BUILDING AN ENVIRONMENT FOR PENSION REFORM – GLOBAL LESSONS IN DESIGN AND IMPLEMENTATION

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Introduction

- Pension systems should provide old age security, be financially sustainable and offer support to economic growth and efficiency
- Reform needed due to ageing and owing to design failures leading them to fail to meet objectives
- In introducing reform, there is a need to ensure that the overall environment is sound and make appropriate choices for design and implementation
- We will deal with these issues sequentially, bringing out country experiences where applicable

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- The financial environment for pension reform
- Regulatory preconditions for pension reform
- The main choices in design and implementation
- Global lessons: Some country experiences in design and implementation of pension reform

Stylised models for major pension reforms

- Personal defined contribution funds managed on decentralised basis (Latin America, Eastern Europe)
- Personal defined contribution funds invested centrally by public bodies (Hong Kong)
- Mandatory occupational defined contribution funds (Australia)
- Defined contribution pay-as-you-go (Sweden, Italy, Poland)
- Abandonment of provident funds and replacement by pay-as-you-go (African countries)

The financial environment for pension reform

- The stylised pattern of financial development
  - Family based finance
  - Banking development
  - Growth of equity finance (initially held by banks, wealthy individuals, foreigners)
  - Insurance companies and mutual funds
  - Corporate bond markets when firms have reputation for credit quality

- Preconditions for financial development
  - Monetary stability (inflation controlled)
  - Legal aspects - property rights, financial contract enforcement
  - Public information availability
  - Limited liability for equity, collateralisation for debt,accounting and protection from fraud
- Securities markets require stronger infrastructure than banks – and banks essential for securities market development (credit for underwriting, market making)

- Can pension funds be introduced before securities markets develop?
- Case against
  - Pension funds’ comparative advantage in capital markets
  - Need for capital markets to offer annuities
  - In thin and volatile capital markets, high risks, poor diversification, lack of skilled personnel with fund management expertise, risk pension monies are used to fund government deficits

- Case for
  - Initial investment largely in bank deposits and government debt
  - Dynamic link of decentralised funding to capital markets (saving, asset accumulation)
  - Regulations can be eased gradually in line with capital market development
  - Pension funds stimulate improvements in financial infrastructure (auditing, accounting, brokerage, disclosure)
  - Scope to use foreign expertise
  - Endogenous growth benefits of pension reform, raising overall economic growth

- Example: Chile

  The growth and size of Chilean funds
  Effects on equity markets
  Financial markets and Chilean development
  Bond markets and other institutional investors
  Internal resource transfers
  Market resilience
  Less success in corporate governance and ownership dispersion

- Other options
  - International investment – benefits to retirement income security due to diversification but less to domestic market (Singapore, Norway)
  - Centralised provident funds (Singapore, Malaysia) feasible earlier in development process than decentralised funds
  - Personal defined contribution (Chile) feasible earlier than occupational funds (Australia, Switzerland)
  - Retain pay-as-you-go but make defined contribution (Sweden, Italy, Poland)

Regulatory preconditions for pension reform

- Ability to manage an existing public system gives pointers to possible problems with funding
- Issues include record keeping to oversee contributions, efficiency of administration, skilled personnel, degree of political interference
- Need for sound accounting standards
- Reliance of pension reform on wide range of financial regulators’ satisfactory performance – securities markets, banking, insurance

- Bank regulation essential as key investment of nascent pension funds (involves evaluation of assets, monitoring of behaviour, remedies if default)
- Insurance regulation essential given role in annuities (needs to emphasise market discipline, solvency, consumer protection, while market should be open to new entry)
- Training of professional regulatory staff
- Independence of regulators from regulated, strong supervisory and intervention powers, clear criteria for authorisation and closure

The main choices in design and implementation

- Funding or pay-as-you-go
- Mandatory versus voluntary provision
- Fiscal privileges for private funded schemes
- Public versus private administration of funded schemes
- Occupation versus personal funded schemes
- Defined contribution versus defined benefit funded schemes

- Internal versus external funding
- Portfolio regulation versus prudent person rules for funded pensions
- Mandatory or discretionary indexation of benefits
- Annuities or lump sum payments

