Expanding pension coverage: the matching defined contribution approach

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Characteristics of informal sector

- Variable income flows
- Low savings capacity
- Low exposure to financial sector
- Transient career path (rural-urban, informal formal etc.)
- High discount rate/liquidity preference
- High degree of self-insurance (i.e., lack of various types of insurance coverage)
Some ways to address these issues

- Allow small and variable contribution amounts and flexible timing
- Harness groups where possible
  - Targeted groups (e.g., Oportunidades in Mexico)
  - MFIs (Grameen in Bangladesh)
- Use formal scheme infrastructure (India)
- Use IT to lower transaction costs on front end (Philippines mobile phone)
- Limit investment choice, strong defaults
What about incentives?

- Voluntary pensions in rich countries exist due to tax treatment, but irrelevant for informal sector workers.
- Informal workers are credit constrained and have to borrow for big events at high interest rates.
- They face more uncertainties than formal sector workers forcing them to self-insure.
- Bottom line is that they require significant incentive if they are to tie up their savings for two or three decades.
Matching contributions

- MDCs can be targeted and capped (e.g., one state in India matches up to 1000 rupees per year for workers in certain informal sector occupational groups)
- 1:1 match provides an immediate 100% return
- Can be bundled with insurance (e.g. Health) reducing the need for precautionary savings
- In practice, there are a number of countries planning or starting MDCs, but not enough experience to have empirical results
  - India, Indonesia, Vietnam, Dominican Republic
How much take up can you buy?

Duflo et. al. (2005) tested the take up elasticity for US low income workers, but similar studies have not been done for developing countries.
Steps in setting key parameters for MDC

MCT

TBL = x % of MCL

PL = $

AP = % of PL

SR = 1-AP

MCL – minimum consumption target
TRL – target benefit level
CR – contribution rate
PL – premium level
AP – ability to pay
SR – subsidy rate
CT – coverage target
BR – budget requirement

CT - # workers → BR - $
How affordable is the MDC to workers?

Based on a target benefit just above the poverty line, the contribution required with a 1:1 match is 5% of income for decile 3.
Fiscal costs can be limited

- Rough estimate of MDC cost
  - Set target pension at 40% YCAP
  - Calculate required total contribution for full career 10% of YCAP
  - Set match at 1:1 (5% of YCAP from government)
  - With labor force/population (40%)* share in informal sector (80%)* take up (50%) = 0.8% of GDP

- This can be reduced to 0.4% of GDP if targeted to the bottom half of the informal sector; in this case, coverage would be doubled

- Match can be reduced subject to fiscal constraints
MDCs and social pensions

- MDCs take a long time to mature and have any impact on old age poverty; it does nothing for the current or soon to be old
- MDC policy and social pensions can be linked and harmonized to achieve clear objectives over time
- Social pension dependence will be greater for older workers and gradually be replaced by dependence of younger workers on MDCs
- SP can be set at absolute poverty level and indexed to inflation while MDC parameters linked to YCAP; prefunding as population ages
Social pension only

Here there is complete reliance on a social pension indexed to income with no MDC
Social pension and MDC

Here, the social pension indexed to prices, with MDC parameters indexed to income
Concluding thoughts

- MDCs are being considered or started in a number of countries with low coverage
- MDC policies should take into account social pensions and the interaction of the two over time
- Careful analysis of fiscal tradeoffs between the two types of program can only be done with long term projections
- Political economy factors will affect the
Thank you