Introduction and Executive Summary

THE PAST DECADE HAS BROUGHT BROAD RECOGNITION of the importance of pension systems to the economic stability of nations and the security of their aging populations. For the past 10 years, the World Bank has taken a leading role in addressing this challenge through its support for pension reform around the world.

The Bank has been involved in pension reform in more than 80 countries and provided financial support for reform to more than 60 countries, and the demand for such support continues to grow. This experience has significantly expanded the knowledge and insights of Bank staff and stimulated an ongoing process of evaluation and refinement of the policies and priorities that guide the work in this area.

What emerges from these interactions with policymakers, pension experts, and representatives from civil society in client and donor countries is the continued relevance of the main objectives of pension systems—poverty alleviation and consumption smoothing—and of the broader goal of social protection. The Bank continues to perceive advantages in multipillar designs that contain some funded element when conditions are appropriate but increasingly recognizes that a range of choices can help policymakers to achieve effective old-age protection in a fiscally responsible manner.

The suggested multipillar pension system is composed of some combination of five basic elements: (a) a noncontributory or "zero pillar" (in the form of a demogrant or social pension) that provides a minimal level of protection;[1] (b) a "first-pillar" contributory system that is linked to varying degrees to earnings and seeks to replace some portion of income; (c) a mandatory "second pillar" that is essentially an individual savings account but can be constructed in a variety of ways; (d) voluntary "third-pillar" arrangements that can take many forms (individual, employer sponsored, defined benefit, defined contribution) but are essentially flexible and discretionary in

nature; and (e) informal intrafamily or intergenerational sources of both financial and nonfinancial support to the elderly, including access to health care and housing. For a variety of reasons, a system that incorporates as many of these elements as possible, depending on the preferences of individual countries as well as the level and incidence of transaction costs, can, through diversification, deliver retirement income more effectively and efficiently.

The main changes to the Bank's perspective concern the enhanced focus on basic income provision for all vulnerable elderly as well as the enhanced role for market-based, consumption-smoothing instruments for individuals both within and outside mandated pension schemes. The Bank increasingly recognizes the importance of initial conditions and the extent to which conditions in a particular country necessitate a tailored or tactically sequenced implementation of the multipillar model.

This policy report was written to clarify and update the World Bank's perspective on pension reform, incorporating the lessons learned from recent experience and research that has advanced the understanding of how best to proceed in the future. It has been developed as a policy note, not as a research paper. As such, it is intended to conceptualize and explain current policy thinking within the Bank rather than to announce a new policy approach.

This articulation of policies and priorities is intended to assist Bank clients and the broader international public to understand and appreciate the Bank's framework for pension reform and to facilitate its ability to work effectively with clients in meeting the challenges ahead. This report provides a guide to the criteria and standards that the World Bank will apply in deciding when and where to provide financial and technical support for pension reforms.

The report has two main parts. Part 1 presents the framework for the Bank's thinking on pension reform, including its origins and scope, and the structure of Bank lending in this area. Part 2 highlights key issues pertaining to design and implementation. This introduction summarizes the main messages and outlines the structure of the report.

A Framework for Pension Reform

The evolution of the Bank's perspective on pension reform over the past decade reflects the extensive experience with reform in client countries, an ongoing dialogue with academics and partner organizations, and intensive internal discussion and evaluation of pension reforms worldwide. As a result, the original concept of a specific three-pillar structure—(a) a mandated, unfunded, and publicly managed defined-benefit system, (b) a mandated, funded, and privately managed defined-contribution

scheme, and (c) voluntary retirement savings—has been extended to include two additional pillars: (d) a basic (zero) pillar to deal more explicitly with the poverty objective and (e) a nonfinancial (fourth) pillar to include the broader context of social policy, such as family support, access to health care, and housing.

The past decade of experience, while contributing considerable depth to the understanding of the nuances and challenges of pension reform, has reinforced the need in nearly every circumstance to move away from the single-pillar design. Experience has demonstrated that the multipillar design is better able to deal with the multiple objectives of pension systems—the most important being poverty reduction and income smoothing—and to address more effectively the kinds of economic, political, and demographic risks facing any pension system. The proposed multipillar design is much more flexible and better addresses the main target groups in the population. Advance funding is still considered useful, but the limits of funding in some circumstances are also seen much more sharply. The main motivation for the Bank to support pension reform has not changed. Instead it has been strengthened by the past decade of experience: most pension systems in the world do not deliver on their social objectives, they create significant distortions in the operation of market economies, and they are not financially sustainable when faced with an aging population.

