



The Strategy for Pension Reform

Pension reform is a focus of World Bank activities because pensions are an important part of the social safety net for workers covered by the formal pension system in many client countries. Pensions provide a mechanism to reduce the risks of old-age poverty and a means to smooth lifetime income to maintain living standards in retirement.

Pensions are only one part of the safety net to protect the aged, which may include other public programs, such as targeted benefits for the aged poor or universal benefits for all the aged, and a host of informal arrangements, including direct family support. Pension systems must be fiscally and politically sustainable to achieve their income-support objective. Unsustainable pension systems can be an obstacle to fiscal stability, economic growth, and poverty reduction.

The need for pension reform has become pressing as demographic aging has strained pension systems around the world, leading to large expenditures, large deficits, and high contribution rates. Even countries with relatively young populations have experienced these problems because of high benefits and lax eligibility requirements. In addition, poor administrative capacity and practices have resulted in ineffective collection, entitlement, and benefit determination. In many cases the pension system has become a source of fiscal and macroeconomic instability, a constraint to economic growth, and an ineffective and/or inequitable source of re-

tirement income. Even civil service pensions in countries with no other pension system may become a fiscal drain on government resources.

The World Bank has been a leader in assisting countries in pension reform. Since 1984 the Bank has helped 68 countries reform their pension systems with more than 200 loans and credits. In addition, the Bank has issued over 350 papers and publications on pension reform. This report is the first comprehensive evaluation of the Bank's involvement, assessing the relevance of the Bank's strategy and the resulting development outcomes.

During the 1990s the Bank was criticized for following a dogmatic approach, providing little support for the improvement of public systems and aggressively promoting the privatization of social security, regardless of the country's characteristics and initial conditions. Critics claimed that the Bank oversold the benefits of multi-pillar systems, particularly the benefits of a new second pillar, while simultaneously underestimating the advantages of publicly managed programs. Supporters of the Bank's approach stress

Box 1.1: Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth

Strategy praised *Averting the Old Age Crisis* for being the first comprehensive diagnosis of pension programs and for recommending greater reliance on private-sector investment management to address the challenge of (1) demographic trends that undermine fiscal sustainability and (2) government policies that are subject to political pressure. *Averting* argued that the best way for most countries to meet the challenges of an aging world is through a multi-pillar system with:

- A mandatory tax-financed public program designed to alleviate poverty
- A mandatory funded, privately managed program (based on personal savings accounts or occupational plans) for savings
- A supplementary voluntary option (through personal saving or occupational plans) for people who want more protection.

Averting proposed four alternatives for the first two pillars:

- A mandatory personal saving plan with a flat benefit public scheme

- A mandatory personal saving plan with a minimum pension guarantee in the public scheme
- A mandatory occupational plan with a flat benefit public scheme
- A mandatory occupational plan with a means-tested public scheme.

Averting discourages the use of an earnings-related scheme for the public pillar, but if one is provided, “*the wage replacement rate should be based on lifetime earnings...* [italics in original].” *Averting* notes that the “right mix” of pillars is not the same at all times and places, but depends on a country’s objectives, history, and current circumstances.

Averting suggests adopting a slow reform process for formal systems in low-income countries, and that public programs in the rural areas of poor countries “should concentrate on social assistance for the neediest of all ages, while every effort is made to develop the capacities that will enable more complex formal systems to work well. Mandatory contribution programs should be introduced first in the formal labor markets of urban areas, where the informal system is most likely to have broken down.”

The Bank has been criticized for aggressively promoting the privatization of social security.

the balance of assistance which covered both single- and multi-pillar reforms and suggest that pension reform failures have been primarily the result of inadequate government policy.

