Designing pension systems

DEFINING RETIREMENT-INCOME ADEQUACY

BALANCE: ADEQUACY | INCOME-REPLACEMENT SCHEMES

EDWARD WHITEHOUSE

WORLD BANK
PENSIONS CORE COURSE
WASHINGTON DC
OCTOBER 2019

AXIA ECONOMICS
Goal of retirement-income provision

• Primary objective
  • ensuring older people have a decent standard of living in retirement

• Two interpretations
  • ‘Core’ adequacy: ensuring older people meet a basic standard of living
  • ‘Broad’ adequacy or ‘income-replacement’: ensuring a reasonable standard of living in retirement relative to position before retirement
Measuring core and broad adequacy

• Core adequacy: an absolute measure of living standards
  • individual pension entitlement as a proportion of economy-wide average earnings
  • relative pension level

• Income-replacement: a relative measure of living standards
  • individual pension entitlement relative to individual earnings when working
  • replacement rate
International experiences

- Different degrees of emphasis on the alternative approaches: **core-adequacy** and **income-replacement**
- Analysis of **mandatory** retirement-income provision
  - using Apex models for OECD countries
- Highly redistributive systems versus strong link between pension entitlements and individual earnings
  - (and intermediate cases)
- Two benchmarks:
  - universal, flat rate benefit
  - constant replacement rate
Benchmarks

Relative pension level

Replacement rate

Individual earnings multiple of economy-wide average

Earnings related

Basic

Earnings related
Relative pension level

Ireland

New Zealand

United Kingdom

Basic schemes + voluntary savings
No mandatory income replacement

Individual earnings
Relative pension level

- Significant targeted (AUS, CAN) or basic (CAN) schemes
- Highly redistributive public scheme (CHE) and low ceiling (CAN, CHE)
Relative pension level

Strong link between individual earnings and pensions
World Bank’s multi-pillar framework

Retirement-income system

Zero pillar: mandatory, public, adequacy
- Basic
- Resource-tested
- DB
- Points
- NDC
- Public DC
- Minimum pensions
- Private DC
- Private DB

First pillar: mandatory, public, mainly income replacement

Second pillar: mandatory private, income replacement

Third pillar: voluntary private
Design of income replacement pensions

EARNINGS-RELATED SCHEMES
DEFINED-BENEFIT | POINTS | NOTIONAL-ACCOUNTS

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Single, over-arching principle

- Each dollar, euro etc. of contributions should produce the same amount of benefits to all individuals
- It does **not** say that each contribution should deliver benefits equal to the amount contributed
Fairness

• Pension systems based on this principle are fair:
  • between people at different stages of their careers
  • between low and high earners
  • between early, normal and late retirees
• Many pension systems are unfair:
  • it favours short contribution histories over longer
  • low earners get relatively more than higher earners
  • early retirees receive benefits for longer, which is not adequately taken into account
Incentives

• Pension systems based on the core principle – of equal contributions for equal benefits – **minimize distortions to individuals’ economic behaviour**
  • saving, labour-supply, retirement and contribution decisions

• Gains from well-meaning policies addressing important challenges can be outweighed by their negative side-effects
Unintended consequences

- Powerful incentives to contribute for short periods and move into the informal sector
- Encourage under-declaration of earnings towards or down to the minimum wage
- Induce people to retire earlier than under a neutral pension system

- Fairness and incentives go hand-in-hand
Violating the fundamental principle

• Might be justified
• But the onus of proof must be on the violator
  • Men *versus* women
  • Clash between objective of retirement-income adequacy and strict fairness/incentives
• But many ways to ensure adequacy with different effects on fairness and incentives
Three kinds of earnings-related plan

- **Defined benefit**
  \[ DB = \sum_{i=0}^{R} w_i (1 + u)^{R-i} a \]
  AUT, BEL, CAN, CZE, FIN, FRA, GRC, HUN, ISL, JPN, KOR, LUX, NLD, PRT, SVN, ESP, GBR, USA

- **Points**
  \[ PP = \sum_{i=0}^{R} \frac{w_i v_i}{k_i} = \sum_{i=0}^{R} \frac{w_i v_i}{k_i} (1 + x)^{R-i} \]
  EST, FRA, DEU, SVK

