Voluntary Savings:
Options for Emerging Economies

Heinz P. Rudolph
Lead Financial Economist
World Bank Group
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Mandatory Funded Schemes have been downsized in the ECA region

- Short term fiscal target are at the core of the reversals
- The financial crisis triggered incentives to hide pension liabilities.
  - The Stability and Growth Pact does not help either
- Some reforms were not conduced as initially planned
  - Inability to cut benefits to elderly people at the time of the reform (Poland)
  - Temptation to overspend the temporary pension surpluses during the transition (Hungary)
  - Multiple switching between opt in and opt out system (Slovakia)

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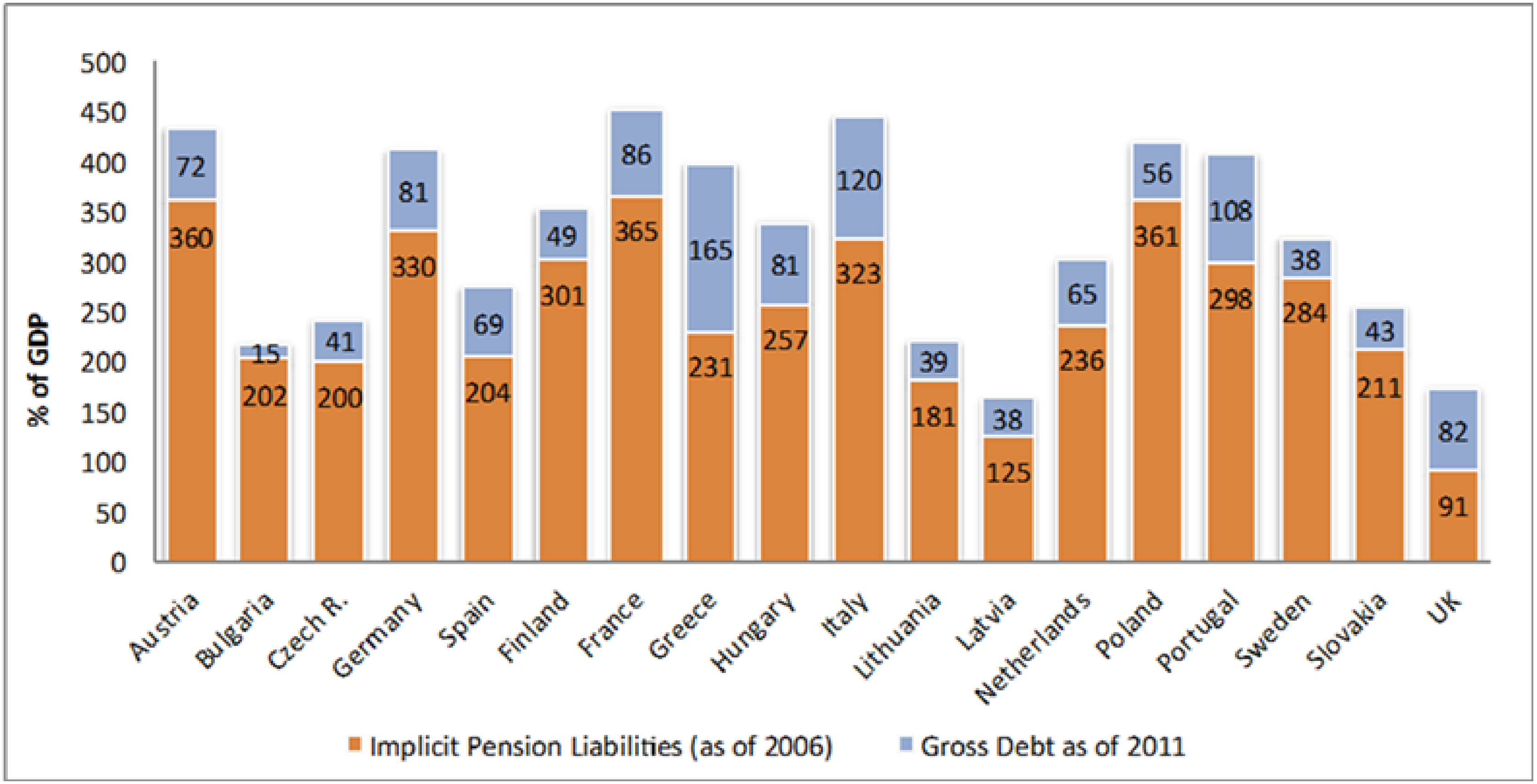
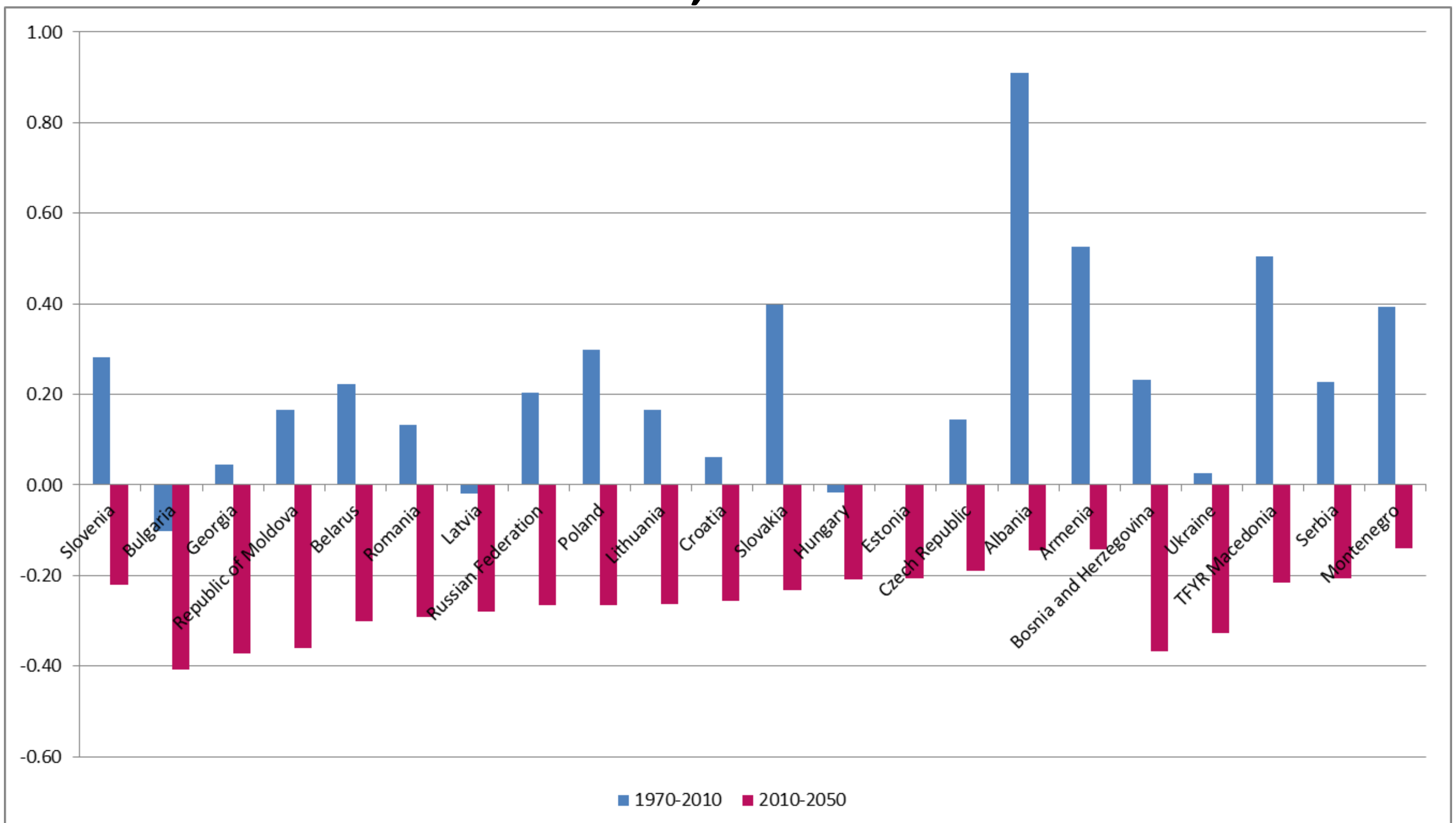
But the Europe still has a problem



