel to *Averting the Old Age Crisis* would go into greater detail on the criteria for choice. I address some of these criteria below.

The MPG is the cheapest way to protect contributors and to set a floor on their retirement income. It is also very easy to administer because only the pension needs to be evaluated. Means-tested benefits are similar to MPGs; however, they consider all income and sometimes assets. Rather than covering only contributors, these means-tested benefits cover the entire elderly population, so they achieve greater coverage than does the MPG. In principle, they are better targeted toward the poor than are flat pensions (discussed later), and can therefore be much cheaper. In the real world, however, some of these advantages are lost by high transaction costs, inaccurate targeting, or bribery. One study calculated that 30 percent of all expenditures on means-tested programs for the elderly in India were lost due to bribery (Palacios and Sluchynsky 2006). Means tests are particularly difficult to apply in developing countries, where many old people live with their extended families. Whose income counts, and who gets the benefits? Which equivalence scales should be used? Perhaps most important, means tests reduce incentives to save, work, and contribute.

In contrast, a flat benefit that is paid to every person once he or she passes a residence and age test is easier to administer, less subject to corruption, and less distortionary than a means-tested benefit—a big advantage in low-income countries. The big disadvantage is that a uniform payment to every old person can cost a lot of money and government must consider whether that money should be spent in some other way. It could give that money to young families, or to children who attend schools, or to health clinics in rural areas, and so on. Even worse, the flat benefit may appear to be cheap when the country is poor and has a young population, which might lead a government to promise a generous pension. However, twenty years later, when the population has begun to age, the flat benefit has become much costlier. So if a flat pension is adopted, it is important to include with it an exit strategy. One way to keep costs low and under control as populations age is to set a high age of eligibility, such as 70 years, and index it to life expectancy, so the eligible age gradually rises as longevity increases. Another way is to claw benefits back from high earners through the income tax system, so the proportion of old people who retain the benefit falls as national per capita income rises.

Administrative Costs and Fees

High administrative costs and fees is another significant issue in Latin America. *Averting the Old Age Crisis* discusses this issue, but not in great detail, perhaps because competition was expected to do the job. However, as the mandatory funded pillars have evolved in Latin America and elsewhere, high costs and fees have been observed. Many of these costs arose in the early stages, with start-up expenses—putting technology in place, beginning a collection and recordkeeping system, covering the fixed cost per account, and paying marketing expenses to gain the new clientele. Because assets were small and start-up costs high, costs as percent of assets were also high initially, and most, though not all, were passed on to worker-investors in the form of high fees. As assets have grown, however, costs as a percent of assets have fallen dramatically. For example, in the Chilean system, which has been operating for more than twenty-five years, costs are now under 1 percent of assets (whether measured on a current-year basis or a lifetime equivalent fee basis)—considerably less than the mutual fund or 401(k) industry in the USA.

The question we must address is whether the current situation is good or bad. Compared with voluntary retail plans such as those in the USA, Chile's record is good. However, when we compare Chile's pension system with large, institutional pension funds, we find that its costs are high and should be lower. Moreover, fees are much higher than costs. In many Latin-American countries, the rate of return on equity of the AFPs (Administradoras de Fondos de Pensiones, or pension fund managers) is 30–60 percent, and even higher by some estimates. In a mandatory scheme this rate is unacceptable. If we believed that worker-investors have a high price-elasticity of demand, we could rely on them to exert downward pressures on price and upward pressures on efficiency. However, evidence in financial markets suggests that small investors are not price-elastic. Indeed, they may not even be aware of the price that they pay, responding instead to marketing, which raises costs and fees. What, then, should be done?

We do not yet have the full answer to this question, but it appears that a good starting point is the recognition that scale economies are greater for the account management function—which includes collections, record-keeping, and communications—than for the investment function. This situation calls for an unbundling of these two functions, because their optimum degree of concentration differs. Account management could be largely centralized (in one or a small number of firms), through a public agency, a private clearinghouse, or a competitive bidding process. Centralization allows scale economies to be realized, facilitates account transfers, and enables a low-cost method for allocating investments.

Once account management is centralized and separate, asset managers need not even know the identities or amounts associated with each client; they simply get an aggregate sum of money to invest, through the account manager, following the allocation choices of its affiliates. Such 'blind' allocations should reduce the ability of asset managers to market, thereby reducing their marketing costs. Two alternative methods could be used for selecting the allowable asset managers: competitive bidding, to provide a choice of a limited number of investment firms, or open entry, with added measures to assure low costs. Well-known examples of systems that use the competitive bidding approach are the Bolivian pension system, which has the lowest fees in Latin America, and the Thrift Saving Plan for federal civil servants in the USA, which operates at the lowest cost of any pension fund in the world: six basis points. Examples of systems that use open entry with added measures to keep fees low are Sweden's, which effectively imposes price controls, and Mexico's, which assigns new entrants to low-cost pension funds and restricts the ability of existing affiliates to move toward high-cost pension funds. Sweden's costs are low, but most countries could not be counted on to use price controls effectively in the long run. It is too early to determine how successful Mexico will be. For countries like Mexico that rely to some extent on market competition to keep prices down, the question of how to present fee information to elicit an elastic response from workers is an important one that needs to be explored. Behavioral economics has taught us that it matters how information is presented; we need greater experimentation.