- **Notional accounts**
  \[ NA = \sum_{i=0}^{R} \frac{w_i c_i}{A} (1 + n)^{R-i} \]
  ITA, NOR, POL, SWE

- **Two identities**
  if \( u = x = n \)
  then \( a = \frac{v}{k} = \frac{c}{A} \)
Eleven parameter and rules

- Accrual rate
- Maximum pension/replacement rate
- Contribution years needed
- Minimum pension
- Earnings measure
- Revaluing earlier years’ earnings
- Contribution rates
- Adjusting pensions in payment (indexation)
- Actuarial adjustment
- Pension eligibility age
- Ceiling
Accrual rate structure
Maximum replacement rate
Accrual rates: structure

- **Accrual rate per cent of earnings**
  - Tunisia (Government employees)
  - Tunisia (Private-sector employees)

<table>
<thead>
<tr>
<th>Years of contributions</th>
<th>Accrual rate</th>
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<tr>
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<tr>
<td>45</td>
<td>4.5</td>
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</table>
Accrual rates: structure

Accrual rate
per cent of earnings

Greece Pre-reform
Greece Post-reform
Accrual rates: structure

Accrual rate
per cent of earnings

Year of contributions

Finland

Luxembourg
Accrual rates: structure

Accrual rate
per cent of earnings

Mexico
Pre-reform

Mexico
Post-reform
Defined-contribution

Years of contributions
Accrual rates: structure

Accrual rate
per cent of earnings

Hungary
Pre-reform

Hungary
Post-reform

Years of contributions
Accrual rates: structure

Accrual rate
per cent of earnings

Spain
Pre-reform

Spain
Post-reform
Accrual rates

• Same accrual rate for all years and at all ages is fair
• It is an international norm:
  • 23 out of 27 OECD countries with a public, earnings-related scheme are now linear
  • (8 of 35 OECD countries do not have such arrangements)
• Each extra year of contributions should deliver extra benefit
  • reduce impact of maximum replacement rate
Minimum pension
Interaction with accrual rates
Qualifying conditions
Accrual rates with minimum pensions

Accrual rate per cent of earnings

- Minimum-wage worker (SMIG)
- Worker earning 2.5 times minimum wage (SMIG) or more
Accrual rates by earnings

Accrual rate per cent of earnings

Individual earnings, multiple of minimum wage

10 years’ contributions

5 years’ contributions
## Contribution years for minimum pension

<table>
<thead>
<tr>
<th>Years</th>
<th>MENA</th>
<th>AFR</th>
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<tbody>
<tr>
<td>Tunisia</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>DR Congo</td>
<td>16</td>
<td>2</td>
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<table>
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<th>25</th>
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<td>AFR</td>
<td>DR Congo</td>
<td>3</td>
<td>16</td>
<td>2</td>
<td>0</td>
<td>25</td>
</tr>
</tbody>
</table>
Alternative approaches

• 23 OECD countries do not have contributory minimum pensions

• Use basic or targeted universal schemes, social assistance to achieve adequacy objectives

• These are fairer than minimum pensions and improve incentives
  • better at achieving adequacy objectives because universal
  • basic scheme means all contributions accrue benefits at all earnings levels
  • targeted schemes often have withdrawal rates of less than 100%, giving low earners some incentive to contribute
Addressing core adequacy: three ways

- **Basic**
  - Non-contributory pension (no minimum)
  - Basic pension

- **Contributory minimum**
  - Minimum pension
  - Income-replacement pension

- **Targeted**
  - Non-contributory targeted benefit
  - Income-replacement pension (no minimum)
Earnings measure
Earnings measure

- Four possible policies:
  - **final** salary: a limited number of the last years’ salaries in the career, such as last year, final five years *etc.*;
  - **best** salaries: a limited number of years with highest pay;
  - a **mix** of best and final: e.g., best three in final five salaries;
  - **lifetime-average** salary, using earnings from all years.