Source: Schwartz and others (2014)

Social security schemes are not going to be able to afford adequate pensions

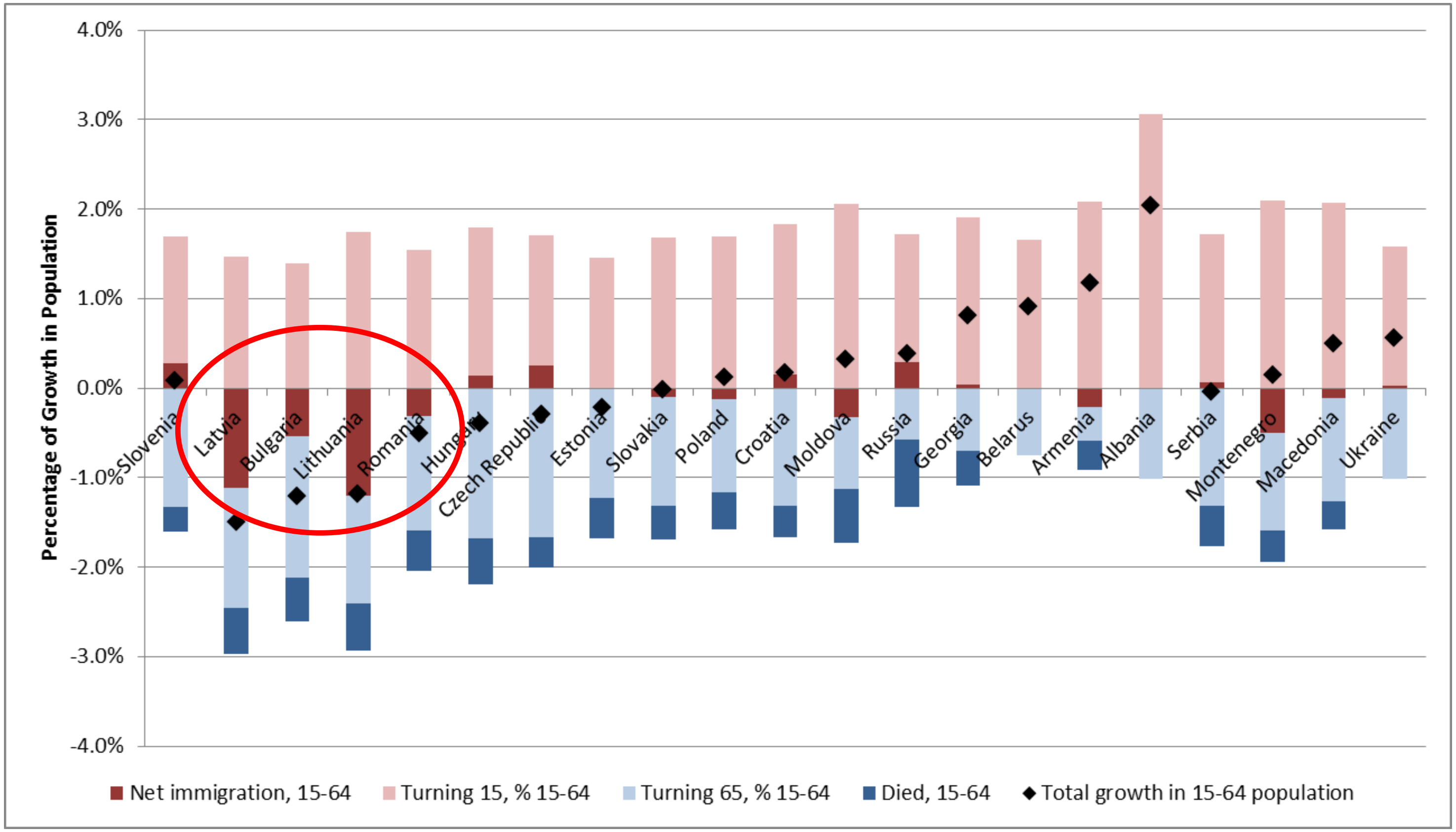
Decline in Working-Age Population, Selected European and Central Asian Economies, 1970–2010 and 2010–2050



Source: Schwartz and others (2014)

