

Issues Facing the Pension System in Iraq and a Framework for Reform



David A. Robalino
Senior Economist
The World Bank

Workshop on Social
Protection in Iraq
Amman, Jordan
October 21-23, 2005



Background

- In November 2004 GOI – WB organized a workshop to discuss issues with the pension system and options for reform.
- Policy note assessing main issues and proposing a framework for reform was delivered to the government:
 - Iraq pension system has structural problems in terms of design that compromise financial sustainability, efficiency, and equity.
 - It was not a good idea to eliminate flat-payments and go back to old benefit formulas.



Three objectives for this session

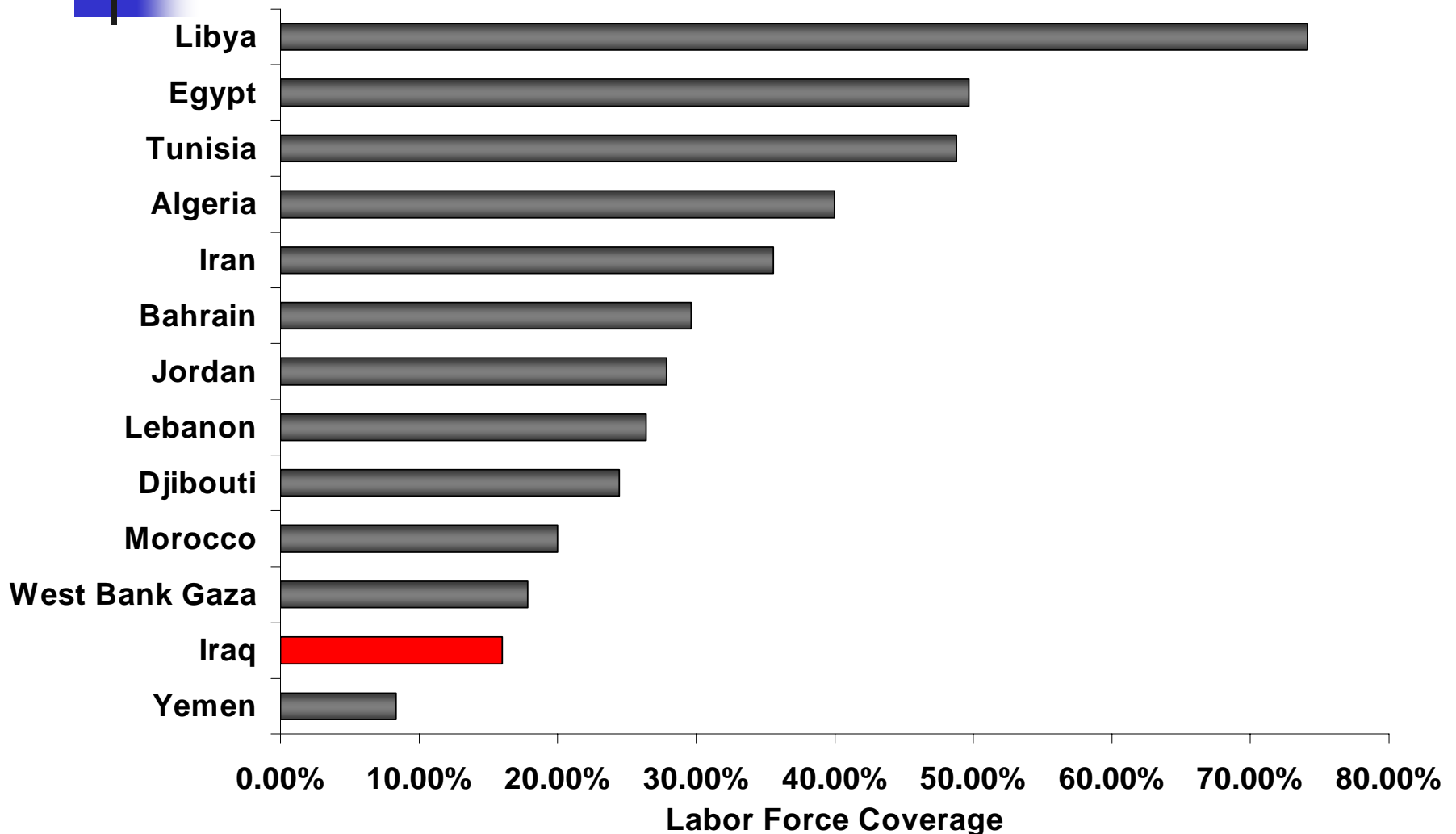
1. To review the current situation of the pension system and the main policy challenges.
2. To propose a framework to guide discussion about reform.
3. To identify administrative issues that will need to be addressed to support pension reform (major challenge).
4. To agree on the components of a potential operation to support the government reform efforts.