Payouts

When the authors wrote *Averting the Old Age Crisis*, they did not pay much attention to the payout stage, because that stage was years away. Nor did countries starting their multipillar systems pay much attention to payouts, for the same reason. However, it is now time to put these arrangements in place, because they do require considerable advance planning, including constructing accurate mortality tables for annuities. Policymakers have to determine whether to require annuitization, in order to ensure lifelong income, or to offer other options. Given a choice, would retirees purchase annuities, which provide longevity insurance, and will insurance companies offer credible annuities with a high money's-worth ratio? In the event retirees do not, what would be the government's contingent liability? In addition, policymakers will have to establish the allowable retirement age and decide whether to permit early retirement. They also have to establish risk categories, including whether to require gender-specific or unisex mortality tables. Should price-indexed annuities be required to maintain real values over the retiree's lifetime? Should joint annuities be required to protect spouses? Above all, policymakers have to formulate the regulations that will produce the outcomes they seek.

The experience of Chile's pension system, which has been in place long enough to have many retirees, indicates that if retiree choice is very limited, many people will purchase annuities, and insurance companies then develop to meet the demand. (Two-thirds of Chile's retirees under the new system have purchased annuities.) Competition is effective in producing a high money's-worth ratio, perhaps because payouts for a given premium are easily compared, and having many indexed instruments in which insurance companies can invest enables them to offer price-indexed annuities at relatively low costs. Furthermore, joint annuities substantially increase wives' lifetime retirement income, almost to that of men. Insurance companies will use gender-specific tables unless they are prohibited. Even if they are prohibited, insurance companies will likely look for proxies for gender. In addition, workers will start taking out their money at the earliest feasible age, possibly running out of money if the age is too low. Above all, a well-constructed regulatory regime is essential.

Pitfalls in Financing the Transition

With respect to transition costs, we must ask if they are higher than was expected and how countries should cover them. When funded pillars were adopted, workers were often given a choice of switching. For a couple of reasons, policymakers estimated very conservatively how many workers would switch. First, it is better to guess low and be pleasantly surprised. Second, guessing low produces low transition costs, making it politically easier to sell the idea of the conversion. In almost every case, more workers than expected switched, so transition costs were higher.

Such an outcome is not an insurmountable problem. Indeed, this consequence should be good for these systems in the long run. The absence of a plan for covering the transition costs is more of a problem since it is very difficult to devise politically acceptable ways to finance the transition. Covering transition costs requires either cutting benefits and services or increasing taxes, at least for the short and medium term. It could mean relying on debt finance to cover costs. Chile was able to accumulate a budgetary surplus to cover transition costs, but it did this under Pinochet, when Chile was hardly a democracy. In contrast, relying on debt as the primary means to finance the transition is problematic for two reasons. First, the government must pay high debt service, and the increased debt negates the object of increasing national saving. Second, government dissaving offsets private saving, canceling out any positive saving effect. If I were at the Bank today overseeing a country implementing such a reform, I would put pressure on the government to devise a realistic way to finance the transition without creating a huge increase in its explicit debt.

Conclusion

Partially funded multipillar systems have the great advantage over PAYGO single-pillar systems because they are fiscally sustainable without the governments having to impose large tax increases as populations age. They also have the advantage over centrally controlled funded systems because they are less subject to politically motivated capital allocations, and so yield a more efficient use of retirement savings. However, multipillar systems pose such implementation problems as low coverage or low density of contributions, high administrative costs, failure to provide lifelong income protection, and debt-financed transitions. In general, life consists of choosing the problems you wish to confront; you choose some because they are less serious and more tractable than others.

Because many countries have undergone pension reform in the years since the publication of *Averting the Old Age Crisis*, we have a clearer grasp today of some of the implementation problems inherent in multipillar systems. In the preceding paragraphs, I have outlined some potential solutions to these problems. The empirical experience of these countries that have adopted new systems can teach us what works well, what does not work, and what issues remain for future analysis.

