Understanding the World Bank's Position on Pension Reform

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Background: Trends

- 1990s: Major Pension Reforms in Developing and Developed Countries
  - – Latin America: 10 countries
  - – Eastern Europe: Hungary, Poland, Latvia,…
  - – OECD countries: Australia, Sweden, ...
- 2000s: Reform Dynamic toward Multi-pillar will continue with some Changes in Focus
  - – European Union – post-German reform effects
  - – Second generation reform issues
  - – Africa: Fiscal and social requirements

Background: How to measure success of WB advice for Multi-pillar?

- World Bank Pension Reform Primer: www.worldbank.org/pensions
- Holzmann, R. and Stiglitz, J. (2001 eds.): *New Ideas About Old-Age Security*, The World Bank, Washington, D.C.
- The World Bank's Position on Pension Reform (in draft)
- Assessing Pension Reforms in Latin America (under preparation)
- Reviewing of Pension Reform Advice: An OED Study (under commissioning)

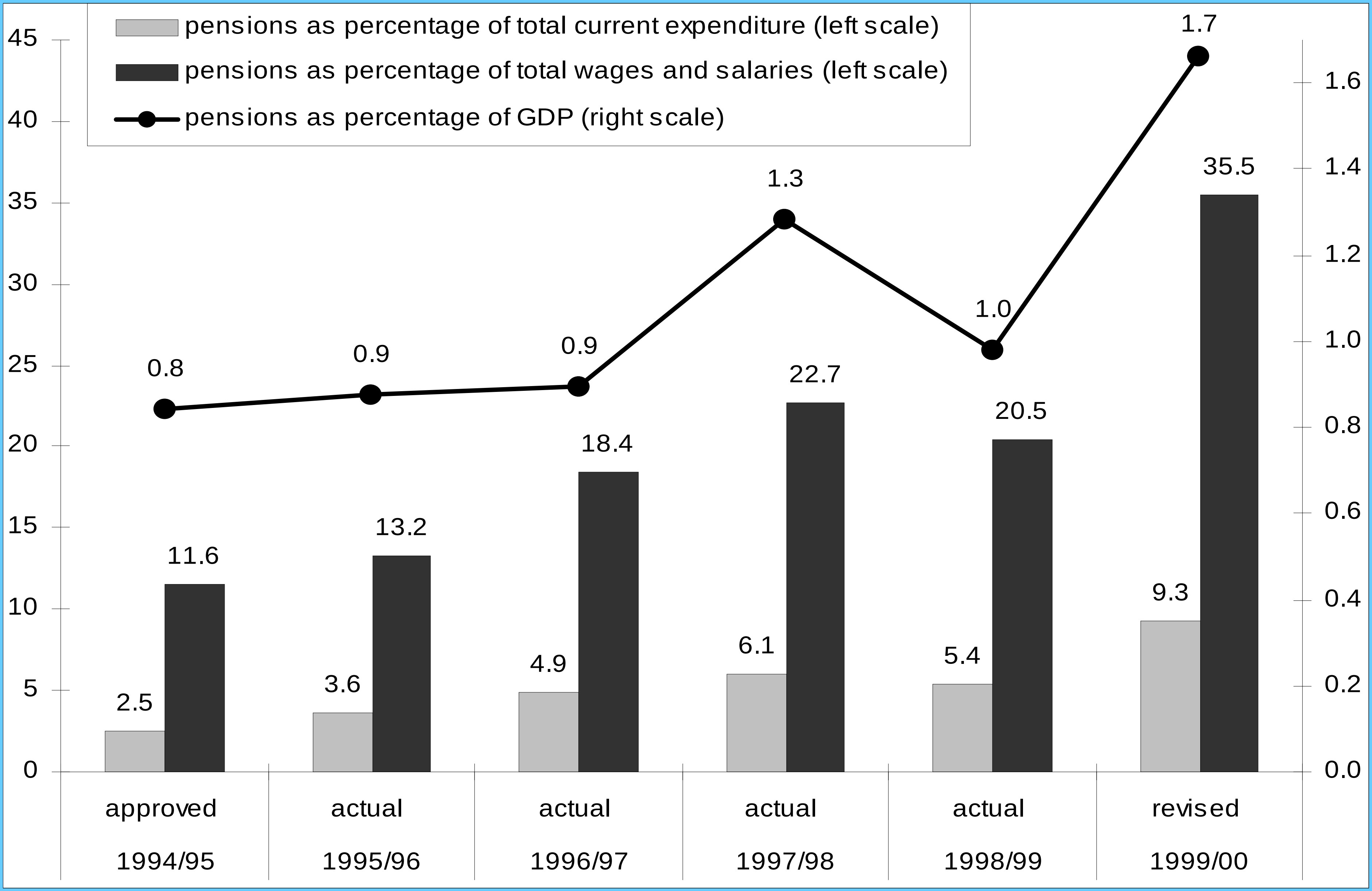
