The Pillars of Old Age Security: What are the implementation issues?

by

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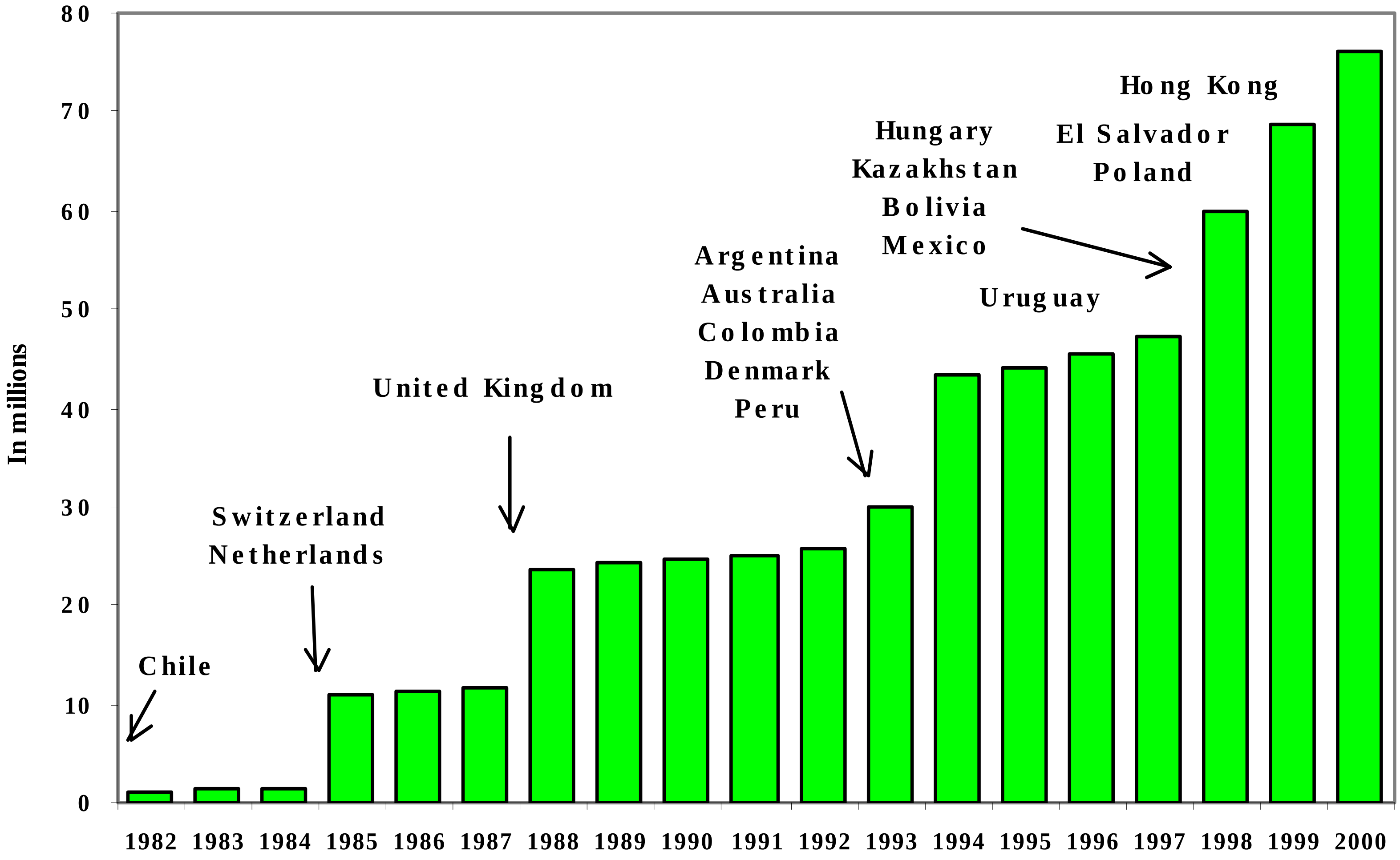
Three functions of old age security systems

- Mandate saving for old age
- Redistribute according to social objectives
- Insure against age-related risks (disability, survivors, longevity)
- Traditionally, these 3 functions were bundled together in mandatory pay-as-you-go defined benefit (PAYG DB) system
- But these often led to
  - high payroll taxes
  - evasion and early retirement from labor force,
  - perverse intra- and inter-generational redistributions
  - non-sustainability as populations aged

Many countries now separate these functions, to provide better incentives and redistributions

- Chile was pioneer, but 30 other countries now
- Pillar 1 or 0 handles redistribution—smaller defined benefit (DB), publicly managed, pay-as-you-go or general government revenues
- New pillar 2 handles mandatory saving—defined contribution (DC), funded, privately managed
- Pillar 3 for voluntary saving
- Insurance—combinations of all 3 pillars



In millions
80
70
60
50
40
30
20
10
0
Chile
Switzerland
Netherlands
United Kingdom
Argentina
Australia
Colombia
Denmark
Peru
Hungary
Kazakhstan
Bolivia
Mexico
Uruguay
El Salvador
Poland
Hong Kong
1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000

All these countries have pillar 2--mandatory saving for old age

- Usually defined contribution--close link between benefits and contributions for incentives, equity
- Funded--to avoid intergenerational transfers, rising payroll tax rate as populations age
- Privately managed--to get highest return, best capital allocation, avoid political manipulation
- Pillar 2 contribution rate is 2.5-13%, provides 30-90% of total benefits. US is considering 2-4%
- I am big proponent of these systems but this talk discusses implementation problems—in Chile and rest of world. Important to make them better.

