Pension reform: Past and present

Pension Core Course 2019

Pensions Global Solutions Group
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Pension reforms: drivers and challenges

- Pension design has adopted different paradigms:
  - Defined benefit (DB), financed with contributions from employers and employees (occasionally also the government, beyond its role as employer): dominant scheme for over a century
  - Defined contribution (DC, Chile, 1980 – other countries followed in the 90s, mostly in LAC)
  - Non financial DC (also known as “Notional Accounts”) – Sweden, Poland

- For the past three decades, solutions have been attempted to correct:
  - Population aging
  - Sustainability
  - Low coverage and informality
  - Adequacy of pensions

- ... but results have not been too promising,

- And new challenges emerge:
  - Changes in the world of work
Pension paradigms: Timeline

- 1870-1980: Contributory, publicly managed DB model
- 1980-2008: Rapid expansion of voluntary DC schemes and development of mandatory DC or multi-pillar
- 2008-2020: DC pension reform “reversals” with return to DB and expansion of non-contributory pensions
- 2020-....: Technology threatens formal sector employment, making the case against payroll taxes stronger; A new model of pension provision that relies less on payroll taxes may emerge in the coming years
Pension paradigm shifts: historical drivers and beyond

- Historical context (economic and political) shapes social preferences, but this is not deterministic.
- At country level, structural reforms have replaced old patterns of pension provision by newer ones, but globally there is a mosaic of schemes. This is the result of accumulation rather than global replacement.
- Contributory DB schemes are still prevalent today in most countries worldwide, despite important shifts to DC in the 80s and 90s.
- Reversals reinforced the prevalence of public pension provision, but in the current phase DB schemes are supported by expanding non-contributory schemes.
- Labor market trends may produce a new paradigmatic combination of contributory and non contributory pension schemes.
DB schemes: Unmet promises and challenges

- After decades of demographic dividend, aging population revealed parametric inconsistencies;
- Parametric alignment does not happen automatically;
- Adjustments are slow, and politically resisted
- Inadequate incentives to extend careers
- Low coverage and high informality
- Redistributive effects not always progressive; examples:
  - Benefit formulas based on last salaries
  - Low penalties for early retirement
  - Special treatment for certain activities
  - Budget transfers to pension funds
Sustainability: Beyond demographics, parametric inconsistencies
Sustainability: A major challenge of PAYG schemes – Argentina, 1945-2015

Figure 2.11 Contribution Revenues–Benefit Expenditures Balance, Argentina’s Pension System, 1944–2010

Source: Centrángolo and Grushka 2004 and Bertranou et al. 2012.
Parametric adjustments are politically difficult
DC schemes: Unmet promises and challenges

- Automatic adjustments resulted in low level of pensions
- Free choice is expensive: marketing costs eroded the value of retirement savings;
- Behavioral response did not happen as predicted in economic textbooks; therefore coverage and pensions did not increase as expected
- Financial literacy is limited and difficult to extend, and so is “maximizing behavior”
DC schemes: Automatic adjustments have social costs
Contributory pension schemes: Unmet promises: Informality

% of the Labor Force not Contributing to Social Security

- MENA: 67.0%
- GCC: 6.4%
- non-GCC: 67.2%
- Developed: 8.9%
- ECA: 39.4%
- LAC: 61.3%
- EAP: 76.1%
- SA: 91.0%
- SSA: 94.7%
... and Informality remains unchanged

Contributions in active life: 1990s vs 2010s
Economic change, technology, labor markets and pensions

- Self employment
- Flexible work
- “gig economy”
- Informality
Combination of instruments for multiple risks: Extended basic coverage and income replacement

- Regulated market provision of secure savings & insurance;
- Micro finance saving and insurance

- Default opt-ins;
- Information

- N/DC accounts;
- Actuarially-fair DB

- Minimal "adequate" smoothing
  - N/DC accounts;
  - Actuarially-fair DB

- Minimum DB**
  - Transfers;
  - Subsidized premiums

** Replaces contributory min guarantees and tax incentives
Main areas of World Bank’s work on pensions

• The World Bank provides technical assistance in several areas related to pensions, including the following:

  • Actuarial analysis and financial projections
  • Sustainable pension schemes: design and pension reforms
  • Disability and survivorship pensions
  • Long term care and aging
  • Administrative reforms
  • Privately managed and voluntary pension schemes
  • Pension Supervision
  • Coverage extension for national and expatriate workers
World Bank’s global knowledge – Priority areas

- Pensions for self-employed
- Extending pension coverage to informal sector workers and migrants
- Survivors’ pensions
- Long term care for the elderly and disabled
- The mix of contributory and non-contributory pension (links between non-contributory and social pension)
- Pensions and Social Insurance as a building block of the Human Capital Project
- Assessment tools
  - Pension Reform Options Simulation Toolkit (PROST)
  - Microsimulations
  - Social Insurance Administration Diagnosis (SIAD)
Current challenges and new policy directions: A summary

• Main challenges facing pension systems worldwide:
  • Demographic trends – aging population
  • Labor force participation, notably of women and youth
  • Economic growth, productivity and price stability
  • Low coverage to self employed, casual and rural workers, resulting in high informality in most middle and low income countries;
  • The new economy and changes in work modalities

• Poor design and inability to adapt to changing environment result in lack of financial sustainability. This is a trigger of many reform processes, although improving equity in pension design demands a comparable amount of efforts

• Weaknesses of key business processes and inadequate IT solutions for service delivery (identification, enrollment, collection and payments)

• Low level of financial education and access to financial products.

• Often fragmentation of schemes, resulting in inequalities and limited labor mobility

• Inadequate solutions for migrant workers (particularly those who migrate on a temporary basis)