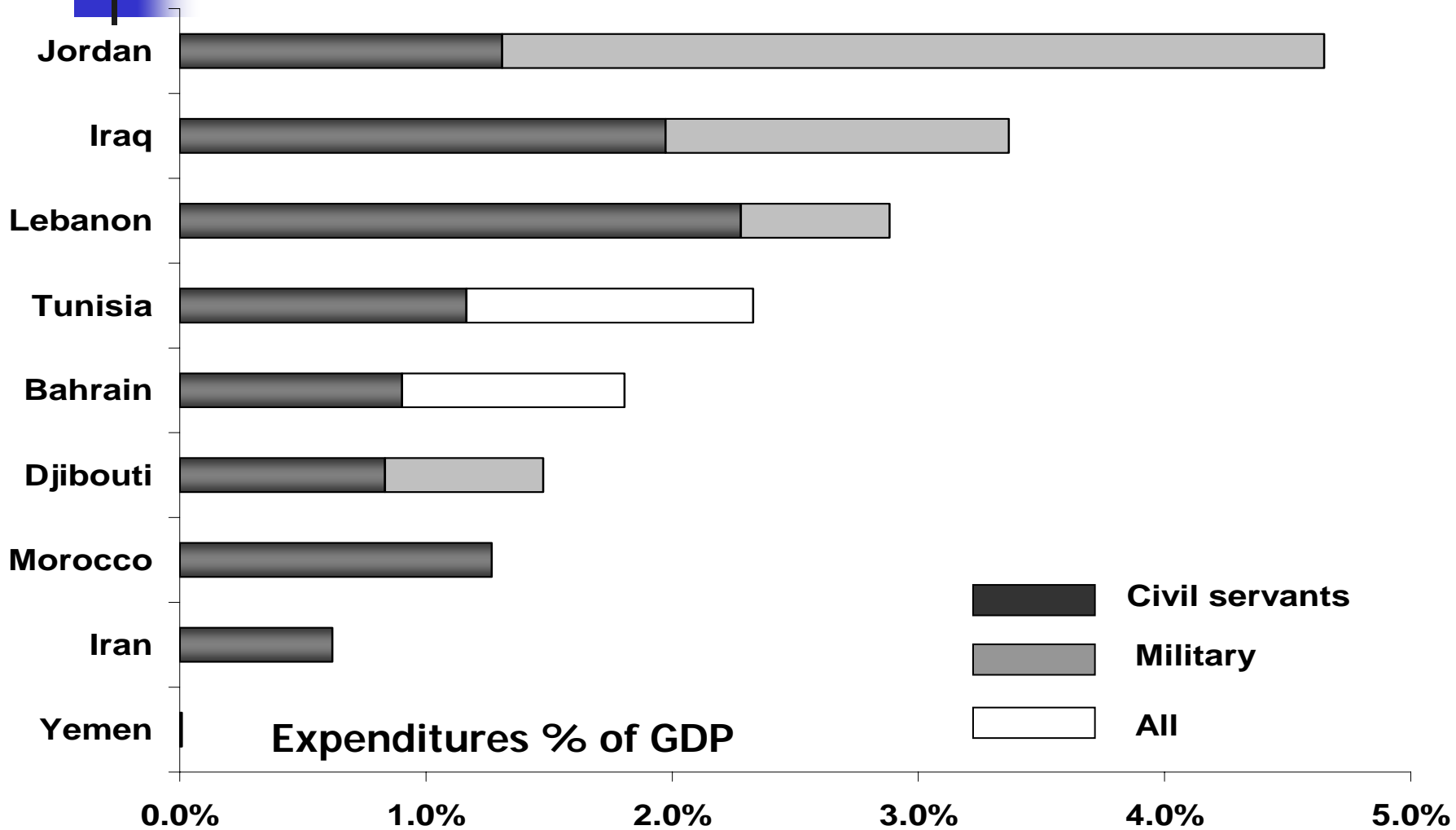
Basic facts

- Coverage actives:
 - Civil service/SOEs = 1.7 million (17% of labor force)
 - Military = ?
 - Private sector = 76 thousand (1% of labor force)
- Coverage old age:
 - Civil service/SOEs = 556 thousand.
 - Military = 478.8 thousand.
 - Private sector = 14.1 thousand.
- Expenditures (emergency flat payments):
 - Civil service/SOEs = ID 1 trillion (2.5% of GDP).
 - Military = ID 693 billion (1.6% of GDP).
 - Private sector = ID 11.6 million (0.03% of GDP).

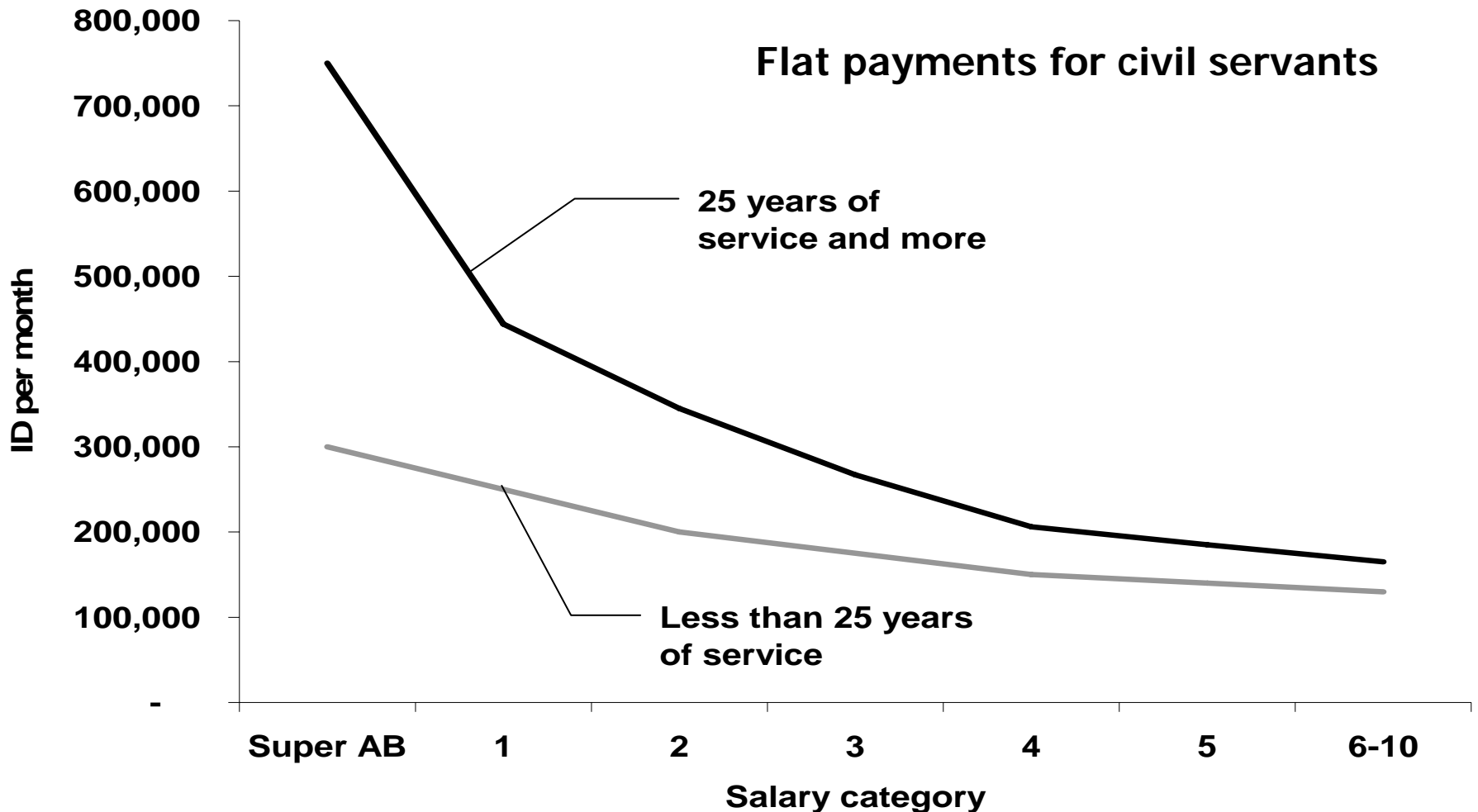
So, when compared to other countries in the region the system has very low coverage