Structure

- Why does the Bank care about pension systems and reforms?
- What are the goals of pension systems?
- Multi-Pillar: Benchmark not blueprint
- How does this translate into the work with countries/different client segments?
- Positions for discussion:
  - Coping with aging: Does the form of financing matter?
  - Contractual saving and financial market developments
  - Minimum conditions for funded schemes
  - Pension reform and actuaries

Why does the Bank care about Pension Systems and Reforms?

- Current pension systems in client countries mostly do not deliver the expected coverage and benefit levels
- Unsustainable pension systems lead to the crowing-out of other social expenditure
- Unsustainable pension system lead to macroeconomic instability (e.g. Brazil 1998)
- Most pension systems exhibit major labor market distortions
- Pension reforms can importantly contribute to financial market development

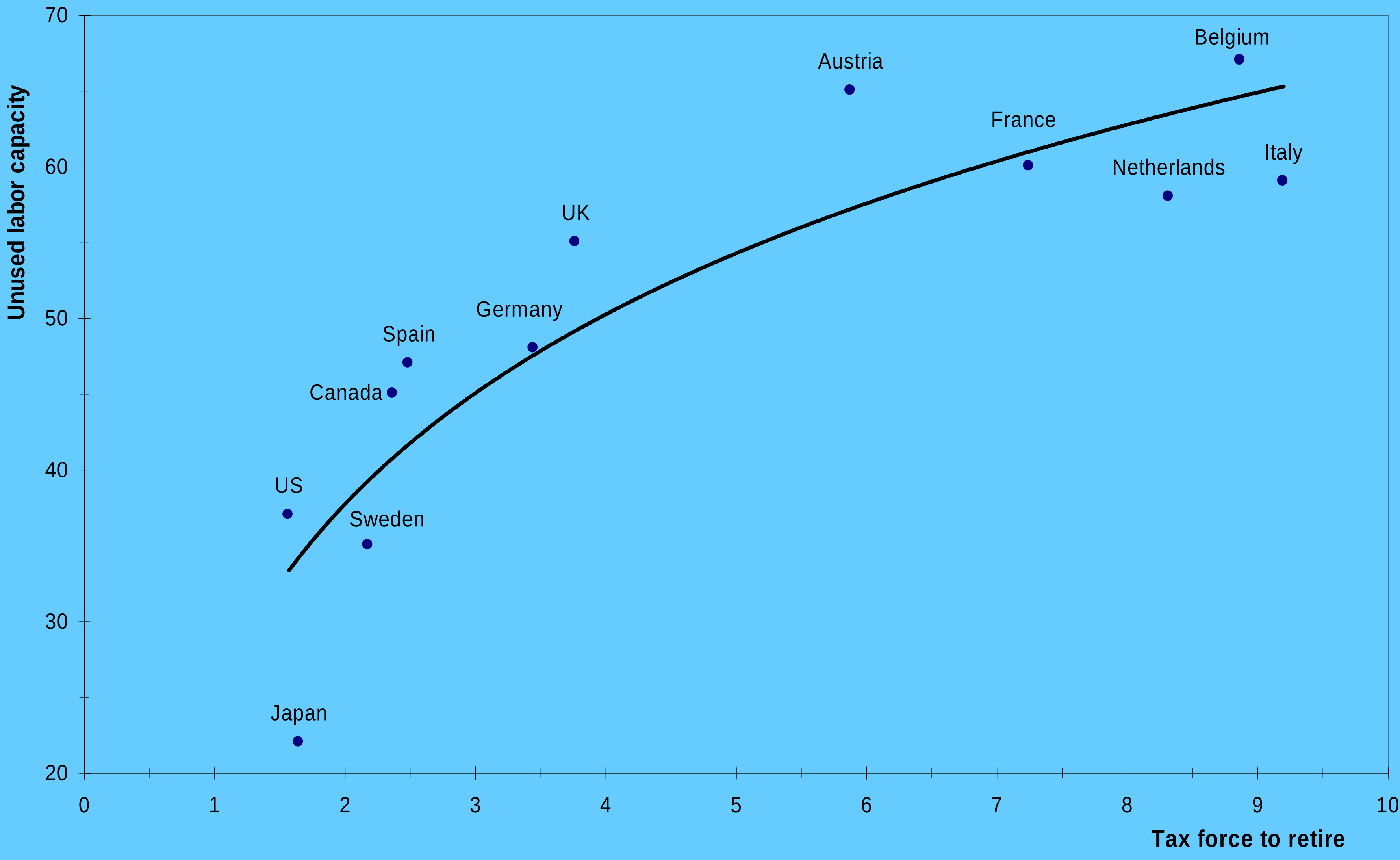
Mali: Public Pension Expenditure and Wage Bill



