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# Chapter 6

# Key Reform Issues: Firm Positions and Open Questions

THIS CHAPTER PRESENTS SOME OF THE KEY ISSUES REGARDING THE DESIGN of pension systems and the implementation of reform, highlighting areas where the World Bank holds a solid position and areas where it is still searching for good answers. Specifically, it presents the Bank staff's views on pillar design, poverty relief, and redistribution; financial sustainability; administrative and implementation issues; regulatory and supervisory issues; the options for countries with small financial markets; and issues of political economy. The chapter ends by acknowledging some major reform dilemmas—that is, areas where there is substantial disagreement or simply an absence of well-developed knowledge of the optimal design of reform.

## Pillar Design, Poverty Relief, and Redistribution

Ideally, every elderly person should have access to old-age income, at a minimum in the form of poverty relief or, even better, an income-replacing pension. In reality, access to one or the other is scarce in a typical client country because the income level and coverage rate are closely related. Coverage for the typical low- to middle-income country ranges from a single-digit percentage of the labor force and elderly population to almost 50 percent, with an average of about 20 percent. Exceptions are the former transition economies in Eastern Europe and Central Asia, where coverage is still very high among the elderly (and partially among the workforce), and a few countries in Southern Africa (Botswana, Mauritius, Namibia, South Africa) and some Latin American countries (Brazil, Costa Rica) that have basic pension provisions. Traditional wisdom is that coverage under an earnings-related scheme is simply a question of per capita income level, with almost full coverage in rich OECD countries a benchmark that

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will be reached over time. This wisdom, however, is increasingly challenged, as coverage in OECD countries is decreasing and coverage in developing countries has not increased as envisaged (Gill, Packard, and Yermo 2004; Holzmann 2003; Holzmann, Packard, and Cuesta 2001). This creates special challenges for the priorities and design of pillars, the level of benefits, and the role of redistribution. In addition, the design of disability and survivor pensions needs to be reviewed—in its own right and as part of the design of a multipillar pension scheme.

### *Role of Pillars*

The role of pillars is largely dependent on the country context and stage of development. While in more developed countries all pillars may be assigned a function in pursuit of the primary and secondary goals of a pension system, the inherited system typically creates a constraint on the choices. In contrast, less-developed countries are often essentially unconstrained by an inherited pension system. However, lacking both financial markets as well as the capacity to implement and administer new systems limits the choices among the various pillars for these countries.

In countries where coverage and administrative capacity are high, the zero or basic pillar can serve as a safety net and should be means tested. Even in countries with high coverage, some individuals, particularly those working primarily in the informal sector, do not have sufficient years of service or did not participate in the labor force and therefore are at risk of becoming poor in old age. The contributory system can be covered under pillar one (a public pay-as-you-go, or partially funded, defined-benefit system—perhaps revamped as a notional defined contribution), pillar two (a market-based and fully funded defined-contribution system), or a combination of pillar one and pillar two. These pillars may be complemented by a (usually tax) subsidized voluntary system organized at either the occupational or the personal level (pillar three).

In countries where coverage is low, the zero pillar ideally is the dominant tool to protect against old-age risk, offered either to all individuals above a certain age or to a large percentage of individuals rationed by a means test or other mechanism. There could be a pillar one, a pillar two, or a combination of the two. But in many low-income countries, neither the public nor the private sector can deliver coverage, which creates a dilemma. Under such circumstances, pillar three (voluntary pensions) should be envisaged and promoted, with the basic pillar only covering the most basic needs of the most vulnerable. Voluntary savings instruments are of particular importance for covering the retirement needs of the large informal sector in low-income countries and for addressing the high incentives for microentrepreneurs and workers to avoid formal earnings-related schemes. There are usually pressures from civil servants or other special groups to offer special pension plans, which then are extended to other groups, as

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well as pressures to comply with international labor standards (see ILO 2002b). As a result, despite the low coverage and difficulty of administering such systems in the lowest-income countries, the tendency is to embrace a mandatory pillar one or pillar two for at least some segments of the population, with nothing for the remainder.

### *Design Issues for a Basic Pillar*

The first step in structuring the basic pillar is to consider the pros and cons of the available design options.[18] Four options are worth considering: (a) expanding the contributory system, (b) integrating programs to address elderly poverty with the general social safety net (that is, general poverty-targeted social assistance for households regardless of age), (c) a universal basic pension, and (d) a means-tested basic pension.

#### EXPANSION OF THE CONTRIBUTORY SYSTEM

The main problem with a contributory system is that it cannot cover everyone, especially the lifetime poor, those with incomplete employment history, and workers in the informal sector who may stay outside the formal sector. Even if it were possible to cover all of the categories of vulnerable individuals, an enormous data collection and record-keeping effort would be required, which is nearly impossible, especially in rural areas where information constraints preclude such programs in nearly every country. Similarly, simply mandating increased coverage will not be effective in most settings because of the practical problems of identifying the relevant population and establishing cost-effective enforcement.

#### INTEGRATION WITH THE GENERAL SOCIAL SAFETY NET

In principle, integration with the general social safety net—poverty-targeted social assistance for all households, including households with elderly—is possible, but it does not empower the elderly or provide them with some choices to look after themselves. It also may create adverse incentive effects on the labor market if it targets households where both the able-bodied and the elderly are living together. The potential stigma associated with enrollment of the elderly in these types of programs is also a significant impediment. Given these considerations, most countries do not adopt the social assistance route to protect the elderly.

#### UNIVERSAL (NONCONTRIBUTORY) BASIC PENSIONS

A number of countries, both developed and developing, are implementing a noncontributory pension program. Table A.2 provides a list of countries and the basic features of the universal pension program. This is probably the best way to provide poverty relief to the elderly. Considering the difficulty of identifying who among the elderly is poor, the principal merit of the program is that its universality avoids the targeting issue.

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However, its principal merit is also the principal problem: fiscal affordability, especially in low-income countries. Consequently, many countries where a universal pension program is currently in operation are considering ways to target the program or reduce the benefit levels (by letting inflation erode the real value of benefits).

Fiscal affordability of universal pensions leads one to consider several central questions prior to considering this policy option, especially in low-income countries, where the value of a marginal dollar of public money may have valuable alternative uses aimed at national poverty reduction (as opposed to poverty reduction solely among the elderly). Addressing these questions requires evaluation of the poverty status and living conditions of the elderly, their vulnerability compared to other groups (such as children), the impact of targeting the poor elderly on the national poverty rate, as well as the alternative use of resources for poverty reduction (such as investment in physical and human capital).

Initial empirical investigations in this direction are currently being undertaken by the World Bank for 15 African countries (Kakwani and Subbarao 2005) and select countries in other parts of the world (such as Nepal). While the preliminary results do not undermine the request to investigate the contribution of social pensions to social and economic development in a country context, neither do they support this policy option in all developing countries. The study points, in particular, to the heterogeneity among African countries with respect to the proportion of the population that is elderly and their living conditions and arrangements. Most elderly live in extended families, and in some countries, the elderly living with children (usually grandchildren) appear to be the most vulnerable. The budgetary resources required to fill the poverty gap among the single elderly and the elderly living with children are not high, but a much larger envelope is needed to move from the single elderly to all elderly-headed households (table A.3).

Targeting a social pension program only to the poor among the elderly is undoubtedly a less costly option and has greater impact on group and national poverty rates. But such a benefit assessment abstracts from the (administrative) costs of targeting. Providing a fixed benefit level (0.70 percent of the poverty threshold) to all of the elderly is a very expensive option, even when the benefit is limited to the poor among the elderly (table A.4). In the case of an eligibility age of 60, it ranges from 1 percent to more than 3 percent of GDP if given to all elderly and is more than half of this level if provided only to the poor elderly. In many low-income countries, 2 percent of GDP represents 15 percent of tax resources: about 5 to 10 times the amount of total social assistance resources for all other vulnerable groups and more than half of the amount typically spent on education. Furthermore, even if these benefits could be financed, we still know very little about how to disburse small amounts of money to people in thinly

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populated rural areas, where the age of many potential recipients is difficult to establish.

Nevertheless, the rationale for investigating the vulnerability of the elderly in general, and in developing countries in particular, remains strong. Careful consideration needs to be given to three design parameters: (a) the level of the benefit, (b) the age of eligibility, and (c) other eligibility requirements. In this context, Nepal's experience is of particular interest. Nepal kept the level of the benefit low (under $2 per month per person) and set the age cutoff point at 75, maintaining the universality feature. The result has been excellent coverage (87 percent of all eligible participants are covered by the program, with minimal errors of exclusion) at a low budgetary cost so that the country not only can afford the pension but also can sustain the fiscal cost of the program over time. India is also implementing old-age pensions with age cutoffs and benefit levels that differ across states, costing no more than 0.1 percent of GDP.

It is not surprising that many countries where universal pension programs are currently in place are attempting either to target the program or to allow the benefit level to erode over time, largely driven by fiscal considerations. If the features of program design are well constructed from the outset, this policy option still merits serious consideration in many countries. However, any decision regarding the best instruments and the tradeoffs between a universal pension and reduced programs for other groups (such as children and widows) needs to be placed in the context of the specific country.

### MEANS-TESTED BASIC PENSION

A basic pension for the elderly is provided based on a means test (which may take the form of an affluence test), persons living in particular geographic locations, or other categories determined to indicate vulnerability (such as families with AIDS patients). The main impediment to implementing this type of program is the cost of service delivery, especially in countries where means testing involves significant administrative costs. Countries differ a great deal with respect to their ability to administer a means test, and implementation modalities need to recognize that the degree of decentralization has a major influence on costs and effectiveness. For example, in Thailand village social workers are able to identify the elderly poor relatively easily and cost-effectively. This may not be the case in other countries. Yet cross-country evidence suggests that targeting in developing countries does work (Coady, Grosh, and Hoddinott 2004).

### SUMMARY AND IMPLICATIONS FOR POLICY

For most developing countries, an optimal strategy would be to begin with a basic pension at an advanced age, keeping the level of benefit small. This would ensure self-selection with a low budgetary cost. It is

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important to consider explicitly the size of the benefit and intended coverage in low-income countries because of competing fiscal needs: widows and women with many children may be worse off than the elderly. In a fiscally strapped economy, more for the elderly means less for other programs (such as health and education). Also, a risk and vulnerability assessment is needed to determine whether the elderly as a group faces risks significantly more onerous than other groups. Based on such an assessment, benefit levels could be revised upward or downward. Regardless of the current level of benefits, the fiscal cost is bound to increase as the number of elderly increases, which, given the current demographic patterns, will occur in virtually all settings. When that happens, other policy options to consider are keeping the benefit level constant at a low level so that it continues to be unattractive to the nonpoor, raising the age of initial eligibility for benefits as life expectancies improve, and gradually introducing means testing as the information base becomes more robust and reliable.

### *Design Issues for a Contributory System, Pillars One and Two*

The actual shape of a country's contributory system is strongly influenced by historical precedent and the country's preferences. However, several principles should be applied regardless of the distribution of pillars. Contributory systems should be self-financing and fiscally sustainable. The labor market implications of the level of overall contribution rates and the benefits provided need to be considered, recognizing that high contribution rates often lead to evasion and a decline in revenue and that generous benefits simply encourage skilled labor to withdraw from the covered labor force. Moreover, it is important to avoid fragmenting the labor market by offering different pension systems to different occupational groups. Finally, to minimize welfare costs, relatively modest replacement rates under a mandatory system are preferred over higher replacement rates. Any obligatory system entails welfare costs for many. Pension systems are obligatory to counteract myopia during one's working years, which might lead to old-age poverty, and to prevent the elderly poor from becoming a burden on the state. A fairly modest pension is required to fulfill these objectives.

High-coverage countries might want to include some income redistribution within the contributory pension system. This can be done through a progressive benefit formula in defined-benefit systems or explicit transfers to match contributions for low-income workers in nonfinancial as well as funded defined-contribution systems. While the financing of this redistribution in an unfunded scheme can, and perhaps should, be done fully internally, for funded defined-contribution schemes, this would require explicit government transfers. Special periods of noncontribution (sickness, maternity, military service, and unemployment during which

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benefits are received, but not education) should be financed explicitly out of the corresponding social insurance funds in a highly transparent and individualized manner (not as unspecified transfers). Another approach would be to redistribute earnings with pillar one and to replace income with pillar two. A third approach would be to recognize the risks involved with both pillar one and pillar two. To diversify risks, pillar one could be used for both redistribution and income replacement, while pillar two could add further income replacement.