Pillar 2 has been organized in 3 different ways:

- Retail market—open entry subject to regulations and direct relationship between fund managers and workers (Latin America, E. and C. Europe)
- Employer-sponsored plans (Australia, Netherlands, Switzerland, Denmark). History of collective bargained plans, became mandatory in late 1980's & 1990's. Initially DB but now shifting to DC: less risk for employer, more choice for worker
- Institutional market with centralized records and competitive bidding for fund management (Bolivia, Kosovo, Panama, US Thrift Saving Plan)
- Big implications for administrative costs

Have the reforms worked?

- Vast majority of workers switched to new system
- Pillar 2 is fiscally sustainable—liabilities not greater than assets (but high transition debt)
- High return in early years, will probably fall in long run—but even modest contribution rate will support pensions despite population aging
- Low earning contributors protected
- In Chile much research that it helped develop financial markets and raise national saving
- Preliminary evidence that labor supply of older workers, increased, especially for pensioners
- Therefore increased size of GDP pie, which is best way to increase old age security

But important implementation issues remain:

1. High administrative costs at start of Pillar 2
2. Potential financial market risk in future
3. Payout stage needs further development and coordination with safety net
4. Doesn’t solve problem of uncovered workers
   – This depends on stage of economic development, form chosen for public pillar and fiscal priorities
5. Disability and survivors insurance—little studied but cost are rising and will continue to rise
6. High transition costs (probably in some cases too much debt finance, too little saving)

Problem 1: Administrative costs and fees—very controversial

- Importance: If fee is 20% of contributions or 1% of assets per year, reduces final pension 20%
- Some facts: collection, record-keeping and communications costs are biggest unavoidable expense. Fixed $ cost per account regardless of account size but falls as # accounts grows
- Scale economies for asset management, leads toward oligopoly
- High start-up costs
- High marketing costs in retail systems
- Therefore costs and fees fall as % of assets as average account size and system assets grow

Are special measures needed to keep costs low in mandatory system?

- Price competition? Doesn’t work well in financial markets, due to differentiated products, volatility, investor inexperience, inertia
- Blind allocations to cut commissions (Sweden)
- Price controls? (Sweden)—potential problems: may get wrong price, wrong quantity or quality
- Most important method is method of picking managers for Pillar 2 (retail, employer groups, institutional market)

Pillar 2 organization and costs

1. Costs and fees in retail market
   - most common, highest cost method
   - in Chile over 10% of assets per year initially, will be 0.7% per year over lifetime of full career worker
   - higher in most other countries with newer systems
   - average US mutual fund (401k's) charges 1.4%
   - half of cost in retail fund markets is for marketing
2. Employer-sponsored plans
   - large employer plans are cheaper (0.3-0.5%) but as they shift to DC with choice, admin costs will rise
3. Institutional market
   - Aggregate small accounts, use competitive bidding for large blocs, centralized record-keeping, lower marketing costs, greater bargaining power
   - Lower fees but less choice and political insulation
   - US proposal would use this system, emphasize passive investment, costs 0.3% of assets or less

Competitive bidding can lower costs but poses other problems

- Greater danger of political manipulation
- Possible corruption, collusion, regulatory capture
- Choice restricted--may choose wrong #, types
- Credible rebidding strategy needed or first entrants have long run monopoly advantage
- Performance incentives hard to specify
- Less flexibility, slow to adapt to new conditions, difficult to handle unforeseen contingencies
- Less marketing means fewer workers may join
- But if done well admin. cost is low—so trade-off

Problem 2: Financial market risk

- Not big problem in past but may increase in future
  - In Latin American and Eastern/Central Europe few financial instruments initially and they were fixed income (bank deposits, bonds). But financial markets are developing, greater equity investments allowed, so greater choice, expected returns, volatility, disparities
  - In other countries more risk for workers as employer plans shift from defined benefit to defined contribution
  - Big concern in US discussion—volatility vs. good historical experience for investments over 20 years
  - Political sustainability a problem if bad initial outcomes

