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# Chapter 3

# Goals and Criteria That Define the World Bank's Perspective

EVALUATING THE VALUE AND FEASIBILITY OF PENSION REFORMS on the basis of the expected outcomes and viability of the process requires the articulation of goals toward which reform should be directed and the formulation of criteria against which these and the process of reform will be judged. These goals and criteria define the standards that a reform must achieve in order for the World Bank to provide financial and other support for it.

## Primary Goals: Adequate, Affordable, Sustainable, and Robust Pensions

What are the primary goals that mandated schemes should achieve? The World Bank holds that pension systems should provide adequate, affordable, sustainable, and robust benefits.

*Adequate* refers to both the absolute level (preventing old-age poverty) as well as the relative level (replacing sufficient lifetime earnings) of retirement income that the pension system will provide. The goal of any pension reform should be to ensure that all people regardless of their level or form of economic activity have access to the capacity to remain out of extreme poverty in old age and that the system as a whole provides assurances that those individuals who live beyond the expected norms will be protected from the "risk" of extreme longevity.

How much lifetime earnings should be replaced on a mandatory basis will depend on a number of factors that are specific to the conditions in which the reform is undertaken. These include access to housing, health care, and other basic services, average propensity to save, level of economic development, and level of income in the country. World Bank experience

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generally indicates that, for a typical, full-career worker, an initial target of net-of-tax income replacement from mandatory systems is likely to be about 40 percent of real earnings to maintain subsistence levels of income in retirement.[11] Lower-income workers require somewhat higher rates, while higher-income workers require lower rates. The age at retirement will also affect the measure of adequacy, with older workers requiring higher replacement rates because they have little potential to supplement their pension benefits. Targeting average replacement rates above 60 percent is not likely to be viable over the long term because the required contribution rates would impose an untenable burden.

Whether and how a zero-pillar pension is provided will depend very much on the circumstances in a given country. While providing income support to the most vulnerable elderly should be a clear objective of system design and reform, in many client countries the sparse budget resources will have to be evaluated against alternative uses, such as support for the most vulnerable children and youth. While targeted approaches will, in principle, ease the issue of choice and selection, many client countries may be lacking administrative capacity, and community-driven approaches may not yet be available.

*Affordable* refers to the financing capacity of individuals and society. Although higher replacement rates seem desirable, they come at a cost. The direct cost is through higher contribution payments for individuals, which interfere with more pressing needs (such as child raising) or investment needs (such as housing). The indirect cost is through higher incentives for evading contributions by engaging in informal sector activities, with negative consequences for individual lifetime opportunities and macroeconomic consequences for budget sustainability and economic growth. World Bank experience indicates that mandated contribution rates in excess of 20 percent are likely to be quite detrimental for middle- and high-income countries with a well-developed structure of collection; for low-income countries, the threshold may be as low as 10 percent.

*Sustainable* refers to the financial soundness of the scheme, now and in the future. The pension program should be structured so that the financial situation does not require unannounced future hikes in contributions, unannounced future cuts in benefits, or major and unforeseen transfers from the budget. Put differently, all the adjustments needed to keep the scheme financially sound (through changes in contributions, benefits, or age of retirement) should be decided, announced, and factored into the design of the program. These may include mechanisms to adjust the program to address economic shocks in a manner that keeps financing within the established macroeconomic envelope. Since the whole population (active and retired) lives off current output (actually gross national product), the amount of available resources is highly significant to the extent

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that countries cannot borrow from abroad indefinitely to sustain high consumption. Sustainability, therefore, ultimately refers to the primacy of output in determining overall constraints and the capacity of any reform to provide the promised benefits without unduly displacing other claims on future resources.

*Robust* refers to the capacity of the system to withstand major shocks and to remain viable in the face of unforeseen conditions and circumstances. The key outcome in this regard is the capacity of the system to sustain income-replacement targets in a predictable manner over the long term. Main shocks to the system may come in the form of economic, demographic, or political risks. Any pension system must be designed to withstand the range of stresses from these and other sources, explicitly taking into account the anticipated stability of the environment in which it is implemented.[12] A central element in meeting this goal is a credible analysis of the financing of reform across the full range of likely scenarios and over the full term required for a reform to mature and reach long-term stability. To fulfill this goal, countries are likely to need to develop or adapt one of the sophisticated modeling tools to their own conditions and to present analyses that incorporate a significant range of variation in basic assumptions to demonstrate the viability of a reform over the long term.

## Secondary Goal: Contribution to Economic Development

The secondary goal of mandated pension provisions (and their reform) is to create developmental effects, either by minimizing negative impacts, such as the effects on labor markets or macroeconomic (in)stability created by imbalanced systems, or by leveraging positive impacts, especially by increasing national saving and by promoting financial market development. Pension schemes have an important impact on the level and growth of output and distributable resources. Hence, the goal of creating economic effects is important since all retirement income—whether funded or unfunded—is essentially financed out of a country's output.