In low-coverage countries, the situation is different. The need for redistribution within the contributory system—at least in the short run—is less compelling because redistribution only occurs within the covered population. As a result, the country could adopt pillar one, pillar two, or a combination of the two. It is absolutely imperative, regardless of the shape of the contributory system, that the system be self-financing. Since pillar two is more efficient at income replacement and is self-financed more easily, pillar two may be preferable. However, financial sector conditions, historical precedents, and the country's own preferences would determine the choice of pillars.

### *Design Choices for Pillars One to Three*

*Pillar one* could be designed in a variety of ways. It could be a flat benefit (or a means-tested flat benefit with regard to a minimum pension), a proportional or progressive earnings-related defined benefit, or a defined benefit in the form of a nonfinancial defined-contribution system. A tight link between contributions and benefits helps to combat evasion and makes the system fairer, but this has to be balanced against the objective of redistribution, the provision of insurance, and the way it is provided. The benefits should also be based on lifetime average earnings rather than final earnings. This would make the system fairer and less open to gaming, in which individuals declare too few earnings during their working years and then declare huge wage increases right before retirement in order to maximize their pension. The benefits should also be explicitly indexed for inflation after retirement to avoid having the oldest and most vulnerable fall into poverty.

*Pillar two* would be defined contribution regarding the manner in which benefit levels accrue, and the management and investment of the accumulated assets should be market based. Second pillars should, however, on reaching the benefit payout phase, provide a means for participants to convert account balances to a lifetime annuity. Consequently, they cannot be perceived as purely defined contribution in nature. The international experience with centralized public management has been dismal, and the encouraging recent experience in some OECD countries is still too untested and may not be transferable to a typical low-income client country. Introducing competition among private

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providers by auctioning the fund management or using multiple fund managers is, in principle, encouraged. Key design issues include the means of keeping administrative costs reasonable, the scope of choice (as there are strong indications of a tradeoff between choice and costs), the structure of private providers and the savings instruments offered, and the design, implementation, and regulation of payouts. The basis for these often-difficult choices is discussed below.

If the role of pillars one and two is to provide modest pensions, the role of *pillar three* is to enable and encourage individuals and businesses to save for more generous benefits or earlier retirement, if desired. Since long-term savings generate positive externalities for the economy as a whole, tax advantages usually are provided to encourage pillar-three savings. However, discretionary savings are more likely for high-income individuals than for low-income individuals. Tax advantages also are less likely to induce the poor to save, since poor individuals often pay few taxes to begin with. The high-income individuals who take advantage of these programs often have savings, which they move from one investment vehicle to another to take advantage of tax preferences, reducing the potential gain to the economy. Since scarce tax revenue is being given up, the redistributive impact of tax preferences is usually regressive. Targeted subsidies are, in theory, preferable but impose major administrative challenges that may make tax preferences the only practical alternative. Finally, pillar three cannot be a full substitute for pillars zero, one, and two, since one of the primary reasons for public involvement in pension provision is to counter myopia and prevent old-age poverty.

### *Disability Benefits*

How best to provide disability benefits is an open question in both traditional single-pillar schemes as well as newly established multipillar schemes. Traditional disability programs tend to be more open to abuse than the basic old-age pensions and are often used by countries as a substitute for unemployment benefits (Andrews 1999). This has led to proposals to delink the design and financing of disability from (earnings-related) old-age benefits and to establish them as distinct benefits. Conceptually, the separation can be seen as a reaction to rising life expectancy and the increasing distinctions between the two. At the start of the Bismarckian-type pension scheme, disability benefits were much more important for individuals than old-age benefits, as only one in six workers could expect to reach the advanced retirement age of 70. Old-age pensions then could be conceptualized as generalized or categorical disability pensions—that is, as insurance for much the same risk. Nowadays an old-age pension is a life annuity paid with accumulated funds or acquired rights that insures against the uncertainty of death; conceptually it is totally delinked from a disability pension, which insures against income loss due to incapacity to work.

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The countries that have adopted multipillar schemes have devised an array of solutions to disability pensions, including keeping them in the public system, outsourcing them to insurers, and adopting solutions in between, such as outsourcing with a public top-up. The systems to date have not existed for that long and have not been studied sufficiently to provide sound advice. The challenge in most countries is to design a program that shows compassion for those falling under unfortunate circumstances, which is what social insurance is intended to do, but is not subject to rampant abuse. Much more work and experience in this area are needed. A recent review of 10 Latin American countries that have undertaken pension reform suggests that an important degree of freedom exists for defining the structure of the disability subsystem under a multipillar system (Grushka and Demarco 2003). A review of OECD country approaches to disability benefits provides another (but not necessarily replicable) information set (OECD 2003).

The design, provision, and reform of disability benefits in the Bank's client countries will receive much more emphasis in the Bank's conceptual and operational work in the years to come. This reflects the increased recognition of the importance of this benefit for those in both formal and informal employment (and the neglect so far). Furthermore, in 2002 the Bank created a Disability and Development Unit, which looks at the broader development issues of disability and disability benefits and their importance for the poverty mission of the World Bank.

### *Survivor Pensions*

Traditional survivor benefits are based on the concept of a working husband and a housekeeping wife taking care of children and a low incidence of divorce. In some cases the resulting benefits have been overly generous and redistributions have been perverse, placing a burden on the public purse to finance large benefits to women from high-income families. In other cases, they have been meager or have discouraged work because women have had to give up their own benefit in order to qualify for the widow's benefit. A redesign of spousal survivor benefits is needed as a result of increasing (formal) labor force participation of women in both developing and developed countries and also because of changing family structures due to rising divorces. In many developed countries, the divorce rate is more than 50 percent of the marriage rate, and many developing countries are catching up quickly. How this redesign is best implemented in client countries is still open for discussion.

The conceptual, administrative, and budgetary issues of designing and running survivor pensions in the face of changing family structures and the existence of own and derived pensions have reinforced the need to establish individual pension rights for women. These rights may be derived from their own claims and contributions, from the work history

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or contributions of the prior partner for the period of a joint household (for example, determined by splitting pension rights or accumulated amounts), and, perhaps, from transfers by the insurance pool or government budget. Nonfinancial and funded defined-contribution schemes enable the implementation of such an approach (Holzmann and Palmer 2005).

An alternative view states that survivor benefits will remain essential for the well-being of older women. It is less clear how they should be provided and what the relative public and private roles are. Two simple principles have been suggested for this approach: access to widow's benefits should not drive out the woman's own benefit and thereby discourage her own work, and women from low-income families should have first claim on public subsidies. Some countries with multipillar systems require the husband, when he retires, to purchase joint annuities or other joint pensions that cover his spouse. For example, in Chile and Mexico, husbands must finance a survivor benefit that is 60 percent of their own benefit; in Argentina the mandated level is 70 percent. When the husband dies, the widow gets the survivor benefit in addition to her own pension. The combination of the two brings her income to two-thirds of the prior combined household income (on average), which is just enough to maintain her prior standard of living without putting a burden on the public treasury. In effect, these joint pension requirements compensate for household economies and scale and formalize the informal family contract that led women to work and earn less in the first place (James, Cox-Edwards, and Wong 2003a, 2003b).

### *Civil Service Pensions*

In most countries, pensions for civil servants were the first to be developed, and in about half of the countries they remain distinct from pensions for private sector workers, often without explicit contributions from employees or employers (government; see figure 6.1). The promised benefits, often still calculated on the last salary paid, are typically very high relative to the real value of lifetime earnings and often are considered compensation for the low remuneration during active life (this is not necessarily true for many developing countries, where civil servants often profit both from higher active wages and pensions and from more job security).

Such pension schemes have major implications. They virtually eliminate labor mobility between the public and private sector, especially at older ages, since the civil servant would lose a major share of his or her lifetime income. They limit the ability to raise the retirement age as a cost-saving tool, since the government still would have to pay wages, instead of pensions, often based on the seniority principle. And, in many cases, continued services for the government beyond a certain age may not be feasible (military) or useful (teachers). They also create major problems for reform since the lower active wages and higher pensions constitute a

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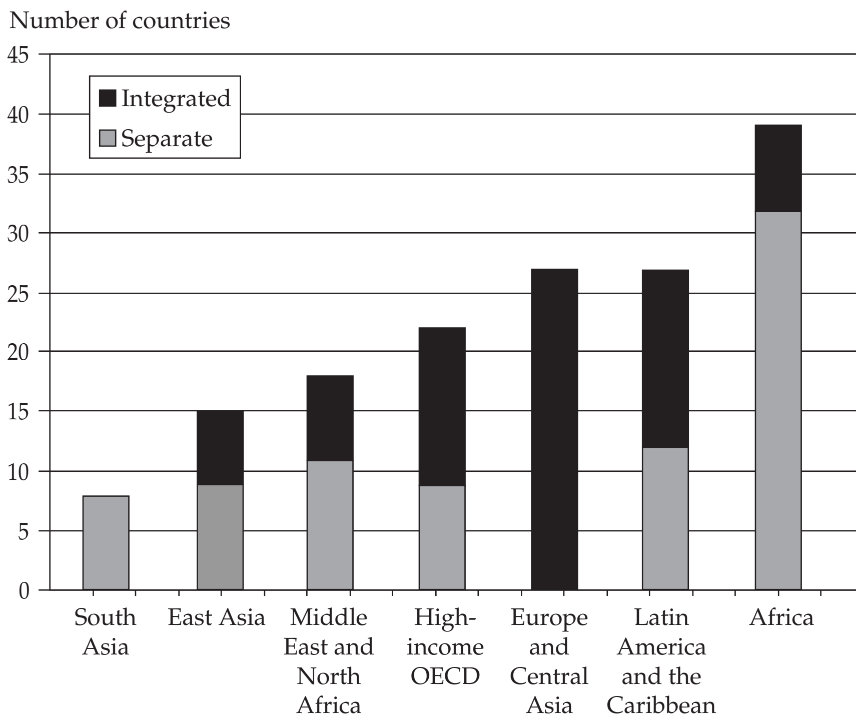
**Figure 6.1. Parallel and Integrated Civil Service Pensions, by Region**




*Source:* Palacios and Whitehouse 2004.

loan by the civil servants to the government (implicit debt), which needs, in principle, to be repaid if the system is changed.

Nevertheless, various countries have started to reform their civil service pensions (Palacios and Whitehouse 2004). While the design of reform differs, these efforts have similar goals: to align the civil servants' scheme with that of the private sector to allow full mobility; to see such a reform as part of an overall review of civil servants' remuneration and as an alignment with private sector pay as the benchmark; and to fund supplementary pensions for civil servants, if provided, in a way similar to occupational pensions in the private sector. India, for example, has eliminated the defined-benefit scheme for all civil servants of the central government hired after January 1, 2004, and replaced it with a funded defined-contribution system in which 20 percent of pay is contributed, designed to be a rough approximation of the replacement value of its predecessor without the associated fiscal and labor mobility implications. Many civil service systems will require parametric reforms to reduce benefit accrual

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rates, change overly generous commutation formulas, or raise minimum retirement ages to make them fiscally sustainable and bring them in line with pensions provided to other formal sector workers. Another strategy, not yet implemented, is to move all sector schemes, including for civil servants, to nonfinancial defined contributions in which the accrued rights under the old scheme are immediately transformed into a notional amount. Over time this would lower the replacement rate for civil servants to sustainable levels, while creating a smooth transition between new entrants to the labor market and workers close to retirement (Holzmann 2005).

## Financial Sustainability Issues

One of the main goals of pension reform is to achieve financial sustainability—the payment of current and future benefits according to an announced path of contribution rates—without unanticipated hikes in contribution rates, cuts in benefits, or deficits that need to be covered by budgetary resources. To be credible, a pension reform must make progress in this direction; this requires, above all, credible financial projections, a view of both short-term and long-term flows, and an assessment of both the stocks and flows involved. In the case of funded pillars, it also requires assessment of the rates of return achieved, including the role of foreign investment in diversification and management of returns.

Pension reforms are often driven by short-term financial disequilibria to which politicians react by making ad hoc adjustments (cutting benefits or hiking contribution rates) and by submitting reform proposals in an effort to put the scheme on a sustainable basis. However, unless it is fully costed and compared with a current scheme, such a reform should not be undertaken (and will not be supported by the Bank). Credible projections are based on detailed modeling of the pension system(s); the demographic, labor market, and economic structure; and conservative assumptions about key parameters such as future growth rates of wages, labor market participation, and investment returns. Countries can use their own models, commission projections from actuarial bodies, or use the Bank-developed PROST model to undertake these projections. The use of multiple models is helpful, because different models may project different outcomes, and these differences need to be explained.