The 2001 publication *Social Protection Sector Strategy: From Safety Net to Springboard* (hereafter *Strategy*) details the Bank’s official strategy on pension reform, supporting a multi-pillar framework as best practice if proper initial conditions are in place. *Strategy* followed the Bank’s 1994 policy research report *Averting the Old Age Crisis* (hereafter *Averting*), which set an agenda for pension reform and provided the intellectual underpinnings to much of the Bank’s activities in the 1990s. *Averting* proposed a similar, but more detailed strategy; it has been influential worldwide as a blueprint for pension reform and is widely perceived as representing the Bank’s thinking, especially throughout the

1990s. Nevertheless, *Averting* was never presented or agreed upon as a sector strategy with the Bank’s Board¹ (see box 1.1).

The Social Protection Sector Strategy

Strategy outlines a social risk management framework spelling out how public safety net programs can cope with, mitigate, or prevent the risks that increase a population’s vulnerability to poverty.² This document is the basis for the Independent Evaluation Group (IEG) pension evaluation, as it provides the official strategy for Bank operations. It supports flexible multi-pillar pension reform while ensuring adequate retirement income for informal sector workers and the lifetime poor.

Strategy offers a clear description of the purpose and function of pension systems, indicating that the improvement of old-age income security in the formal sector begins with “a flexible approach . . . focusing on a ‘multi-pillar’ system that many countries throughout the world are

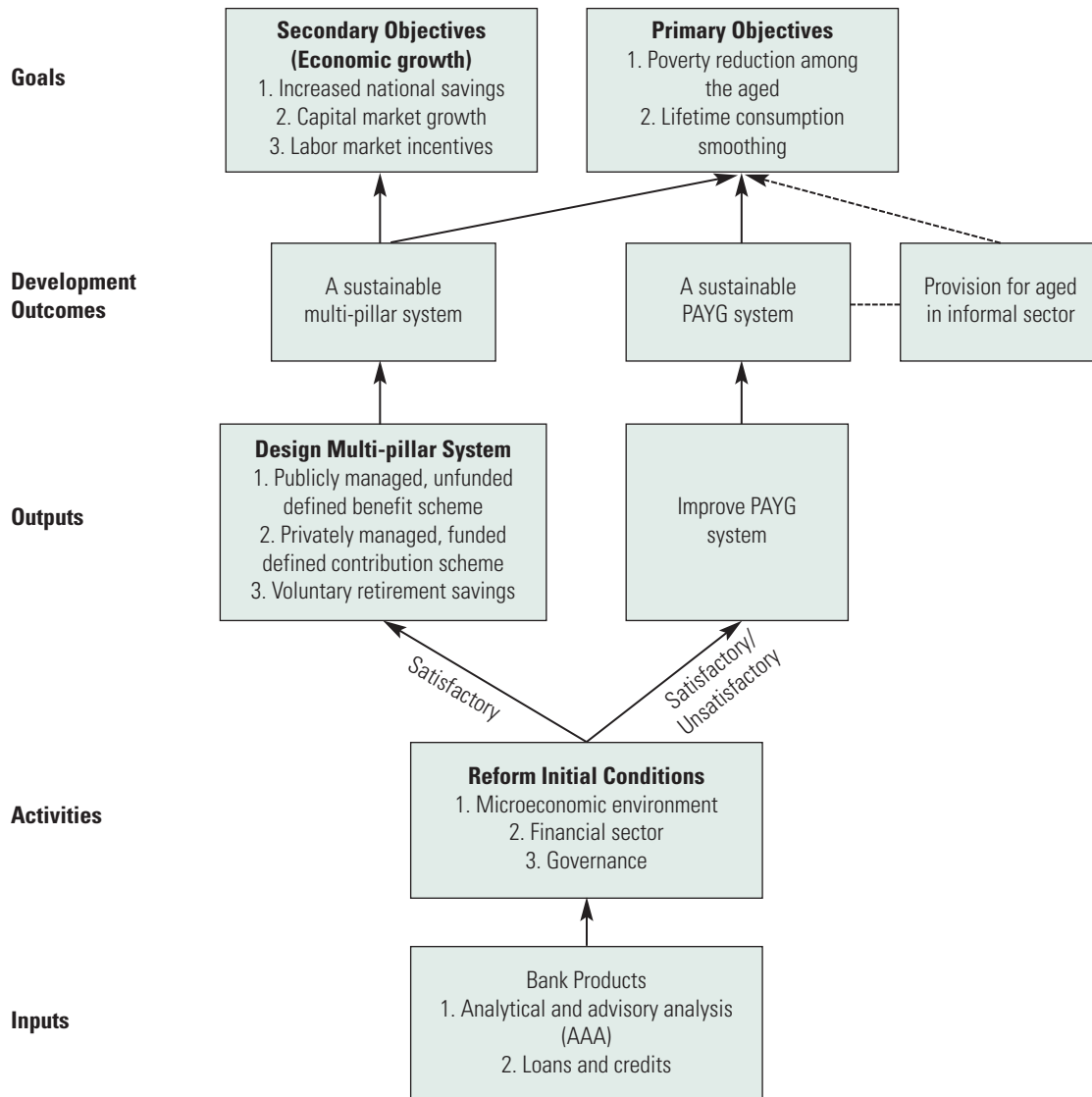
successfully implementing.” Further, while “maintaining this approach, the main challenges are to ensure adequate retirement income for informal sector workers and lifetime poor people, as well as for particularly vulnerable groups such as widows, by strengthening their access to earnings, savings, and other assets.” This is outlined more succinctly in figure 1.1, which is the framework used for this evaluation.

