Pension reform: Past and present

Pension Core Course 2019

Pensions Global Solutions Group
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Pension reforms: drivers and challenges

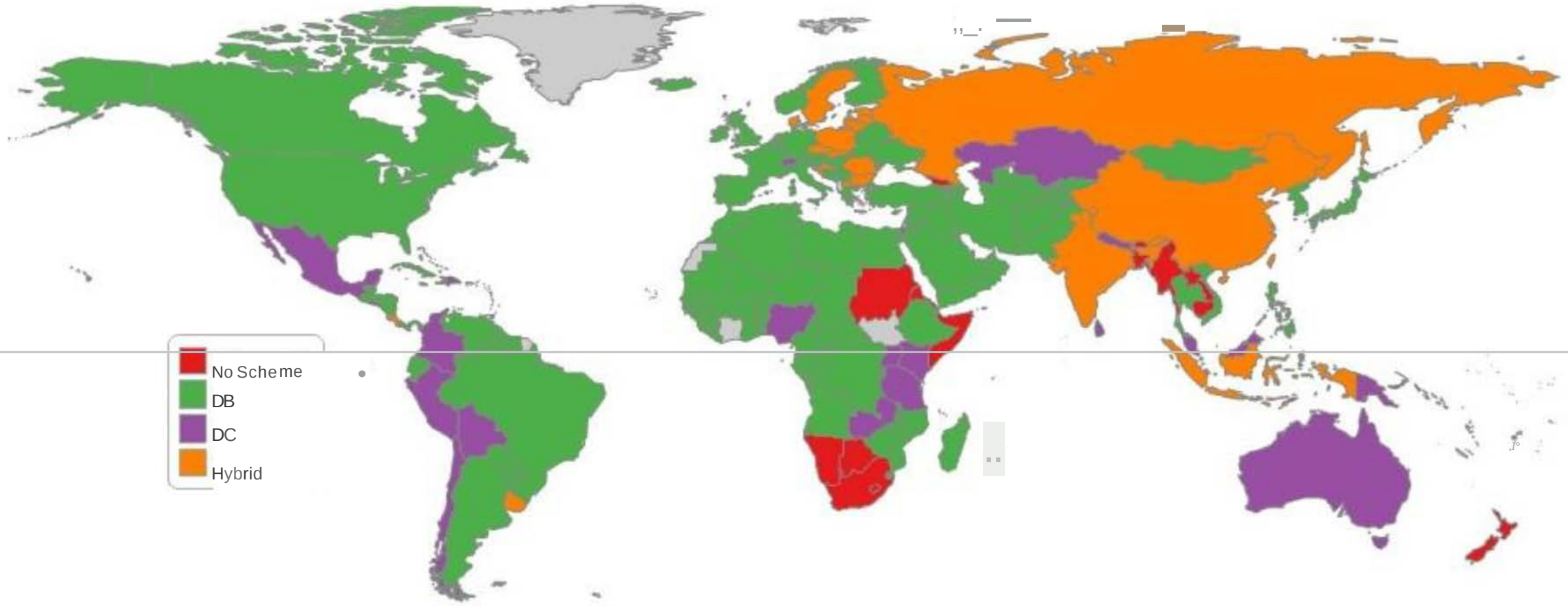
- Pension design has adopted different paradigms:
  - Defined benefit (DB), financed with contributions from employers and employees (occasionally also the government, beyond its role as employer): dominant scheme for over a century
  - Defined contribution (DC, Chile, 1980 – other countries followed 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