To prevent ad hoc adjustments and reforms, the Bank encourages countries to undertake periodic assessments of the financial sustainability of the pension scheme (this is best done every year but should be done at least every three years). Such assessments should be conducted by independent bodies with an agreed set of assumptions about demographic and economic development, and the results should be published and discussed in open public forums.

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To assess financial sustainability (in particular of unfunded schemes) requires taking a long-term view and considering flows as well as stocks. A short- and medium-term view of newly established, unfunded schemes provides no assessment of financial sustainability. After its creation, the scheme pays few or no benefits for many years, while levying contributions from an increasingly covered labor force. This resulting cash surplus is no indicator of financial sustainability, since the inflow and contributions create a liability that needs to be honored in the future as a pension payment, often 40 years away and then for a period of 20, 30, and more years. For this reason, flows (expenditure, revenue, and balance) need to be projected for 75 years or more.

In the same vein, an evaluation of flows should be enhanced by a calculation and assessment of the stock of commitments and assets (as suggested for other and future fiscal challenges as well; see Heller 2003). The first is done through the implicit pension debt, operationally best defined as the accrued-to-date liability (Holzmann, Palacios, and Zviniene 2004)—that is, the present value of accrued pension rights to retirees and contributors. The second is done through a mark-to-market evaluation of accumulated reserves, if any. A large and rising implicit pension debt needs to be covered by future contributions and, together with low and stagnant assets, provides an early warning of financial lack of sustainability.

The calculation of implicit debt is also important to assess the progress in pension reform. In a parametric reform of an unfunded scheme, the effects on the flows are felt only gradually through lower expenditure (for example, after a change from wage to price indexation). In an evaluation of stocks, the effects are capitalized immediately, and the fall in implicit pension debt from changes in benefit indexation can amount to 20 percent (and more) of the original value (Holzmann 1999).[19]

The evaluation of reform through stocks becomes even more important when moving away from unfunded and toward fully or partially funded schemes. In such a reform, the implicit pension debt is gradually reduced because part of the contribution is now paid to the funded scheme, which diminishes the liability of the unfunded scheme. But old commitments need to be honored (and pension benefits paid); therefore, some contributions are lost, and the deficit of the scheme grows. Unless covered by higher taxes or lower public expenditure on other items, the fiscal deficit and debt increase. Partial debt financing can be justified for reasons of tax and consumption smoothing. As a result, and in order to assess the overall progress of the reform, the total pension debt—the implicit debt plus the reform-related explicit debt (including capitalized interest rates)—needs to be calculated and evaluated annually. Knowledge about the scope and development of this total pension debt is important not only for tracking progress in reform but also for signaling the financial markets, which otherwise may react negatively to a temporary rise in explicit financial debt (and deficit).

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In defined-benefit schemes (both partially and fully funded) as well as in funded, defined-contribution schemes (both centrally and privately managed), the rate of return on financial assets is critical for financial sustainability. In defined-benefit systems (such as a typical first-pillar scheme with reserves), a sustained higher real rate of return on assets requires a lower contribution rate or fewer transfers by sponsors or from government than otherwise and thus directly enhances financial sustainability. In the case of funded defined-contribution systems—which, by definition, are financially sustainable—issues of unsustainability through low or even negative real rates of return enter through contingent liabilities (Smetters 2002): a guaranteed minimum rate of return or a minimum pension, a substitution for social pensions, or simply a political obligation to pay if the amount is too low.

## Management of Public Pension Funds

In various regions of the world, mandated pension systems with sizable publicly managed funds are the dominant retirement scheme, at least for a main subset of the covered population (see figure 6.2). These sizable funds and the defined-contribution nature of the systems reflect the legacy of the British Empire and its strong preference for provident funds for both the public and private sector. Many defined-benefit-type systems with substantial reserve funds are a legacy of the "phased-premium systems" promoted by the ILO after World War II, in which a large surplus of revenues over expenditures was intended to allow substantially lower future contribution rates if the invested funds delivered sufficiently positive rates of return (Cichon and others 2004).

Many of these partially or fully funded systems are in dire need of reform, and most of the pressures for reform are similar to those of unfunded schemes: the inability to deliver on social objectives, the need to harmonize public and private sector schemes, and financial (un)sustainability due to low and in many cases negative rates of return. Publicly managed pension funds have a poor record on rates of return (Iglesias and Palacios 2001). In most cases, the rates are negative in real terms (for a period of 20 and more years), but even if they are positive, they are seldom above wage growth and compare unfavorably with privately managed funds.

### *Main Reform Options*

Given this consistent record of failing fund management in many countries, what are the alternatives for reform of such systems? There are essentially three: (a) abandoning the illusion of funding and moving to a pure unfunded—pay-as-you-go—system; (b) keeping the funding but reforming the system toward market-based and decentralized manage-

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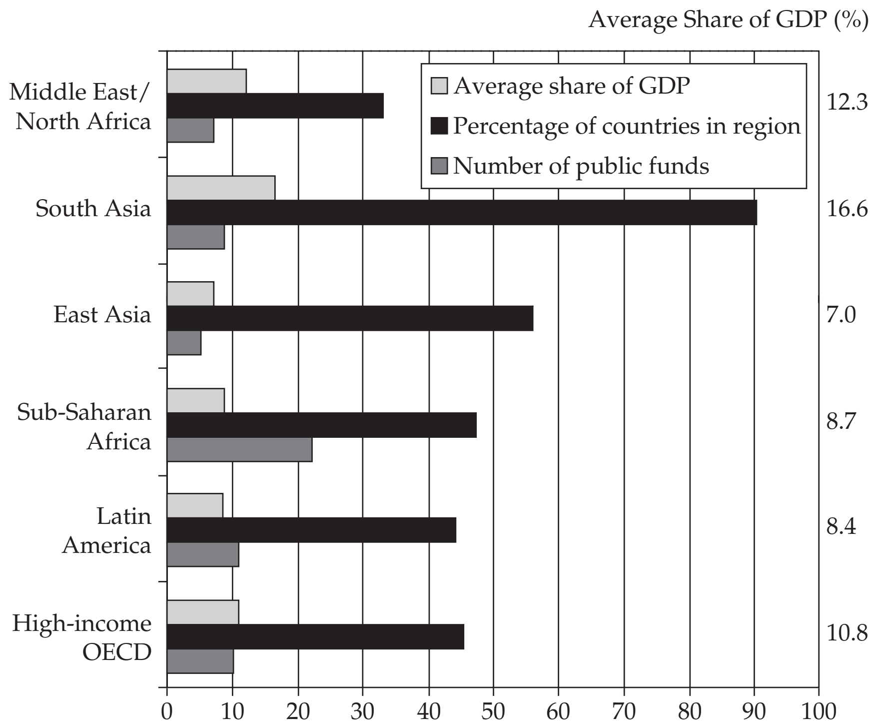
**Figure 6.2. Distribution and Importance of Public Pension Funds, by Region**




*Source:* Carmichael and Palacios 2004.

ment of pension funds (as in Chile or Switzerland); and (c) keeping the funding structure of the system as is, but improving the governance structure of the fund by applying best practice from private and public pension funds.

MOVING TOWARD AN UNFUNDED, PAY-AS-YOU-GO SYSTEM

Such an approach may be desirable if the country does not have the capacity to operate a public fund due to the lack of appropriate financial instruments or the incapacity to defend the fund against the political pressure for inappropriate use. Such situations clearly occurred in the aftermath of decolonization, when large provident funds were present. Provident funds were an ideal retirement-income system for expatriates in an empire with a dominant currency and the presence of currency boards in the colonies. During the accumulation stage, the provident fund had access to domestic as well as international assets with essentially no

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currency risk. At retirement, the individual would repatriate the funds, mostly to Great Britain, and purchase an annuity in what were then the most sophisticated annuity markets. With independence, these funds typically lost their access to international markets, potential investments in the new currency became very limited, and the capacity to withstand political pressure to use the funds for other purposes disappeared. Many were simply forced to buy government securities in captive markets. Various countries in Sub-Saharan Africa have experienced similar conditions, leading to the erosion of such public funds until the formal move to a pay-as-you-go system has become unavoidable. In others, such a move may need to be seriously considered.

#### Moving toward a Market-Based and Decentralized System

Such an approach may be beneficial if the financial market conditions with regard to instruments as well as regulation and supervision are fulfilled, but serious doubt exists that the capacity to withstand political pressure for suboptimal use of funds can be expected soon. A main challenge for such a reform is the need to replace the predominant investment in government bonds with a more diversified portfolio and to address the fiscal consequences of such a change. When the fund holds a large share of outstanding government debt, such a change in portfolio requires shifting the fiscal stance and repaying the debt, as required by a move from an unfunded to a funded scheme. From the pension or provident fund's point of view, a move toward a more diversified portfolio may not increase the rate of return (even less the risk-adjusted rate of return). In some countries (such as India) the rates paid on government bonds issued to the provident funds are quite high for political reasons but are not sustainable in view of the government's high deficit and public debt.

In a partial approach to a more decentralized investment regime, a few countries have allowed individuals with accumulated assets above a minimum amount to invest the surplus in the private market (for example, Malaysia and Singapore). The attractiveness of this reform has diminished in these countries because it was implemented during the onset of the Asian financial crisis of the late 1990s. This has led private sector asset managers to claim that a level playing field has not been achieved.

#### Improving the Governance Structure of the Existing Pension Fund

Using centralized public funds has advantages if the problem of investment performance and the use of ownership rights in the "private" enterprises can be solved. The two main advantages are (a) the capacity to pool risks across individuals, as every participant receives the same rate of return, and (b) efficiencies attained from the centralized collection of contributions, administration of records, management of consumer information, disbursement of benefits, and management of investments. A more

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individualized risk-return approach could be envisaged if the fund offered a limited set of portfolios from which the individual could choose. Except for gains from the consolidation of investment management, all of these advantages may, however, also be achieved with a clearinghouse approach. To address the issue of ownership rights in private sector enterprises held by the centralized fund requires the use of proxy rights and other instruments to avoid a nationalization of enterprises. To address the issue of investment performance requires major changes in the governance structure of funds.

Central public funds appear to have become more feasible with recent developments in Canada, Ireland, New Zealand, and Norway (see Musalem and Palacios 2004; Palacios 2002), which have created some optimism among economists about the usefulness and feasibility of central funding (Orszag and Stiglitz 2001). National and international experience with the governance of private and public pension funds provides important lessons and suggests principles of good investment process design that may also be introduced in advanced client countries.[20]

### *Suggested Principles of Good Investment Process Design*

As it became clear that governance matters for performance, countries as well as international organizations started to develop guidelines for governance. For example, the Association of Canadian Pension Management, the Office of the Superintendent for Financial Institutions, and the Pension Investment Association of Canada have all developed independent sets of governance guidelines. As these guidelines contain many common principles, these organizations have formed a Joint Task Force on Pension Plan Governance in order to develop a common set of governance principles as well as a guide for plan administrators to conduct an assessment of their governance practices.

Very recently the International Social Security Administration also began to develop guidelines for public pension fund management. The ISSA fund management guidelines focus on governance structure, governance prerequisites, and the investment function (ISSA 2004). They clearly highlight the problem of the politicization of public fund management and the need to improve investment performance while managing risk. ISSA (2004) contains very similar prescriptions to what is detailed below. Despite appearing less stringent than desirable on the exclusion of social mandates, they clearly indicate that "where investment in a particular venture of economic and social utility is considered desirable by the government and/or by the governing body of the social security scheme but the returns likely to be achieved are below market norms, the investment should be structured so that the subsidy is made from other government resources, in order to avoid compromising the fiduciary responsibilities of the social security scheme" (ISSA 2004, 7).