The Economic Rationale for the MultiPillar Model: Distinctions That Matter and Those That Do Not

Truman Packard

In the preceding section, Estelle James refers to points that she would like to make if she were to cowrite a sequel to *Averting the Old Age Crisis* (WB 1994). I have often felt that *Keeping the Promise of Social Security in Latin America* (Gill, Packard, and Yermo 2004) is that sequel. In fact, the first working title that Indermit Gill, Juan Yermo, and I came up with for the book was *A Crisis Not Yet Averted*. However, we thought that title might make it even more difficult to get the draft through the internal review process of the World Bank, so we went with the less controversial *Keeping the Promise of Social Security in Latin America* instead.

In this section, I summarize some of the issues raised in *Keeping the Promise of Social Security in Latin America* and underline the most important points for pension policymakers. In particular, I address the issues of low coverage and the expected outcome of pension reforms. In many ways, what I address in this section appears very similar to what Estelle James writes in the previous section.

Is an objective of pension reform to increase coverage, as the authors of *Averting the Old Age Crisis* noted? We frequently came back to this question during the review process of *Keeping the Promise of Social Security in Latin America*. In trying to answer it, I can empathize very much with Estelle James and the main authors of *Averting the Old Age Crisis* because several misperceptions about *Keeping the Promise of Social Security in Latin America* have arisen, often from those who have not actually read the book. The authors of *Averting the Old Age Crisis* did *not* say that private individual retirement accounts will solve all problems. Likewise, the authors of *Keeping the Promise of Social Security in Latin America* did not say that individual accounts were a big waste of time, nor that countries should replace pension fund managers with universal pensions.

I question whether *Averting the Old Age Crisis* actually claimed that pension reforms would increase coverage. However, rightly or wrongly and somewhat opportunistically, the proponents of the pension reforms enacted in Latin-American countries sugarcoated the difficult measures that were pushed through with the promise of gains in coverage through an expected improvement in workers' incentives to participate in the new pension systems, and they backed these promises with *Averting the Old*

Age Crisis and other World Bank publications. Thus, while it might be comforting for the proponents of reform and even many of us at the World Bank to seek recourse from critics in what *Averting the Old Age Crisis* actually says on the matter, given the low coverage of pension systems in Latin America, clearly people in the region expected much more from pension reform. Whatever the book actually says, it is a matter of record that reform proponents fueled these expectations with frequent and sometimes embellished references to a perceived and exaggerated orthodoxy in pension policymaking, most visibly represented in *Averting the Old Age Crisis*.

In an attempt to clarify the most important points made in *Keeping the Promise of Social Security in Latin America*, I would like to point to a part of the book that, in my opinion, is its most distinguishing feature but which does not get much attention from the people who have commented on it: the conceptual microeconomic framework of insurance and savings in Chapter 6 (borrowed from Ehrlich and Becker 1972).

In terms of actual policy recommendations, much of what the book says is similar to what is said in *Averting the Old Age Crisis*. However, *how* the authors came to these conclusions is very different, and it is precisely this difference that is critically important for readers to understand. By applying a microeconomic framework of insurance and savings, we were able to focus rigorously on the primary policy objectives of old-age income security: ensuring efficient consumption smoothing and preventing poverty in old age. By using a classical insurance approach, we arrived at two very powerful conclusions. First, as populations age and old age becomes more widespread, mechanisms that pool this risk are strained and individual savings become a more efficient way to cover the loss of earnings-ability and to achieve consumption smoothing. Second, as economies develop and households get richer, and if poverty among the elderly is relatively less frequent than poverty among other groups because of this development, then risk pooling is the most appropriate instrument to cover poverty in old age. Put more simply, as countries get richer, publicly offered risk-pooling mechanisms to cover the relatively rare risk of poverty in old age grow in importance.

In this way, we arrived at a set of policy conclusions that look a lot like some of the conclusions made in *Averting the Old Age Crisis*, but the path we took to get there is very different and is critical to our arguments. Critics might ask, if we arrived at a similar place, does it really matter how we got there? Is it overly academic to insist that applying an economic rationale makes a difference? I would argue that *how* we arrived at our recommendations does matter, and that insisting on working through the economic rationale for policy recommendations makes a difference to real-world reform outcomes.

By anchoring our arguments in a microeconomic model and focusing on the primary objectives of pension policy, we were able to identify what the fundamental distinctions that frame the pension policy debate should really be. From a microeconomic perspective, the fundamental distinction is not PAYGO financing versus prefunding, nor is it public versus private management. The real fundamental distinction is between instruments that *define benefits* (a form of risk pooling) versus those that *define contributions* (essentially, individual savings). By arriving at this fundamental distinction through the application of an economic model, we could afford to be much more agnostic in our book about second-order issues and features of pension reforms that have provoked very heated debates or that have led to sometimes unrelenting policy positions.