Issues for consideration in each design-choice

- Retirement income security
- Financing issues - sustainability
- Effects on labour markets
- Effects on capital markets

Appropriate balance depends on the situation of the country in question

Global lessons: detailed example – mandatory and voluntary provision

- Following tables present main benefits and *costs (italic)*, encapsulating country experience

	Voluntary provision	**Mandatory provision**
Retire-ment income security	Allows a greater degree of individual choice in the level of retirement income security. *Leaves "myopic" individuals at risk of poverty in old age. Unwillingness to save may be rife in transition economies where the state has traditionally been all-embracing and financial markets are viewed with suspicion.* *Voluntary provision may lead to a skewed pattern of coverage, with middle class, organised labour, workers in large firms, men, being disproportionately covered.* *Faces difficulty of adverse selection in annuities market (where costs of annuities reflect the worst risks owing to asymmetries of information between annuitants and insurers), especially if there is an option of "lump sum" benefits, implying only those expecting to live long will require annuities.* *Voluntary schemes cannot feature redistribution.* *Low income workers are less likely to save voluntarily or be attracted by tax privileges (owing to lack of taxable income)*	Ensures all individuals have basic cover for retirement income needs, as is necessary in the absence of the "extended family". Overcomes the adverse selection problems of private annuities markets, as long as annuitisation of benefits is the only option. Overcomes the free rider problem that individuals might refuse to save for retirement if they know society will protect them from poverty (note: governments may overlay investment risk with a minimum income guarantee). *Where pension provision is itself a novelty (i.e. it does not replace pay-as-you-go) it may hasten the demise of informal networks of support.* *Low income workers forced to save at a high rate may lose out on lifetime consumption, especially if they tend to die earlier than the better off.* *Mandatory funded schemes tend to be defined contribution (generally on grounds of economic efficiency but also to minimise costs to the corporate sector), offering greater risks in some respects to workers than defined benefit.*

Finan-cing issues	For occupational schemes, allows firms in financial difficulty to avoid costs of provision, that might otherwise hasten bankruptcy (i.e. given the option not to set up a scheme). More generally, firms will only set up schemes when these are justified on cost grounds, e.g. taking advantage of economies of scale in administration and investment. *Requires forms of tax incentive to encourage take-up across the entire workforce, thus raising the cost to the state.* *The tax benefits accrue particularly to higher income workers who would have saved in any case.* *Requires considerable and costly information dissemination.*	The government need not gather costly information on individuals' preferences The government need not offer tax incentives. Funded schemes on a compulsory basis are more likely to relieve social security of its burden of provision. *For compulsory occupational schemes, companies cannot avoid pension obligations, which may reduce labour demand and/or impact on competitiveness.* *Since there are economies of scale, there are high average administrative costs as a proportion of assets initially as mandatory funded schemes are phased in.* *A mandatory funded scheme puts a considerable onus on government to provide strong safeguards in terms of regulation and insurance, which may be costly.*

Effects on labour markets	Limits labour market disincentive effects if contributions are seen as saving. *For occupational schemes, may hinder labour mobility, notably if terms of voluntary schemes are not standardised*	Facilitates labour mobility if scheme is uniform in terms of vesting and offers transferability. *May worsen disincentive effects on labour supply if contributions are seen as a tax; at low rates of return ultimately may lead to early retirement, evasion and shift of labour to the "informal sector".*
Effects on capital markets	*Voluntary provision is likely to induce shifts between types of asset accumulation without affecting the overall level of saving.*	Compulsion is more likely to generate an increase in saving, as lower income individuals who have no discretionary saving and face liquidity constraints on borrowing are forced to accumulate assets. Impacts also on national saving as long as governments do not cut saving as a consequence.
Country examples	Funded occupational schemes: United Kingdom. Netherlands, United States, Japan. Funded personal schemes: Most OECD countries	Funded social security schemes: Sweden, Finland. Funded occupational schemes: Switzerland, Denmark, Australia. Funded personal schemes: Chile

Assessment

- For relatively advanced countries, equity and efficiency best balanced by compulsion in "basic" social security (i.e. flat rate payments) only; development of an efficient private pension sector based on opting out of earnings related social security, with appropriate tax incentives, should be sufficient to attract employers and employees.
- Where a pre-existing voluntary system is wholly absent, where a "savings culture" is wholly absent and/or even basic social security schemes are moribund (e.g. in transition economies), a mandatory funded scheme may be appropriate.