Review and Extension of the Original Concept

The extensive experience in implementing pension reforms in a range of settings since the early 1990s has motivated Bank staff to review and refine the Bank's framework to guide the appropriate objectives and path of a reform effort. The evolution of policy is characterized by five main additions to the Bank's perspective:

- *A better understanding of reform needs and measures.* This includes (a) assessing the need for reform beyond fiscal pressure and demographic challenges to address issues such as socioeconomic changes and the risks as well as opportunities of globalization; (b) understanding the limits and other consequences of mandating participation in pension systems, particularly for low-income groups, for which risks other than old age may be more immediate and much stronger; and (c) reassessing the continued importance, but also the limitations, of prefunding for dealing with population aging in recognition of the importance of associated behavioral changes, including enhanced labor supply and later retirement.
- *The extension of the multipillar model beyond the three-pillar structure to encompass as many as five pillars and to move beyond the conventional concentration on the first and second pillars.* Experience with low-income countries has brought into focus the need for a basic or zero

(or noncontributory) pillar that is distinguished from the first pillar in its primary focus on poverty alleviation in order to extend old-age security to all of the elderly. Experience in low- to middle-income countries has heightened awareness of the importance of the design and implementation of the third and voluntary pillar, which can effectively supplement the basic elements of a pension system to provide reasonable replacement rates for higher-income groups, while constraining the fiscal costs of the basic components. Last, but not least, is recognition of the importance of a fourth pillar for retirement consumption, which consists of a mixture of access to informal support (such as family support), other formal social programs (such as health care), and other individual financial and nonfinancial assets (such as home ownership) and the need to incorporate their existence or absence explicitly into the design of the pension system.

- *An appreciation of the diversity of effective approaches, including the number of pillars, the appropriate balance among the various pillars, and the way in which each pillar is formulated in response to particular circumstances or needs.* Some pension systems function effectively with only a zero pillar (in the form of a universal social pension) and a third pillar of voluntary savings. In some countries, the introduction of a mandatory second pillar is required to gain popular acceptance for a reform of the first pillar, while the political economy of other countries makes a reformed (first-pillar) public system in conjunction with voluntary schemes the only realistic alternative.
- *A better understanding of the importance of initial conditions in establishing the potential for and limitations within which reforms are feasible.* There is now greater awareness of the extent to which the inherited pension system as well as the economic, institutional, financial, and political environment of a country dictate the options available for reform. This is particularly important in establishing the pace and scope of a viable reform.
- *A strong interest in, and support of, country-led innovations in pension design and implementation.* These innovations include (a) the nonfinancial or notional defined-contribution system as a promising approach to reforming or implementing an unfunded first pillar; (b) the clearinghouse and similar concepts as a means to reduce transaction costs for funded and privately managed pillars; (c) the transformation of severance payments into combined unemployment and retirement-benefit savings accounts; and (d) public prefunding under an improved governance structure as introduced in a number of high-income countries. While each of these innovations is promising, they require close monitoring and evaluation, as transferability to other countries cannot be assumed.

Statement of Key Principles

Although the essential policy formulation explicitly recognizes country-specific conditions and leads to implementation of the multipillar model in a variety of ways, the Bank's perspective incorporates several principles that are deemed essential to any successful reform.

First, all pension systems should, in principle, have elements that provide basic income security and poverty alleviation across the full breadth of the income distribution. Fiscal conditions permitting, this suggests that each country should have provisions for a basic pillar, which ensures that people with low lifetime incomes or who only participate marginally in the formal economy are provided with basic protections in old age. This may take the form of a social assistance program, a small means-tested social pension, or a universal demogrant available at higher ages (for example, age 70 and up). Whether this is viable—and the specific form, level, eligibility, and disbursement of benefits—will depend on the prevalence of other vulnerable groups, availability of budgetary resources, and design of the complementary elements of the pension system.

Second, if the conditions are right, prefunding for future pension commitments is advantageous for both economic and political reasons and may, in principle, be undertaken for any pillar. Economically, prefunding requires the commitment of resources in the current period to improve the future budget constraints of government and may contribute to economic growth and development. A key issue in determining whether advance funding is advantageous is the extent to which it results in net additions to national savings. Politically, prefunding may better guarantee the capacity of society to fulfill pension commitments because it ensures that pension liabilities are backed by assets protected by legal property rights, regardless of whether the funding is through government debt or other types of assets. The decision to prefund, however, requires careful consideration of benefits and costs, as net benefits are not automatically assured and political manipulation can make prefunding illusory. This decision also requires a close look at the implementation capacity of a country.

Third, in countries where prefunding promises to be beneficial, a mandated and fully funded second pillar provides a useful benchmark (but not a blueprint) against which the design of a reform should be evaluated. As a benchmark, it serves as a reference point for the policy discussion and a means to evaluate crucial questions about welfare improvement and the capacity to finance the transition from pay-as-you-go to funded regimes. The efficiency and equity of alternative approaches to retirement savings, such as a significant reliance on voluntary individual or occupational systems, should be evaluated in relation to this benchmark.