The distinctions of PAYGO financing versus prefunding, public versus private management, and mandatory versus voluntary participation (a dimension of pension policy not really touched on in *Averting the Old Age Crisis*, but one which we explore extensively in *Keeping the Promise of Social Security in Latin America*) are essentially secondary. These are clearly important issues in pension policy. However, they are distinctions on which one can afford to be agnostic if one accepts the fundamental principles of defining benefits (risk pooling) to cover the risk of poverty in old age, and defining contributions (individual savings) to cover the loss of earnings-ability. Thus, in *Keeping the Promise of Social Security in Latin America* we are able to press for individualization and individual savings accounts to achieve better consumption smoothing without having to rely on arguments of government failure (although there are plenty of examples of this in Latin America's history), nor on an overly naive view of what private markets can achieve. We do not need these arguments in order to recommend measures that look, in many ways, very similar to those of *Averting the Old Age Crisis*. However, having a strong economic rationale to examine policies allowed us to be agnostic about and see the merits of pension reforms in the 1990s that did not take the traditional Latin-American path, including those that implemented individualization through notional defined contribution (NDC) accounts and took other similar measures, such as Brazil's 'social security factor' that incorporated some NDC features.

The danger of not having an underlying microeconomic rationale for the same policy prescriptions is that without such a rationale, reform proponents prescribe the multipillar approach without any guidance as to the relative weights that each pillar should have. Without guidance, policy-makers can assign, and have assigned, the weights of the pillars arbitrarily and sometimes in the pursuit of secondary objectives, to the detriment of poverty prevention and consumption smoothing.

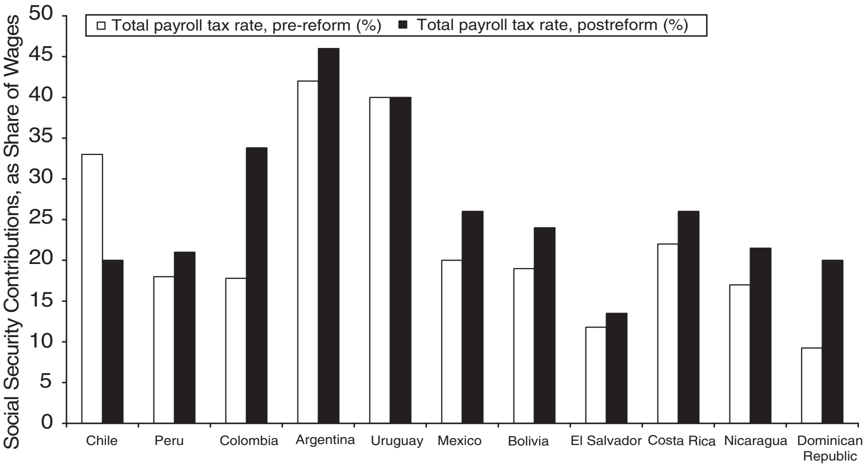

Figure 6-1. Payroll taxes for national pension systems (pre- and postpension reforms).

To illustrate this danger, I would like to take a point from the perceived pension orthodoxy of the 1990s—namely, that *the introduction of individual retirement accounts leads to capital market development*. This assertion was just one of several widely accepted justifications for many of the reforms that took place in Latin America. However, in order for this development to take place, a very large injection of cash into the new individual accounts is necessary. Without guidance in weighting the private-savings pillar relative to the poverty-prevention public pillar, a policymaker pursuing the objective of capital market development might set the contribution rate—or the share of earnings that are subject to the mandatory contributions—very high, or at least higher than he or she otherwise would if the only objective were to achieve efficient consumption smoothing. Indeed, among Latin America's pension reforms, only in Chile and Uruguay did the mandatory contribution rate, collected as a payroll tax, actually fall (see Figure 6-1). Across Latin America today, the share of earnings subject to mandatory pension contributions is much greater than in OECD countries. In Chile, where it is lowest, the share of earnings subject to mandatory contributions is about twice that of most OECD countries. In Peru, there is no ceiling on the portion of earnings subject to the mandate (see Figure 6-2). Thus, paradoxically, even where pension systems were seemingly 'privatized', the impact of government on household savings and insurance decisions actually increased with pension reform. Among lower-income households, where credit is scarce, such large savings mandates can deter participation, exacerbating the coverage problem.