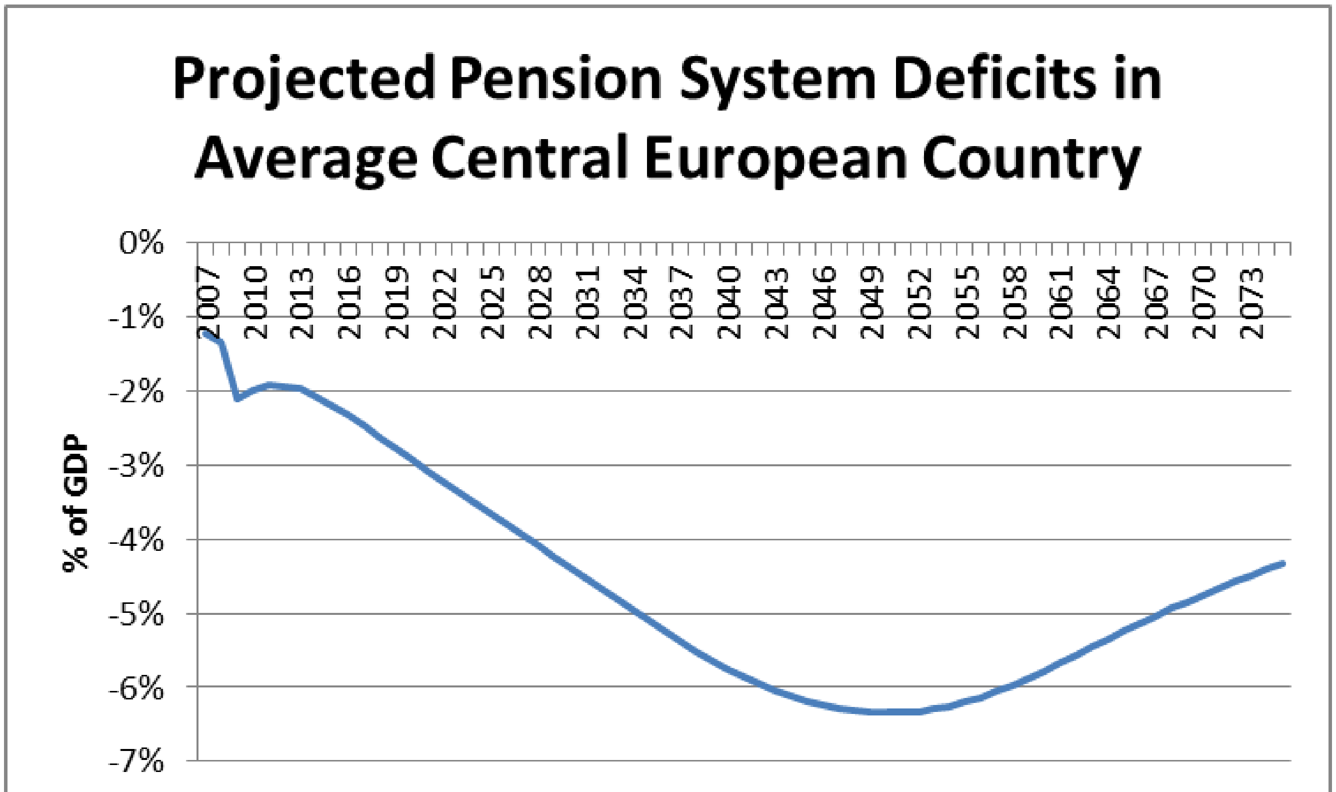
Emigration is also an issue in some of these countries

Decomposition of Average Annual Change in Working Age Population in Selected European Countries, 2000-2010



Source: Schwartz and others (2014)

Pension deficit will become unaffordable for some governments in the region



Source: Schwartz and others (2014)