Goals of a Pension System and Reform

This policy framework considers pension systems and their reform in terms of adherence to core principles and the capacity to achieve a flexible and context-specific set of social and economic outcomes. It does not narrowly prescribe the structure, implementing institutions, or operations of a system. On a practical level, the application of such a standard requires the articulation of goals and criteria against which a proposed reform can be evaluated.

The primary goals of a pension system should be to provide adequate, affordable, sustainable, and robust retirement income, while seeking to implement welfare-improving schemes in a manner appropriate to the individual country:

- An *adequate* system is one that provides benefits to the full breadth of the population that are sufficient to prevent old-age poverty on a country-specific absolute level in addition to providing a reliable means to smooth lifetime consumption for the vast majority of the population.
- An *affordable* system is one that is within the financing capacity of individuals and the society and does not unduly displace other social or economic imperatives or have untenable fiscal consequences.
- A *sustainable* system is one that is financially sound and can be maintained over a foreseeable horizon under a broad set of reasonable assumptions.
- A *robust* system is one that has the capacity to withstand major shocks, including those coming from economic, demographic, and political volatility.

The design of a pension system or its reform must explicitly recognize that pension benefits are claims against future economic output. To fulfill their primary goals, pension systems must contribute to future economic output. Reforms should, therefore, be designed and implemented in a manner that supports growth and development and diminishes possible distortions in capital and labor markets. This requires the inclusion of secondary developmental goals, which seek to create positive developmental outcomes by minimizing the potential negative impacts that pension systems may have on labor markets and macroeconomic stability while leveraging positive impacts through increased national saving and financial market development.

Criteria for Evaluation

The application of a goal-oriented and context-specific flexible policy framework also necessitates the formulation of criteria against which a reform proposal is evaluated in comparison with the existing arrange-

ments. These include criteria directed to the content of the reform and others directed to the process of reform.

The Bank uses four primary content criteria to judge the soundness of a proposal:

- *Does the reform make sufficient progress toward the goals of a pension system?* Will the reform provide reasonable protections against the risks of poverty in old age by efficiently allocating resources to the elderly? Does it provide the capacity to sustain consumption levels and provide social stability across the full range of socioeconomic conditions that are prevalent in the country? Does the reform meet distributive concerns? Does it offer access to retirement savings and poverty protection on an equivalent basis to all people with significant economic participation, including informal sector workers and those performing mainly noneconomic work? Is the burden of transition financing equitably distributed between and within generations?
- *Is the macro and fiscal environment capable of supporting the reform?* Have financial projections been thoroughly evaluated over the long-term periods appropriate to pension systems and rigorously tested across the range of likely variations in economic conditions over these time periods? Is the proposed financing of the reform within the limits reasonably imposed on both public and private sources? Is the reform consistent with the macroeconomic objectives and available instruments of government?
- *Can the public and private structure operate the new (multipillar) pension scheme efficiently?* Does the government have the institutional infrastructure and capacity to implement and operate publicly managed elements of the reform? Is the private sector sufficiently developed to operate the financial institutions required for any privately managed elements?
- *Are regulatory and supervisory arrangements and institutions established and prepared to operate the funded pillar(s) with acceptable risks?* Is the government able to put in place sustainable and effective regulatory and supervisory systems to oversee and control the governance, accountability, and investment practices of publicly and privately managed components?

Experience also dictates that major emphasis must be given to the process of pension reform. Three process criteria are, therefore, also relevant:

- *Is there a long-term, credible commitment by the government*? Is the reform effectively aligned with the political economy of the country? Are the political conditions under which the reform will be implemented sufficiently stable to provide a reasonable likelihood for a full implementation and maturation of the reform?

- *Is there local buy-in and leadership?* Even the best technically prepared pension reform is bound to fail if it does not reflect the preferences of a country and is not credible to the population at large. To achieve this goal, the pension reform has to be prepared primarily by the country itself, by its politicians and technicians, and be communicated effectively to, and accepted by, the population. Outsiders, such as the Bank, can assist with advice and technical support, but ownership and public support must come from the client country.
- *Does it include sufficient capacity building and implementation?* Pension reform is not simply a change of laws, but a change in how retirement income is provided. Accomplishing this typically requires major reforms in governance, the collection of contributions, record keeping, client information, asset management, regulation and supervision, and benefit disbursement. With the passage of legislation providing for reform, only a small part of the task has been achieved. A major emphasis on and investment in local capacity building and implementation as well as continued work with the client and other international and bilateral institutions beyond reform projects or adjustment loans are required.