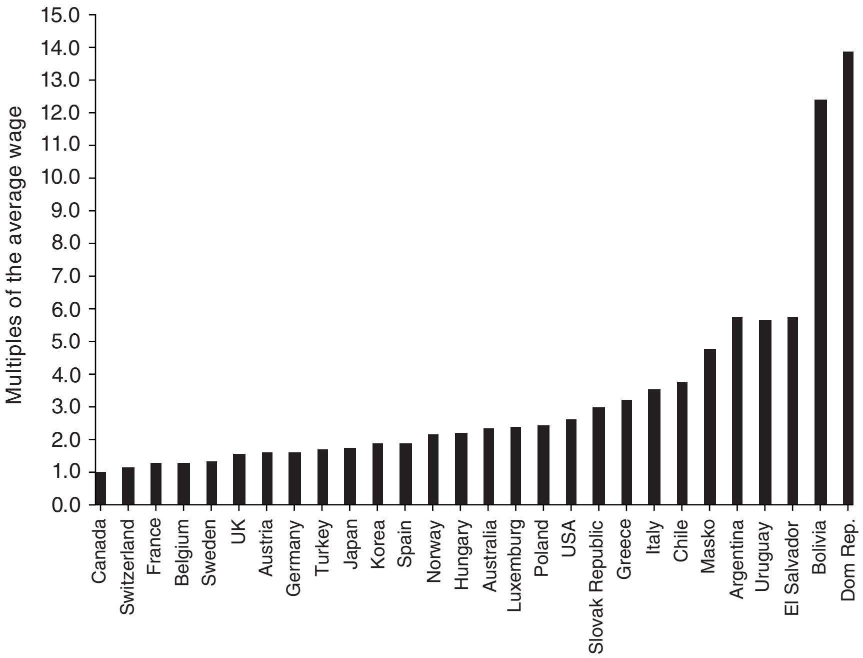

Figure 6-2. Earnings subject to mandatory contributions, as multiples of the average wage.

In contrast, by working through a microeconomic model, we are able to show that the multiple pillars of old-age income security are not distributed equally in economic space. Additionally, the weights that should be assigned to each pillar will vary from country to country and, indeed, in the same country over time, as certain economic fundamentals change. These fundamentals include (*a*) the generosity of the pre-reform defined benefits and thus household expectations of what a publicly mandated pension system should deliver, (*b*) the availability of financial instruments for households to take up on a voluntary basis to complement or act as an alternative to the mandatory system, and (*c*) governments' institutional capacity not only to target minimum pension benefits accurately to the poorest, but also to regulate the provision of mandated services by strong private actors in the financial sector. The conclusion that the relative weights of the pillars of old-age income security will vary from country to country, and even in the same country over time, has clear implications for the design of pension reform in a region as diverse as Latin America, with countries as different in level of development and regulatory capacity as Nicaragua and Chile. From our perspective, one size *cannot* fit all.

In *Keeping the Promise of Social Security in Latin America*, we argue that the fundamental distinction that policymakers should keep in mind is between risk-pooling to cover poverty in old age and individual savings to achieve efficient consumption smoothing. To use the widely accepted lexicon of pension policy, the differences that really matter are between 'pillar zero' and 'pillar three'. The economic distance between pillars zero and one and between pillars two and three is too small to justify a huge amount of debate and expense in political capital.

So, *is* low coverage a problem? The answer is clearly yes. But what is the real nature of this problem? There are two problematic groups for pension policymakers: the 'poor noncontributors' and the 'nonpoor noncontributors'. A basic targeted flat benefit financed with general revenues responds rather conclusively to the needs of the first group and, at the same time, establishes a good form of 'poverty insurance' (in the real insurance sense of covering only those who suffer the 'bad state' of old-age poverty) for the rest of the population.

For the nonpoor noncontributors, the real coverage problem is actually a policy dilemma. In fact, it is a dilemma (one of three) raised in the first few pages of *Averting the Old Age Crisis*: 'If mandatory schemes are needed because of shortsighted workers, how can these same workers be counted on to make wise investment decisions?' (WB 1994: 203). In other words, *Averting the Old Age Crisis* questions whether people will achieve consumption smoothing efficiently if left to their own devices. The authors of *Keeping the Promise of Social Security in Latin America* pose a similar question, with a twist: 'Once a fiscally sustainable poverty-prevention pension is securely in place, what is the appropriate level of state-mandated consumption smoothing?'

In *Keeping the Promise of Social Security in Latin America*, we chose to be skeptical about government mandates to pursue the consumption-smoothing objective of pension policy. We chose to believe more in people's rationality and somewhat less in their myopia. However, that skepticism for mandates does not mean that we advocate a repeal of the mandate to save privately, either immediately or totally over time. It does mean, however, that where mandates do exist, policymakers must scrutinize them for their demand-side and supply-side effects. In doing so, policymakers simultaneously grapple with the issues of low coverage and high system costs. How much saving is mandated is really an issue of coverage because a large savings mandate may dissuade people from participating in the system at all. On the supply side, it is an issue affecting costs. A large mandate managed by the private financial sector in countries where governments have little regulatory capacity can lead to the kind of competition problems and industry concentration that we have seen in Latin America's private pension systems, as well as to higher prices than households would pay in truly competitive markets.