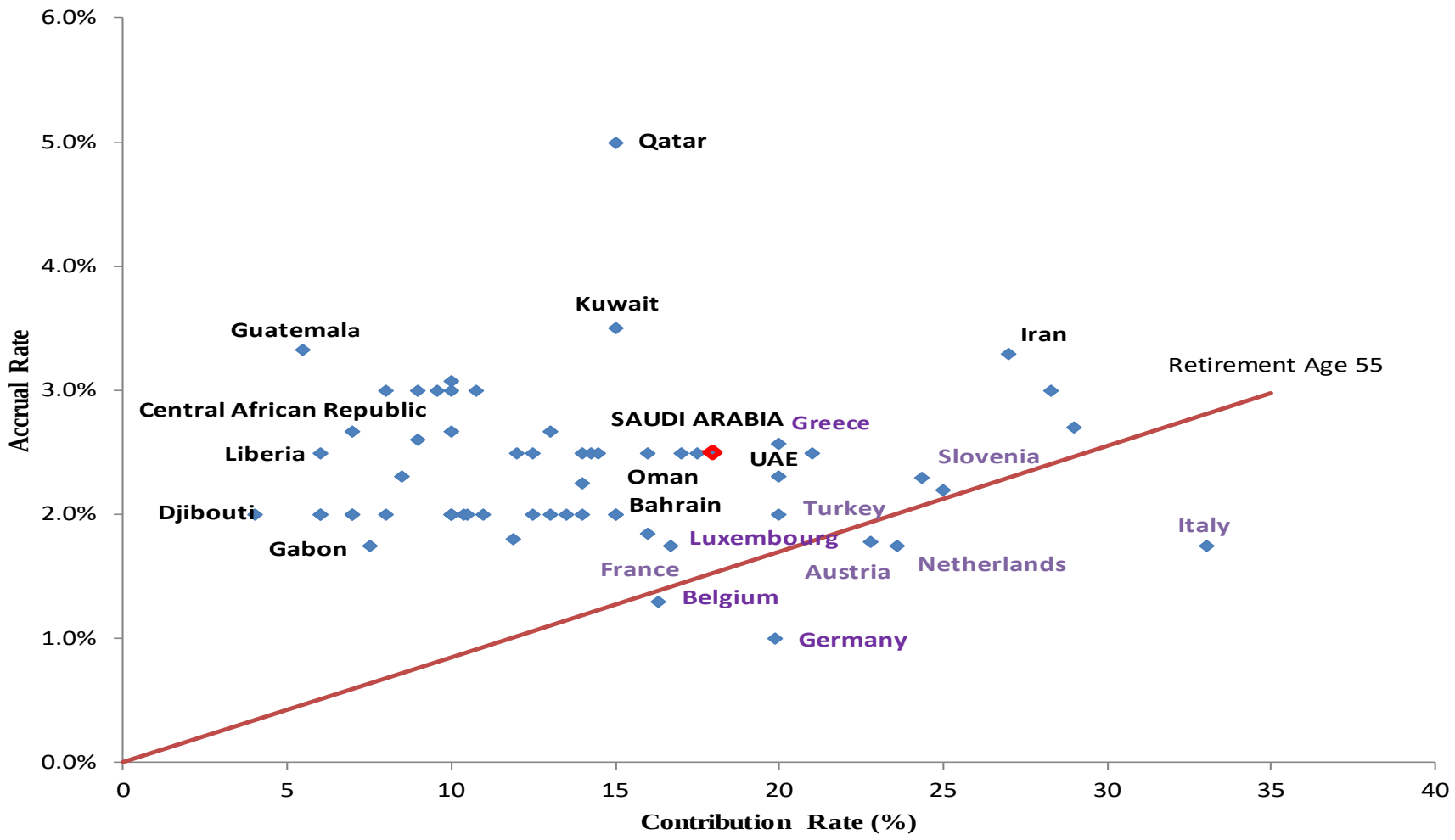
- Historical context (economic and political) shapes social preferences, but this is not deterministic
- At country level, structural reforms have replaced old patterns of pension provision by newer ones, but globally there is a mosaic of schemes. This is the result of accumulation rather than global 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