World Bank Financial Support for Pension Reform

From 1984 through 2004, the World Bank made 204 loans involving 68 countries that had some type of pension component. Analysis of these loans demonstrates the Bank's support for a diverse range of pension reforms within the broader, multipillar framework. Within the group of multipillar loans, the majority of lending followed the enactment of a reform rather than coming in the analysis and design phase. The lending related to pension reforms confirms the application of the policy framework set forth in this report. It indicates that the Bank has provided financial support for a diverse array of pension system designs and that only a small proportion of Bank lending has been directed toward reforms characterized by a dominant mandatory second pillar.

In addition to its lending activities, the World Bank provides technical assistance and analytical support to pension reforms undertaken by its clients and to this end relies on internal and external expertise. The vast majority of this support is associated directly with the lending activities of the Bank and is, therefore, aligned with the distribution of reforms outlined above. An effort to evaluate the scope and quality of this advice is currently under way within the Bank, and the distribution of reforms was derived from the initial data gathering associated with this undertaking. This project should yield additional insights into the nature of the World Bank's activities associated with pension reforms.

Design and Implementation Issues

Through its pension reform activities in client countries and the work of other institutions and analysts, the Bank has developed a clear understanding of good and best practices—of what works and what does not—in an increasing number of design and implementation areas. In a variety of other areas, however, open issues remain, and the search for good solutions continues.

Feasible Reform Options

The relevant subset from among the full scope of general options includes (a) parametric reforms that keep the structure of benefits, public administration, and unfunded nature of the system but change key elements of the parameters; (b) a nonfinancial or notional defined-contribution (or similar) reform that changes the structure of benefits but keeps public administration and the unfunded nature of the system; (c) a market-based approach that provides fully funded (defined-benefit or defined-contribution) benefits under private management; (d) public prefunding that provides defined benefits or defined contributions that are publicly administered; and (e) multipillar reforms that diversify the structure of benefits, administration, and funding of the pension system.

Each of these main options embodies pros and cons in pursuit of the primary and secondary goals of pension systems. The Bank-favored multipillar pension system (especially the inclusion of a zero pillar and an appropriate combination of mandatory and voluntary savings arrangements), with or without a notional defined-contribution reformed first pillar, is perceived as best directed to the needs of the main target groups in client countries: the lifetime poor, informal sector workers, and formal sector workers (see table 1).

The relevant options for reform depend on country-specific considerations, especially the existing pension scheme (and other related public programs); the special reform need(s) of these schemes; and the (enabling or disabling) environment, such as administrative capacity and development of financial markets. These considerations are broadly linked with the development status or income level of a country, which suggests a policy progression from mere focus on poverty-oriented systems in low-income countries through systems that support limited consumption smoothing under a public and unfunded, earnings-related scheme to the full breadth of all pillars that is feasible in high-income countries. While there is, indeed, a link between capacity and reform potential, the relationship is not linear with income level. Feasible reform options and actual choices are (co)determined by the inherited system and the transition costs of moving from unfunded to funded pillars, which in many cases are prohibitive. This path dependency implies that middle-income

Table 1. Multipillar Pension Taxonomy

	Target group			*Main criteria*		
Pillar	*Lifetime poor*	*Informal sector*	*Formal sector*	*Characteristics*	*Participation*	*Funding or collateral*
0	**X**	X	x	"Basic" or "social pension," at least social assistance (universal or means tested)	Universal or residual	Budget or general revenues
1			**X**	Public pension plan, publicly managed (defined benefit or notional defined contribution)	Mandated	Contributions, perhaps with some financial reserves
2			**X**	Occupational or personal pension plans (fully funded defined benefit or fully funded defined contribution)	Mandated	Financial assets
3	x	**X**	**X**	Occupational or personal pension plans (partially or fully funded defined benefit or funded defined contribution)	Voluntary	Financial assets
4	**X**	**X**	X	Access to informal support (family), other formal social programs (health care), and other individual financial and nonfinancial assets (homeownership)	Voluntary	Financial and nonfinancial assets

Note: The size and appearance of x reflect the importance of each pillar for each target group in the following increasing order of importance: x, X, **X.**

countries need to assess carefully their choice of reform and work diligently on their capacity to undertake reform if they want the full range of options to be available in the future.

Pillar Design, Poverty Alleviation, and Redistribution

The role and capacity of each pillar to provide poverty relief, consumption smoothing, and redistribution from the (lifetime) rich to those at risk of old-age poverty depend not only on the design and associated incentives and disincentives but also on administrative capacity. For each of the pillars, choices need to be made and coordinated among the pillars to avoid counterproductive outcomes. In more developed countries, all or any subset of the pillars may be directed toward the primary and secondary goals of a pension system, although the inherited system typically imposes constraints on the available choices. In contrast, developing countries are usually far less constrained, or even entirely unconstrained, by an inherited pension system but, lacking financial markets as well as the capacity to implement and administer new systems, face constraints on the available choices, at least in the short run. For old-age pensions, three main suggestions stand out. First, basic income support (a zero pillar) to alleviate old-age poverty should be part of any complete retirement system. While financing in low-income countries will be a challenge and needs to be assessed against the competing demands of other vulnerable groups, such as children, youth, and the disabled, the challenges of implementation are equally strong and require close attention. These include administering eligibility criteria and efficiently paying small amounts to a largely rural population that has little involvement with financial systems or institutions.

