Issues in survivors’ insurance

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Why survivors & disability insurance?

- Old age, disability and survivors (D&S) insurance is designed to support people who cannot earn and work productively,
  - disability insurance pays benefits to workers who are incapacitated before old age
  - survivors’ insurance pays benefits to families of deceased workers and pensioners
- D&S benefits came before old age pensions historically—disabled veterans & widows
- D&S costs 1-6% of GDP, 3-12% of wage
- Usually >40% of old age spending
  - mostly survivors benefits in low-income countries, disability in high-income countries
Public+mandatory private spending on survivors’+disability insurance as % of GDP, 2005
Spending on survivors’ and disability benefits as % of spending on old age pensions
Common issues in social insurance programs

- I will talk about survivors’ insurance this morning, disability insurance this afternoon
  - how have these programs been structured?
  - what problems have arisen?
  - how can costs be controlled?
  - how can inequitable subsidies be avoided?
  - how can moral hazard and work disincentives be reduced?
Need for survivors’ insurance stems from women’s traditional role in society

• Traditionally, women provide household services while men earn financial resources in market and promise to support them
• Even if women work, it is often part-time, at lower rates of pay and without pension
• Wives are younger than husbands, have longer expected lifetime, become widows, may have children to support
• Life or survivors’ insurance helps to prevent poverty, maintain widow’s living standard, protect children
Why mandatory?

• Myopia and underestimate of risk—people don’t buy enough life insurance voluntarily

• Adverse selection by workers:
  – sicker workers will buy insurance
  – so insurance companies assume high risk and charge high price (too high for average worker)
  – cherry-pick low risks and try to exclude high risks

• Husband controls family income and may not give up current consumption to protect future widow

• If workers don’t insure, eventually widows become poor, need social support

• Mandatory insurance avoids these problems. But creates other problems. What are the pitfalls? How can we design systems to avoid them?
Design questions

• Who should be eligible for benefits?
  – young or old widows? widowers? children? parents? unmarried or divorced partners?

• How should they be financed?
  – role of spouse v. pool, public v. private sector?
  – who should get ex ante cross-subsidies?

• How large should benefits be?
  – should public benefits be focused on poverty-avoidance or maintaining standard of living?

• When should benefits stop?
  – should they stop upon remarriage?
  – or when widow has own pension?

• How should systems adapt to changing social and economic roles of women?
Snapshot picture of survivor benefit programs

- Usually handled by public system (P0 or 1), even in countries with multi-pillar system (except L. Am.)
- PAYG, so long-term costs are hidden
- Defined benefit, based on recent wages or pension, even when old age system is DC
- Eligibility varies, reflects social norms
- Costs 1-2% of GDP or 3-4% of wages
- >30% of old age spending in many low-income traditional societies; less in most high-income countries, where women work
In low-income countries with traditional social norms (Middle East, Africa, parts Asia)

• Almost everyone marries, divorce rare, many children, wife doesn’t work; husband supports extended family

• Survivors’ benefit system extends this support after his death to:
  – widows, even if young (and multiple)
  – children, parents, siblings (unmarr. daughters?)
  – widowers, divorcees, unmarried partners often not covered

• Benefit is earnings-related: widow gets 50-80% of husband’s benefit or wage, even if she is young when he dies
High- and middle-income OECD countries

• High female Ifpr and divorce rate, low birth rate--women are expected to work and support themselves

• Survivors’ benefits reduced to cut costs
  – young widows not covered unless disabled or have children, subject to means-test
  – mixed pattern after retirement age
  – parity for divorcees, civil partners, widowers
  – usually children covered, even if parents not covered
After retirement age, two patterns—

• 1) flat Pillar 0 old age benefit for all residents to avoid poverty (Australia, Denmark, New Zealand, Netherlands)
  – special widows benefit phased out
  – eliminates high cost, inequities, disincentives but leaves widows with small hh income

• 2) earnings-related widow’s benefit in Pillar 1 + means-tested min. pension in Pillar 0 (Italy, Belgium, Hungary, Poland)
  – some FSU countries have dropped widow’s benefit but remains high in southern Europe
  – usually working widow must choose between her own pension and widow’s pension
Problems: 1) cost and moral hazard