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These and other guidelines provide the central contours of principles for good investment processes. These contours are strengthened by international experience and the research and field experience of Bank staff with financial sector and pension fund reforms. While there is clearly a need to develop further understanding of how governance mechanisms that work in more advanced countries can be translated and implemented in the reality of our client countries, we believe that the following general principles should apply to the design of the investment process of public pension plans.[21]

*The public pension plan should be free from inappropriate interference from the government in pursuing its objectives and meeting its responsibilities.* Ideally, the government should remain at arm's-length from the investment decisions of the fund manager. To this end, countries have introduced different approaches. New Zealand has chosen the disclosure route. While the minister has explicit power to direct the governing board of the public pension fund, the directives must be in writing, presented to Parliament, and published in the official gazette. Ireland directly restricts one possible avenue toward misuse of the public pension fund for the government's own purposes by explicitly prohibiting investment by the fund in Irish government securities. Canada has established the CPP Investment Board as a separate crown corporation for the management of CPP assets. Japan has established a separate Government Pension Investment Fund to manage public pension funds.

*Public pension plans should have to clearly disclose their overall commercial mandates.* Multiple (and unclear) mandates induce a strong bias in the control structure of the plan, compound the problem associated with the multiple-constituency structure of plan stakeholders, and should be avoided. Ideally, public pension plans should have a unique and unequivocal commercial mandate.

*The optimal control structure of a public pension plan should be linked to the structure of residual claimants.* The control structure of public plans should be aligned with the structure of residual claimants of the plan. As residual claimants of public pension plans, active members and, more generally, taxpayers should be granted more control in the deliberations of governing bodies. This can only be achieved if clear commercial mandates are provided for in the law or in the plan documents.

Since granting direct control to taxpayers is problematic in practice, several mechanisms (mostly behavioral) should be established to correct the de facto bias in favor of passive members, such as the government.

*The number of independent, professional governors should be maximized.* Even if active members are granted more responsibility in public pension plans, this does not ensure that effective monitoring of management takes place. Active members are a dispersed group of stakeholders, and a governance structure that reduces the collective action problem of public plan

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stakeholders is still necessary. Furthermore, since many governance mechanisms traditionally used by corporations are not available for public pension plans, a strong governing body is required to monitor the performance of management. The role of independent directors appears to be more necessary in pension plans than in corporations.

*The regulatory framework of the plan should detail unequivocally the conditions, such as the use of fit-and-proper and professional qualification tests, under which governors can be appointed and removed.* For example, in Canada, the appointment process involves a nominating committee that recommends qualified candidates to the federal and provincial governments. The appointment process is subjected to close public scrutiny, and candidates, in addition to having suitable qualifications, are required to meet demanding skill and character requirements.

*Governors should be subject to fiduciary duties, and failure to comply with those duties should result in legal liability.* In the United States, private pension plans are subject to the strict fiduciary requirements of the Employee Retirement Income Security Act (ERISA) statute. ERISA's "exclusive purpose" (duty of loyalty), "prudent person" (duty of care, diligence, and skill), and diversification rules require the responsible individuals to have the relevant expertise and to exercise due diligence while making decisions in administering the plan, including the choice of investments. They also require that all decisions be made solely for the purpose of increasing the economic value of the assets of the plans and providing benefits to plan participants. Although these particular standards apply to private employer-sponsored arrangements, they represent a useful framework that should be applied to public plans as well.

*All staff, but critically senior management and governors, should abide by a publicly disclosed code of conduct and conflict-of-interest rules.* Another tool to control the behavior of governing bodies is a code of ethics (or conduct). For governors, the code covers such issues as conflicts of interest and the acceptance of gratuities. Through such provisions, the code should guide governors toward decisions based on prudence rather than personal gain, and this, in turn, should lead to better overall performance of the pension fund. Similar to the prudent-person standard, a code of ethics should help to control agency problems.

*The governing body should establish a governance committee.* A governance committee would recommend governance policy, guidelines, and procedures, make recommendations on the board's effectiveness, monitor the application of the code of conduct and the conflict-of-interest guidelines, and conduct periodic governance assessments.

*There should be full and open disclosure about the governance structure of the scheme and the managing agency, including rules for selecting members of the governing body and managers.* Accountability requires that details about the governance structure be made public. In particular, there should be adequate

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disclosure of the arrangements put in place to detect and prevent fraud. As part of its disclosure of governance arrangements, the managing agency should be required to publish its formal delegations of powers and responsibilities. Once the agency has formalized its structure of delegations, it should make these available to all stakeholders (for example, through its Web site).

*The governing body should establish an internal audit committee.* An internal audit committee should be formed with the responsibility for overseeing financial reporting, the external and internal audit, information systems, and internal control policies and practices.

*Internal and external financial, accounting, actuarial, and governance audits, as well as their public disclosure, are essential to increase transparency in the operations of the fund and, therefore, improve accountability.* The likelihood of mismanagement or undue influence can be drastically reduced if the public is regularly informed about issues such as the governance structure, the financial situation, and the performance of the governance framework as well as the financial performance of the fund. Internal audits should be supported by external audits carried out by independent auditors.

*The governing body should establish an investment committee.* The role of the investment committee should be to establish the investment policy of the plan. Sound statements of investment policies should be produced, and at the same time there should be a transparent process for disclosing to the public how the investment policy is implemented and adhered to. The investment policy document should clearly express the desired asset mix needed to match assets and liabilities. It could also describe the role and composition of the investment committee, if this is not defined in the governance manual; how investments are recorded; both short- and long-term performance measures; the universe of vehicles that can be used to meet these measures; risk tolerance guidelines either in terms of quantitative limits or outcome of asset-liability models; and, finally, the reporting, compliance structure, and performance reviews. The investment policy should also establish due diligence criteria for investment transactions, valuation of the underlying assets, accounting treatment of the assets, and procedures to be used for approving investments by the investment committee and should require that each investment be recorded with double signatures by an officer of the plan and the chairman of the committee authorizing it. Above all, measures of long-term target performance should be consistent with the long-term target funding ratio of the plan.

*The policy statement should outline the fund's approach to corporate governance as a shareholder and potentially dominant force in the domestic market.* A final aspect of investment policy that should be addressed by the governing board is its attitude to exercising its voting rights as a shareholder. Since the fund could potentially be a major shareholder, it has a responsibility to exercise its governance rights wisely. The exercise of voice is

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important, but to avoid a situation in which the government de facto directs private business, it is usually better to delegate this power to the fund managers. One way of minimizing the conflicts of interest that may arise from such situations is for the fund to publish, with a time lag, a summary of the way in which it voted in its various shareholder capacities. In response to the fear that government-controlled investing would mean partial nationalization of major businesses, which, in turn, would allow politicians direct involvement in the economy, some countries have imposed concentration limits or have delegated voting rights to fund managers. Other countries, such as Sweden, have put a cap on the effective voting power of the fund. In all cases, a policy for stakeholder voice should be explicit, documented, and publicly disclosed.

*Periodic reporting to active-member representative bodies should be required.* Full disclosure of performance in both absolute and relative terms is fundamental to protecting the interests of plan members. Both Canada and Ireland use publicly disclosed benchmarks for performance comparisons. In Canada, the benchmark is private sector fund performance, while Ireland uses a predetermined set of benchmark indexes. In addition, the Canadian fund managers are required to hold public meetings at least every two years in each province to discuss performance. It is worth noting that since instituting public reporting of this type, the Canadian administrative costs have fallen more than 60 percent. If practical reasons preclude taxpayers' representation on the board, clear disclosure procedures (like periodic reporting to Parliament and other representative associations) should be in place to inform taxpayers' representatives about the performance of plans.

*Funding shortfalls should be identified and disclosed, along with the government's proposed remedial actions.* The process for assessing and dealing with a funding shortfall should be transparent and preferably contained in law. Where the government has an explicit policy of partial funding, the extent of the underfunding with respect to clearly disclosed minimum funding ratios should be assessed and reported in the government's accounts.

*To the greatest extent possible, rewards for performance should be linked to delegated responsibilities and should be risk based.* Those who make delegated decisions should be rewarded or sanctioned according to the way in which they exercise their delegations. Managers should be required to review periodically the exercise of delegations they have made. Compliance should be rewarded, and breaches of guidelines, regarding either governance or investment, should be penalized, even where the returns are higher than expected.

*The government should require that the management agency be regulated and supervised by an authority with sufficient powers and independence to conduct effective oversight. In most cases, this can be accomplished by the same agency that is responsible for regulating private pension funds, and, where feasible, it*

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*should meet the same standards imposed on private funds.* Canada has not placed its public fund under the jurisdiction of any of its private sector financial regulators, but it has imposed a similar set of standards for governance and investments as those required of the private sector. In contrast, regulatory reforms proposed in Indonesia would see the Indonesian public pension fund come under the same regulator as private pension funds. This is already the case in Costa Rica, Fiji, Honduras, Kenya, Morocco, Namibia, and, to a certain extent, all the countries belonging to the Conférence International de Prévoyance Sociale region in West Africa. Direct supervision of public pension fund management could be enhanced by the establishment of an independent ombudsman with adequate resources to investigate allegations of fraud, waste, and abuse.

## Administrative and Implementation Issues

Many administrative and implementation issues are linked with pension reform and the introduction of a multipillar scheme. Some issues are well understood (for example, tax treatment of mandatory schemes), and some recent innovations create optimism (for example, clearinghouses for the collection of contributions and fund management, record keeping, and benefit disbursement in decentralized schemes). Other issues are still awaiting good or best practices (for example, the provision of annuities through the private sector). Although administrative and implementation issues have typically been underestimated and undervalued in the discussion of pension reform, this section highlights the main areas and main topics therein. Even a slightly more comprehensive treatment is well beyond the objective of this report and the space available.

### *Administrative Preparedness and Institution Building*

The key issues in administrative preparedness of the new pension system, especially a defined-contribution one, are the introduction of personal accounts, the unified collection of social contributions, and the issuance of social cards. The introduction of personified reporting is key for tracking individual contributions. It is also difficult, as all employers must submit personified reports, indicating gross wages and pension contributions for each employee. Those individual reports then have to be entered electronically or manually, and data have to be transferred to the central level. The unified collection of social contributions requires a central database that supports the future unification of data collection for pensions and other social contributions, preferably on a frequent schedule (quarterly or even monthly). The purpose of social cards is to ensure direct access to individual records in a way that allows identification of the social status of an individual and prevents abuse of the system. Changes in all three areas take time and effort.

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Our experience shows that most difficulties arise in the process of deciding how to integrate the flow of money and the flow of data at the national level. From the point of view of social security institutions, the flow of money could remain decentralized, while the flow of data could be partially or fully centralized. Leaving both flows decentralized would seriously undermine the effort to improve compliance and the efficient collection of pension contributions—and, ultimately, the collection of all social contributions. Centralizing the flow of both data and money at the national level (for example, in a form of clearinghouse) would improve control over the system but could entail new transaction costs in the money-handling process, but the economies of scale should prevail.

One of the most important findings of reforms so far is that ample time is needed for implementation. The reforms in Latvia and Mexico were postponed to allow time for administrative systems to be developed. The Polish reform ran into problems because inadequate time was allotted to implementation. In particular, the obligation to send monthly individual information to the social security institution and to submit new reports should not be introduced without a sufficient waiting period and time for preparation. If not enough time is allowed to test the new procedures, the quality of data in the social insurance system will be poor.

Monthly reporting reduces the time it takes money to get to the individual accounts, compared with annual reporting, but it generates a large and continuing flow of data, making it extremely difficult to check the accuracy of data closely. It may often be appropriate to consider intermediate options, such as quarterly or biannual reporting. This not only would decrease the amount of time that money is held in a central holding fund (earning a government bond rate) but also would minimize the burdens on both employers and administrators that result from monthly reporting.

The quality of the data depends on how information is sent to the social security institution. Usually, there are three ways to communicate information: (a) manually filed forms, (b) printouts from special software, and (c) electronic data transfer. Papers filed manually have the most errors, while data transferred electronically have the fewest. Setting up a system of electronic transfer is a big investment and takes time to design and test. It is usually better to wait until electronic transfer is possible than to initiate a system of manually filed forms, as the change later on may be difficult and time-consuming.

One important decision is the choice of an identification number for contributors. Administrative aspects of any reform should start with a careful assessment of the quality of current systems of account numbering and information transfer. Above all, a clear national strategy is needed concerning the enumeration of workers and their dependents (effectively all citizens) as well as employers. As part of this strategy, governments at the

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highest level will have to understand the purposes and ownership of the numbering system or systems (and linkages). It is important to pick the best existing number, if a good one already exists, rather than to create a special social security number. In the United States, the social security number serves many purposes, largely because it was the first number ready to use in the 1930s.