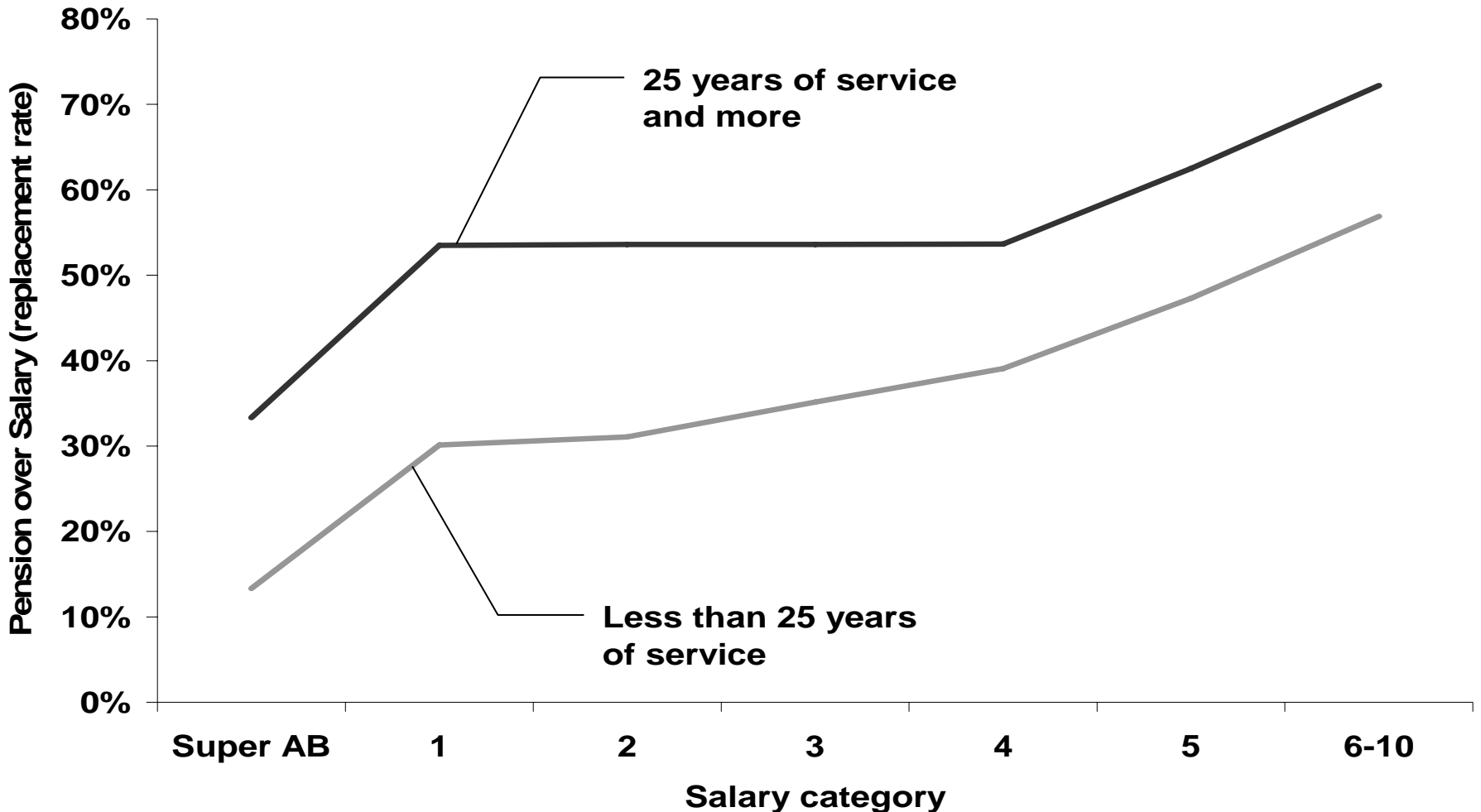
And is expensive

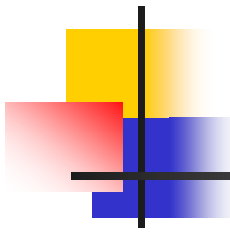


Flat payments have been increasing and differentiated by categories



But because wages have also increased, replacement rates have declined

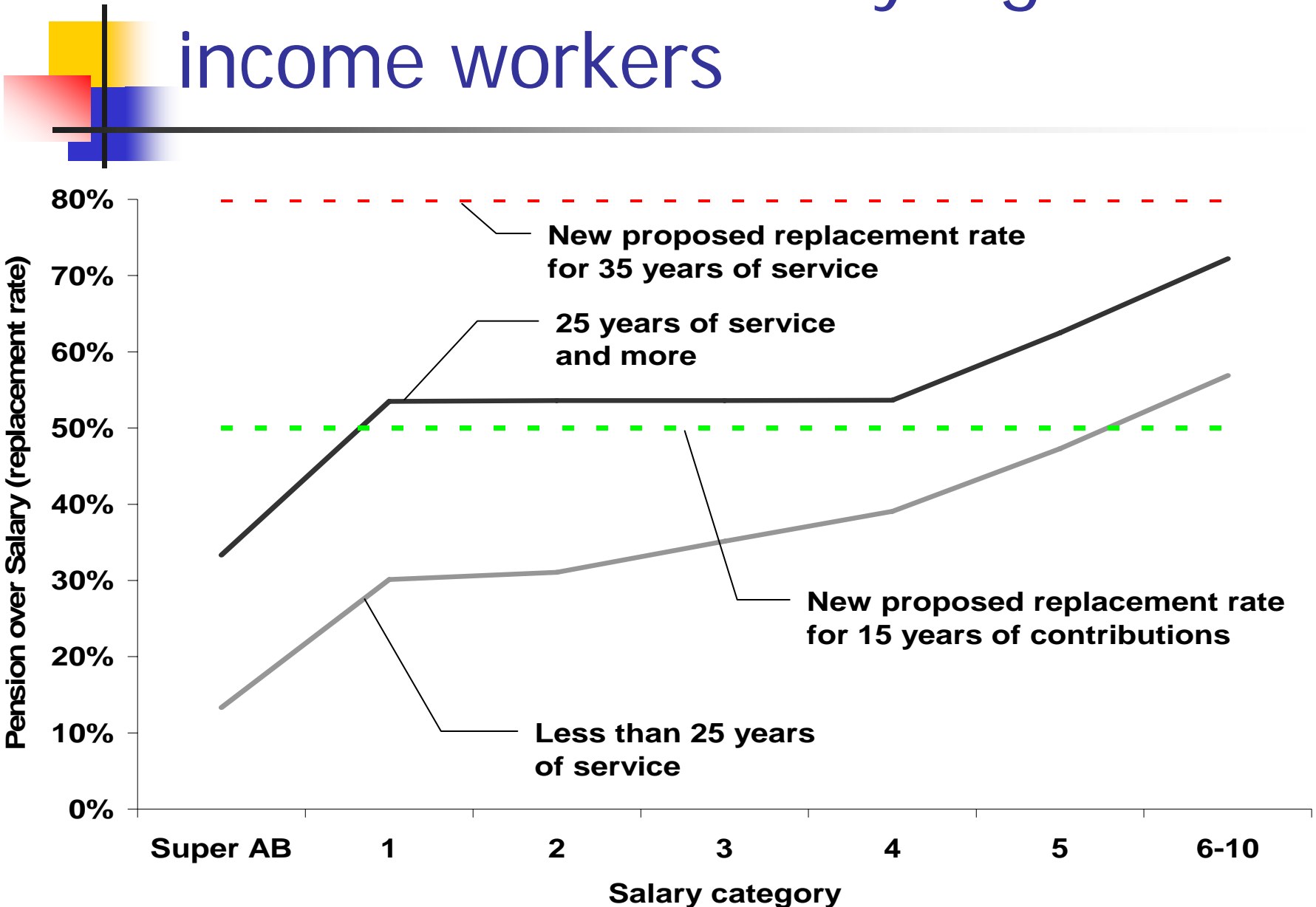




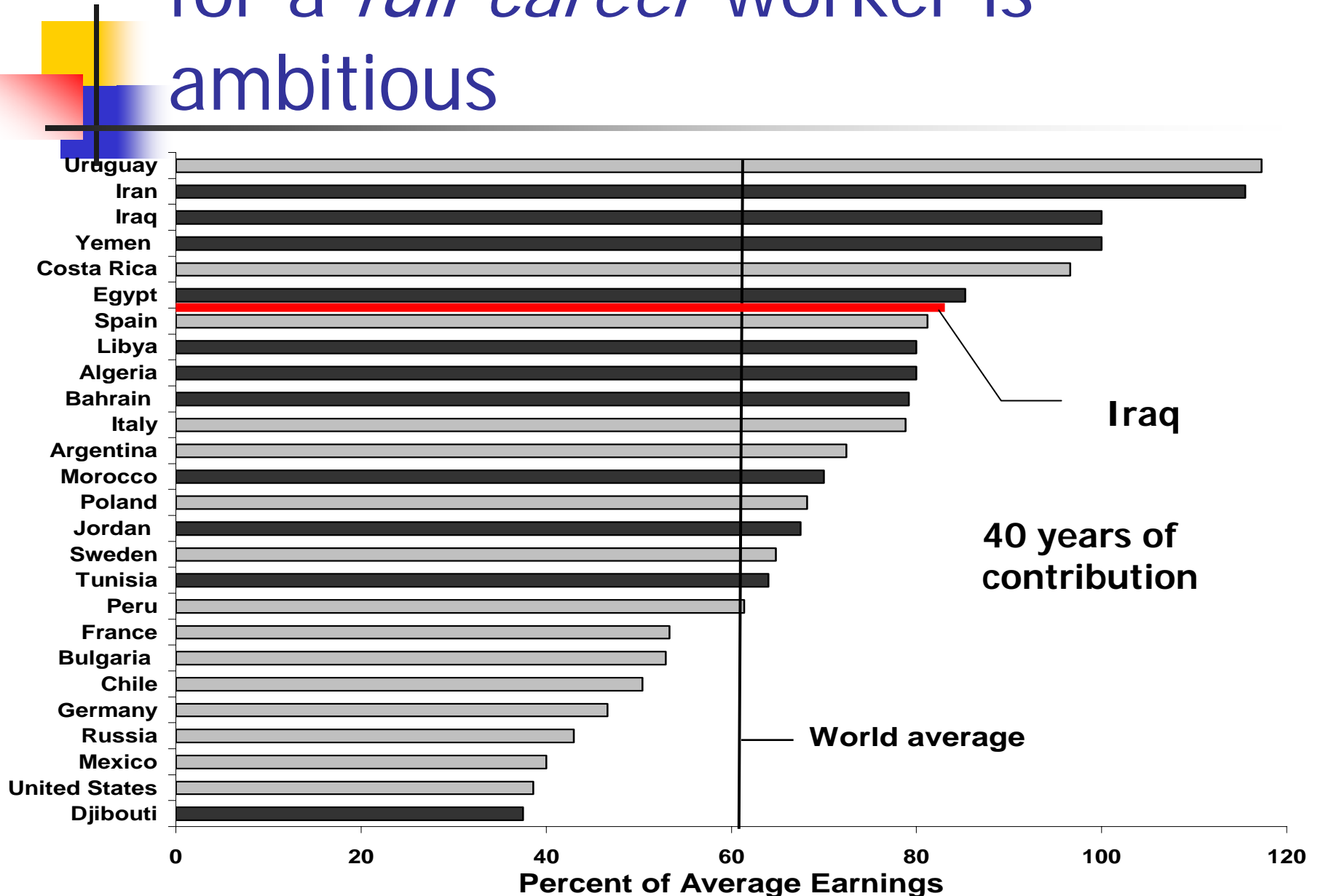
Government has been considering to go back to “old” formulas?