No Scheme
DB
DC
Hybrid

DB schemes: Unmet promises and challenges

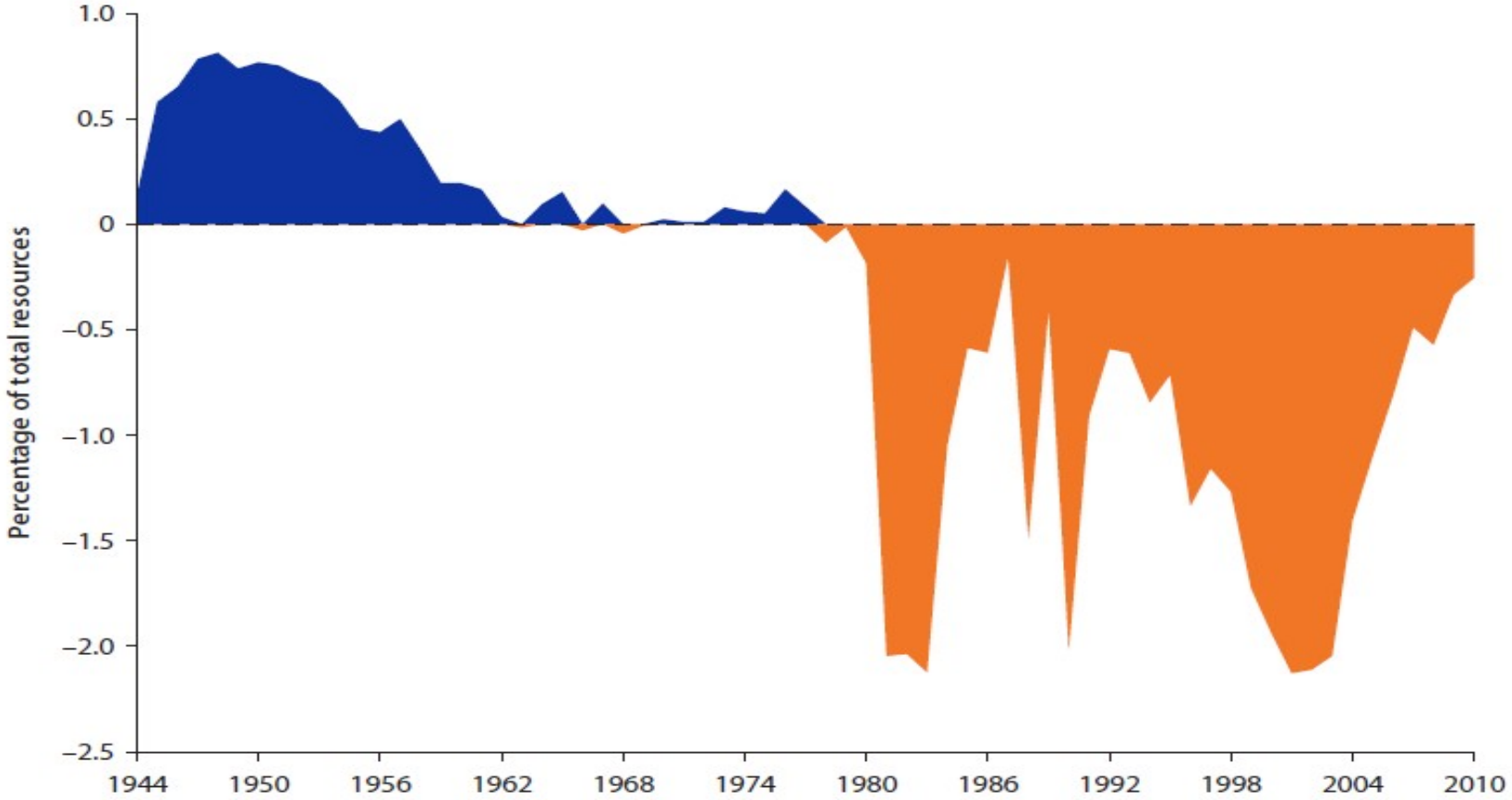
- After decades of demographic dividend, aging population revealed parametric inconsistencies;
- Parametric alignment does not happen automatically;
- Adjustments are slow, and politically resisted
- Inadequate incentives to extend careers
- Low coverage and high informality
- Redistributive effects 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.