The centrality of output for a pension system's ability to deliver on its primary goals makes it imperative that the design and implementation of a pension system be evaluated in terms of the developmental effects (Barr 2000, 2001). There is rising empirical evidence that the system's characteristics—most important being the design, financing mechanisms, and administrative implementation of benefits—have an important bearing on developmental effects and hence on level of output. But there is not yet enough empirical evidence to unequivocally guide the design and implementation in detail, making reform assessments and knowledge sharing even more important.

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## Reform Criteria

Because the World Bank is willing to support a broad range of reform attempts, sound and transparent criteria are needed to define those approaches to which the World Bank will lend its support (Holzmann 2000). While the World Bank reacts flexibly to country preferences and circumstances, it does not support all reforms proposed by a country. Too much is at stake for the current and future retirees, and the country as a whole, to engage in a pension reform that is unlikely to attain the country's social and economic objectives. The suggested criteria address both the content of the reform and the process through which it is to be undertaken. Four primary content criteria are currently applied.

First, *does the reform make sufficient progress toward the goals of a pension system?* Will the reform provide reasonable protections against the risks of poverty in old age by efficiently allocating resources to the elderly? Does it provide the capacity to sustain consumption levels and provide social stability across the full range of socioeconomic conditions that are prevalent in the country? Does the reform meet distributive concerns? Will it offer access to retirement savings and poverty protection on an equivalent basis to all persons with significant economic participation? Does the reform offer savings mechanisms and basic poverty protection to informal sector workers and those performing mainly noneconomic work (for example, through a basic pillar and joint annuity requirements)? Does it provide different groups of workers (for example, men, women, high-income workers, low-income workers) equal incentives in principle (that is, no special rules) to participate in the labor market? Gender equity must be explicitly considered within these criteria.

Second, *is the macro and fiscal environment capable of supporting the reform?* Have financial projections been thoroughly evaluated over the long time periods appropriate to pension systems and rigorously tested across the range of likely variation in economic conditions over these time periods? This includes detailed projections of the scheme's long-term fiscal sustainability; an assessment of the proposed measures to finance the transition toward a funded pension (the level of transitory debt financing and budgetary financing); and the proposed reforms of revenue and expenditure programs. Is the proposed financing within the limits reasonably imposed on both public and private sources? Quantitative assessments of the long-run fiscal and distributive implications of the current pension scheme and of alternative schemes under consideration are basic ingredients of any reform process. Because most client countries with an ailing pension scheme do not possess the required model, the World Bank has developed a generic pension model, PROST (Pension Reform Options Simulation Toolkit), which, when filled with country-specific data and

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system information, provides long-term projections of the current scheme and main alternatives, including the reform of an unfunded scheme and the introduction of a (partially or fully) funded scheme.

Third, *can the administrative structure operate the new (multipillar) pension scheme efficiently?* Does the government have the institutional infrastructure and capacity to implement and operate publicly managed elements of the reform? Can the private sector be reasonably expected to develop and operate the institutions required for any privately managed elements? This includes an assessment of the capacity to levy contributions, to channel them to the different pillars, and to pay benefits in a timely fashion; the level of computerization; the availability of personal identification numbers (important for individualized accounts both on a notional and funded basis); and the level of competence and training needed for administrative staff.

Fourth, *have steps been prepared to establish the regulatory and supervisory arrangements and institutions to operate the funded pillar(s) with acceptable risks?* Is the government able to put in place sustainable and effective regulatory and supervisory systems to oversee and control the governance, accountability, and investment practices of publicly and privately managed components? This includes an assessment of the regulatory agencies and their strength of supervision and the powers of intervention for pension funds and insurance companies; the criteria for entry and exit of funded pension institutions; the availability of sound custodian banks; and an assessment of the proposed internal versus external management of assets, fee structure, and a variety of other aspects of operating a pension system.

The experience of the World Bank also indicates that the process and political environment under which a reform is undertaken are significant determinants of the likelihood of success. Consequently, three criteria are considered relevant to process; they are centered around the issues of commitment building, consensus building, and implementation (see also part 2 on the political economy of reform).

First, *is there a long-term, credible commitment by the government?* Is the reform effectively aligned with the political economy of the country and supported by a clear political mandate? Are the political conditions under which the reform will be implemented sufficiently stable to provide a high likelihood for a full implementation and maturation of the reform? This is, perhaps, the most difficult reform criteria because it is subjective. Political indicators include broad consensus among the central ministers and ministries about the need for and direction of reform, the existence of a champion of reform and empowerment of a technical group to develop the supporting analysis, the willingness to undertake broad-range parallel reforms (such as taxation and financial sector and budget reforms), and

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a high probability that a new government will not undo the reform. Other related indicators are the development of sound analysis and effective communication of the objectives, costs, and outcomes of the reform to the public and the inclusiveness of the reform process, including the involvement of trade unions or other worker representatives.