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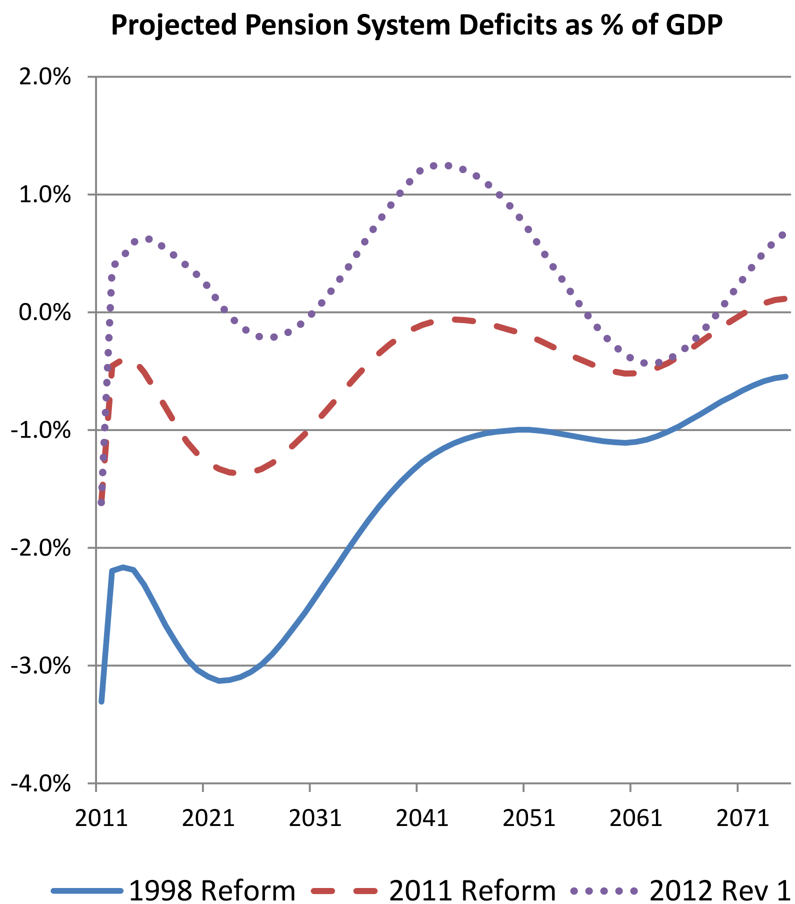
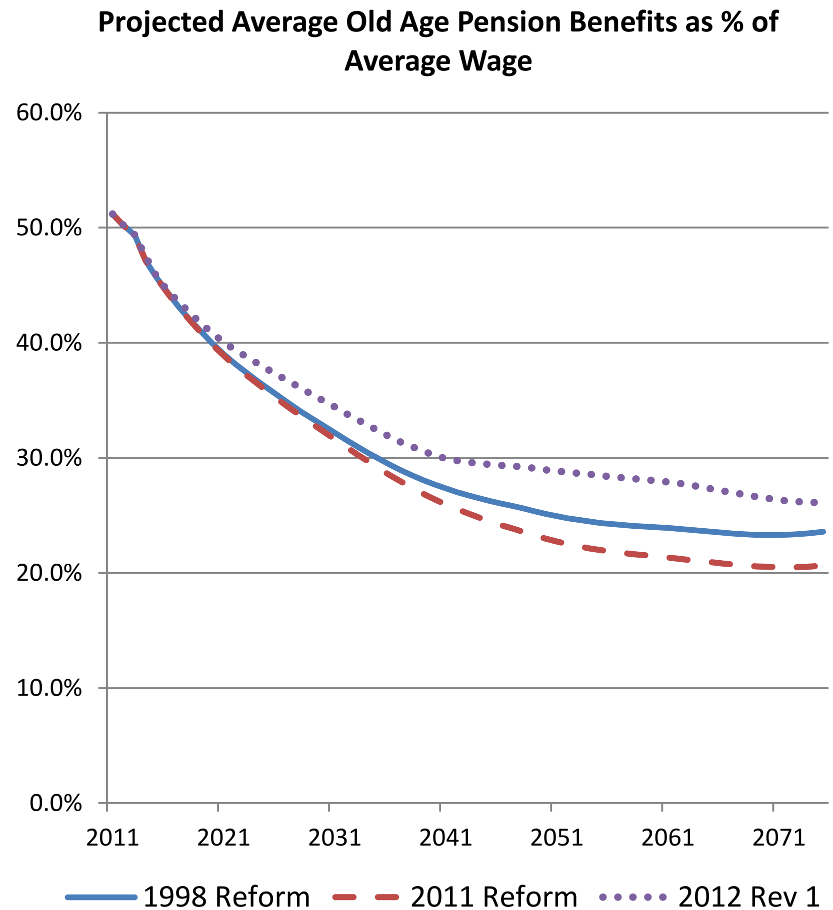
In others, it will be fiscally sustainable, but low pensions are expected…





The case of Poland

Source: World Bank (2012)

Low pensions are not a sustainable solution

- While it is going to take time for people to realize that pensions are too low, it is likely to happen…
- It is essential to put in place savings mechanisms such that individuals may not suffer from abrupt changes in income after retirement
- The sooner the working generations start saving, the higher the replacement rates and the welfare of future retirees