Second, mandated systems should be kept small and manageable. In many low-income countries, this may be a basic (zero) pillar that can be supplemented by a voluntary third pillar. If a mandated contributory (unfunded or funded) system can be effectively implemented, it should be aimed at modest replacement rates and require only moderate contribution rates.

Third, low-coverage, earnings-related systems should minimize redistribution, be self-financing, and not rely on budgetary transfers. Any redistribution to low-income groups should be financed by resources obtained from the group already within the system and not rely on budget resources financed in part by the less fortunate outside the system. In high-coverage situations, redistribution, especially for funded systems, can and should be provided by budgetary transfers, but this must be done in a transparent manner at the time the liability is created.

For the reform of disability and survivor pensions, best practices are less obvious and therefore require much more attention. For disability pensions, it appears that severing linkages with old-age pensions may be the best way to secure appropriate benefits, while keeping the potential for abuse low. Spousal and survivor pension rights compete with more

redistributive and traditional approaches of compensating gender discrimination via the pension system and require more consideration to formulate best practices as well.

Mandated systems separated along professional and occupational lines should be avoided because they impede labor mobility and can lead to expensive and unsustainable pensions for some subgroups of the population. Civil servant pensions, often the oldest scheme in a country, should be integrated into a general and harmonized scheme for all sectors. Supplementary schemes should be established strictly on a funded basis.

Financial Sustainability

One of the main goals of pension reform is to achieve financial sustainability, meaning the payment of current and future benefits according to an announced path of contribution rates without unannounced hikes in contribution rates, cuts in benefits, or deficits that need to be covered by budgetary resources. To be credible, a pension reform requires, above all, credible financial projections that include both short-term and long-term flows and an assessment of the status and utilization of stocks of accumulated assets. For funded pillars, this requires a reasonable assessment of anticipated rates of return, including the role of foreign investment in diversification and management of returns. To this end, three main suggestions stand out.

First, a pension reform proposal that is not accompanied by credible cost estimates comparing it with the current scheme should not be undertaken (and will not be supported by the World Bank). For the projections, alternative models (in addition to the Bank's Pension Reform Options Simulation Toolkit—PROST—model) can, and should, be used. Differences in projections need to be understood and fully considered. Differences arising from alternative analytical methods provide valuable insights into the sensitivity of results to modeling assumptions and the degree of uncertainty and risk associated with the outcomes of reform.

Second, assessing the financial sustainability (in particular, of unfunded schemes) requires taking a long-term view and considering flows as well as stocks. For typical pay-as-you-go schemes, the stock is reflected in the implicit pension debt, which, for conceptual and data reasons, generally should be measured as the accrued-to-date liability. Defined-contribution systems need to recognize explicitly the volatility of benefit levels associated with variations in both asset returns as well as interest rates at the time account balances are converted to annuities. They require funding rates appropriate to benefit targets in consideration of these risks and need to communicate the degree of variation in anticipated benefit outcomes. Similarly, adjustments based on demographic and economic outcomes may need to be incorporated into some designs to ensure their long-term sustainability.

Finally, for partially and fully funded systems, the correct assessment of available assets and sustainable risk-adjusted rates of return is important. Publicly managed (central) pension funds have a poor track record to date in sustaining reasonable investment returns, which leaves three main options: (a) moving to an unfunded system if financial instruments, the capacity to keep the political pressure at bay, or both do not exist; (b) keeping the funding approach but moving to a privately managed and decentralized system; and (c) improving the governance structure of the centralized system. There is growing empirical evidence that governance is crucial for investment strategies that are the primary determinant of performance. Some countries and international organizations have developed guidelines for governance and investment process design. Part 2 of this report presents the key principles of good investment process design that may also be introduced in advanced client countries.

Administrative Preparedness and Implementation Constraints

There remains a broad range of implementation issues for which good answers are still required. Simply enumerating and summarizing them would be a challenge. This subsection presents some of the highlights, main messages, and suggestions.

The key issues in administrative preparedness of the new pension system, especially a defined-contribution one, are the introduction of personal identification systems and accounts (personification) and the unified collection of contributions. The greatest difficulties appear to be in integrating the flow of funds and 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. Whatever the selected solution, the institutions need to be technically ready prior to implementation. Otherwise the reform may fail, and the approach to reform will be discredited for the wrong reason.