- Recent proposal:
 - Retirement age is set at age 60 for both men and women with mandatory retirement at age 63.
 - The minimum vesting period is set at 15 years.
 - For the first 15 years of contribution individuals receive 50 percent of their last salary (a 3.3 percent accrual rate).
 - For each additional year of contribution the accrual rate is 2 percent and there is a maximum replacement rate of 80 percent [*maximum reached after 35 years*]

Would benefit mainly high income workers



The targeted replacement rate for a *full-career* worker is ambitious

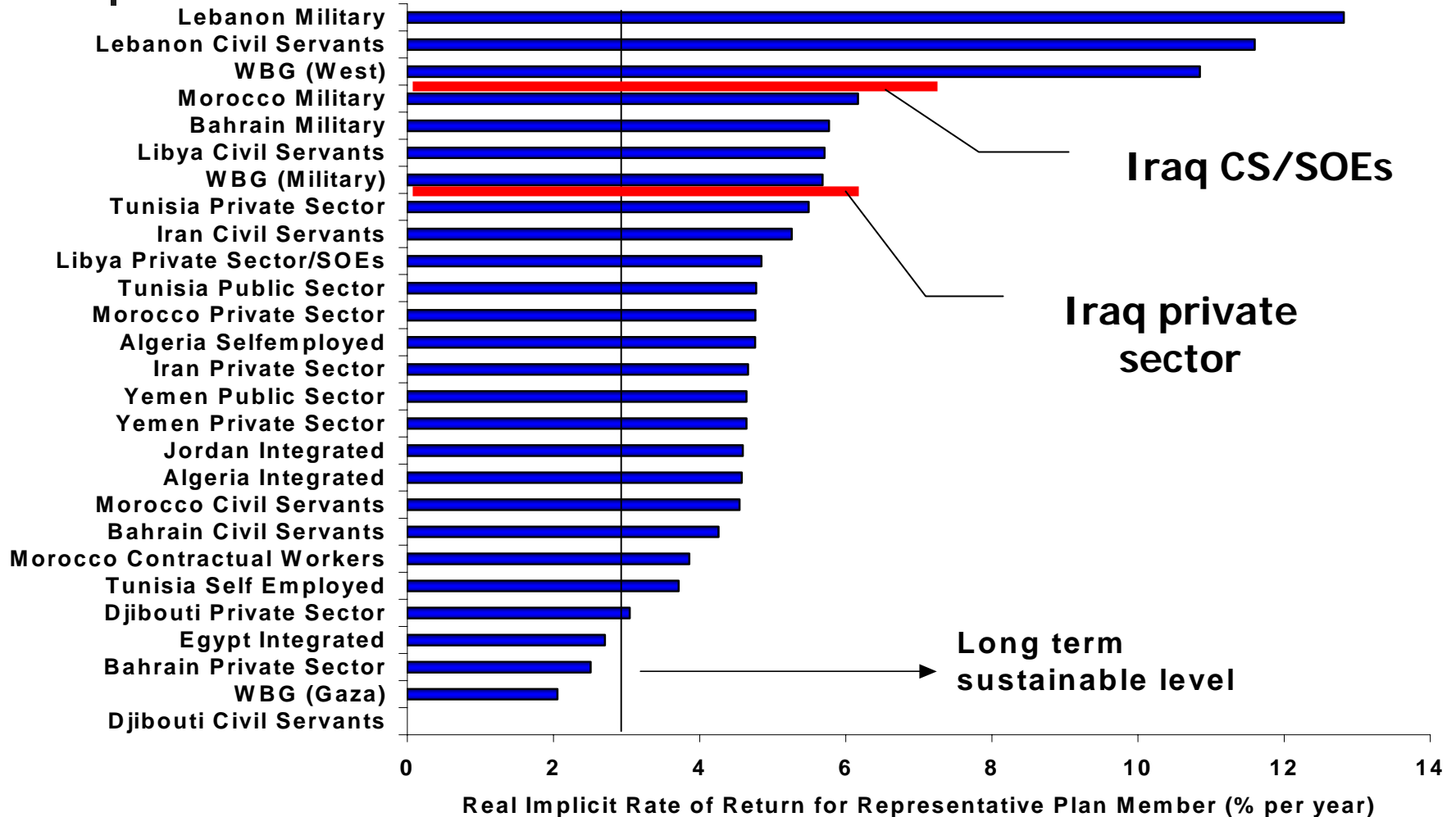




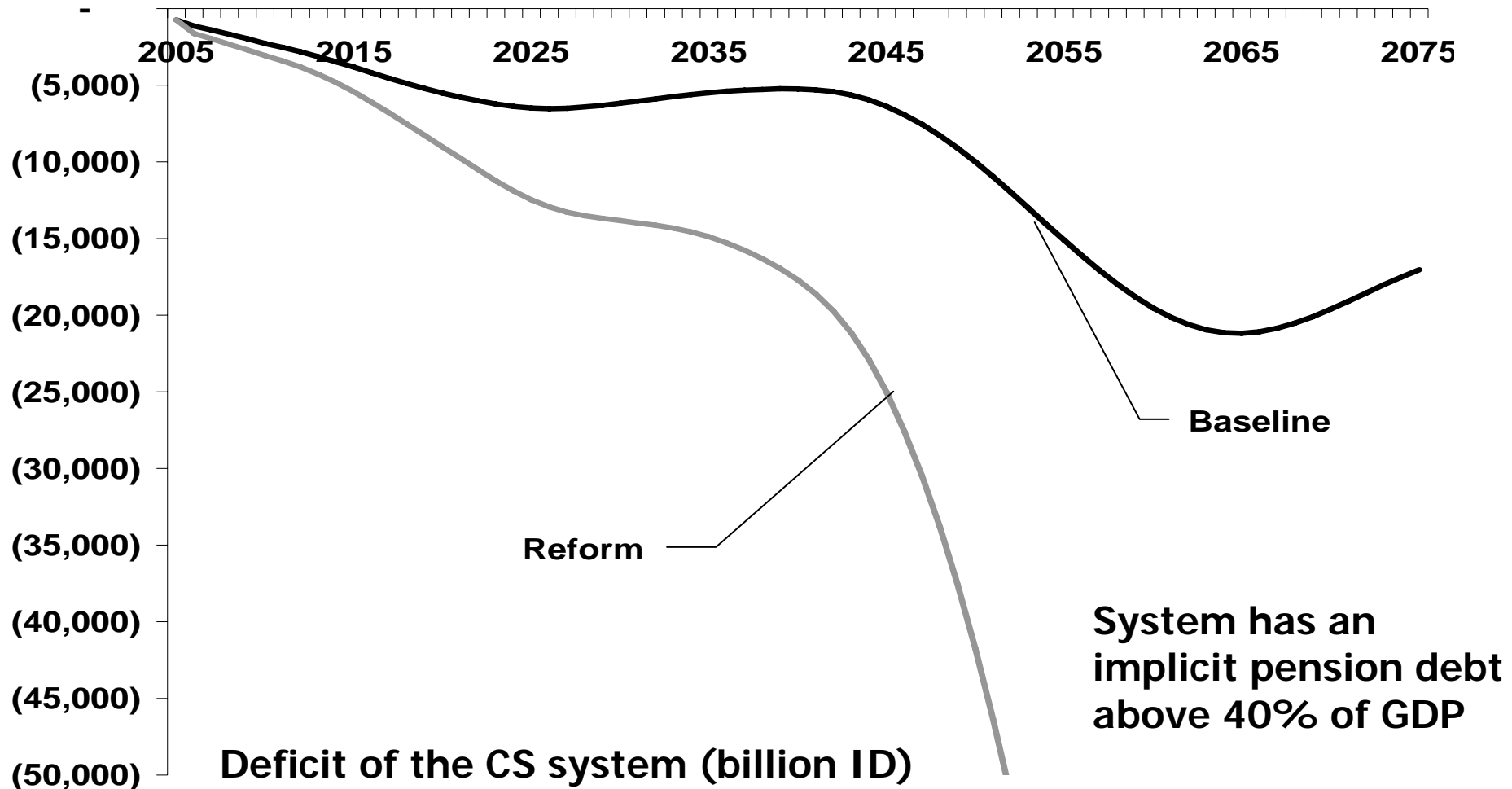
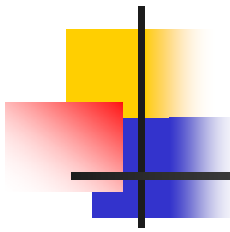
Old formulas do not respect basic norms in terms of design and make the system financially unsustainable

- A pay-as-you-go system can be financially self-sustainable, despite population aging.
- Condition: to pay a rate of return on contributions that is more or less equal to the growth rate of the wages ~ 3% per year real.
- For this:
 - Replacement rate, retirement age, and contribution rate need to be appropriately set (policy makers can only choose two of the three).
 - All wages incorporated in the calculation of the pension.
 - Wages and pensions appropriately indexed (indexation should be automatic).

Iraqi system among the most generous in the region



So the system will require large subsidies... for a minority of the labor force (population)





There are other problems as well

- Dual system:
 - Mobility of the labor force.
 - Administration costs.
 - Unequal treatment of workers.