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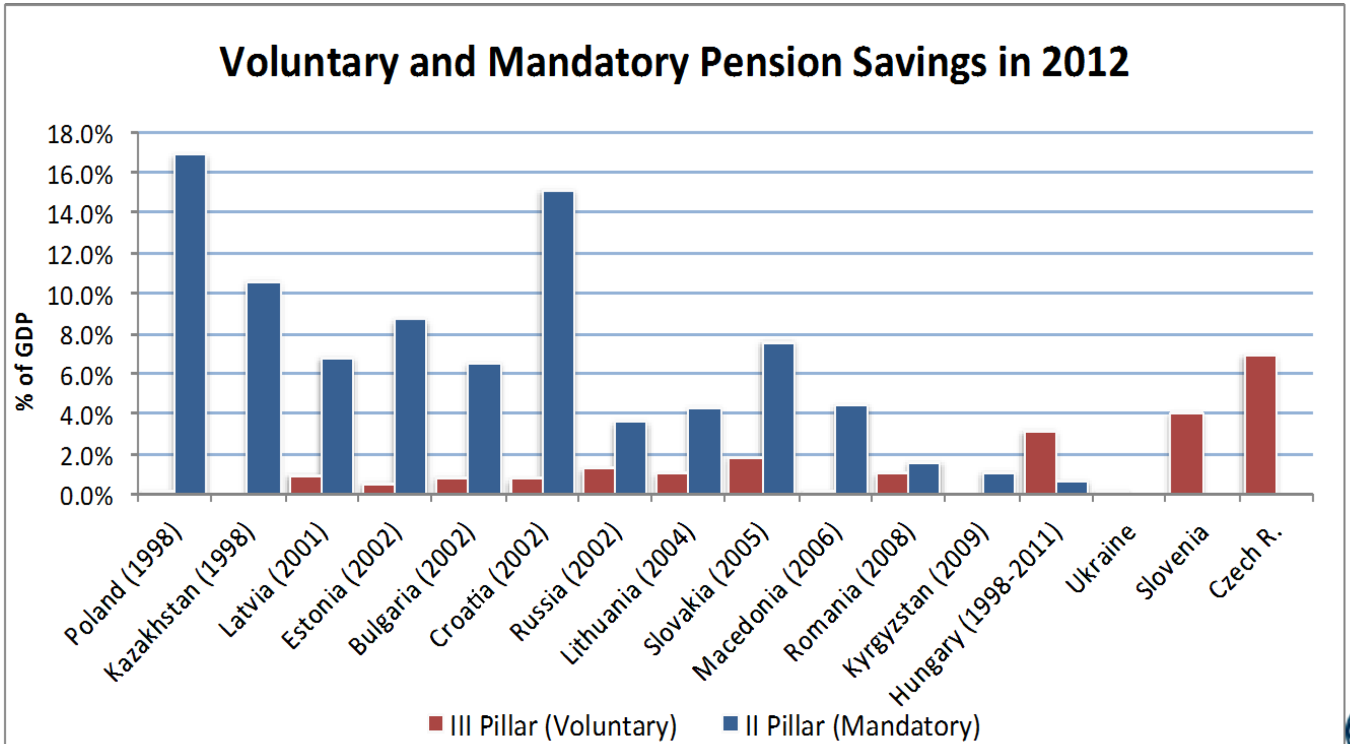
Voluntary pension schemes are a good alternative for improving funded schemes

- This is not an easy task…
  - The public (and unfair) criticism against mandatory funded pension schemes as a justification for downsizing the second pillar does not help in building voluntary schemes
  - Voluntary funded pension scheme providers in Hungary are having a hard time selling products after the nationalization of the system
- Trust is essential
  - Property rights needs to be clearly defined
- It requires fiscal incentives…
  - Otherwise contributors are unlikely to participate

…but voluntary funded schemes in CEE countries are not a successful story

- Small coverage
- Expensive to manage
- Focused in high income individuals
- Collective schemes offered exclusively by large companies (typically SOE)



Source: Schwartz and others (2014)

Rethinking about collective schemes

- It is **not** about dusting old DB schemes with broad collective agreements
  - Probably most of the participating companies will not have unions or will not be part of a unionized sector
  - Proposed funds are DC
  - Are there any value added of having in place an occupational pension fund in a DC scheme?
    - The core of the business (asset management) is expected to be outsourced
- It is **not** about replicating Northern Europe pension schemes…
  - The fact that it works well in Denmark does not mean that can be replicated in other countries
  - The Dutch system is currently under revision…
  - Pension plans of the multiple economic sectors are being consolidated…simply to take advantage of the scale economies

Rethinking about collective schemes

- It is about expanding coverage
  - Collective schemes can promote savings of white and blue collars
- It is about creating incentives for proper asset allocation in the presence of voluntary pension scheme.
  - Recognizing limited rationality of individuals
  - Making employers accountable in the selection of pension plans
  - Providing default portfolios and other safe harbors in case the employers do not feel in a position to make an informed decisions
- It is about keeping the administration costs low
  - Targeting companies versus targeting individuals helps to keep the fees low

It is essential to set up expectations

- Recent experience suggests that it is possible to create voluntary funded schemes with broad coverage, and with limited fiscal impact
- Voluntary pension schemes do not increase the transitional pension deficit, but it has fiscal costs
- Basic questions:
  - What is the fiscal space available?
    - This is a “one shot” opportunity
    - CEE countries cannot repeat the same 180 degree shift in opinion as in the case of mandatory funded schemes
  - What segment of the market are countries planning to cover?
  - What replacement rate are countries targeting?

Main drivers of coverage in funded schemes

1. Compulsion
   – Continue supporting 2nd pillars
2. Sales Force
   – Results in low coverage and skewed to high income

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3. Soft Compulsion
   – Automatic Enrollment
   – Simple plans
4. Peer Pressure
   – Differentiation of contribution limits
   – Non discrimination test

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3. Automatic Enrollment

- The employer has to offer a pension plan all employees
- Employees can opt out.
- Expected contribution rate will depend on
  - Fiscal space.
    - Better a low contribution rate but sustainable
  - Overall contribution rate of the economy
    - Countries with 30%+, should only expect modest additional contributions
  - Transition for getting to steady state
- Is there a possibility of exiting the collective agreement?
  - It has a direct effect on the administration costs