What are the perceived Goals of Pension Provisions?

- **Primary goals:** The delivery of adequate, affordable, sustainable and diversified pension benefits
- **Secondary goals:** To create developmental effects by minimizing negative impacts (e.g. labor market) while leveraging on positive impacts (e.g. financial market development)

Unused Labor Capacity and the Tax Force to Retire



Multi-Pillar: Benchmark not Blueprint

- **Multi-pillar:** Relying on multiple benefit types, administration and funding mechanism to deal with economic, demographic and political risks
- **Reforms assessed against five criteria**:
  - Does the reform meet distributive concerns?
  - Is the macro and fiscal policy sound?
  - Can the administrative structure operate the reform?
  - Are the regulatory arrangements and institutions in place?
  - Is there a long-term commitment by government?

How does this translate into work with countries?

- **LICUS** (Low Income countries under stress): Working with communities and NGOs
- **Low Income Countries:** Basic pensions, providing for informal sector workers, and keeping things functioning and simple for the formal sector
- **Middle Income Countries:** New approaches for unfunded schemes (NDCs) and support of partially funded schemes

Multi-pillar pension reform and coverage: it helps, but moderately

- Econometric results for 18 Latin American countries (Packard 2001)
  - An overall mandated high SS contribution rate has a stark **negative** impact on coverage (10pp less contribution rate means 12pp higher coverage rate)
  - A higher share of contributions to individual accounts has **positive** effects on coverage (50-50 split of UF-FF contribution rate means 7.5pp higher coverage rate)
  - Effect of multi-pillar scheme on coverage follows a J-curve (4pp lower after 4 years, cross-even point after 10 years, and a long-term net-addition of 10pp)