- Benefit formulas and eligibility conditions damage incentives and equity:
 - Incentives to manipulate wages / evade.
 - Non-transparent redistribution and possibly regressive (from low to high income individuals).
 - Large implicit debt that the system is accumulating implies a large and adverse intra-generational transfer of wealth.
- Problems with administration and management.



What to do?

- Proposal is not to rush with the implementation of ad-hoc adjustments...
- ...these adjustments should be part of an integrated multi-year program for pension reform – medium/long term view.
- For now, define objectives/design of the new pension system, one that would be operating 2 or 3 years from now...
- Carefully assess welfare, financial and fiscal implications of the reform.
- Carefully design the transition to the new system.



A first step: to agree on a set of general principles for the new pension system

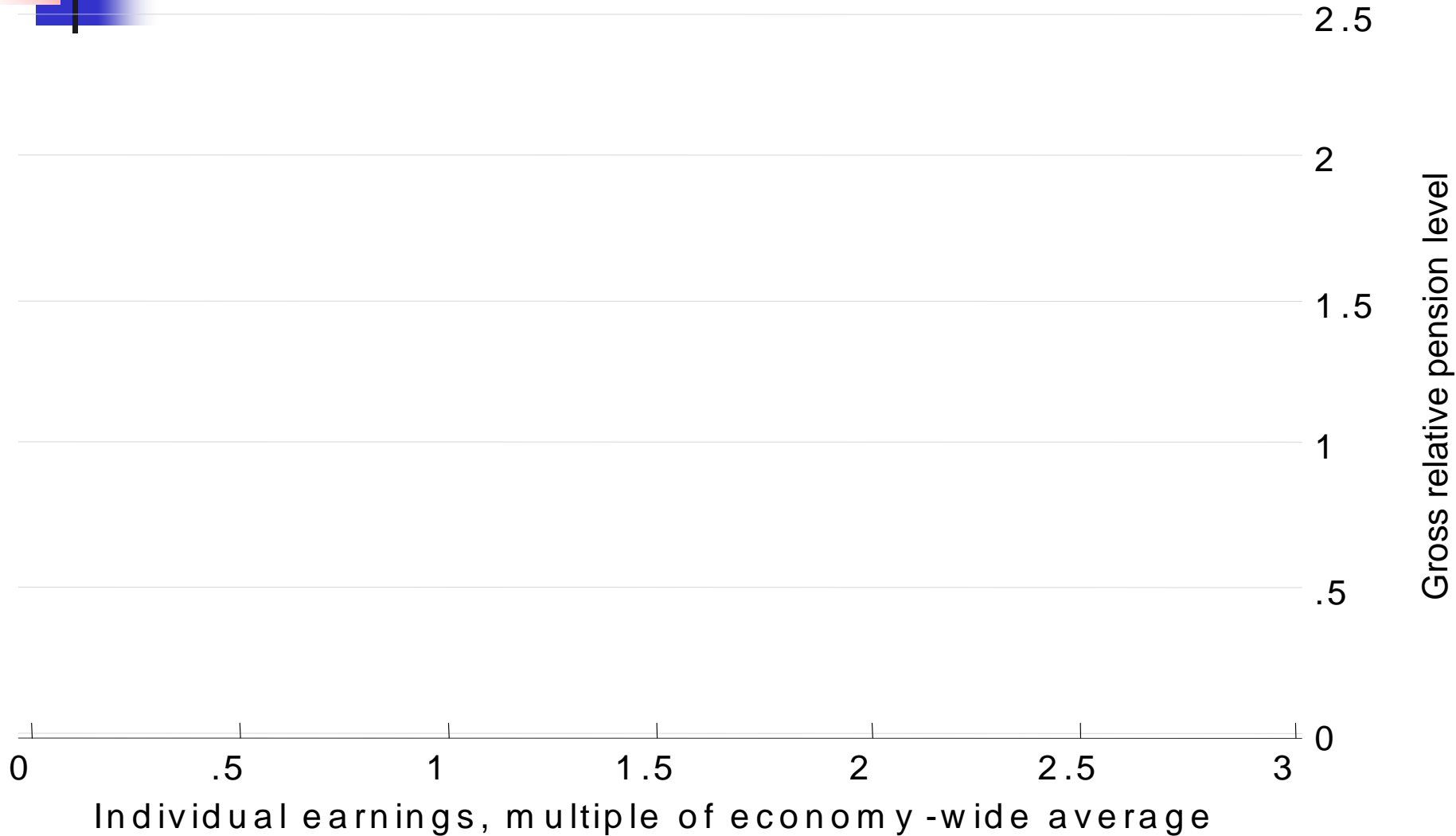
1. To provide adequate and secure benefits.
2. To respond to the demands of all population groups:
 - Implies expanding coverage, including to the lifetime poor.
3. To be financially self-sustainable over the long term.
 - Implies that general revenues should be used to finance the implicit pension debt of the current system.
4. To allow individuals to diversify sources of savings for retirement.
5. To minimize economic distortions: to support, not constraint employment creation and growth.
6. To be administratively efficient.
7. If redistribution takes place it should be transparent and progressive (from high to low income individuals).