### *Public-Private Partnerships in Contribution Collections: A Clearinghouse Approach*

The recommended centralization of the flow of data calls for the creation of a clearinghouse to consolidate some aspects of second-pillar operations with operation of the state's first-pillar agency or tax authority. The word "clearinghouse" has come to encompass a variety of options on a spectrum that includes using a state agency to collect second-pillar contributions and allocate them among second-pillar funds, being an alternative record keeper, and being an exclusive record keeper and information agent for fund participants. The arguments for consolidation include the following:

- *Economies of scale.* Economies of scale would be gained as a result of the operation of a single transfer agent (Demarco and Rofman 1999). This can happen at the level of first pillar (such as in Poland) or second pillar (in Mexico).
- *Smaller burden on employers.* Employers would only have to deal with one collection entity.
- *Information barriers between employers and pension funds.* Because contributions are funneled through the first-pillar agency (as in Costa Rica, Poland, and Uruguay) or the tax authority (as in Argentina), employers would typically not know to which funds their workers are subscribing. This would minimize the fund's ability to use employers as a means to pressure workers to sign up with a particular fund.
- *Greater investment flexibility for second-pillar participants.* Under a centralized registry participants would have the ability to divide their fund accumulations among qualified funds without administrative difficulty.
- *Information barrier between fund managers and fund participants.* Reducing the information barrier would reduce marketing cost and pressure. With a centralized registry, fund managers would not have to know the identity of their individual clients, as they would deal with the aggregate amount of assets lodged with the fund by the collector or registry (blind accounts). The fund would report to this entity the performance of the account and would prepare statements and other reports for participants, indicating the amount of units purchased and owned and the value of each unit.

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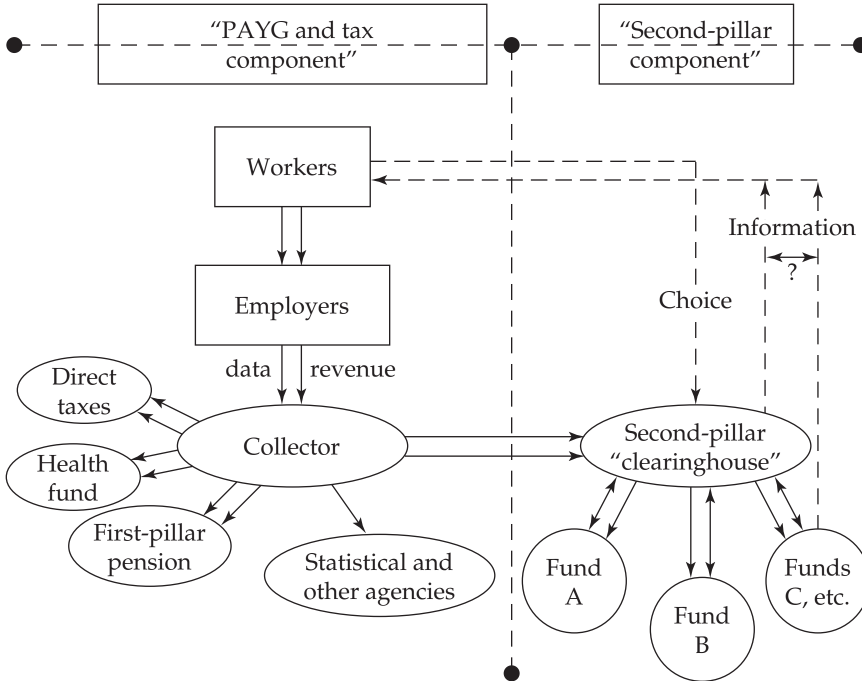
**Figure 6.3. Combined Collection and Clearinghouse**




In theory, this second "information barrier" between funds and their clients within a central registry system would greatly reduce the emphasis on direct marketing to increase market share. These direct marketing costs have led to very high costs of acquisition, with a resultant decline in the value of funds accumulated on behalf of clients. This kind of information clearinghouse is part of the Latvian and Swedish second pillars now being implemented. Any information clearinghouse would have to be included in a country's original second-pillar design if it were to be introduced successfully. Once an industry of commissioned agents develops, it becomes a powerful lobby group opposed to its own extinction.

Figure 6.3 illustrates a unified revenue and data collection system, combined with an integrated second-pillar clearinghouse. The much-debated issue of an information barrier between funds and clients is shown as an open question by having dual reporting lines back to workers and a question mark between those lines. A combined collection scheme can be created without a second-pillar clearinghouse (left-hand side of the diagram) in countries that do not have a second pillar. In addition, the function of social insurance collection may *not* be combined with

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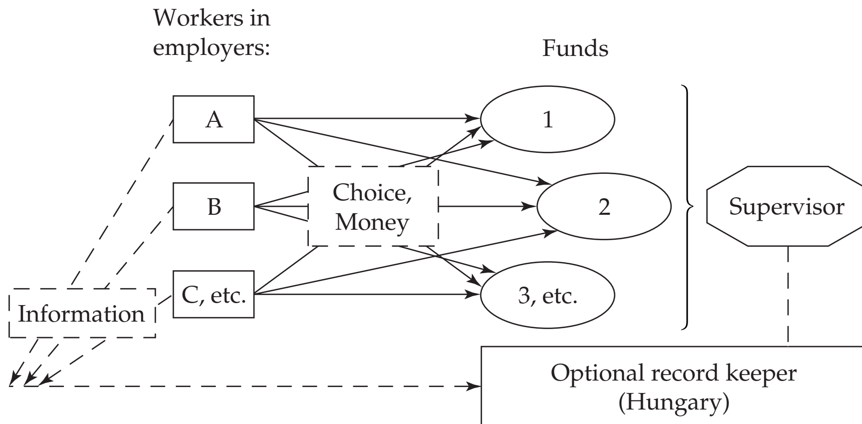
**Figure 6.4. Decentralized Funded Pillar in Chile and Hungary**




the national tax authority; instead, it may operate as a full or partial clearinghouse for the second-pillar funds. It is conceivable that a second-pillar clearinghouse could operate independently of an otherwise unified collection system or even as a third independent collector, but such institutional arrangements would consume more real resources, placing a greater burden on employers and requiring more state resources.

Some countries will pursue a decentralized model, with direct flows of information between participants and funds (see figure 6.4). Such a model (Chile, Hungary) is quicker to implement, but it imposes a greater transaction burden on employers. Instead of having to deal with one or two potential collectors (tax and social insurance agencies), employers each must sort out second-pillar contributions among a larger number of second-pillar companies. Accordingly, the higher transaction costs to employers probably lead to a higher level of noncompliance, especially regarding the intrayear transmittal of contributions and data. Along with these additional burdens come opportunities for employers to try to influence workers' choice of funds.

A related but separate issue concerns the coexistence of tax collection and social insurance collection units. While there are many good arguments for having only one collection unit in the long run (which is suggested to be the national tax authority), experience in some regions (in particular, the transition economies) indicates that the speed and preparedness to undertake such a merger need to be considered. For example, as social insurance contributions are earmarked revenues, compared with general taxes, the link between revenue and expenditure and the incentives to the involved institutions need to be taken into account. Meanwhile, the existing tax authority may not have enough intimate

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knowledge of enterprises or technical capacity to levy contributions in a sustained manner. The Bank is working with the Fiscal Affairs Department of the IMF to identify the conditions under which joint collection can take place.

### *Taxation of Pension Benefits*

The tax treatment of pension schemes raises many issues (Dilnot and Johnson 1993; Whitehouse 1999), but three stand out: (1) What taxation concept should be applied: comprehensive income tax or consumption-type taxation? (2) If the latter, should the taxation be front loaded or back loaded? (3) What is the role of preferential tax treatment for voluntary retirement savings?

Most countries tax income under a comprehensive income tax regime. Under such an approach, income is taxed irrespective of the source. Hence, saving is undertaken out of taxed income, and interest income on these savings is taxed again. For mandated retirement income, however, most countries provide an exception. In unfunded systems, contributions typically are tax exempt, while benefits are fully taxed. The same approach is used for funded schemes, where the interest earned is mostly not taxed. For retirement income, a consumption-type tax is applied, which eliminates distortions on intertemporal consumption and savings decisions. We believe that this is the appropriate treatment of retirement income. However, the double taxation on savings should be avoided, as should the lack of taxation. In some countries, retirement savings remain totally untaxed, leading to distortions in the other direction and questionable distributive outcomes, since the higher-income groups profit disproportionately from this treatment.

An expenditure-tax regime maintains tax neutrality of consumption over time and treats savings as deferred consumption, therefore exempting it. Such a regime can, in principle, be achieved either by front loading or back loading taxation, while remaining neutral for the intertemporal budget constraint of government. Under the latter, contributions as well as interest earned remain untaxed, while benefits are taxed (hence an exempt-exempt-tax [EET] treatment). Under the former, contributions are taxed, while interest rates earned and benefits remain untaxed (hence a tax exempt-exempt [TEE] treatment). In a model-type setting (including constant marginal tax rate), both treatments are equivalent. In a real-world setting, differences do emerge. For political purposes, EET treatment may be preferred, since a TEE approach may not be credible (as further taxation can be introduced in the future). For budgetary reasons, however, TEE treatment may be preferred because the extended tax credit to individuals under the EET approach may not be feasibly financed. When the tax system is progressive, TEE is likely to provide more tax revenues, while EET is likely to provide more incentives for individuals to

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participate. Also, if one stands by the notion that public investments have a lower marginal product than private investments, then EET treatment has the advantage of freeing resources earlier to be invested by the private sector and resulting in a more favorable composition of investments. Hence, in a dynamic sense, EET treatment may provide, at least in theory and ceteris paribus, higher overall tax revenues than TEE treatment. We believe that either EET or TEE treatment is acceptable. The option a country chooses will depend on its politics and the outlook of its fiscal accounts. Any difference in the economic impacts of either option would be of a second order of magnitude.

While there is strong consensus about the tax treatment of mandated schemes (unfunded or funded) in the pension community, there is no consensus about the tax treatment of voluntary schemes—of individual retirement account or employer-sponsored savings arrangements such as 401(k)-type plans in the United States. For some economists inside and outside the Bank, preferential tax treatment (that is, consumption-type taxation) should also be applied—within limits—to voluntary schemes in order to encourage the take-up of these schemes and to allow governments to play a more active role in regulation and supervision. For other economists, such tax treatment does little to increase overall individual saving, and an increase in take-up reflects largely a substitution for other forms of saving. Even worse, the income effect of the preferential tax treatment may even reduce individual and government saving. And recent estimates for OECD countries suggest that the fiscal costs of tax-favored schemes may be sizable, while the effects on saving are still unclear (Antolin, de Serres, and de la Maisonneuve 2004; Yoo and de Serres 2004). Although we do not exclude the reduction in savings, we consider some preferential tax treatment of standardized retirement-income products as useful. Even though it may not increase savings and may not deepen financial markets, it changes the composition of financial intermediation favoring long-term funds. This, in turn, reduces the refinancing risks of governments, banks, and enterprises and reduces the leverage of enterprises, making them more resilient to shocks.

### *Fee Structure and Levels*

The amount of fees or charges levied on financial retirement products is an area of considerable debate and research. For critics of a funded pillar, these fees are much too high, in particular compared with the (best) unfunded and public benchmark; they reduce the net rate of return to sometimes unacceptably low levels and thus eliminate the potential return advantage of a funded pillar; and the structure of fees is often nontransparent and antipoor, which prevents a broader pension coverage of lower-income groups. Also, supporters of a funded pillar (including the Bank) recognize the need to bring fee levels down and to rework fee structures.

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But they see the problem as much more manageable, with fee levels in client countries much more in line with those of popular financial services in developed countries and falling after start-up costs have been covered. Still various areas require closer investigation in and across countries and regions (first stock-taking exercises include those by James, Smalhout, and Vittas 2001; OECD 2001a; Whitehouse 2000; World Bank 2003a; Yermo 2002). This subsection concentrates on three issues dealing with the measurement of fee levels and the approaches for their reduction or limitation.

#### MEASURING AND COMPARING FEE LEVELS

Across countries, charges or fees (administrative charges and management fees) on long-term financial products, such as pensions, are levied in many different ways. Some are one-off fees, usually a fixed sum payable either up-front or at maturity. Others are ongoing and can take the form of a fixed fee per period, a percentage of contributions or premiums, or a percentage of assets. One main problem with international comparisons is that products offer different services and pension systems have different structures. For example, some plans have guaranteed minimum returns or guaranteed minimum pensions, while others do not. Obviously, everything else being equal, guaranteed products should have higher fees. Also, some plans provide better services, such as higher rates of return and immediate benefits to plan members, and could justify being more expensive. Finally, funded pillars that rely on the public pillar to collect contributions (for example, Argentina) should have lower administrative costs than those that are independent of government.