The recommended centralization of the flow of data calls for the creation of a clearinghouse to consolidate some aspects of second-pillar operations with operations of a first-pillar agency or tax authority. The phrase "clearinghouse" has come to encompass a variety of options along a spectrum that includes using a state or quasi-public agency to collect second-pillar contributions and allocate them among second-pillar funds, to be an alternative record keeper, or to be an exclusive record keeper and information agent for fund participants.

A related issue concerns the coexistence of tax collection and social insurance collection units. Although there are many good arguments for having only one collection agency over the long run (the national tax authority), experience in some regions suggests that the speed and preparedness to undertake such a merger need to be well considered.

The tax treatment of pension schemes is also critical to establishing appropriate and affordable incentives for retirement savings, while avoiding

unintended subsidies to the wealthy or opportunities for tax evasion unrelated to pension savings. In quite a number of client countries, contributions, investment income, and benefits are essentially untaxed, providing windfall gains for the richer part of the population and leading to the substitution of tax-favored savings for savings that otherwise would have occurred. A better approach is to accord mandated pensions consumption-type income-tax treatment that exempts contributions and earned interest, while taxing benefit payments as ordinary income. A similar tax treatment of voluntary pension schemes, in view of their concentration in the upper-income strata, is less clear but should be considered only if reasonable limitations are imposed and there is some likelihood of positive externalities (such as enhanced savings or contributions to financial sector development).

However, the provision of subsidies should be considered as a means of enhancing the distributional equity of pension systems and expanding coverage. The establishment of tax credits or matching contributions to pension savings can provide significant incentives for lower-income workers, who typically remain outside the tax system, to participate. It may also alleviate the degree of redistribution in favor of higher-wage earners associated with a consumption-tax treatment in low-tax-coverage environments. The positive externality may include—besides increasing pension coverage—an increase in the national savings rate.

The level of fees or charges levied on financial retirement products is an area of considerable debate and research as well as an area of major concern for both critics and supporters of funded pensions. Although more research on this topic is needed, three approaches are promising. First, limit overall costs by saving on administrative expenses (for example, the collection of contributions and the administration of accounts) through the use of a central clearinghouse. Second, limit marketing expenditures by pension funds through blind accounts or constraints on switching among investment funds by individuals. Last, but not least, limit asset management fees by restricting the choice of individuals, including the use of passively managed investment products, employers' choice of financial provider, or competitive bidding for a restricted number of asset managers.

Finally, the provision of annuities by the private sector in funded retirement-income systems creates major challenges and constraints that may significantly influence the design and sequencing of the overall reform. While the conceptual and implementation issues during the accumulation phase of funded schemes are relatively well understood and manageable in most circumstances, the design and operation of the disbursement phase require more development. Some of the issues, such as the types of providers (whether to limit these to insurance companies or to include other financial institutions as well) and the products permitted

to be offered, seem relatively settled. Issues related to the degree of mandating and, most important, the question of allocating and managing risks—in particular, rising life expectancy—remain quite open.

Financial Market Readiness, Regulatory, and Supervisory Issues

The question of what conditions are required for the introduction of a mandatory funded pillar has given rise to considerable debate that will take a few more years to resolve. Five issues are at the core of the debate: (a) Can funded pensions be introduced in a rudimentary financial market environment? (b) What are the regulatory standards and practices needed to ensure effective operation and security? (c) What supervisory practices and institutions need to be developed? (d) What level of costs is acceptable in the operation of a system, and at what threshold do operating costs mitigate the potential advantages of funding? (e) What are the options for countries with small open systems?

Not all countries are ready to introduce a funded pillar, and consequently some should not do so. However, the introduction of a funded pillar does not require perfect conditions, with all financial institutions and products available at the outset. Funded pillars ideally should be introduced gradually to enable them to facilitate financial market development. Nevertheless, minimum conditions need to be satisfied for the successful introduction of a funded pillar, including (a) a solid core of sound banks and other financial institutions capable of offering reliable administrative and asset management services; (b) a long-term commitment by government to pursue sound macroeconomic policies and related financial sector reforms; and (c) the establishment of core regulatory and supervisory systems concurrent with the implementation of a funded system and a long-term commitment for the support and continued development of a sound regulatory framework.

The extensive recent experience with pension reforms in Latin America and Central and Eastern Europe in addition to the much longer experience in the economies of the member countries of the Organization for Economic Co-operation and Development (OECD) has advanced the understanding of issues of financial market regulation. This experience indicates that certain basic (and less controversial) regulations should be applied to mandated funded schemes from the very beginning. These include appropriate licensing and capital requirements for providers, full segregation of pension assets from the other activities of sponsors and management firms, the use of external custodians, and the required application of broadly accepted and transparent asset valuation rules and rate-of-return calculations. There remains uncertainty regarding how and when a number of more controversial regulations should be applied. These include controls on market structure and choice of portfolio by members, minimum funding standards for defined

benefits, investment requirements or specific limitations on particular types of assets, portability rules, profitability or minimum rate-of-return requirements, and guarantees.