Second, *is there consensus building through local buy-in and leadership?* Even the best technically prepared pension reform is bound to fail if it does not reflect the preferences of a country and is not credible to the population at-large. To achieve this, the preparation of a pension reform has to be undertaken primarily by the country itself, by its politicians and technicians, and be effectively communicated to and accepted by the population. Outsiders, such as the World Bank, can assist with advice and technical support, but ownership and public support must come from the client country.

A major challenge for any comprehensive pension reform is to create an awareness of the issues among politicians and the population at-large. Once the seeds for pension reform are sown, the challenge is to train technicians in the new skills required in administration, regulation, and supervision. The activities of the World Bank, headed by the World Bank Institute, include (a) an annual workshop together with reputable academic institutions (originally with the Harvard Institute for International Development, then with the Harvard Kennedy School of Government, and as of summer 2004 with Oxford University); (b) a core course on pensions targeting technical staff from our client countries and World Bank staff, which was launched in December 1999 and is now offered on a regional basis; (c) an annual conference on public pension fund management; (d) an annual conference on contractual savings; and (d) regional workshops and conferences to discuss broad policy issues in the area of pensions or to draw lessons from regional experiences with reform (including the October 2003 Stockholm conference to review critically the concept and implementation of notional defined-contribution schemes; see Holzmann and Palmer 2005).

Third, *does it include sufficient capacity building and implementation?* Pension reform is not simply a change of laws but a change in how retirement income is provided. Accomplishing this typically requires major reforms in governance, collection of contributions, record keeping, client information, asset management, regulation and supervision, and benefit disbursement. With passage of a legal framework, only a small part of the task has been achieved. A major emphasis on and investment in local capacity building and implementation and continued work with the client and other international and bilateral institutions beyond reform projects or adjustment loans are still required.

The World Bank is increasingly involved in pension reform in all regions of the world. On the one hand, this exposure requires that cutting-

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edge knowledge be available within the World Bank to provide the best advice, to address the specific needs of a country, and to issue innovative proposals for solutions. In short, this requires knowledge to empower the country to find its own specific solution. On the other hand, the lessons learned in each country provide a unique set of information that can be productively applied in other reforms. This requires the analysis and sharing of information within the World Bank, with the outside world, and with the countries implementing reform. The World Bank has created a Primer on Pension Reform series that provides comprehensive information on design and implementation issues, including case studies of country experiences for the benefit of World Bank task managers as well as politicians and technicians in client countries. For the dissemination and sharing of reform-related information, emphasis is being placed on the development of a Web site, including the publication of conference and workshop proceedings, basic pension data, and links to other reform-related Web sites from academic, financial sector, and partner institutions (http://www.worldbank.org/pensions).

The World Bank also supports outreach to old and new international partners in order to strengthen the message and impact of reform. In the past, countries too often received sharply conflicting advice from different international institutions and bilateral donors. The World Bank is seeking to engage partner institutions in a constructive dialogue in order to determine areas of agreement and difference and to examine the reasons behind them (such as differences in objectives, values, assumptions, views on the functioning of the world, or constituencies). This approach will not dissipate all disagreements and perhaps should not do so. The outcome of such a dialogue, however, should help client countries to assess the differences and arrive at their own judgments.

To this end, dialogue has been strengthened with the International Labour Organization, which traditionally has been opposed to enhancing funded provisions to the detriment of unfunded provisions but has recently adopted a more open stance (see, for example, Beattie and McGillivray 1995; Gillion 2000; Gillion and others 2000; ILO 2002a). One forum for such an exchange of views has been created by the International Social Security Association (ISSA) through its Stockholm Initiative, a worthwhile attempt to create a new consensus on social security (ISSA 1998; Thompson 1998). The World Bank has also established partnerships with nongovernmental organizations such as HelpAge to deal with income support for the vulnerable elderly. Intensive contacts with regard to the design and implementation of reform exist with the World Bank's sister institution, the International Monetary Fund. In the past, the fiscal stance of the IMF and its defense of government deficits have hampered the move toward funded pensions. A note by the Fiscal Affairs Department to the IMF board in 1998,

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however, recognized that reform-induced deficits do not reflect an expansionary fiscal policy if they are caused by a reduction in the implicit pension debt. The application in a country context occurs on a case-by-case approach. More recently, cooperation in the pension area has been established with the regional development banks such as African Development Bank, Asian Development Bank, and Inter-American Development Bank. Last, but not least, the World Bank cooperates with the OECD's Working Party on Private Pensions and the recently established International Organization of Pension Supervisors (IOPS) on the regulation and supervision of private schemes.