Coping with Aging - I

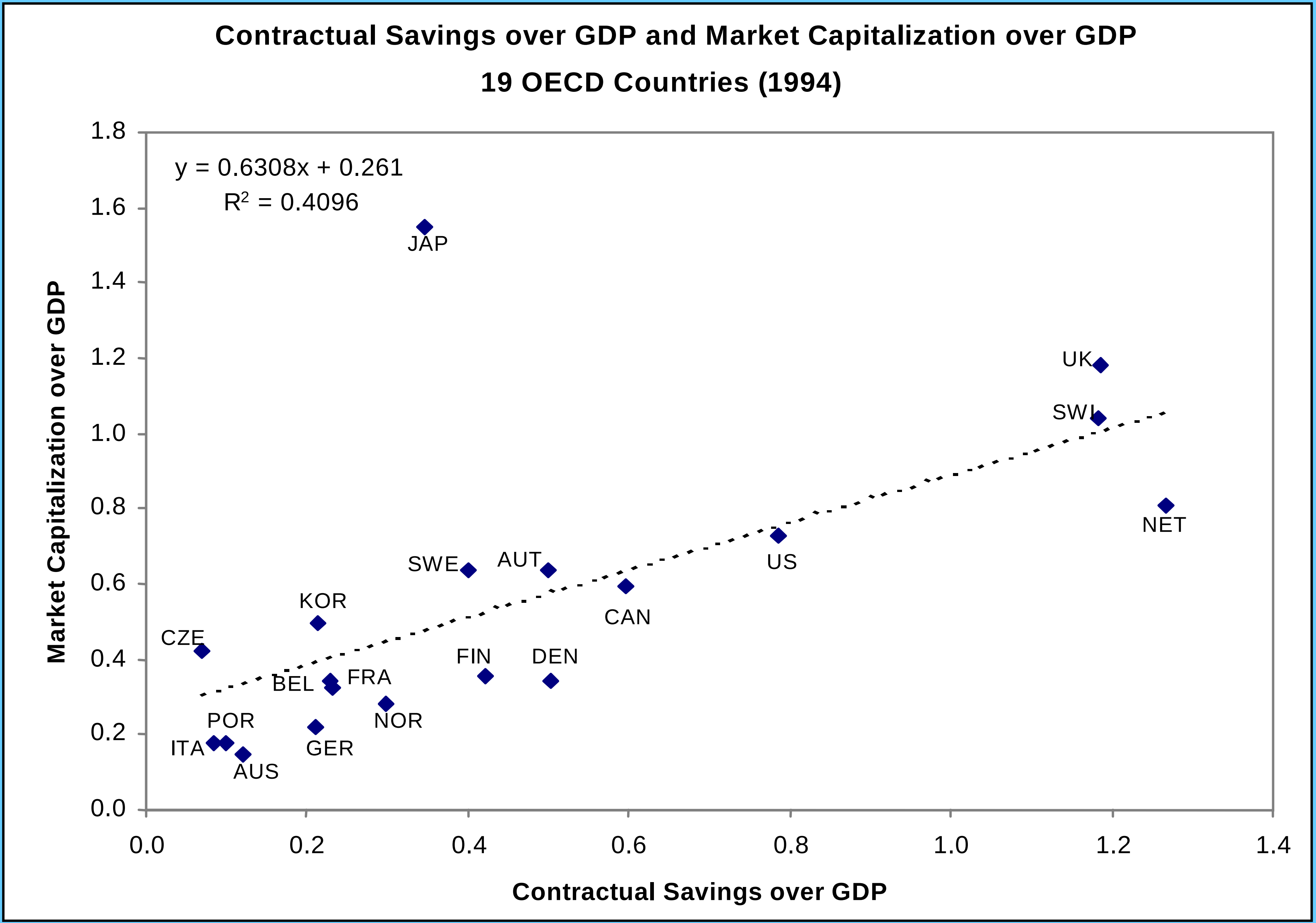
- Both unfunded and funded pensions need the next generation to complete the inter-generation contract
- From individual and societal perspective, an increase in remaining life-expectancy is best dealt with by both longer work and more retirement leisure
- Higher income leads to higher demand for (retirement) leisure and the willingness to pay for it
- Individuals differ in their preferences (including leisure) and capacities/work record

Coping with Aging - II

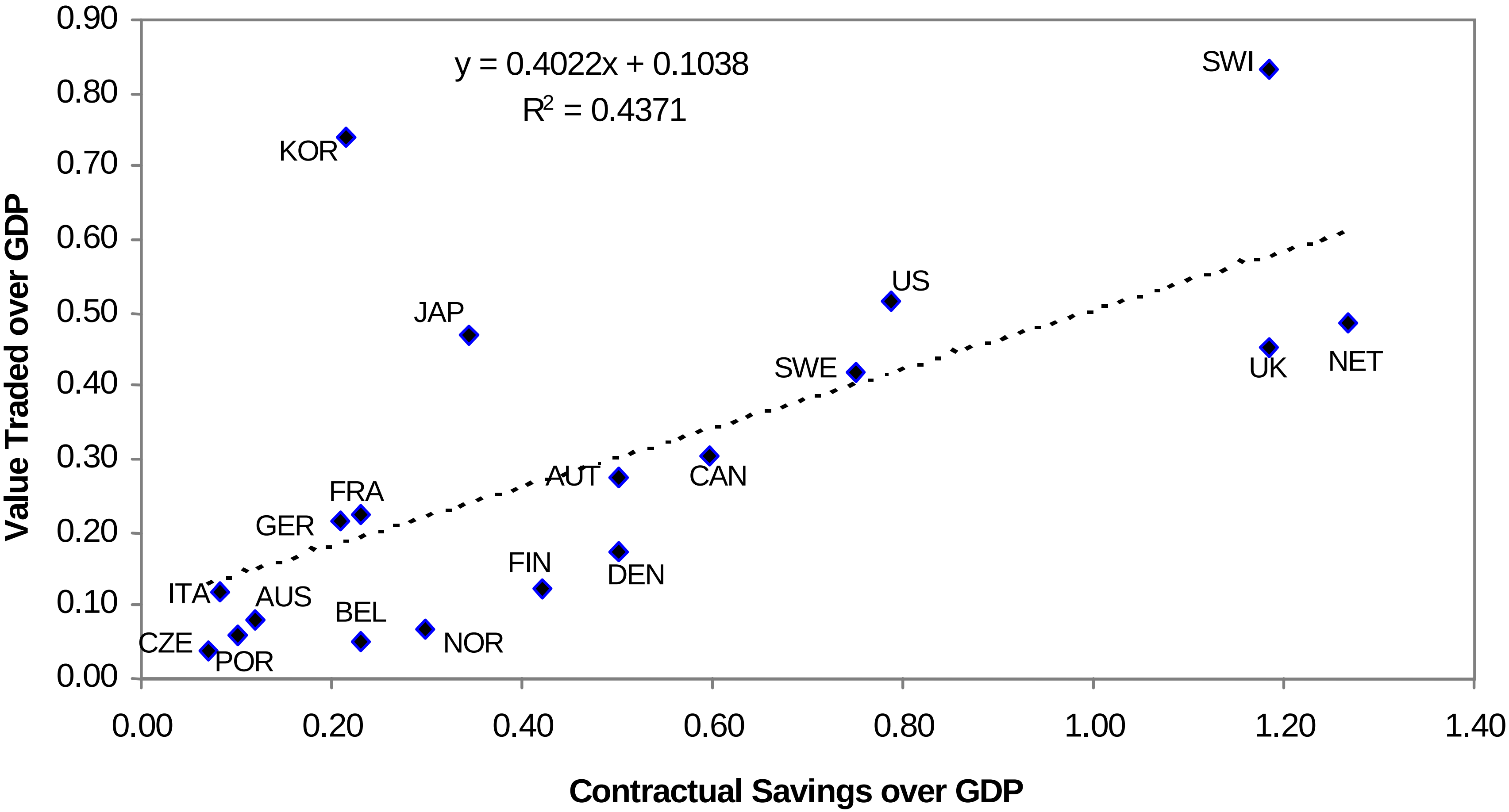
- A multi-pillar pension scheme helps coping with population aging, if
  - Breaks-up the rigid division between education, work and retirement leisure
  - Effects as little as possible labor supply and retirement decisions (and works in an environment of life-long learning
  - Credibly promises adequate, affordable, sustainable and diversified pensions
  - Allows mobility across professions and borders