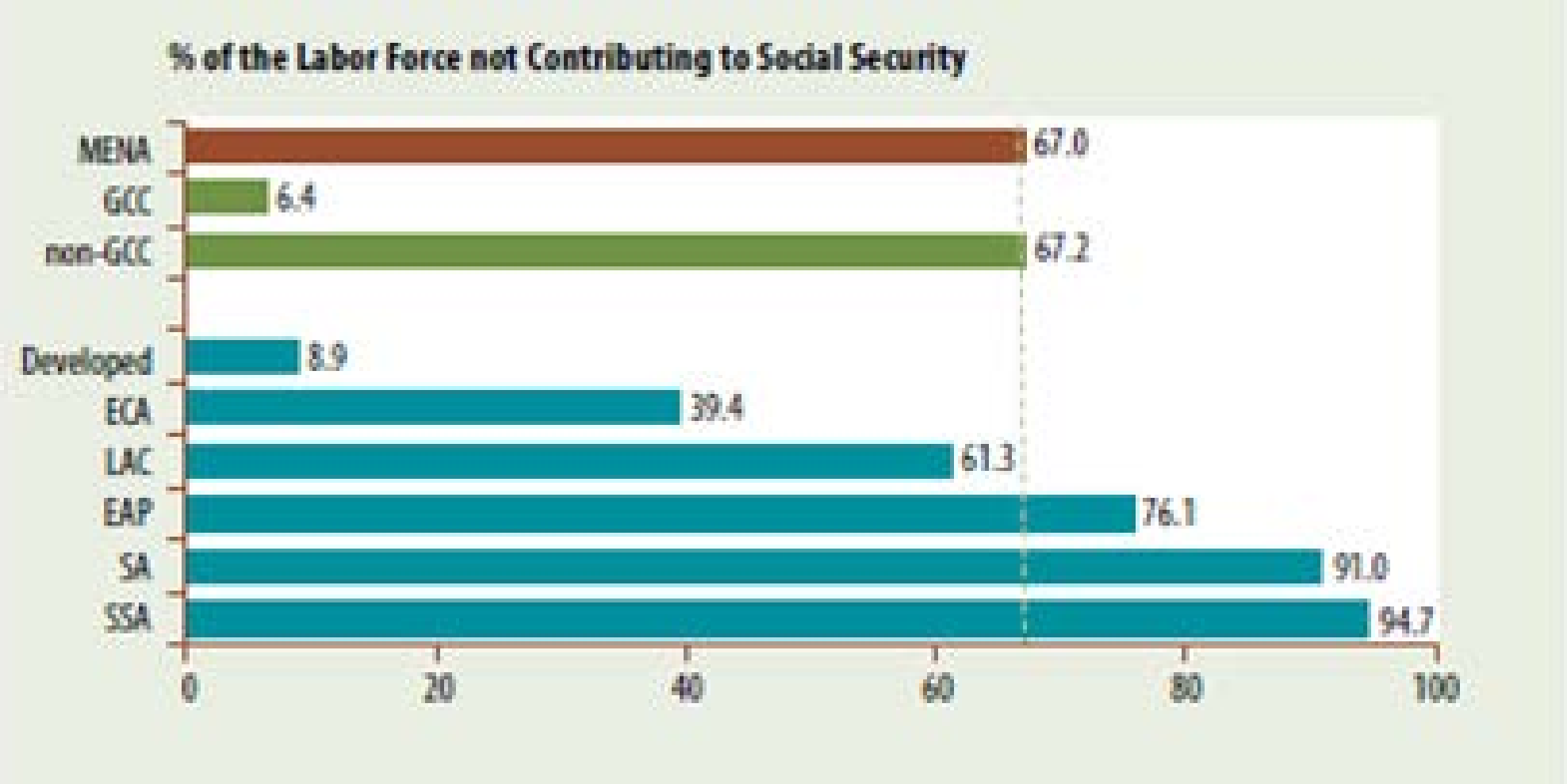
Parametric adjustments are politically difficult