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4. Peer Pressure

- Contribution limit on collective plans set at a higher level than individual plans
  - In USA, limit on collective and individual plans are USD 17,500, and USD 5,500 respectively
  - High income individuals would prefer participating in collective schemes
- For collective schemes to qualify regulation requires minimum participation of blue collar workers
  - Non Discrimination Test (highly and non highly compensated)
- High income workers to propose incentives for attracting participation of blue collar workers
  - Matching contributions
- High income employees make efforts to bring lower income employees to the system
  - Not for altruism, but for their own benefit

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Automatic Enrollment

	United Kingdom	New Zealand	Italy	USA	Canada/Quebec	Chile	Poland
	(2012)	(2006)	(2007)	(2012)	(2014)	(2008)	(1999)
Automatic Enrollment	Mandatory	Mandatory	Mandatory, but implemented as "opt-in"	Optional, but considered a safe harbour (mandatory in Simple plans)	Mandatory	No, opt in	No, opt in. Plan to be offered to more than 50% of employees
Requirement on the minimum number of employees for opting for a plan	250+ 2012; 50+ 2014; 30+ 2016; 30- 2017	No	No	No, but 100- can opt for SIMPLE plans	5+	No	No
Period for opting out	30 days	Between 14 and 56 days	180 days	90 days	60 days	Not applicable	Not applicable
Collective plans	Yes	Yes	Yes	Yes	Yes	Yes	Yes

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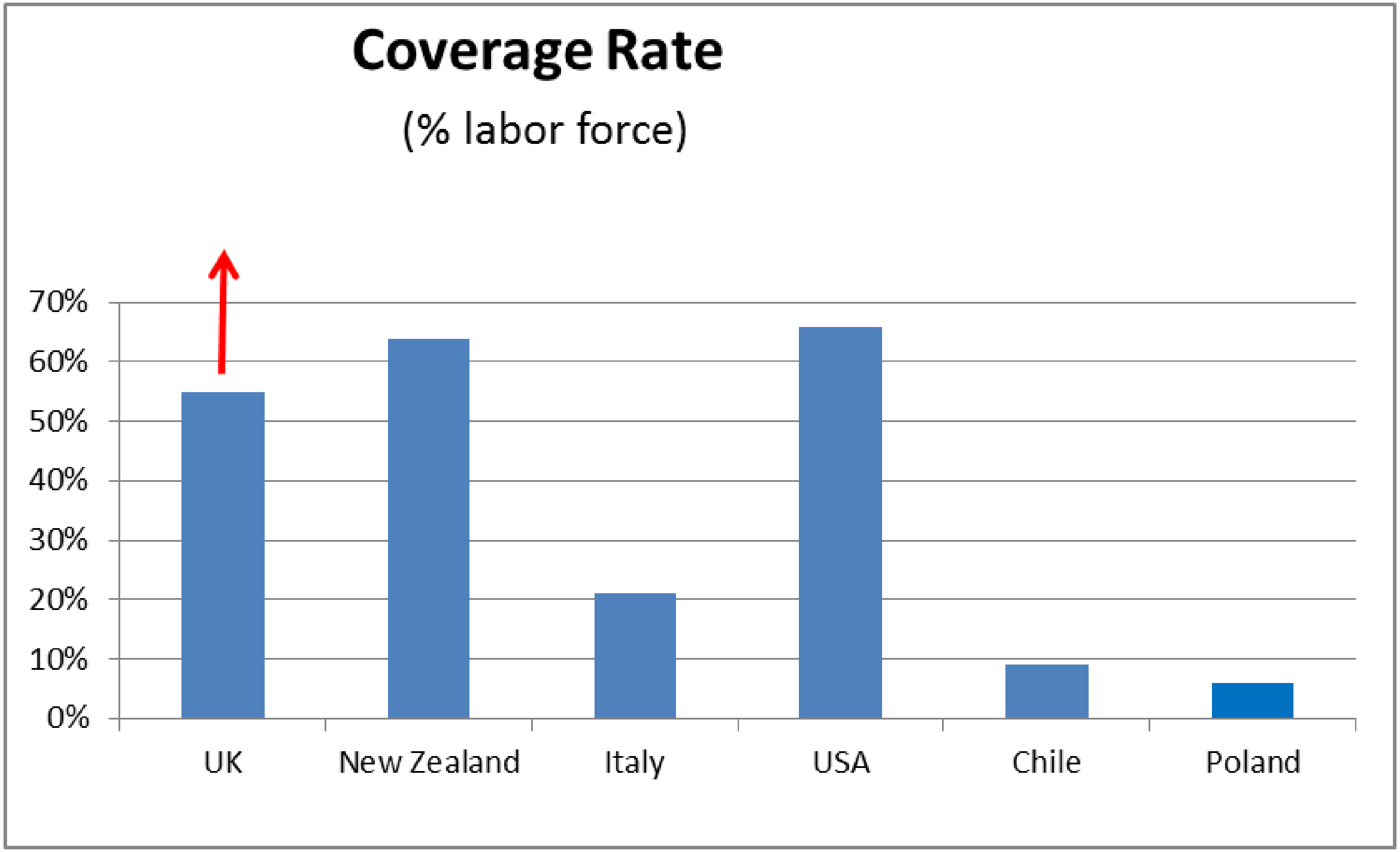
Coverage in systems with automatic enrollment tends to be much higher than in “opt in” schemes