Conclusion

In sum, *Keeping the Promise of Social Security in Latin America* expressed strong support for the forward steps Latin-American policymakers have taken to reform their pension systems. However, the magnitude of their achievements cannot be cause for complacency, as a growing number of workers and their households require better protection than social security systems currently offer.

Pension Systems and Reform: The World Bank's Evolving Conceptual and Operational Framework

Robert Holzmann

The past decade has brought increased recognition of the importance of pension systems to the economic stability of nations and the security of their aging populations. Populations are aging and, in developing countries, the traditional systems for support of the elderly are being eroded by migration, urbanization, and other factors that break down extended families. At the same time, pension systems, where they exist, are proving limited and increasingly costly.

A Framework for Pension Reform

The framework for analyzing pension systems and their reform should be based on some core principles and the capacity to achieve a flexible and context-specific set of social and economic outcomes. It should not narrowly prescribe the structure, implementing institutions, or operations of a system. On a practical level, the application of such a standard requires the articulation of goals and criteria against which a proposed reform can be evaluated.

Goals of a Pension System and Reform

The primary goals of a pension system should be to provide adequate, affordable, sustainable, and robust retirement income, while seeking to implement welfare-improving schemes in a manner appropriate to the individual country.

An *adequate* system is one that provides benefits to the full breadth of the population that are sufficient to prevent old-age poverty on a country-specific absolute level, in addition to providing a reliable means to smooth lifetime consumption for the vast majority of the population. An *affordable* system is within the financing capacity of individuals and the society, and does not unduly displace other social or economic imperatives or have untenable fiscal consequences. A *sustainable* system is financially sound and can be maintained over a foreseeable horizon under a broad set of reasonable assumptions. Finally, a *robust* system has the capacity to withstand major shocks, including those coming from economic, demographic, and political volatility.

The design of a pension system or its reform must explicitly recognize that pension benefits are claims against future economic output. To fulfill their primary goals, pension systems must contribute to future economic output. Reforms should, therefore, be designed and implemented in a manner that supports growth and development and diminishes possible distortions in capital and labor markets. This requires the inclusion of secondary developmental goals, which seek to create positive developmental outcomes by minimizing the potential negative impacts that pension systems may have on labor markets and macroeconomic stability while leveraging positive impacts through increased national saving and financial market development.

Review and Extension of the Original Concept of Pension Reform

The evolution of the general perspective and the World Bank's perspective on pension reform over the past decade reflects the extensive experience with reform in countries and an ongoing dialogue with academics and partner organizations, as well as intensive discussion and evaluation within the World Bank of pension reforms worldwide. As a result, the original concept of a specific three-pillar structure—(*a*) a mandated, unfunded, and publicly managed DB system; (*b*) a mandated, funded, and privately managed DC scheme; and (*c*) voluntary retirement savings—has been extended to include two additional pillars: (*d*) a basic ('zero') pillar to deal more explicitly with the poverty objective, and (*e*) a nonfinancial ('fourth') pillar to include the broader context of social policy, such as family support, access to health care, and housing.

The past decade of experience, while contributing considerable depth to the understanding of the nuances and challenges of pension reform, has reinforced the need in nearly every circumstance to move away from a single-pillar design. Experience has demonstrated that the multipillar design is better able to deal with the multiple objectives of pension systems—most importantly poverty reduction and income smoothing—and to address more effectively the kinds of economic, political, and demographic risks facing any pension system. The proposed multipillar design is much more flexible and better addresses the main target groups in the population. Advance funding is still considered important, but the limits of such funding in some circumstances are also seen much more sharply. The main motivation for the Bank to support pension reform has not changed. Instead it has been strengthened by the past decade of experience: most simple pension systems do not deliver on their social objectives, they create significant distortions in the operation of market economies, and they are not financially sustainable when faced with an aging population.

The extensive experience in implementing pension reforms in a range of settings since the early 1990s has motivated a review and refining of the framework in terms of the appropriate objectives and path of a reform effort. From the World Bank's perspective, the evolution of thinking and policy on pensions is characterized by five main additions.

A better understanding of reform needs and measures. A better understanding includes: first, assessing the need for reform beyond fiscal pressure and demographic challenges to address issues such as socioeconomic changes and the risks as well as opportunities from globalization; second, understanding the limits and other consequences of mandating participation in pension systems, particularly for low-income groups, for which risks other than old age may be more immediate and much stronger; and, finally, reassessing the continued importance, but also the limitations, of prefunding for dealing with population aging in recognition of the importance of associated behavioral changes, including enhanced labor supply and later retirement.