DC schemes: Unmet promises and challenges

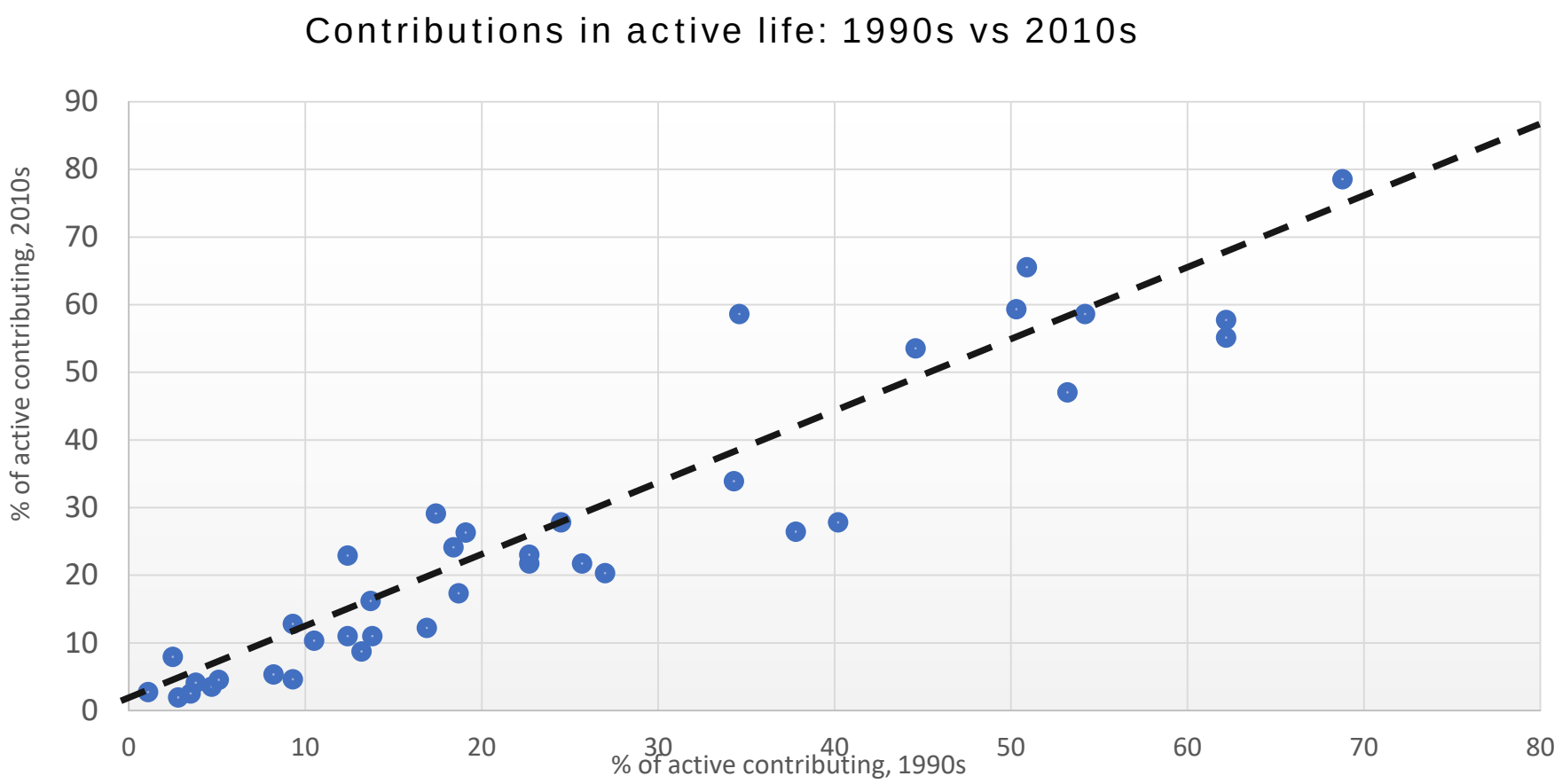
- Automatic adjustments resulted in low level of pensions
- Free choice is expensive: marketing costs eroded the value of retirement savings;
- Behavioral response did not happen as predicted in economic textbooks; therefore coverage and pensions did not increase as expected
- Financial literacy is limited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