Contractual Savings and Financial Market

- Contractual savings ((pension funds and insurance industry) is neither necessary nor sufficient for FM development, but can accelerate it
- Contractual savings make the financial markets deeper, more liquid, innovative and sophisticated
- Contractual savings increases market capitalization (shifts from debt to equity instruments) and provides long-term instruments which render economies less vulnerable to shocks
- Financial markets intermediate resources AND price risks


Contractual Savings over GDP and Market Capitalization over GDP
19 OECD Countries (1994)
y = 0.6308x + 0.261
R2 = 0.4096
Market Capitalization over GDP
Contractual Savings over GDP
1.8
1.6
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0
0.0
0.2
0.4
0.6
0.8
1.0
1.2
1.4
JAP
UK
SWI
NET
US
CAN
AUT
SWE
KOR
CZE
FIN
DEN
FRA
BEL
NOR
POR
ITA
AUS
GER

Contractual Savings over GDP and Value Traded over GDP
19 OECD Countries (1994)



Financial Markets and Economic Growth

- Economic growth depends only to a low extend on capital - most growth is derived from total factor productivity
- TFP depends on property rights, innovations, and…financial market development
- Well developed financial markets can lead to a permanently higher growth rate

Table 7. Chile: The Impact of the Pension Reform on the Economic Growth Rate

	Low estimate	High estimate
Through TFP 1/	0,4%	1,1%
Through capital formation 2/	0,5%	0,6%
Through labour market 3/	0,0%	1,1%
Total	**1,0%**	**2,9%**

Minimum Conditions for Funded Pension Schemes

- Low-middle income level (US$ 2000 per capita and above) as proxy for broader demand of financial market services
- Credible macroeconomic policies to provide enabling environment for the development of long-term financial instruments
- Core functioning financial market institutions (Banks and custodian services) and long-term government commitment for development of FM
- Open capital account to diversify investment and risk

Pension Reform and Actuaries

- Pension reform is a team effort which requires a large variety of skills (macro and microeconomic, labor market, public finance and financial sector, industrial organization, demographic….and actuarial)
- Actuarial studies provide
  - Excellent source of factual information
  - Commonly accepted methodological framework
  - Great check if legal provisions are followed
- Actuarial studies
  - Are of limited use for policy analysis where economic and political concerns prevail (e.g. budget and redistribution)
  - Concentrate on stocks, little on flows
  - Fail, at times, to consider the broader macroeconomic picture and the interaction between markets and policies