A national and international comparison of fee levels requires a comprehensive and life-cycle-type approach in which all types of charges for, say, a full working life are considered and, for example, the gross amount and the net accumulated amount are compared at retirement (Whitehouse 2000). Time-specific comparison of fees on flows (contributions) and stocks (assets) alone are of little value.

#### FEE-LEVEL LIMITATION VIA REGULATION OF STRUCTURE

Countries have taken different approaches to regulating the fee structure of pension funds. For example, Australia, Hong Kong (China), the United Kingdom, and the United States have few, if any, explicit restrictions on charges and instead regulate charges under the broader "prudence" or "reasonableness" standards. This is partly explained by the fact that private pensions in the United States remain voluntary, while in other countries they are built on preexisting voluntary systems. Most World Bank client countries limit the structure of charges, and quite a few have restrictive regimes in that companies are limited to two charges (an asset-based and a contribution-based charge), one of which is subject to a ceiling (asset-based charge), while the other can take any value.

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It is still unclear to what extent these limitations on the structure lead to effective lower fee levels or what they imply for the longer supply structure (number of funds) or demand structure (scope of coverage). It appears that these limitations may be of lesser relevance than other elements of the second-pillar design and implementation (for a first assessment of four European and Central Asian countries, see World Bank 2003a). We suggest that a simple and transparent fee structure with well-thought-through price caps is a useful approach when such a new pillar is introduced. But these limitations need to be reviewed regularly and adjusted with other pillar characteristics if deemed necessary; it is quite likely that they will be relaxed as time progresses and individuals become more familiar with the system.

#### FEE-LEVEL LIMITATION VIA SPECIAL ORGANIZATION OF PROVIDERS

Several models of pension fund management are aimed at reducing fees by reducing costs. The basic idea is that, in competitive markets, costs are the major determinant of fees and, moreover, we should be concerned with the real cost of producing the services. International experience indicates that close-end funds (those limiting membership to employees of a firm, industry, or profession) have lower fees than open-end funds, perhaps because they incur lower marketing costs. Some countries use a centralized competitive-bidding process to outsource fund management (Bolivia, Kosovo, and Latvia, but not Sweden). These systems have resulted in lower fees, although it is not clear whether the related reduction in worker choice is sustainable. In this regard, the experience of the Federal Thrift Savings Plan in the United States (covering only federal government workers) is encouraging. Its gross expense ratio has declined steadily as the fund assets have grown, from an average of 0.67 percent of funds in 1988 to 0.07 percent in 1999 (Hustead and Hustead 2001; James, Smalhout, and Vittas 2001). It is by far the lowest fee structure in the industry.[22] Another important case for reducing fees while providing almost unlimited investment choices to plan members is the Swedish scheme. The majority of Latin American and some Eastern European countries adopted a model of open-end and specialized fund managers, with either centralized or decentralized collection and record-keeping systems. These models have produced relatively high management fees, especially in their early years. Although their fees are not higher, and in some cases are lower, than those of personal and stakeholder plans in the United Kingdom, there is still room for reducing them by addressing the issue of industry concentration.

Deregulation of fees and market contestability (for example, providing options to plan members) promote competition but require stronger disclosure of information. Fund managers have to provide affiliates with statements of their accounts. In addition, at least once a year they need to

provide affiliates with basic information about the pension fund management company (ownership, managers, directors, and audited financial statements, including the auditor's report) as well as information on the fee structure and rate of return relative to the respective system's average, taking into account the long-term view. The greater the choice and contestability, the greater the incentive of fund managers to spend money on public relations and marketing—costs that eventually are passed on to worker-affiliates.

Again, it is too early to make strong recommendations, but the experience, so far, suggests three promising approaches. First, limit costs by saving on the administrative costs of contribution collection, account administration, and so forth (that is, adopt the clearinghouse approach). Second, limit the incentives for marketing expenditures by pension funds through blind accounts or constraints on the ability of individuals to change funds as a result of laws or exit fees. Last, but not least, limit asset management fees by restricting the choice of individuals, including the use of passive investment options, employers' choice of financial provider, or competitive bidding for a restricted number of service suppliers.

### *Can the Private Annuity Market Deliver?*

A privately managed, funded pillar (mandated or voluntary) requires the provision of annuities that transform at retirement an accumulated amount into a lifelong income stream (that is, until death). This raises a number of issues for which good answers are not always available. For example, how much annuitization is required, in what form, and at what age (or ages if plan members are given the option of purchasing annuities through time) in order to improve risk management? What type of providers should offer what products? To what extent can and should unisex life tables be applied? What prudential and business regulations should be applied? What risk-sharing arrangements can or need to be put in place between providers and annuitants? What is the appropriate allocation of the risk of future changes in mortality among public and private sources? What role is there for governments in ensuring that appropriate financial products are available to back indexed annuity contracts?[23] This subsection concentrates on five issues: (a) What type of providers should be allowed to offer annuities? (b) What kinds of products should be allowed? (c) When must a private annuity market be ready? (d) Should there be price indexation of annuities? (e) How should we deal with the main challenges?

#### WHAT TYPE OF PROVIDERS SHOULD BE ALLOWED TO OFFER ANNUITIES?

Because of the insurance nature of annuity products, the insurance sector is bound to represent the largest set of annuity providers in any country. Pension funds (occupational and individual) may also provide annuities,

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especially if they provide defined benefits. Among insurance companies, there is an issue whether general life insurance companies should be allowed to sell annuities or whether specialized annuity companies should be licensed under the regulation (as in Mexico, for instance). On the one hand, life insurance companies may "hedge" the longevity and mortality risks when selling annuities and (say) term life products. On the other hand, information disclosure in the insurance industry is poor in practically all jurisdictions. Accounting standards are mostly opaque, and, from the point of view of consumer protection and transparency, an argument can be made for specialized annuity companies, especially to provide annuities from mandatory schemes.

#### What Kinds of Products Should Be Allowed?

Annuity markets are characterized by large asymmetric information between suppliers and demanders. This results in adverse selection and a difference between an actuarially fair price for an average individual and the typically insured of some 10 to 15 percent even in well-developed markets. This also results in complex products that compete on price as well as many other characteristics. It also results in differences in prices between deferred annuities (for example, where individuals pay premiums periodically through their active life) and annuities bought at retirement. Last, but not least, it results in price differences between individual and group insurance. To address the issue from a public policy perspective, a few needs stand out: (a) the need for comprehensive consumer information and protection for all products, (b) the need for standardized products as benchmarks for consumers, (c) the need for employers to be included in the selection of products, and (d) the need for innovative solutions (such as the auctioning of whole pension cohorts in a mandated pillar).

#### When Must a Private Annuity Market Be Ready?

At the inception of pension reform in client countries, a functioning life insurance sector typically is not available and need not be so. These reforms concentrate initially on the accumulation phase, with the payout phase some 10 or more years away. But can a reform be launched without a view to the insurance sector? For example, the choice of individuals to join the second pillar may depend on available products and their characteristics (such as indexation and joint annuities). Our take is that if a financial sector fulfills the minimum requirements for launching such a reform, the insurance sector can (and must) be built over a period of five or so years. Major contributions to its development would be the adoption of a modern law establishing an operationally independent regulatory and supervisory authority, encouraging actuarial training, promoting reinsurance arrangements with highly reputable reinsurers, and opening up to well-established foreign life insurance companies

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from reputable jurisdictions, either in the form of joint ventures or the privatization of existing public institutions. For very small jurisdictions, considerations need to be made about unification or integration of several supervisory authorities, especially securities, insurance, and pensions (Impavido, Musalem, and Vittas 2002).

SHOULD THERE BE PRICE INDEXATION OF ANNUITIES?

For annuities to provide real consumption smoothing to individuals, they need to be price indexed; otherwise, even moderate inflation over a lengthy period of retirement will lead to a major fall in the real value of the annuity. For insurance companies to provide indexed annuities at reasonable prices (if at all) requires access to price-indexed assets, preferably in the form of price-indexed government bonds. Various countries have started to provide such bonds (Chile, Sweden, the United Kingdom, and the United States), but they are far from universal and often not long term. Even if indexed government bonds are available, insurance companies offering indexed annuities must forgo other more profitable investments and must therefore charge a higher price to annuitants than they would for nominal annuities. Therefore, indexation involves a difficult tradeoff between the higher financial security of older pensioners and the lower payouts they will receive when young. This tradeoff needs to be taken into account by governments when projecting the replacement rates that the new system will generate (Impavido, Thorburn, and Wadsworth 2004). Moreover, if governments want to ensure (or mandate) the availability of price-indexed annuities, they will need to issue the appropriate inflation-indexed or other specialized instruments to enable this market to develop. This, however, potentially imposes significant distributional tradeoffs because in nearly all developing (and many developed) countries the beneficiaries of indexed annuities are higher-income groups, while all will bear the costs of providing the financial instruments to enable them to develop.

HOW SHOULD WE DEAL WITH THE MAIN CHALLENGES?

Two issues are addressed around the question of who should bear the risk. The first concerns *rating or differential underwriting of survival probabilities* (such as genetic testing, for instance). One of the disadvantages of pooling risks is that good types (in the case of annuities, those who die early) subsidize bad types, giving rise to the pooling premium. For some groups of pensioners—for example, those with health impairments or those with poorer socioeconomic backgrounds—the terms on which pooling takes place may mean a high probability of subsidizing other parties to the pool because of the lack of homogeneity of lives.

Disallowing access by insurance companies to this information increases asymmetric information, adverse selection, and the danger of a

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breakdown of the market. Providing this information for both sides of the market leads to segmented risk pooling and the exclusion of some groups (those with identified high survival rates), for which public provisions may have to be established. The introduction of rating would eliminate the nonstochastic component (that is, those elements that would induce strong adverse selection) from the pooling equilibrium. In other words, types systematically better than the average (that is, who die earlier) would be better off, while types systematically worse than the average would be worse off.

The other main issue concerns the question of who should bear the risk of rising life expectancy and uncertain future investment income. Some demographers have been predicting large increases in life expectancy due to scientific breakthroughs. Some economists have been predicting prolonged drops in stock prices or bond interest rates due to aging populations who cash in their stocks and use them to buy more stable bonds. Evidence from many countries indicates that these companies now return the government bond rate to annuitants over their expected lifetime; that is, the "money's worth ratio," discounted at the government term structure, is close to 100 percent (see, for example, James, Vittas, and Song 2001). A large increase in longevity or a decrease in investment income may bring losses to these companies, including the possibility of insolvency and failure to keep their promises to annuitants.

How should we deal with these risks? Who is best equipped to deal with them? At least three approaches are relevant here. In the first approach, insurance companies continue to bear the risks, but with careful government regulation to ensure that their reserves are large enough to cover unexpected shocks. Such reserves and regulations have significant costs, so we would expect them to be factored into the prices (or money's worth ratios) offered annuitants.

The second method explicitly shares these risks with annuitants by allowing and possibly encouraging variable annuities whose value varies annually depending on actual longevity and investment outcomes. Annuitants get a higher expected return than they would under fixed-rate annuities, but they also bear some of the risk, which may be difficult for low-income pensioners. Also, they may not understand the complex terms of the variable annuity, and companies may take advantage of their lack of information. Obviously, if this approach is taken, government has a large responsibility for providing consumer information and for standardizing the terms of payout variation to facilitate comprehension and comparability.

The third method of assigning risk places a heavier burden on government, which might offer a minimum pension guarantee, sell longevity-indexed bonds, or provide the annuities directly. This enables the broadest possible intergenerational risk sharing, but it also creates the

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danger that government will be faced with a large contingent liability many years in the future. The "best" solution for the annuity dilemma remains an unresolved and controversial issue.

## Readiness and Regulatory and Supervisory Financial Market Issues

The introduction of a mandated funded pension pillar has given rise to considerable debate inside and outside the Bank, and it will take many more years before a clear consensus is reached. This section addresses four issues that are at the core of the debate: (a) Can funded pensions be introduced in a rudimentary financial market environment, and, if so, what are the minimum conditions? (b) What are the good or best regulatory practices that typical client countries should follow? (c) What are the good or best supervisory practices to be applied? (d) What are the options for countries with small open systems?