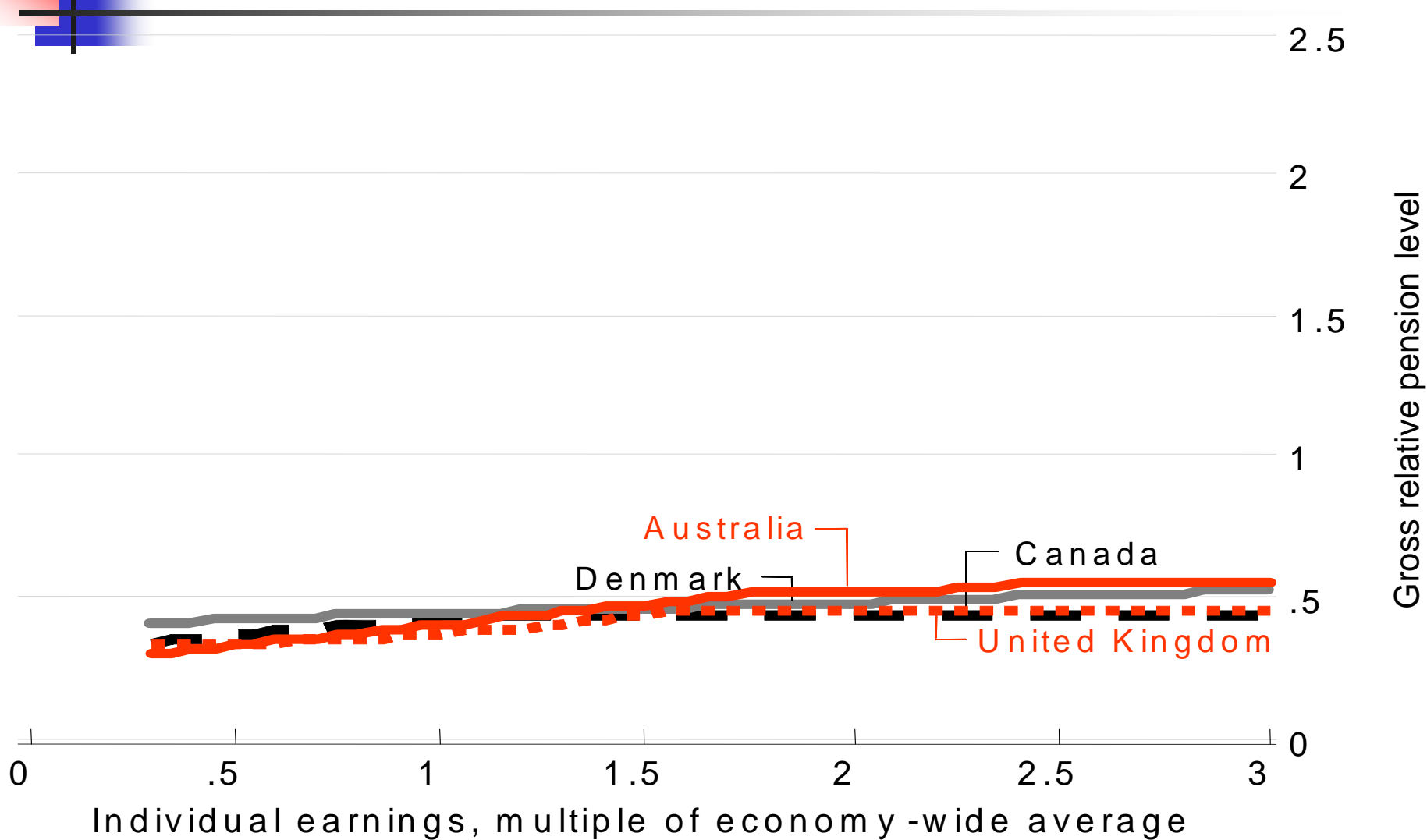
Policy discussions could then be separated in two components

- What should be the objectives/mandate of the pension system?
 - Provide a basic pension for all?
 - Provide a pension that replaces part of pre-retirement earnings, and if yes, how much?
- How to design de new system:
 - **Calculation of benefits:** function of earnings; function of savings; flat; combinations.
 - **Financing:** pay-as-you-go; funded; general revenues; combinations.
 - **Management and administration:** one or more systems; public/private; centralized/decentralized...

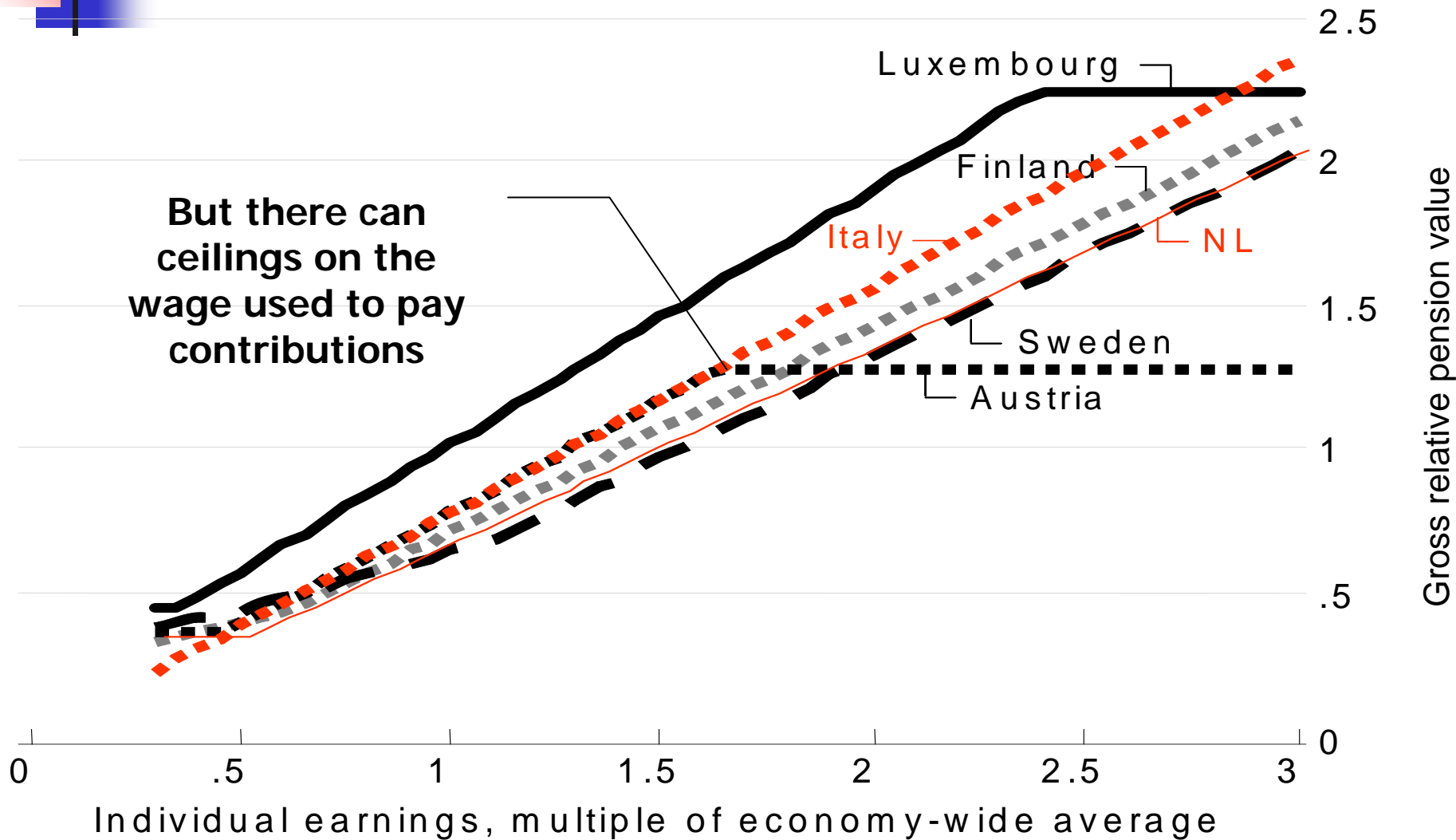
Objectives/mandate of the pension system varies considerably across countries