The extension of the reform model beyond the three-pillar structure. The reform model should encompass explicitly as many as five pillars and move beyond the conventional concentration on the first and second pillars. Experience with low-income countries has brought into focus the need for a basic, or zero (noncontributory), pillar distinguished from the first pillar in its primary focus on poverty alleviation to extend old-age security to all the elderly. Experience in low- to middle-income countries has heightened awareness of the importance of the design and implementation of the third, voluntary pillar, which can effectively supplement the basic elements of a pension system to provide reasonable replacement rates for higher-income groups, while constraining the fiscal costs of the basic components. Last, but not least, is recognition of the importance of a fourth pillar for retirement consumption that consists of a mixture of access to informal support (such as family support), other formal social programs (such as health care), and other individual financial and nonfinancial assets (such as home ownership) and the need to incorporate their existence or absence explicitly into the design of the pension system and old-age security.

An appreciation of the diversity of effective approaches. This diversity includes the number of pillars, the appropriate balance among the various pillars, and the way in which each pillar is formulated in response to particular circumstances or needs. Some pension systems function effectively with only a zero pillar (in the form of a universal social pension) and a third pillar of voluntary savings. In some countries, the introduction of a mandatory second pillar is required to gain popular acceptance for a reform of the first pillar, while the political economy of other countries makes a reformed (first-pillar) public system in conjunction with voluntary schemes the only realistic alternative.

A better understanding of the importance of initial conditions. A good understanding of initial conditions is important in establishing the potential for and limitations within which reforms are feasible. There is now greater awareness of the extent to which the inherited pension system as well as the economic, institutional, financial, and political environment of a country dictate the options available for reform. This is particularly important in establishing the pace and scope of a viable reform.

A strong interest in, and support of, country-led features in pension design and implementation that are often innovative. These features include (*a*) a nonfinancial or NDC system as an approach to reforming or implementing an unfunded first pillar (Holzmann and Palmer 2006); (*b*) use of a single clearing house and other approaches to reduce costs for funded and privately managed pillars; (*c*) the transformation of severance payments into combined unemployment and retirement-benefit savings accounts; and (*d*) public prefunding under an improved governance structure, as introduced in a number of high-income countries. While each of these features is promising, they depend on close attention to country circumstances and require close monitoring and evaluation, as transferability to other countries cannot be assumed.

Three Key Concepts in Considering Pension Reform

Although the essential policy formulation explicitly recognizes country-specific conditions and leads to implementation of the multipillar model in a variety of ways, from the World Bank's perspective three key concepts should be considered.

First, all pension systems should, in principle, have elements that provide basic income security and poverty alleviation across the full breadth of the income distribution. Fiscal conditions permitting, this suggests that each country should have provisions for a basic pillar, which ensures that people with low lifetime incomes or who participate only marginally in the formal economy are provided with basic protection in old age. This may take the form of a social assistance program, a small means-tested social pension, or a universal demogrant available at higher ages (e.g. age 70 years and older). Whether this is feasible will depend on the prevalence of other vulnerable groups, availability of budgetary resources, and design of the complementary elements of the pension system, as will the specific form, level, eligibility, and disbursement of benefits.

Second, if the conditions are right, prefunding for future pension commitments is advantageous for both economic and political reasons and may, in principle, be undertaken for any pillar. Economically, prefunding requires the commitment of resources in the current period to improve the future budget constraints of government and the resources to support retirees; it usually contributes to economic growth and development. Politically, prefunding may better guarantee the capacity of society to fulfill pension commitments because it ensures that pension liabilities are backed by assets protected by legal property rights, regardless of whether the funding is through government debt or other types of assets. The decision to prefund, however, requires careful consideration of benefits and costs, as net benefits are not automatically assured and political manipulation can make prefunding illusory. This decision also requires a close look at the implementation capacity of a country.

Third, in countries where prefunding promises to be beneficial, a mandated and fully funded second pillar provides a useful benchmark (but not a blueprint) against which the design of any reform should be evaluated. As a benchmark, it serves as a reference point for the policy discussion and a means to evaluate crucial questions about welfare improvement and the capacity to finance the transition from PAYGO to funded regimes. The efficiency and equity of alternative approaches to retirement savings, such as a significant reliance on voluntary individual or occupational systems, should be evaluated in relation to this benchmark.

Design and Implementation Issues

Through its pension reform activities in client countries and the work of other institutions and analysts, the World Bank has developed a clear understanding of good and best practices—of what works and what does not—in an increasing number of design and implementation areas. In a variety of other areas, however, open issues remain, and the search for good solutions continues. These open areas range from design issues of the various pillars and their relative weight to issues of financial sustainability, administration, implementation, and political economy, and to lessons from multipillar pension reforms in the world's regions.