Similarly, in financial market supervision, many rules are not controversial and should be applied early on. The less controversial rules and tasks for the supervisory body include (a) the need for an operationally independent, proactive, well-financed, and professional staff; (b) the vetting of the application for licensing; and (c) collaboration with other regulators. The more controversial rules and questions for supervision include choosing between a single-purpose or dedicated supervisory agency (such as pioneered in Chile) or integrating various supervisory authorities (such as insurance, securities markets, banking, or mutual funds) into a single agency; choosing the range of institutions permitted to offer retirement-income products; establishing effective collaboration among regulators and supervisors; and creating effective oversight and accountability of the supervisor.

Various small and open economies, such as in Central America and Central Europe, but also in Africa (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. The opportunities include full integration into the world economy, with much better opportunities to share and manage risks for retirees and the economy as a whole. The way forward is not easy, and the potential options include regional development of funded pension systems (which is a promising approach that, so far, has never been adopted), the application of practices of other countries, such as centralized public management (which is possible, but not fully convincing), and a mixture of importing knowledge by opening the financial sector up to foreign investment and keeping the government out of investment decisions, while undergoing cost-intensive buildup of institutions, regulations, and supervision. This capacity building may have positive overall developmental effects because reliable domestic financial markets are needed in any economy that wants to participate in and profit from globalization.

The Importance of Political Economy

Undertaking a successful and sustainable pension reform requires a deep understanding of the political economy of reform. While no dominant paradigm has emerged, experience with pension reforms in a variety of settings has advanced the understanding of effective approaches to the organization and process of reform. A conceptualization bor-

rowed from political science that distinguishes three main phases of pension reform—commitment building, coalition building, and implementation—has proved useful in client countries.

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. It also is important to expose to, and share with, the general public and key policy players the relevant reform experience of other countries. Key players include 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. Open disagreements at this stage help everyone to reach agreement in subsequent phases.

The *coalition-building phase* starts when the government decides to put forward a reform concept. Crucial for the move from the commitment-building to the coalition-building phase 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 tried and tested knowledge and should bring in the experience of other countries. It should have strong long-term projections, including sensitivity analysis. It is essential to link the concept 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. This stage concludes with dissemination of the concept and its translation into a specific legislative proposal.

The passage of legislation marks the start of the most critical phase: *implementation.* Almost invariably, the administrative capacity to support the new system is lower than expected, and knowledge of best practices is in the early stages of development. Experience indicates that tension between political readiness and administrative preparation is inevitable, making it necessary to enact the reform law when the political opportunity emerges and expectations for continued commitment are sufficiently secure but to implement the reform only when the administrative preparation is sufficiently advanced and problems are expected to be manageable. Continued, active political support must continue throughout implementation for any reform to be successful.

Regional Reform Experience

Since the beginning of the 1990s, two regions—Latin America and Europe and Central Asia—have undertaken most of the reform activities and thus invite a first assessment. While the transition economies in Europe and Central Asia were somewhat influenced by the early experience in Latin America, reform developed quite differently in the two regions, including some innovative approaches to design and implementation of multipillar pension

reform. In the four other Bank regions—South Asia, Sub-Saharan Africa, the Middle East and North Africa, and East Asia and the Pacific—actual and comprehensive country reforms are still limited, but not unknown. In these regions, it is encouraging to see that the policy discussion about the need for reform and its direction is taking place in many more countries.

Latin America

Through the first half of 2004, 12 Latin American countries had passed legislation stipulating multipillar reforms, with implementation begun in 10 of the 12. Each of these countries has introduced a mandatory funded pillar, but the extent of the mandatory pillar relative to the pay-as-you-go system, as well as many other features, is unique to each of the reforms. In addition, all countries except Mexico and, partially, Colombia unified previously fragmented pension systems into a single system covering the whole formal labor market. Unifying the civil servant system with the national systems has been a significant achievement for both labor market flexibility and fiscal sustainability.