### *Readiness, Minimum Conditions, and Synergies*

Bank staff take the position that not all countries are ready to introduce a funded pillar and should not do so. Nevertheless, the introduction of a funded pillar does not need perfect conditions, with all financial products available from the very beginning, since the pillar is introduced gradually and creates synergies for moving toward improved financial markets. Hence, minimum conditions need to be satisfied, and these can be highlighted when discussing three types of countries and their financial market readiness (Impavido, Musalem, and Vittas 2002).

There are three main types of financial markets: (a) those that are incomplete but the segments that operate are sound, are associated with high per capita income, have a credible macroeconomic policy framework, and have open capital accounts (but domestic and international financial instruments are not perfect substitutes); (b) those that are incomplete and the segments that operate are predominantly unsound, are associated with low per capita income, have a long history of macroeconomic policy imbalances, and have closed capital accounts; and (c) those that have an intermediate position between the two.

Countries with incomplete but sound financial systems that have relatively high per capita income, credible macroeconomic policies, and free capital movements offer the best case for funded pension and annuity systems. This is true for several reasons. First, (voluntary) funded pension and annuity products are luxury financial services. They are demanded at high rather than low per capita income (that is, at high per capita income, the time preference or discount rate is lower, which increases the valuation of purchasing coverage for future contingencies, and family ties are weaker, which reduces self-insurance within the family). Second, credible

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macroeconomic policy provides an enabling environment for the development of long-term financial instruments (for example, pension savings and annuities). Third, even under incomplete financial markets (for example, embryonic capital markets), but where sound banks are operating, they provide a vehicle for channeling long-term savings into long-term loans to borrowers (government, enterprises, and individuals). Finally, open capital accounts do not constrain pension funds from investing in the local market.

The second type of countries—those with chronic macroeconomic imbalances and other limitations—provide little room for the development of funded pensions and annuities. Long-term savings instruments cannot prosper in a macroeconomic environment with high and volatile inflation, and pensions and annuities are not affordable at low per capita income. Furthermore, the financial systems of these countries are essentially limited to the banking sector, which usually is weak. Although it would be possible to invest abroad, these countries, by having weak domestic financial institutions, should have closed capital accounts. Hence, before trying to develop these instruments, the authorities should focus on establishing a credible long-term macroeconomic framework and strengthening prudential regulation and supervision of banks. These two conditions are necessary for the successful development of funded pensions and annuities.

In the third and intermediary category of financial systems, there are a variety of cases. There are countries with a credible macroeconomic policy, a relatively sound banking system, and an open capital account. However, they have incomplete financial markets (underdeveloped securities markets, insurance, pensions, and mortgages) and relatively low per capita income. These countries have the preconditions for developing funded pensions and annuities, although their relatively low per capita income imposes a barrier to the scale of the market. Initially, the portfolios of these funds would be composed primarily of government bonds and banks' long-term certificates of deposit. In addition, they could have small fractions in shares, foreign securities, and possibly leasing companies. As financial markets develop, investment regulations should allow more diversified portfolios by allowing higher investments in shares, foreign securities, corporate bonds, and asset-backed securities and small investments in venture capital companies.

These countries will obtain the benefits from the development of funded pensions and annuities. Gains from financial sector development will initially be concentrated in development of the government bond market and long-term lending through banks. In a second stage, benefits will come from development of the corporate bond market, asset-backed securities, and, in a later stage, the stock market. The development of funded pensions and annuities will encourage financial market innovation through develop-

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ment of the fund management industry and improved financial regulations, including stronger minority shareholder rights, transparency, and corporate governance. They also will provide competition to the banking system and foster efficiency and innovation in financial markets.

In summary, instead of a full-fledged financial system with a full array of efficient institutions and financial instruments, the following minimum conditions are needed for the successful introduction of a funded pillar (Vittas 2000): (a) the presence of a solid core of sound banks and insurance companies, (b) a long-term commitment by government to pursue sound macroeconomic policies, and (c) a long-term commitment to financial sector reform through the establishment of a sound regulatory and supervisory framework for pensions and insurance products and providers.

### *What Regulatory Practice to Follow?*

Seasoned development practitioners respond to the call for best-practice application in developing countries by posing a question: If the countries could apply these practices, would they still be World Bank clients? Applied to contractual savings, the question implies that the best OECD-type practices may be beyond low- and middle-income countries for some time (OECD 2004b). Nevertheless, the many pension reform pilots in middle-income countries in Latin America and Central and Eastern Europe have created a rich body of experience. This subsection presents the main lessons from this experience (Carmichael and Pomerleano 2002; Hinz and Rao 2003; Rocha, Hinz, and Gutiérrez 2001; Vittas 1998a, 1998b).

For a country following the open-end fund concept (as in Chile), the Bank strongly suggests initially applying strict regulations and relaxing them gradually as sound financial markets develop. The strict initial rules include a limited choice for participants, the licensing of specialized providers under the rule of one fund–one account, uniform pricing and limited forms of fees, detailed investment limits, extensive disclosure, minimum return rules and state guarantees, and proactive supervision. The reason for the initial "Draconian rule" is essentially twofold. On the one hand, the new compulsory system starts with a weak capital market, limited traditions, and a lack of familiarity. On the other hand, strict regulations offer safeguards, control moral hazard, overcome opposition to the funded scheme, and are better able to prevent early failures. It is imperative to relax the rules as the market develops and the system matures.

The *less controversial regulations* should be applied to mandated, funded schemes from the very beginning. These include (a) appropriate licensing and capital requirements for providers; (b) full segregation of assets, sponsors, management firm, and custodian and the use of external custodian banks; (c) asset diversification and the rules of asset management (the qualifications and licensing of internal or external managers); (d) asset valuation rules (mark-to-market) and rate-of-return calculations (the

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mutual fund instead of the savings account model); (e) periodic actuarial reviews and financial audits; (f) transparency and information disclosure; and (g) effective supervision and consistent application of sanctions.

The *more controversial regulations,* for which there remains uncertainty regarding whether and when they should be applied, include (a) controls on market structure and choice (should only special institutions and products be permitted, and is there a tradeoff between choice and costs?); (b) funding, investment, and portability rules; (c) legal investment limits versus the prudent-man principle (can the latter be applied in a less sophisticated market?); (d) limits on commissions and switching; and (e) profitability rules and guarantees.

### *What Supervisory Practice to Apply?*

Again, many rules are not controversial and should be applied early on. A few others are still uncertain, and the verdict is still out about what works best and under what conditions.

The *less controversial rules* and tasks for the supervisory body include (a) the need for a politically independent, proactive, well-financed, and professional staff; (b) the vetting of the application for licensing; (c) the undertaking of off-site surveillance and on-site inspection; (d) the elaboration and issuance of regulations; (e) the consistent and timely application of sanctions to rectify problems and establish a credible deterrent to abusive practices; (f) the publication of reports and statistics; and (g) collaboration with other regulators.

The *more controversial rules* and questions for supervision include (a) creation of a single-purpose or dedicated supervisory agency; (b) establishment of effective collaboration with other regulators and supervisors for the many institutions offering retirement-income products; (c) the best way to guarantee the independence of the supervisory body in a weak political environment; and (d) oversight and accountability of the supervisor.

Often the threshold decision related to the supervision of funded pensions is whether to establish this as an independent authority (as in Chile and most Latin American countries) or to integrate these functions with the supervision of similar financial entities, such as banks and insurance companies (as in Australia, Hungary, and the United Kingdom, among others). Both models have proven to be effective in achieving the objective of sound and reliable supervision, so there is no simple answer to the organizational question. The appropriate approach is likely to be a function of the design of the system and effectiveness of existing supervisory bodies. Pension funds that operate in a highly specialized manner as very distinctive financial institutions can be effectively supervised by independent authorities, while those that function as adjuncts to existing financial institutions are best addressed by an agency with integrated authority. The form of the institution is secondary to the independence, adequacy of

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resources, quality of staff, and clarity of mandate. The most compelling impetus for an integrated supervisor is the need for consistency and coordination of oversight across similar financial institutions, which are much better facilitated in a single authority. A central counterargument is that an integrated supervisor with a weak governance structure will face conflicts of interest in controlling the activities of institutions within its authority that compete or play multiple roles in a pension system (for example, asset managers, banks, and insurance companies) or be weakened in its ability to protect the system in the face of competing priorities.

### *Options for Countries with Small Financial Systems*

Various small and open economies, such as in Central America, Central Europe, Mauritius, and Senegal, are starting pension reforms that include the development of a funded pillar. Undertaking such a reform in an environment with a limited financial sector creates both opportunities and challenges. The challenges include the resource-intensive development of country-specific regulations and the buildup of supervisory capacity, a potentially small number of pension funds given the small size of the country and the existence of significant economies of scale, and a limited range of financial instruments through which to diversify investment portfolios. These issues raise a number of questions. Would these countries be better off by developing their pension funds in a regional setting? If the regional option is not feasible, how can the costs be contained? How much international diversification should be undertaken, and how does one deal with the exchange rate issue?

There are many good arguments for regional development of financial systems, including institutions for providing funded retirement income. Bank research has found that countries with small financial systems tend to have smaller and shallower financial markets, to be poorer, to have a smaller population, and to be more open (Glaessner and Valdés-Prieto 1998; Impavido, Musalem, and Vittas 2002). Small countries cannot fully exploit the economies of scale and scope in the provision of financial services. The smaller population limits the amount and quality of human capital available. The lack of resources limits the scope for the development of financial infrastructure, such as payment systems, organized markets, supervision, and regulation. The fixed costs of establishing these basic systems may simply be too high for small or poorer countries. As a consequence, small financial markets are generally shallow, incomplete, poorly regulated, illiquid, prone to lack of competition and to concentration in the provision of services, inefficient, and characterized by relatively high transaction costs. Small economies are also more volatile. In fact, their median standard deviation of private consumption, terms of trade, inflation, GDP growth, and capital flows per GDP is between 1.5 and 4.0 times higher than in larger countries (Bossone, Honohan, and Long 2001).

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Despite these potential advantages, little cooperation has taken place so far in client countries and elsewhere to exploit the economies of scale and to use pension reforms in regions to push for more integrated financial markets. Regions that could join such a collaborative for joint development include the Caribbean, Central and Eastern Europe, Central and South America, and Central as well as Western Africa (which both have a common currency and a common regulatory framework). This lack of integration is puzzling and requires research to ascertain the hidden technical reasons or explanations of political economy. Taken as a fact, this calls for other approaches and the review of existing practice.

Different countries have experimented with different institutional setups, and the international experience can serve as a benchmark for the pros and cons of specific designs. As already mentioned, the *one-fund approach* in the form of a publicly managed fund has not been a good experience in most countries, and the recent initiatives in five OECD countries with centralized funds is too early to judge and may be difficult to transfer into a developing-country context (Palacios 2002). One country (Bolivia) has selected *two funds* in an international bidding process guaranteed for a limited number of years (von Gersdorff 1997). While successfully importing knowledge and skills and keeping costs and fees down, the two funds merged ownership at the level of the mother company and, in this stronger position, reportedly are able to resist the pressure of the regulator to open up to competition. The *Kotlikoff approach* of full international diversification in a world index fund (which uses an international asset manager instead of developing a local financial market) has yet to be adopted by any country for reasons that have to do with home bias, incomplete markets, fears of foreign exchange problems, and the absence of a true world index (Kotlikoff 1999). A current experiment in Kosovo plans to use a variant on this approach, so five years from now we will be able to report on how well this works. Most countries, however, have opted for policies between these two extremes.

Countries that have opted for *open, nonemployer funds* have witnessed consolidation and concentration (with Chile seeing a decrease in the number of pension funds—from well over 20 some 10 years ago to 7 or 6 in 2004). Concentration may have created economies of scale and reduced marketing costs, but it also has posed the policy challenge of how to ensure a continued supply of competitive and efficient services. One solution would be to enable employers to opt out of the open-end system by allowing employer-sponsored plans. Countries that have relied on *closed, employer-based funds* have a much larger number of funds; however, these funds do not compete, as each is tied to a particular employer. Since several employers may use the same asset managers, the number of competing asset managers may be much smaller than the number of funds. Closed funds limit marketing costs and enjoy some economies of scope

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(and scale for large employers), but their performance depends on the solvency and integrity of employers as the sponsors of pension plans. The record seems to be positive for the pension funds of large employers, but rather mixed for the plans of smaller firms.