DC schemes: Automatic adjustments have social costs

Contributory pension schemes: Unmet promises: Informality



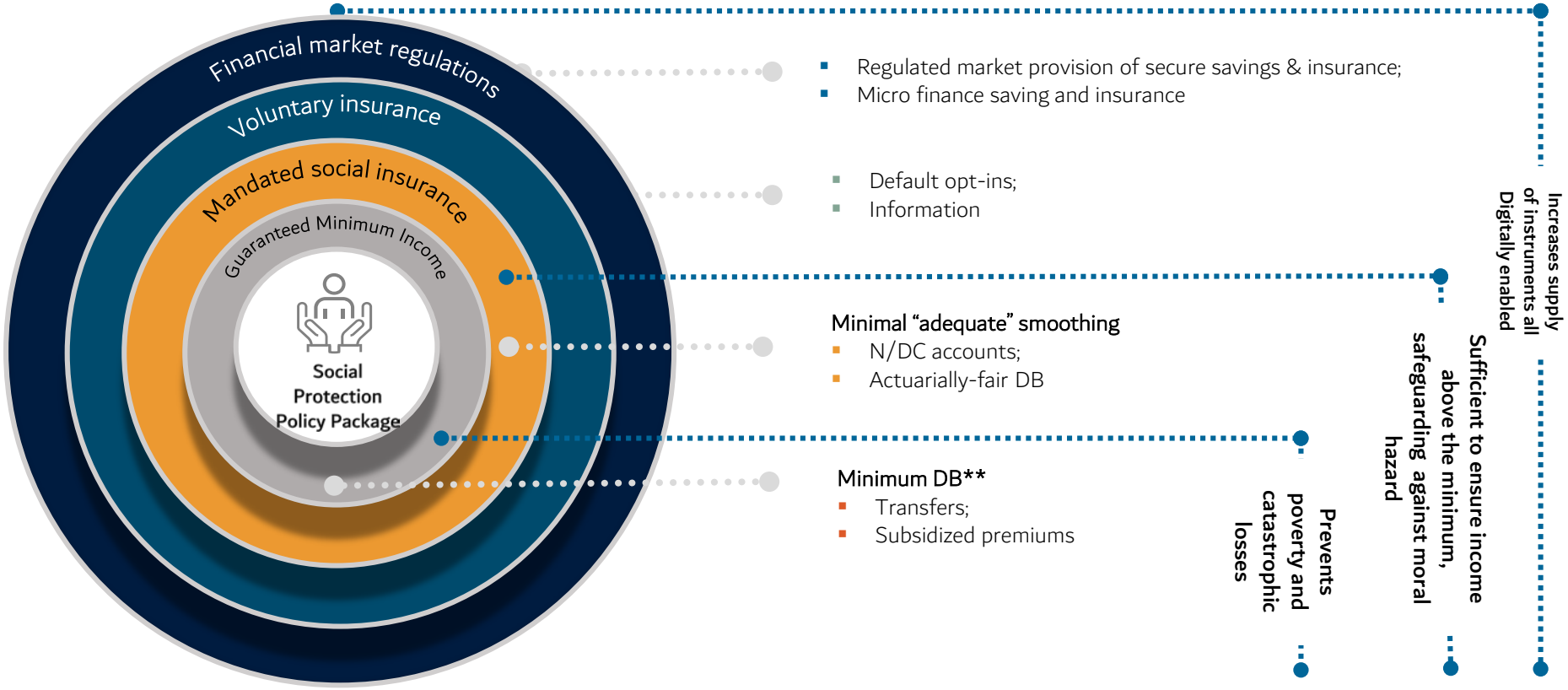
… and Informality remains unchanged



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



** 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)