How to contain worker risk

- Diversification across instruments, sectors, countries (need more international diversification)
- Give workers choice among limited # portfolios with clear risk-return trade-offs (Chile vs Sweden)
- Rule out very risky portfolios
- Careful choice of default; life cycle defaults?
- Use of derivatives—hedging or speculation?
- Public guarantees (contingent liability, moral hazard)
- Private guarantees--set floor with some upside gain (Bodie, Feldstein)--credibility, regulations
- Minimum pensions (MPG, flat or means-tested) and mixed public-private system cushion risk
- Further work needed as investment choice grows

Problem 3: Payout stage

- Neglected at start of new system, but many issues
- Are annuities required?
  - Choice between annuities & PW in Chile; 2/3 annuitize, especially those with large accounts. Annuitants with large accounts & pensions have > longevity
  - US would require annuitization up to poverty level
- What risk differentiation should be permitted for annuities (gender, race, income, health)?
  - Gender-specific tables permitted in Chile
  - US wouldn't allow diff. by gender, race, DNA--cross-subsidization and selection in competitive market?
- Should price-indexation of pensions be required?
  - Required in Chile until now
  - Indexation costly in other countries because difficult for insurance companies to hedge inflation risk.
  - But money's worth ratio in Chile => 100%--many indexed financial instruments

Payout issues (Cont'd)

- What schedule for gradual payouts (PW)?
  - can be level, rising or falling; too front loaded in Chile?
- At what age or size can pension start?
  - conditions for early retirement too easy in Chile until 2004 (110%MPG, 50% own-wage), 60% retired early
- How to coordinate safety net with payout rules?
  - in Chile MPG has gone up with wages while annuities are level and PW falls over retirement period, so as workers age their private pensions will be less than MPG, especially early retirees—future fiscal burden? should private time stream be changed?
- How to encourage continued work by pensioners
  - Evidence that exemption of pensioners from payroll tax has increased their labor supply (Edwards&James)

Problem 4: Redistribution Every country with Pillar 2 has minimum pension for contributors

- Minimum pension guarantee (MPG--Latin Am.)
  - – for contributors only
  - – cheap, easy to administer
  - – but may discourage incremental work & annuitization
- Flat (uniform) benefit (Netherlands, UK)
  - can cover everyone or just contributors, but expensive
  - least distortionary, low transactions cost
- Means-tested benefits (Australia, UK)
  - – can apply to everyone
  - – low benefit cost, high transactions and bribery costs
  - – bad incentives--discourages voluntary saving, work
- Earnings-related with floor (Switzerland, Eastern Europe)

Should redistributive pillar be for contributors or for everyone?

- Big issue in low and middle income countries, since contribution coverage rate depends on stage of development. In poor countries, many workers are informal, aren't affiliates or have low density of contributions
- Affiliation & density lowest among poor, women
- So should public benefits cover everyone based on residence and age, not contributory status?
- But old aren't poorest, family system still works in rural areas, and scarce public resources needed for other public services such as health and education

Two ways to cover formal and informal sector with public benefit

- Same base protection for everyone: Small flat benefit for all (Kosovo, Nepal, Mauritius, Curacao)
  - Higher benefit costs, lower transactions costs
- Or two-tiered public benefit: small means-tested benefit for non-contributors + higher MPG for contributors (Chile--MPG+PASIS)
  - Lower benefit costs, higher transactions costs, administrative capacity needed, distorts behavior
  - Shouldn't have same means test for contributors & non-contributors—will discourage contributions
- General revenue finance, especially for non-contributors
- Long term cost simulations needed (in Chile)

5. Insurance—public or private?

- Mix of public & private pillars diversifies, insures
- Survivors & disability insurance—through public (Switzerland, Netherlands) or private pillar (Chile)
  - pitfalls in public pillar--cost escalation, moral hazard
  - potential pitfalls in private system in Chile
    - interest rate sensitivity if DB is specified--cost of D&S has risen 70% since 1997, now >50% total fee
    - Cross-subsidization & selection due to uniform price in competitive market
  - US proposal has no new plan for D&S benefits
- Longevity and investment (& inflation?) insurance

Problem 6:Transition costs

- How to cover remaining obligations in old system if part of payroll tax is diverted?
- Cut government spending, raise taxes, debt
  - Chile accumulated surplus ex ante
  - Many countries downsized DB promises
  - Important to avoid pure debt finance or won’t increase national saving or reduce cost to future cohorts
  - Some countries have probably over-relied on debt but difficult to know for sure because of fungibility of money and we don’t know counterfactual
- Fiscal burden is still around 3% of GDP in Chile, still partly covered by budget surplus
- US proposal starts with deficit and has no plan for transition finance

New systems are off to good start but need to be improved and research can help

- Worker behavior—which characteristics shape response to fees, portfolio & annuitization choice, age of pensioning, retirement from labor market?
- Which policies will reduce costs and risk, raise saving and labor supply?
- Does MPG lead to moral hazard re years of contributions, portfolio choice, retirement age, annuitization? Fiscal burden and MPG design?
- What should be done about workers with low contribution histories and in informal sector?