- Basing pensions on best or final salary is **unfair**:
  - workers with flat age-earnings profiles lose out

- It is **distortionary**:
  - incentivises people to under-declare earnings in earlier years and over-declare at the career end
  - encourages early retirement when wages have peaked
Earnings measures: OECD

Always lifetime average:
Germany
Hungary
Iceland
Japan
Korea
Luxembourg
Switzerland

...or close to lifetime:
Canada (best 83% of years)
United States (35 years)
Valorisation
Valorisation policies

• Revaluing earlier years’ earnings to wage inflation is *fair*:
  • neutral between earlier and later years
  • replacement rates constant with varying price and wage inflation

• Prices or no valorisation are *unfair* policies:
  • workers with flat age-earnings profiles lose out
  • replacement rates vary arbitrarily with price and wage inflation

• They are *distortionary*:
  • incentivise people to under-declare earnings in earlier years and over-declare at the end of the career
Revaluing earlier years’ earnings: OECD

Prices
100%
75%
50%
20%
100%

Earnings
100%
75%
50%
20%
100%

GDP growth
100%
30%
100%

Wage bill growth
100%
30%

Fixed rate
100%
30%

Countries:
- AUT
- CAN
- CZE
- DEU
- HUN
- JPN
- KOR
- LUX
- NLD
- NOR
- SVK
- SVN
- SWE
- USA
- ITA
- TUR
- POL
- CHE
- ISL
Pension eligibility age
Pensionable age

- No guide from first principles what the *level* of the pension age should be
- But the concept of fairness – equal contributions deliver equal benefits – does show how pension age should *change* over time
- Inter-generational equity
## Demographic context: Tunisia

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Life expectancy at birth, years</th>
<th>Probability of surviving to age 60</th>
<th>Life expectancy at age 60, years</th>
<th>Probability of a 15-year-old surviving to age 60</th>
<th>Life in retirement, per cent of working life</th>
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</thead>
<tbody>
<tr>
<td>1965-1970</td>
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<td>47.9</td>
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<td>1975-1980</td>
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<td>2000-2005</td>
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<td>86.6</td>
<td>19.2</td>
<td>89.2</td>
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<td>2005-2010</td>
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<td>87.7</td>
<td>19.4</td>
<td>89.8</td>
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<td>2010-2015</td>
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<td>87.7</td>
<td>19.5</td>
<td>89.8</td>
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Pension ages: retirees in 2000

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<td>60</td>
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<tr>
<td>61</td>
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<tr>
<td>62</td>
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<td>69</td>
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Pension ages: new entrant in 2015

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<td>BEL</td>
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<tr>
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<td>HUN</td>
</tr>
<tr>
<td>9</td>
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<tr>
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Treatment of early retirees
First principles

• **Actuarial neutrality** should be the goal
• Pension system is **fair** between early and later retirees
• There are no **incentives** to retire early
• Derive actuarially neutral decrements for early retirement
• Tunisia:

<table>
<thead>
<tr>
<th>Pension withdrawal</th>
<th>50</th>
<th>51</th>
<th>52</th>
<th>53</th>
<th>54</th>
<th>55</th>
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<th>57</th>
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<tr>
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<td>18.3</td>
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<td>16.7</td>
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<tr>
<td>Actuarially neutral decrement (%)</td>
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<td>4.9</td>
<td>5.0</td>
<td>5.1</td>
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<td>6.0</td>
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<td>6.4</td>
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<td>Cumulative reduction (%)</td>
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<td>34.2</td>
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## International experience

<table>
<thead>
<tr>
<th>Country</th>
<th>Benefit reduction per year of early retirement, per cent</th>
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<tbody>
<tr>
<td>Spain</td>
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<tr>
<td>Canada</td>
<td>7.5</td>
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<tr>
<td>Iceland</td>
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</tr>
<tr>
<td>France</td>
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<td>Switzerland</td>
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<td>United States</td>
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<td>Portugal</td>
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<td>Greece</td>
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<tr>
<td>Austria</td>
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<td>France (pub)</td>
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<tr>
<td>Norway</td>
<td>5.0</td>
</tr>
<tr>
<td>Slovenia</td>
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</tr>
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<td>Germany</td>
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<td>Italy</td>
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<td>Luxembourg</td>
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<td>Belgium</td>
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<tr>
<td>Saudi Arabia</td>
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<tr>
<td>United States</td>
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<td>Poland</td>
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<td>Turkey</td>
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<td>United Kingdom</td>
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<td>Ireland</td>
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<td>Canada</td>
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<td>Turkey</td>
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<tr>
<td>United Kingdom</td>
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</tr>
</tbody>
</table>