Readiness of the Financial Market and Regulatory and Supervisory Issues

The introduction of mandated funded pension pillars has given rise to considerable debate inside and outside the World Bank, and it will take many more years before a clear consensus is reached. This section addresses three major issues that have arisen: (*a*) Can funded pensions be introduced in a rudimentary financial market environment, and if so, what are the minimum conditions? (*b*) What are the good or best regulatory practices that typical client countries should follow? (*c*) What are the good or best supervisory practices to be followed?

Readiness, Minimum Conditions, and Synergies

Not all countries are ready to introduce a funded pillar, and those that are not, should not do so. Nevertheless, the introduction of a funded pillar does not need perfect conditions, with all financial products available from the very beginning, since the pillar is introduced gradually and creates synergies for moving toward improved financial markets. Hence, minimum conditions need to be satisfied, and these can be highlighted when discussing three types of countries and their financial market readiness (Impavido, Musalem, and Vittas 2002).

There are three main types of financial markets: (*a*) those that are incomplete but the segments that operate are sound, are associated with high per capita income, have a credible macroeconomic policy framework, and have open capital accounts (but domestic and international financial instruments are not perfect substitutes); (*b*) those that are incomplete and the segments that operate are predominantly unsound, are associated with low per capita income, have a long history of macroeconomic policy imbalances, and have closed capital accounts; and (*c*) those that have an intermediate position between the two.

Countries with incomplete but sound financial systems that have relatively high per capita income, credible macroeconomic policies, and free capital movements offer the best case for funded pension and annuity systems. This is true for several reasons. First, (voluntary) funded pension and annuity products are luxury financial services. They are demanded at high rather than low per capita income (i.e. at high per capita income, the time preference or discount rate is lower, which increases the valuation of purchasing coverage for future contingencies, and family ties are weaker, which reduces self-insurance within the family). Second, credible macroeconomic policy provides an enabling environment for the development of long-term financial instruments (e.g. pension savings and annuities). Third, even under incomplete financial markets (e.g. embryonic capital markets), but where sound banks are operating, they provide a vehicle for channeling long-term savings into long-term loans to borrowers (government, enterprises, and individuals). Finally, open capital accounts do not constrain pension funds from investing in the local market.

The second type of country—those with chronic macroeconomic imbalances and other limitations—provide little room for the development of funded pensions and annuities. Longterm savings instruments cannot prosper in a macroeconomic environment with high and volatile inflation, and pensions and annuities are not affordable at low per capita income. Furthermore, the financial systems of these countries are essentially limited to the banking sector, which is usually weak. Although it would be possible to invest abroad, these countries, by having weak domestic financial institutions, should have closed capital accounts. Hence, before trying to develop these instruments, the authorities should focus on establishing a credible long-term macroeconomic framework and strengthening prudential regulation and supervision of banks. These two conditions are necessary for the successful development of funded pensions and annuities.

In the third and intermediary category of financial systems, there are a variety of cases. There are countries with a credible macroeconomic policy, a relatively sound banking system, and an open capital account. However, they may have very incomplete financial markets (underdeveloped securities markets, insurance, pensions, and mortgages) and relatively low per capita income. These countries have the preconditions for developing funded pensions and annuities, although their relatively low per capita income imposes a barrier to the scale of the market. Initially, the portfolios of these funds would be composed primarily of government bonds and banks' long-term certificates of deposit. In addition, they could have small fractions in shares, foreign securities, and possibly leasing companies. As financial markets develop, investment regulations should allow more diversified portfolios by allowing higher investments in shares, foreign securities, corporate bonds, and asset-backed securities and small investments in venture capital companies.

These countries will obtain the benefits from the development of funded pensions and annuities. Gains from financial sector development will initially be concentrated in development of the government bond market and long-term lending through banks. In a second stage, benefits will come from development of the corporate bond market and asset-backed securities. In a later stage, they will come from the stock market. The development of funded pensions and annuities will encourage financial market innovation through development of the fund management industry and improved financial regulations, including stronger minority shareholder rights, transparency, and corporate governance. They will also provide competition to the banking system and foster efficiency and innovation in financial markets.

In summary, instead of a full-fledged financial system with a full array of efficient institutions and financial instruments, the following minimum conditions are needed for the successful introduction of a funded pillar (Vittas 2000): (*a*) the presence of a solid core of sound banks and insurance companies; (*b*) a long-term commitment by government to pursue sound macroeconomic policies; and (*c*) a long-term commitment to financial sector reform through the establishment of a sound regulatory and supervisory framework for pensions and insurance products and providers.

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