Source: World Bank database

It is all about default options...

	United Kingdom	New Zealand	Italy	USA	Canada/Quebec	Poland	Chile
Default Option: Manager	NEST	Selected by the government every 7 years	No	No	Yes, but still needs to be regulated	No	No
Default Option:Investments	Life Cycle	Conservative	Conservative	Not regulated	Life Cycle	No	No
Collective Plans	Yes	**Yes**	Yes	Yes	Yes	Yes	Yes
Employee option for opting for an individual plan	No, but under consideration	**Yes**	No	No	No	No	No
Withdrawals	55+	65+	Retirement	59 1/2	Retirement	60/55	65/60
Liquidity options	Disability and major health issues	Severe financial hardship, major health issues, and purchase of a first house	Not Available	Loans and withdrawals in exceptional cases, including finacial hardship, disability and termination of employment	Employer contributions can be withrawn only in cases of financial hardship and disability. More flexibility is	No	Flexible, paying penalty tax
Penalty Tax for early withdrawal	No	No	No	10%+ income tax	No	No	Yes

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Default rates

	United Kingdom	New Zealand	Italy	USA	Canada/Quebec	Poland	Chile
Contribution Rate Employer	1%	3%	6.91%	No, but 4% of pay for participants who defer at least 5% of their pay is a safe harbour	0%	Less than 7%	No
Automatic Escalation Employer	2% 2017-18; 3% 2018/10+		No	No	No	No	No
Contribution Rate Employee	1%	3%; 4% or 8%	-	No, but 3%+ is a safe harbor	2%	No	No
Automatic Escalation Employee	3% 2017-18; 5% 2019	No	No	No	2% 2014-2015; 3% 2016-2017; 4% 2018+	No	No

There is no magic number, the default contribution rate is the driving force of the contribution rate of employers and employees

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Tax Incentives in EET schemes

	United Kingdom	USA	USA	Canada/Quebec	Poland	Chile	Chile
	Private pensions	401k	IRA	VRSPP	IKZE	APVC-a	APV-a
Type of plan	Collective	Collective	Individual	Collective	Individual	Collective	Individual
Type of Tax system	EET	EET	EET	EET	ETT	EET	EET
Withdrawal of benefits		59 1/2	59 1/2		65/60	65/60	65/60
Coverage	50, moving to 90	60%		just starting	NA	0%	9%
Maximum Employee deduction allowed (USD)	80,000	17,500	5,500	21,300	up to 4% of annual wages	24,000	24,000
Plans for low income people?	Only starting at annual income above USD13,000	Yes	Yes	Yes	Yes	Yes	Yes

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Same pension plans may have different tax incentives

	New Zealand	USA	USA	Poland	Poland	Chile	Chile
Name of the plan	Kiwisaver	**Roth 401k**	**Roth IRA**	PPE	IKE	**APVC-B**	**APV-B**
Type of Tax system	TTE	**TEE**	**TEE**	TET	TET	**TEE**	**TEE**
Withdrawal of benefits	65	59 1/2	59 1/2	60	60	65/60	65/60
Coverage	66%	-	-	2%	6%	0%	-
Employees can deduct upto	NA	17,500	5,500	450% average wage	300% of the average wage	24,000	24,000
Tax credit employee	410	0	0	0	0	425	425

While pension plans for employees may have different tax incentives, employers should be able to credit their contributions from the corporate income tax every period

Conclusions

- Voluntary pension schemes are going to be necessary to face the aging of the population in region
- New approach should rely on collective rather than individual plans
- Evidence suggest that Automatic Enrollment is the main driver of participation in the system
- Peer pressure may also work, but it requires a competent supervisory capacity to validate the non-discrimination test.
- EET and /or TEE work fine, the rest of the combinations create distortions in the savings decisions
- The process needs to be simple, if we want to foster participation of SMEs
- Defaults, defaults, defaults…

Thanks

hrudolph@worldbank.org

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