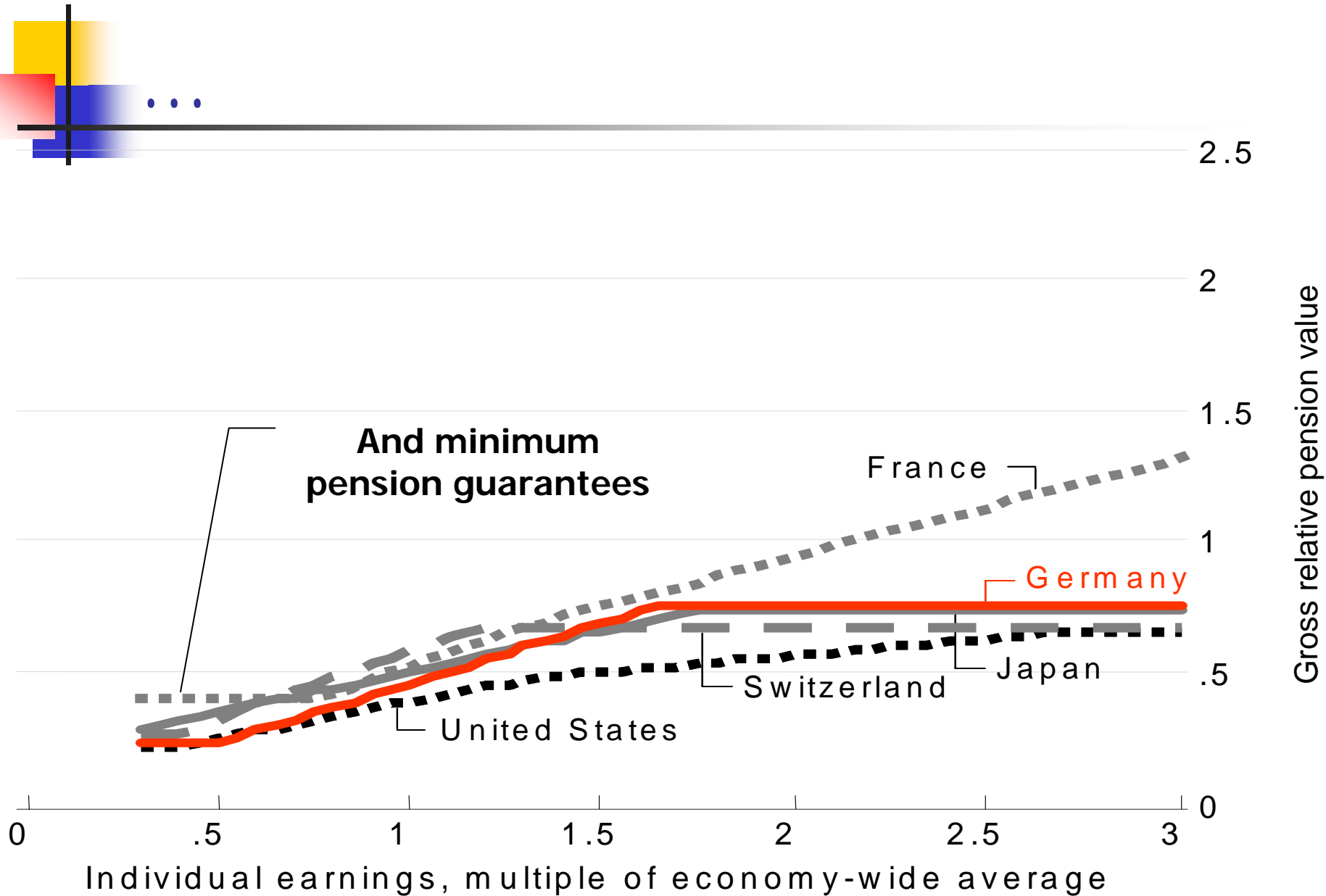
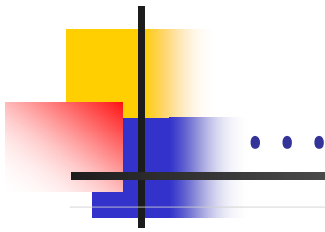