How have the Latin American reforms achieved the goals of a pension system, and what are the remaining issues? The greatest gains have been achieved in the area of fiscal sustainability. In some cases, full sustainability has yet to be achieved, but substantial progress has been made toward this objective. When well designed, the reforms have also been a positive catalyst, stimulating economic growth, which has helped to achieve robustness and to diversify the sources of pension income in old age. The experience with adequacy and affordability is somewhat more mixed, with reforms facing constraints imposed by the original systems. Systems that had high and unaffordable contribution rates typically had generous benefits. Since the generous benefits were acquired rights, it was politically feasible to reduce them prospectively rather than immediately, which meant that lowering contribution rates to affordable levels would jeopardize the objective of fiscal sustainability. As a result, the least affordable systems have remained unaffordable. Similarly, the record on providing adequate pensions for all of the elderly is also mixed. The reforms generally focused on the contributory system, which was nearing, or already in, deficit prior to the reform. After a transition period, the reforms should free up fiscal resources that can then be devoted to other social benefits, including noncontributory pensions. However, because the countries are still in the early phase of the transition, this positive result has not yet been achieved.

Europe and Central Asia

By early 2004, 10 out of 28 countries in the region had introduced multipillar pension systems. These reforms shifted a portion of the mandatory pension contributions to private institutions that have established indi-

vidual defined-contribution accounts for each eligible worker. Some of these countries reformed the public first pillar through the introduction of individual and nonfinancial defined-contribution accounts. Their willing embrace of reforms may be explained by the need to reap the benefits of a funded pillar relatively quickly to increase savings and economic growth and by their willingness, after a profound ideological crisis, to emphasize personal accountability and private savings.

Reforms ran into some implementation problems, including the accurate transfer of contributions to pension funds and inefficient regulatory institutions. Old pension systems (still operating, as reforms have a long phase-in period) continue to constitute a serious fiscal burden, especially with the reform policy reversals that have occurred in several countries, although the old systems clearly constitute an even greater burden in countries that have not adopted the multipillar approach. After initial enthusiasm, there is some skepticism about the new systems because administrative costs are high, current pensions have declined as a part of fiscal adjustment, and the benefits of the new system are not yet visible. Although rates of return are high compared with investment funds or other reasonable benchmarks, it is doubtful whether these high returns can be maintained without a greater diversification of domestic private and foreign assets. The willingness of governments in the region to allow this is not fully in place, however. In addition, Maastricht criteria that are binding for European Union (EU) accession countries count explicit debt, but not the reduction in the implicit pension debt, which means that reforms adversely affect countries' position vis-à-vis the criteria.

The way forward for pension reforms, although clear, remains difficult to implement. Second pillars will continue to grow and consequently reduce net unit costs (although commissions remain high), but fiscal constraints on this growth are a serious issue. There remains a need to continue to reduce the administrative costs of the systems, preferably through more group contracting and less individual marketing. This may be hard to achieve in systems based on competition among pension funds for individual contributions, and thus far caps on expenses have not been very effective. International diversification of funds' investment is essential to optimize risk and returns; however, political opposition continues to be strong. The pension debate is nearing the end of the beginning rather than the beginning of the end.

On balance, however, pension reforms in Central and Eastern Europe have already led to systems that are more adequate, affordable, sustainable, and robust than the old ones. As far as adequacy is concerned, the target replacement rate remains quite high, usually above 50 percent (and much more for less-affluent individuals), given the prevalence of a minimum pension in the reformed systems. Also, with the expansion of voluntary third-pillar arrangements, the total replacement rate can easily reach 60–70

percent. Changes in retirement ages and the reduction of special privileges and overall benefit levels have substantially improved affordability and sustainability. From actuarially bankrupt systems that require year-to-year budget subsidies, countries in the region have moved to systems that are within the capacity of individuals and governments to finance and that are financially sound in both the short and long run. Finally, the new systems are much more robust, as they are diversified (including public and private provision and a combination of defined-benefit and defined-contribution arrangements) and somewhat immune to political shocks as a result of their market-oriented nature.

Structure of the Report

The articulation of the World Bank's perspective on pension reform that follows is organized into two parts. The first part presents the economic and social policy rationale for pension reform and outlines essential foundations of World Bank policy. This part is divided into four chapters. Chapter 1 discusses the impetus and justification for reform. This is followed by a presentation in chapter 2 of the conceptual foundation of the Bank's view of reform, which discusses the social risk management framework and rationale for public intervention in providing for old-age income security, the multipillar model, and the rationale for funding. Chapter 3 articulates more fully the goals and criteria against which reforms are assessed, followed by chapter 4, which summarizes the lending activities of the Bank from 1984 through 2004 to demonstrate the consistency of financing for pension reform with the policy framework. The second part of the report provides an overview of implementation issues and is divided into four chapters. Chapter 5 provides an in-depth discussion of the range of reform options that countries typically face and discusses how these might fulfill the goals and criteria set forth in the first part. Chapter 6 provides a brief but still voluminous overview of design and implementation issues and options that will arise in the reform process. Chapter 7 sketches the recent experience with reform in two regions—Latin America and Europe and Central Asia—and highlights the development of recent reforms in other regions. Chapter 8 provides a few concluding comments.