Civil Servant Pensions: Challenges and Reform Options
October 31, 2019

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Pensions Core Course
Game Plan

1. What are the objectives?
2. What are existing designs & financing?
3. What are prevalent institutional arrangements?
4. What are the key challenges including fiscal affordability, labor mobility, equity & predictability?
5. What are key reform options & directions?
6. What are key takeaways?
What are the objectives of civil service pension schemes?

**Objectives**
Civil-service pension schemes usually set up before national programmes
- Civil service rationale => independence
- Justify investments in civil servants
- Create incentives for long-term employment
- Shift the cost of remunerating civil servants into the future

**Context**
- Colonial histories => design & parametric legacy
- Legal & constitutional restrictions on adjusting acquired rights
- Long work histories + long life expectancies.
What are the Existing Designs?

• Historical DB & legacy parameters
  ➢ Final basic wage
  ➢ Generous, often non-linear accrual rates
  ➢ Accrual from basic salary
  ➢ Discretionary indexation
  ➢ Sometimes low retirement age
  ➢ Commutation & restoration

• DC schemes (publicly and privately managed)
• DC w/DB top-ups
• Government provident funds (& types of benefits)
What are the forms of existing financing and rationale for pre-financing?

Forms
- Unfunded, non-contributory
  - Simplicity
  - But Fiscal risk
- Contributory (with & without separate funds)
- Role of reserve funds (& challenges)
- Provident funds
- Funded DC schemes & unfunded top-ups

Rationale for moving from Non-Contributory to Contributory (& transitions)?
- Cushion for periods when Government revenues fall short.
- Accumulations generate returns
- But transitions accommodating the effect on wages needs to be considered.
- And investment management infrastructure needed.
- Addressing arrears & providing oversight
What are the Institutional Arrangements? (1)

- **Relation with national pensions**
  - No mandated pension schemes
  - Separate from private sector schemes
  - Separate (but harmonized & coordinated)
  - Integrated (with top-up)
  - Fully integrated

- **Management**
  - Separate arrangements for different departments; Federal vs. State & local
  - Mgmt by Civil Service Pension Fund, Ministry of Finance, Separate Departments
Rationale for Integration or Harmonization

• Gives civil servants interest in the plan
• Economies of scale
• Mobility and portability
• Equity

• Recommendation: => Long-term integration of civil-service and national pension schemes
Challenges (1): Fiscal affordability – Keeping the promise

- High & growing costs crowd out other essential public expenditures.
- Generous accrual rates defer costs.
- Headcount growth & real wage growth leads to unaffordable costs.
- Civil service working age profile older than general population + civil servants often live longer.
- Actuarial projections can inform parametric reforms.
Older worker age profile: Example: Brazil
What are the Effects of Raising the Retirement (benefit eligibility) age in Civil Service Schemes?

- Civil service schemes are ‘closed’ systems - increasing retirement age has different effects than in “open” national schemes
- Increase in retirement age cuts duration of benefit payments, but benefit values increase
- Pay bill will increase during the transition (depends upon adjustment for new hires)
- So all-in costs (pay and pension) increase during transition
- Costs reach a new equilibrium after the transition.
Challenges (2): Liberating Labor Mobility

- Civil service schemes are inflexible - flexible schemes can improve productivity:
- ‘revolving doors’: cross-fertilisation of skills & experience between public and private sectors
- Can improve labor market efficiency.
  - Civil service design & rules create barriers to labor mobility:
    - Vesting rules (linked to minimum pensions)
    - Weak preservation
    - Weak or non-existent portability
    - Deferred wage compensation through pension promises
Example of preservation: Mauritius

- **Value of accrued pension**
  - **Lump sum**
  - **Deferred pension**: 1/50th of current salary
  - **Staying to retirement**: 1/50th of final salary
Challenge (3): Weak predictability & fairness

- Indexation generally discretionary.
- Final wage basis for pensions
- Relationship between *basic wage* and non-pensionable *allowances* for equity.
- Commutation factors & restoration not actuarially fair.
- Early & late retirement not subject to actuarially fair reductions/increases
What are Suggested Reform Directions? (1 – Design)

1. Parametric’ reforms to defined benefit plans
   ➢ reduce accrual rate (+ linear)
   ➢ index pensions to prices
   ➢ introduce/increase member contributions
   ➢ raise pensionable age & adjust for early retirement
   ➢ extend income averaging periods + valorize

2. ‘Systemic’ reforms
   ➢ DC reform (& top-up?)
   ➢ Link to national pension scheme
What are Suggested Reform Directions? (2 – Reforms to improve labor mobility)

- Integrate or harmonize with private sector schemes (+ portability)
- Shorten vesting periods
- Preserve pension rights of early leavers
- Extend averaging period
  - career average creates basis for portability
  - deals with incentives for abuse
- Introduce defined contribution scheme (eg. India, Maldives, US, UK, Aus)
What are Suggested Reforms (3): predictability & fairness

- Automatic price indexation
- Lifetime wage base, valorized
- Gradual inclusion of allowances into wage base (with decrease in accrual rate)
- Actuarial fairness in commutation
- Early & late retirement subject to actuarially fair reductions/increases
- DC reforms, with lifecycle adjustment in the risk of funds, 3rd party oversight, indexed annuitization
Conclusions

Parametric & structural reforms of civil service reform essential for:

- Fiscal sustainability,
- Improving predictability & fairness, and
- Removing barriers to labor mobility

A single national scheme can be more administratively efficient, equitable and increase labour-market flexibility
Takeaways

• **Deliver the promise** – Long term, fiscally affordable, diversified risk, predictable, equitable

• **Benefit design** – DB (linear accrual rate, lifetime income averaging, valorization, CPI indexation, reductions for early ret.); DC (efficient, supervised, transparent).

  ➢ **Put most allowances** in pensionable wage base (+ transitions)

  ➢ **Commutation (& restoration?)** – Limited & actuarially fair

• **Financing** – Contributions & reserve funds reduce fiscal pressure & est accountability.

• **Institutional design** – Unified or at least harmonized w/national scheme.

• **Portability & preservation** - Yes + indexed

• **Vesting** – Reduce vesting (linked to minimum pension).

• **3rd Party Oversight** – Investment management, account management; disclosure; data management

• **Leverage DC Civil Service Scheme for private sector workers**