Finally, the recent *Swedish approach* is the prime example of the clearinghouse strategy, which uses a central public agency for collecting contributions, maintaining individual account records, controlling fees, and paying benefits in conjunction with decentralized private asset management. Workers have the right to direct their funds to several hundred authorized mutual funds, most of which predate the start of the new pension system. The system is highly complex and requires the presence of an efficient central administrative agency in concert with robust and effective regulation and supervision of the participating mutual funds. It is a highly promising innovation for advanced countries with well-developed financial markets that moves in the direction of regulated, constrained choice.

As international experience suggests, there is no silver bullet to circumvent significant economies of scale or to find a solution in simply opening fully to the international financial markets. Countries may not be able to avoid all the costs of domestic institution building and may profit from foreign experience, but this needs to be done in a transparent manner.

Countries with small financial systems and few resources may, perhaps, avoid the sunk costs associated with the provision of pension services (from contribution collection to asset management) by attracting investments from highly reputable foreign companies, ideally operating in joint venture with local companies. By attracting reputable foreign companies, reforming countries may also reduce the costs of supervision, which, regardless of cost, takes time to develop. This could provide the host country with a transition period during which effective regulation and supervision are established, while effective oversight is provided through the home country (Impavido, Musalem, and Vittas 2002).

In countries with small financial sectors, the small dimension of institutional relationships, the relative scarcity of human capital, the greater concentration of wealth, and a relatively less independent civil service facilitate the concentration of functions, interference by third parties, and the potential for weak governance. Hence, great importance should be given to the responsibility of governments to create a regulatory environment capable of preserving pension assets. This means that direct government control of asset management and direct investment in target industries, housing, and failing banks should be avoided, while pension funds should be afforded some freedom to invest abroad.

Last, but not least, is the role of international investments and the advantages of portfolio diversification for pension funds and the economy as a whole. While these benefits seem unquestionable, worldwide experience strongly suggests that the necessary conditions for the openness of the capital

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account include a sufficiently developed domestic financial market; otherwise, the country is likely to suffer from volatile capital flows and major exchange rate fluctuations (Karacadag, Sundararajan, and Elliot 2003; Prasad and others 2003). For pension funds, the exchange rates of small countries pose an additional problem because long-term hedging instruments are not available. While a rule of thumb may suggest that the share of foreign investment of pension funds should be approximately the expected scope of tradable goods consumed by retirees, what is the best strategy of a small country such as Mauritius, which imports in dollars and exports in euros? The potential alternative to a fully open capital account is the use of swaps by pension funds. Although discussed for some time inside and outside the Bank, and first suggestions have been put on paper (Bodie and Merton 2001; Vittas 2003), the market has not yet developed and may be too thin.

In summary, in small economies the implementation of pension reforms that move toward funded provisions creates special challenges. While the resource requirements may be high, they may be reduced by linking up with neighbors and international firms to avoid or reduce sunk costs. However, developing a financial market, including regulations, has other beneficial results, as domestic financial market development cannot be imported and is a requirement for an open capital account and risk sharing with the rest of the world.

## Political Economy and Organization of Pension Reforms

A successful and sustainable pension reform requires a deep understanding of the political economy of reform and its organization. While no dominant paradigm has been established, progress has been made in some, but not all, areas (Holzmann, Orenstein, and Rutkowski 2003).[24] This section highlights a useful conceptualization borrowed from Orenstein (2000) and adjusted based on country experiences; a proposed checklist, linked to the conceptualization and based on recent reform experiences; and a link between the type of pension system and its ability to insulate itself from future political risks.

### *A Proposed Conceptualization*

Orenstein (2000) proposes three main phases of pension reform: commitment building, coalition building, and implementation. Although the length of the phases may differ depending on individual country circumstances, there are certain commonalities.

The *commitment-building phase* is commonly the longest of the three phases. In this phase, it is desirable to include many actors in the debate, even at the expense of consensus. At this stage, it also is important to expose to and share with the general public and key policy players the relevant experience of other countries that have undertaken a successful

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pension reform. Key players include the parliamentarians, trade unions, and the national press. The duration and coverage of the debate should not be limited in order to reach a quick but artificial agreement. Just the opposite applies: open disagreements at this stage help parties to reach agreement in subsequent phases.

The *coalition-building phase* starts at a time when the government decides to put forward a reform concept. Crucial for the move from the commitment-building to the coalition-building phase and its successful completion is the emergence of a champion who believes in the need for reform and links his or her political fate with the cause.

During the coalition-building phase, the government remains open to modifications of the reform concept, but not necessarily to wholesale changes. The quality of the concept is of critical importance: the concept should be based on cutting-edge knowledge and should bring in the experience of other countries. It should have strong long-term projections, including sensitivity analysis, and be linked with opinion polls and focus groups showing that the concept responds to genuine concerns of the population with the existing system.

Presentation of the concept requires a focus on key messages. Pension reforms may be viewed as intergenerational struggles in which potential losers, usually current or near-term pensioners, often attempt to block reforms, while potential winners, young workers, are inactive in the debate out of myopia or lack of interest and understanding. At this stage it is, therefore, important to focus key messages on young people. Common strategies are the following:

- Emphasize that the new system brings the net present value of future payments close to the level of current contributions paid;
- Convince young workers that the state will honor its future obligations;
- Activate young workers in the pension debate, turning the debate explicitly into an intergenerational discussion;
- Engage organized workers, pensioners, financial sector representatives, and other parties with a stake in the outcome because the more organized the actors are, the more likely they will be to take into account macroeconomic benefits that will result from the reform.

The following stage of concept dissemination is a complicated activity. The experience of reformers shows that several activities bring significant payoffs. These include using professional public relations firms, focusing on key actors, building a core group of journalists who understand the reform process and are sympathetic to its goals, and working with donor agencies and other international organizations to extend the technical development and analysis.

The concept has to be converted into a legislative proposal and ultimately a draft law in order to initiate legislative proceedings. At this point,

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the reform package and supporting justification and communications materials should be comprehensive. Optimal management and sequencing of the legislative process is highly specific to individual country conditions and legislative processes and heavily influenced by political considerations. Chile, for example, enacted the full reform at once. Poland, however, first legislated the second and third pillar of the package and moved to the first pillar a year later.

The passage of laws begins the most critical phase: *reform implementation.* Almost invariably, the administrative capacity to support the new system is lower than expected. In Mexico the reform had to be delayed for a year until the new institutions required for implementation (Consar to supervise and Procesar to process information related to the transfer of funds to individual accounts) were sufficiently developed to fulfill their respective roles. In Poland, the new system malfunctioned because the social insurance institution was unable to pass contributions accurately and on time to the pension funds. During the implementation phase, it is important to have clear communication with the population, so that flaws in implementation are not confused with flaws in the reform.

A main lesson for Bank staff advice to client countries emerges from the tension between political readiness and administrative preparation: decide on the reform law when the political opportunity emerges and expectations of continued commitment are sufficiently high but implement the reform only when the administrative preparation is sufficiently advanced and problems are expected to be manageable.

### *The Experience of Reforming Countries*

The following criteria could be used as a checklist for judging whether the country is prepared to undertake the reform:

- Presence of a political mandate and organized advocacy groups;
- Empowerment of the reform technical group;
- Development of comprehensive and sound analysis;
- Quality of information about public opinions of the existing system and reform proposals;
- Clear strategy for communication with the affected public;
- Involvement of trade unions and other stakeholder organizations;
- Fully formulated strategy and effective management of implementation;
- Evidence of potential for political consensus.

Overall, the experience of reforms leads to the following conclusions with respect to the organization of the process:

- Policy legacies influence the present choice of reform, and the design of a reform builds on the legacy of existing institutions.

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- Establishing an office solely responsible for managing the reform process is very helpful. The burden of day-to-day management crowds out reformist thinking and acting for entities with other responsibilities.
- A well-thought-out public relations strategy and easily understood message are crucial to success.
- The choice of groups engaged in the reform dialogue systematically influences the outcome of reform because certain groups empower certain types of actors. Excluding actors from one forum often causes them to be more active in another.

*Isolation from Political Risks*

From a political economy perspective, a primary objective of reforms is to move to a system that is more robust to diverse kinds of shocks, which includes better isolation from the risks of political interventions that create adverse consequences for short-term political gains (Diamond 1997). From that point of view, both the nonfinancial and funded defined-contribution type of pillars are improvements relative to pay-as-you-go, defined-benefit systems that mix redistribution and insurance in a nontransparent manner. New structures either (a) move retirement incomes outside the government budget (a funded pillar) or (b) require the identification of an explicit source of financing for the benefits of any group of individuals or (c) make the benefits strictly and exclusively dependent on contributions (notional defined-contribution and funded pillar). It remains to be seen whether these will effectively preclude the political system from appropriating these resources for government revenue or accessing them for redistribution in other ways. Violating nonfinancial defined-contribution principles or requiring investment in government debt, particularly debt paying less than market rates, is the obvious route for the former. Redistributing part of the return on portfolios to "needier" accounts (which may have an age component) is one route for the latter. A central question is whether protection can be achieved by identifying individual accounts (in the nonfinancial defined-contribution as well as the funded form) as private property entitled to the same protection as other assets.

The recent example of Argentina illustrates the challenges in protecting the assets of funded pension systems under catastrophic macroeconomic conditions. The experience of Argentina indicates that simply placing assets in private control cannot guarantee their full protection, as all three pillars of the pension system suffered, along with depositors, insurance policyholders, bondholders, and shareholders. The experience in Argentina also indicates that the outcome for retirees may still be better under the funded pillar than under the potential alternatives.

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## Examples of Reform Dilemmas and Questions

This section presents some of the reform dilemmas in client countries where we do not yet know how best to proceed and what solutions to propose. While we face substantial uncertainty, we strongly believe that doing nothing is not a solution either. Consequently, we propose to substantiate our knowledge with analytical work, while working with clients on innovative solutions and joint learning.

What approach can be effective when the public sector is not delivering and the private sector cannot do so either, a situation frequently encountered in the least-developed countries? On the one hand, the public scheme does not deliver on its promises, is insolvent, and needs to be reformed, but any reform attempt fails. On the other hand, the financial sector does not meet the minimum conditions necessary even to think about replacing the public unfunded scheme with a funded scheme. Should one close down the public earnings-related scheme and provide minimum benefits (the zero pillar) only? Can even minimum benefits be delivered under current conditions? Should one establish a parallel institution, as is being discussed with regard to providing access to basic health and education in the low-performing countries? Should one follow the Kotlikoff (1999) proposal and park all the resources for a new funded scheme outside the country (as is being attempted in Kosovo)? Or should one simply engage in damage control until reform of the public sector makes progress before thinking about systemic reform?

Various client countries with Anglo-Saxon traditions run provident funds, which are defined-contribution systems that are formally funded. Two main problems surround these funds—one, in principle, is manageable; the other is less so. The manageable problem concerns poor performance as a result of poor governance and weak regulations and supervision, an issue for which solutions are, in principle, available if the political will exists. The less manageable problem concerns the pseudo funding of these provident funds because the portfolio consists essentially of government bonds. Diversifying to private assets may be possible, depending on the availability of market instruments, but not feasible for the government regarding access to financing. These are essentially unfunded schemes in which the government debt is implicit. Should the systems be transformed into explicitly unfunded schemes (say, of the notional defined-contribution type)? Should an effort be made to change the form of funding (and hence pay for the transition deficit)? Should these provident funds be phased out and replaced by a truly funded and privately managed system?

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Many social insurance systems in client countries are far from maturation and therefore have accumulated some reserve funds. These funds pale in comparison with the accumulated liabilities but nevertheless constitute 5 percent or more of GDP. They are poorly managed, generally earning low rates of returns. There remains uncertainty about the true size of assets (due to lack of auditing and accepted valuation techniques) and large-scale corruption. In addition, individuals take out loans against many of these funds prior to retirement. While improving fund governance and management would be the best solution, current administrative systems and staff remain entrenched, and progress has been limited. Nevertheless, as asset levels have risen, pressure has intensified to improve benefits, lower retirement ages, and lower eligibility requirements. Would it be better in these circumstances not to accumulate funds at all? What are the possibilities for the Bank and other international institutions to pressure for improved fund management? Is the environment conducive to private sector solutions, or does reform of the existing public institutions offer the most realistic opportunity for improvement?

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