Funding and pay-as-you-go

- UK, Japan – allow scope to opt out of earnings related social security, reducing burden on state
- UK – pay-as-you-go can be reduced “too much”, leaving an issue of old age poverty since funded schemes are unable to redistribute and mandatory contributions often too low (also US)
- Australia – means test on assets for pay-as-you-go leads to dissipation of assets and no reduction in burden on the state
- Chile – issue of transition costs minimised by cutting benefits of public system; helpful if government runs surplus

- Issues in notional defined contribution pay as you go (Sweden, Poland, Italy)
  - Stronger labour market incentives as DC
  - Link of pension to life expectancy
  - No transition costs
  - But government still holds unfunded liability, which is clearly defined, making future reform more difficult

Fiscal privileges

- New Zealand – abolition of tax benefits can lead to sharp decline in voluntary pension saving, or (Germany) limit private provision
- Australia, Denmark – mandatory schemes enable fiscal privileges to be reduced or abolished, possible risk of evasion
- UK – limits on exemption may be introduced for the highly-paid without destabilising system

Public versus private administration

- Singapore – public investment, even if efficient, may lack transparency and involve hidden taxation
- Chile, UK – private (personal) pensions vulnerable to high administrative costs, UK currently attempting direct limits (“stakeholder”)
- Sweden – possible solution via hybrid “monopsony” of public sector buying asset management services on behalf of private individuals
- Argentina – costs reduced if government collects contributions on behalf of funds

Occupational versus personal pensions

- UK, US – high cost of personal pension annuities owing to adverse selection faced by insurers – avoided in occupational funds where risks pooled
- US – concern about financial literacy of personal pension investors
- Transitional and emerging economies – short and uncertain firm life cycle, and need for labour mobility, weakens case for occupational funds

Defined contribution versus defined benefit

- UK, US – DB plans declining partly due to burden of regulation, higher costs of administration
- Switzerland – poor returns to DC occupational funds showing incentive problems (compared with DB in Netherlands, UK)
- Netherlands – possible to have efficient DB system with no barriers to labour mobility (“transfer circuits”) and industry schemes
- No case in the world of mandatory private DB schemes – DC leads to need for safety net (Chile, Singapore)

Internal versus external funding

- Germany, Japan – internal funding popular post-war due to provision of dedicated funds to firms (required mutual insurance). Now in decline, due to:
  - Fiscal changes
  - Concern over credit ratings
  - Firm life cycle and viability of internal funding

Portfolio regulations versus prudent person rules

- Japan – near bankruptcy of private pension funds, largely invested domestically
- Evidence of poorer performance of funds with regulations in range of OECD countries (1980-95):

	Nominal return	Standard deviation	Real return	Standard deviation
Prudent person	**11.9**	**8.7**	**7.8**	**9.5**
Restrictions	**10.6**	**11.1**	**5.8**	**11.4**

Indexation and annuities

- UK – compulsory annuitisation criticised due to low annuity rates (need for flexibility in drawdown and investment)
- US – concern over dissipation of retirement saving, which also worsens adverse selection for those seeking annuities
- Germany – compulsory indexation of pensions while portfolio restrictions impose inappropriate asset mix

Conclusion

- Governments face range of issues in pension reform – including ensuring preconditions are met and appropriate design and implementation
- Responsibility goes beyond pensions and financial markets – provision of stable macro environment crucial for any pension system

Key lessons of global experience

- Keep elements of both pay-as-you-go and funding (given different risks they are exposed to)
- Otherwise tailor reforms closely to current situation, ensuring underlying preconditions met (basic financial markets, regulatory structure and freedom from political interference), with careful attention to sequencing
- Possibly, establishment of legal claims to pension rights
- Once for all reforms better than repeated partial reforms that generate uncertainty
- No system can protect against all risks