...some countries concentrate on the provision of a basic pension

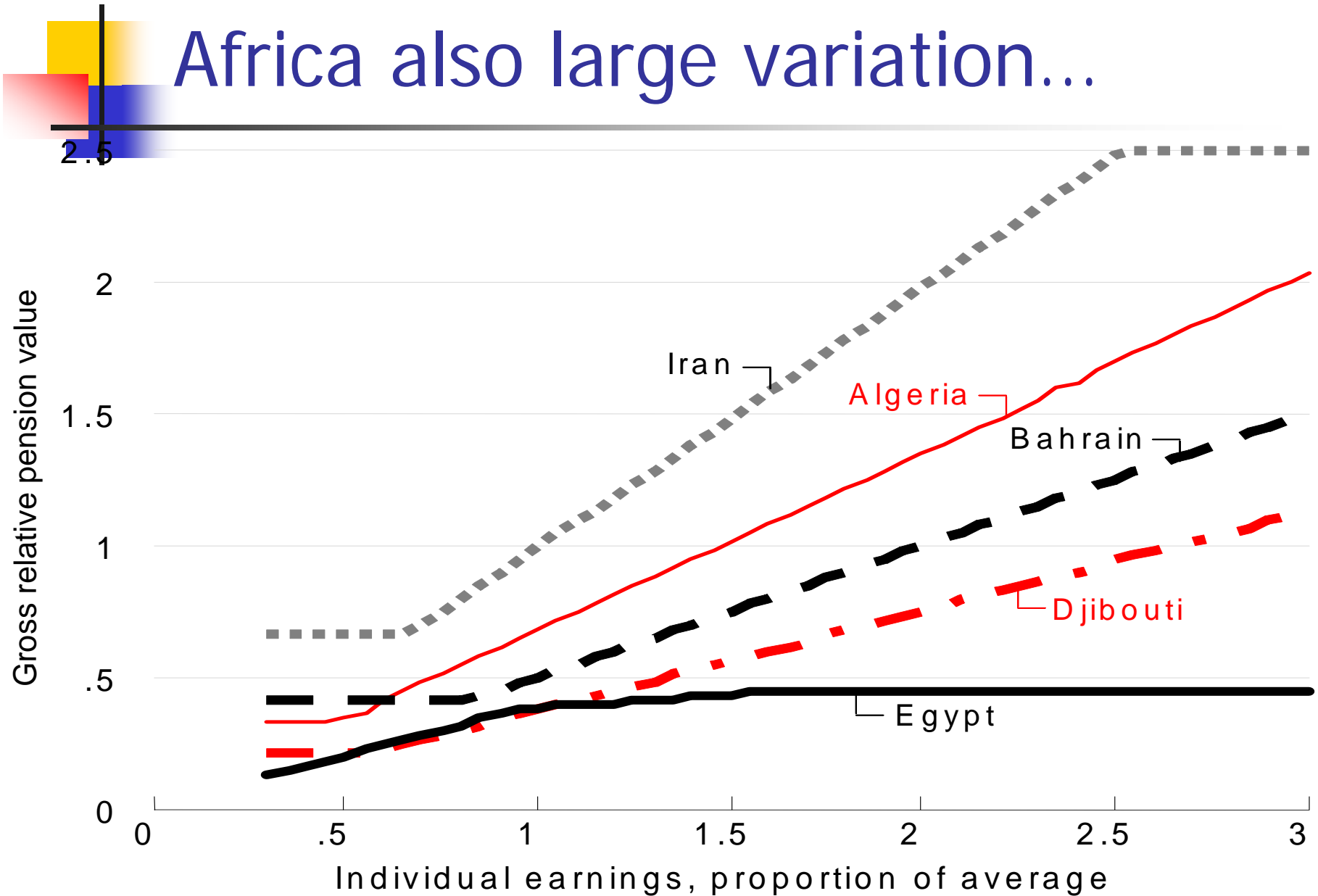


... others provide pensions which are functions of pre-retirement earnings

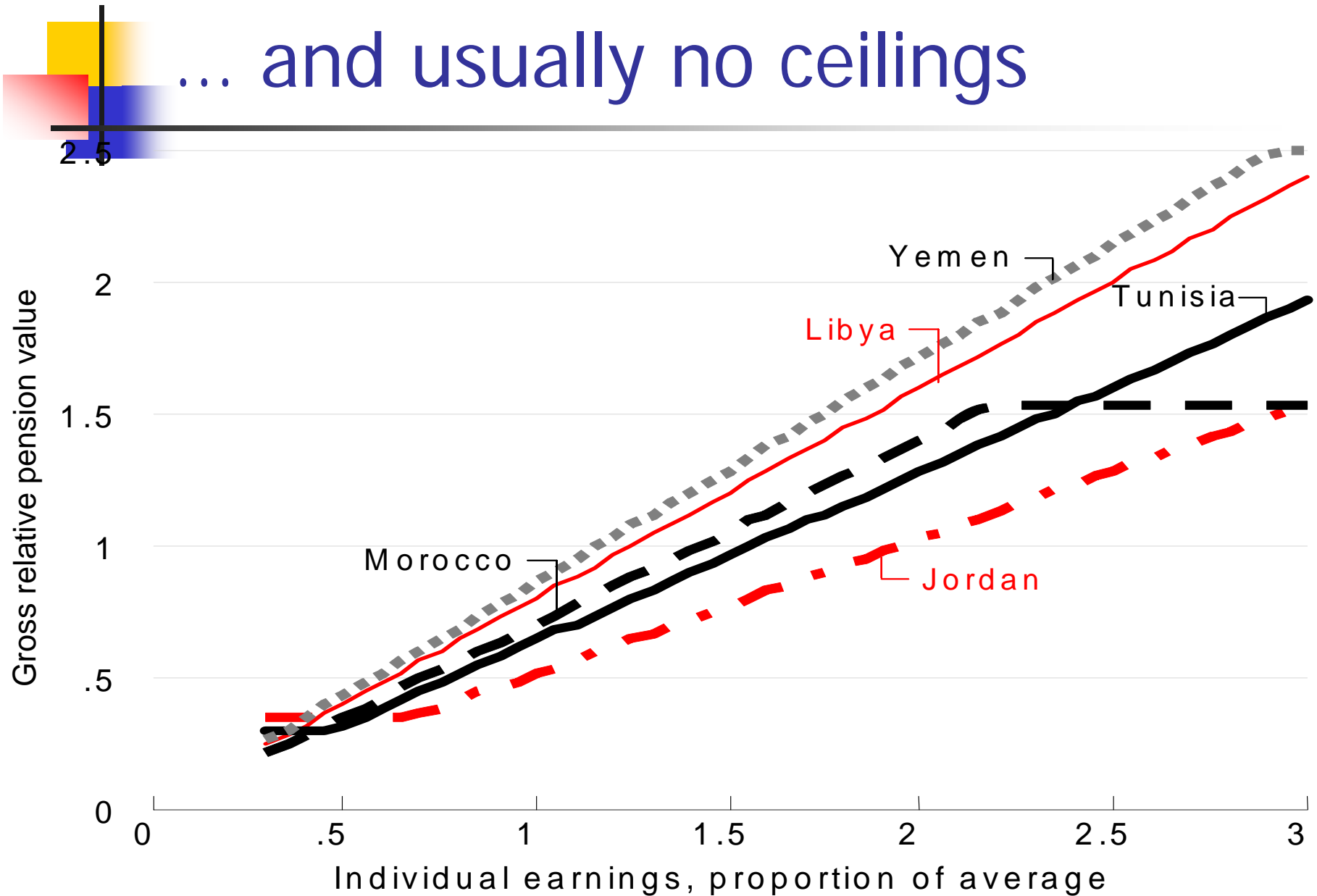




In the Middle East and North Africa also large variation...



... and usually no ceilings





Three important parameters need to be chosen

- The **replacement rate** for the average full-career worker (40 years):
 - At the international level varies between 40% and 100% of pre-retirement income.
- The **minimum pension**:
 - At the international level varies between 15% and 30% of economy wide average earnings.
- The **ceiling on taxable earnings**:
 - Varies between 2 and 3 times economy wide average earnings.



These are social choices but which have financial and economic implications

- Choices depend on:
 - Expectations about changes in consumption patterns during old age.
 - Perceptions regarding the responsibility of the individual and the responsibility of the government in securing income during old-age.
 - The existence of informal social protection mechanisms (e.g., role of the family).
 - Estimates of level of income necessary to satisfy basic needs (poverty line).
- But choices have effects on:
 - Contribution rates / subsidies to finance the system.
 - Retirement ages.

And there are limits to human life and the level of taxation that an economy can support (1)

Equilibrium replacement rates for different combinations of retirement age and contribution rate

With 35 years of service (case of pay-as-you-go system)

Retirement Age	Contribution rate		
	10.00%	15.00%	20.00%
50	21%	32%	42%
55	23%	35%	47%
60	26%	40%	53%
65	31%	46%	62%

There are limits to human life and the level of taxation that an economy can support (2)

Equilibrium replacement rates for different combinations of retirement age and contribution rate

With 40 years of service (case of pay-as-you-go system)

Retirement Age	Contribution rate		
	10.00%	15.00%	20.00%
50	28%	42%	56%
55	31%	47%	62%
60	35%	53%	70%
65	41%	62%	82%



Where do we go from here?

- Setup a High Level Steering Committee for Pension Reform with representatives from government and civil society.
 - Define general principles for the new system.
 - Assess alternative options in terms of design.
 - Inform the public about the problems and the need for reform.
 - Draft new Law.
- Setup of a technical unit to advise the SC.
- Creation of basic infrastructure to prepare/design reform:
 - Office space / communications / basic IT in pension funds.
 - Update records.
 - Provide training.



A general strategy to consider

- Target having a new, integrated, system operational in 2 to 3 years
 - Possibly an earnings related, pay-as-you-go system but that meets basic standards in terms of design.
 - Could include a non-contributory, universal basic pension.
- Current schemes would be closed to new entrants and current contributors would move to the new system.
- Pension rights accrued to date by all plan members would be respected and the associated liability made explicit and financed by the government.
- Individuals retiring before the new system is in place would continue to be covered by current “provisional” arrangements.