### No early retirement possible
- Australia
- Chile
- Denmark
- Ireland
- Mexico
- Netherlands
- New Zealand
- Poland
- Turkey
- United Kingdom
Uprating pensions in payment
Uprating policies

• **No adjustment**
  - real pension value falls in retirement, which might be acceptable if the expected length of retirement is short

• **Ad-hoc uprating**
  - pensions are increased, but only sporadically, and not linked to changes in prices or wages. Typically, nominal pension value follows the electoral cycle

• **Discretionary increases**
  - pensions increased regularly on a fixed time-table: *e.g.* annually. Again, rate of increase not linked to changes in prices or wages

• **Indexation**
  - Pensions are increased regularly and automatically, linked to changes in economic variables. Typically, these are indices of prices or average earnings
Indexation

• No benefit uprating, *ad-hoc* changes and discretionary (albeit regular) increases are **unfair**
  • lifetime benefits are arbitrarily lower or higher depending on price inflation and the adjustments that take place
  • also fails to ensure pension adequacy through retirement

• Uprating pensions in payment in line with price inflation is **fair**
  • lifetime benefits the same, relative to individual earnings, at time of retirement, regardless of future price inflation
  • maintains pensions’ purchasing power through retirement

• Indexation to economy-wide earnings growth
  • individual pensions remain the same during retirement relative to economy-wide average earnings
  • protects relative living standards
<table>
<thead>
<tr>
<th>Prices</th>
<th>100%</th>
<th>80%</th>
<th>67%</th>
<th>50%</th>
<th>40%</th>
<th>20%</th>
<th>33%</th>
<th>50%</th>
<th>60%</th>
<th>-1.6%</th>
<th>-0.75%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>20%</td>
<td>33%</td>
<td>50%</td>
<td>60%</td>
<td>-1.6%</td>
<td>-0.75%</td>
<td>100%</td>
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Indexation

- AUT
- BEL
- CAN
- FRA
- GRC
- HUN
- ISL
- ITA
- JPN
- KOR
- POL
- PRT
- SVK
- ESP
- TUR
- GBR
- USA
- FIN
- CZE
- CHE
- SVN
- SWE
- NOR
- LUX
Conclusions: Designing earnings-related pensions
Fairness and incentives

- **Accrual rates**: same at all ages and contribution years
- **Maximum replacement rate**: ensure all years count
- **Contributory minimum**: think about social pension instead
- **Earnings measure**: lifetime average salary
- **Revaluation of earlier years’ earnings** to calculate benefits: use average-earnings growth
- **Pension eligibility age**: regular reviews so it keeps pace with changes in life expectancy at pension age
- **Benefit adjustment for early retirement**: actuarially neutral reductions
- **Adjustment of pensions in payment**: index pensions to ensure automatic, regular increases preferably in line with price inflation
**Fairness and incentives**

- **Fairness between members of different schemes:**
  - need to consider differences in accrual rates, contribution rates *etc.* together

- **Fairness between covered and uncovered**
  - again, think about social pension instead of contributory minimum benefits
  - earnings-related benefits should be self-financing: no permanent subsidy from the general government budget
Final thoughts

• Fairness/incentives analysis leaves three key questions unanswered
  • guidance on structure of accrual rates, but not the level
  • appropriate change in pensionable age, but not its level
  • right structure of contribution rates, but not their level

• These three need to be determined by looking at two other objectives of pension system:
  • financial sustainability/affordability
  • social sustainability: benefit adequacy and coverage
Objectives for the pension system

- Fairness
- Economic
- Social
- Financial
- Adequacy
- Incentives
- Coverage

AXIA ECONOMICS
Pension possibilities

• Three key variables:
  • accrual rate: 2%
  • pension eligibility age: 60
  • contribution rate: 17% total (employer plus employee)

• Look at the sustainable combinations
Pension possibilities

- **Contribution rate (%):**
  - Pensionable age:
    - Accrual rate: 2%
  - Contribution rate: 17%
  - Pensionable age: 60

- **Accrual rate (%):**
  - Pensionable age:
    - Contribution rate: 17%
  - Pensionable age: 60