- Costs are high in countries that pay large earnings-related survivor’s benefit
  - long run costs should be calculated at start
  - benefits starting at young age are expensive
  - if worker dies young, widow gets benefit for many years. Expected present value (EPV) of survivors’ benefits at age 30 often > EPV of old age benefit (EPV should be calculated but isn’t)

- Moral hazard adds to cost
  - since worker doesn’t bear cost, he may take on more risk (children, young wives), save and insure less, cost system more
2) But survivor benefit still needed because of hh economies of scale

• In countries without survivor benefits, widow’s standard of living falls when spouse dies, even if she has worked
  – she gets small own-pension because of low wages, part-time work
  – hh income falls >50% while hh cost of living falls <30%--household economies of scale

• So need for survivors insurance remains
  – the question is-how should it be structured?
Public + mandatory private spending on survivors’ benefits as % of GDP, 2005
Spending on survivors’ benefits as % of old age pensions
3) Equity issues

- Subsidies: everyone pays same (% of wage) but some have higher expected benefit:
  - subsidies are non-transparent, misallocated (?)
  - men with large families, young (multiple) wives get more
  - women workers less likely to have survivors
  - single men and women get no survivor benefit
  - working women often lose survivor’s benefit or own-pension—high implicit tax
  - largest subsidies go to high earners and single-career couples
  - those outside contributory system get nothing
  - is this fair? Should low risks pay less? Should subsidies be targeted to low earners instead?
4) Incentives

• Widows usually lose survivors’ benefits
  – if they remarry--discourages remarriage
  – if they have own-pension or wages—discourages work, reduces economy’s LF
  – object was to save money but affects behavior
  – this was not a problem when strong social norms kept women at home
  – it becomes a problem as women’s roles change, work is socially accepted and behaviors are discretionary. Is it efficient for disincentives to keep them financially dependent, low income, low human capital?
How Latin American countries with multi-pillar system avoid these problems

- Lifetime costs calculated up-front and pre-funded; private retirement accounts in Pillar 2 cover part of cost and group insurance contract for annuity covers rest
- Undesired subsidies avoided by charging actuarially fair insurance premium (insur. fee=expected present value of benefit)
  - survivor benefits through mandatory intra-family, not inter-family, transfers.
  - subsidies targeted carefully to low earners
- No penalties for remarriage and work
Example from Chile—joint annuities

• Worker’s old age benefit depends on money accumulated in his retirement account
• During working stage, survivors’ benefit is also financed by money in account + top-up from mandatory disability and survivors insurance
  – as account size grows, D&S insurance fee falls
• Upon retirement, worker must purchase joint pension that covers surviving spouse and children
  – worker finances this by taking smaller own-pension
  – actuarially fair, cost depends on wife’s age, children
  – married person pays, singles with no dependents don’t
  – widowers also get benefit, but this costs wives less because they are expected to outlive husbands
Chile (Cont’d)

• Joint pension becomes survivor’s property. Widow can remarry, work and keep own-pension without losing survivor’s benefit
• Low cost to common pool; fewer hidden cross-subsidies
• Eliminates work disincentives, doesn’t distort behavior. My research shows that women respond strongly by working more.
• Joint annuity + own-pension enable widows to maintain previous living standards
• Subsidies are targeted to low earners through minimum pension or basic benefit.
Conclusion

• Survivors benefits are important, to avoid poverty among very old women and maintain widows’ standard of living

• But also important to avoid high costs and inequitable hidden cross-subsidies

• As women’s role changes, essential not to deter work--good for their financial independence and broader economy

• Actuarial fairness and joint pensions for families insure survivors while avoiding these problems
Extension to public PAYG DB systems

- Chile is a privately managed funded DC system, but actuarial fairness and joint pension concepts can be adapted to public PAYG DB pensions by adjusting retiree’s own pension enough to finance benefits to survivors and allowing widow to keep own-pension+ survivor’s benefit. This would eliminate 1 source of high costs, hidden cross-subsides, work disincentives and low income of older women.