As explained in *Strategy*, a multi-pillar system consists of three types of income support: (1) a

publicly managed, unfunded, defined benefit (DB) program; (2) a privately managed, fully funded, defined contribution (DC) plan; and (3) voluntary retirement savings in the form of housing, insurance, or other assets. The first pillar addresses poverty alleviation and the second provides consumption smoothing. In contrast to a single public program, two pillars are expected to safeguard against the costs of an aging pop-

Bank strategy supports a flexible, multi-pillar framework.

Figure 1.1: What Is the World Bank’s Pension Strategy?



ulation, protect the system from political risk, and facilitate individual decision making in the process. In addition, multi-pillar systems are expected to contribute to national savings and financial-market development.

Bank strategy suggests using the multi-pillar approach as a benchmark, not a blueprint.

Strategy indicates that while the proposed multi-pillar approach to pensions “continues to be a useful benchmark, *it is not a blueprint* [italics added], and any reform has to take account of a country’s starting conditions and preferences.” *Strategy* promises that the “World Bank’s future work on pension reform will focus more on the provision of retirement benefits for people in the informal sector and on old-age income support for the life-time poor through public non-contributory schemes and community support.”

Strategy specifies that certain conditions must be fulfilled for the Bank to support a multi-pillar reform, including objectives for income redistribution, macroeconomic feasibility, financial sector readiness, a sound regulatory and supervisory framework, and sufficient administrative capacity. Criteria to judge the soundness of a pension reform include (1) distributive effects on the income of the aged, (2) the macro and fiscal policy environment, (3) the capacity of the administrative structure to operate a multi-pillar system, and (4) the soundness of regulatory and supervisory arrangements.

Because *Averting* was not a formal Bank strategy, Bank staff had considerable leeway throughout the 1990s in developing country-based solutions. While *Strategy* does not indicate which

Specific social, macroeconomic, and financial conditions must be met before implementing multi-pillar reform.

financial sector preconditions are required for a successful multi-pillar reform, related World Bank analysis (Vittas 1998) is more specific.³ *Strategy* also does not provide the criteria against which to evaluate multi-pillar reform success, including improvements in retirement income security, gains in fiscal stability, and increases in savings and capital market development.

The relevance of the Bank’s strategy

The Bank’s strategy for pension reform is highly relevant, as formal pension systems are an important means to reduce poverty among the aged and ensure lifetime consumption smoothing in many World Bank client countries. When pension expenditures exceed revenues, the difference will increase the consolidated government deficit, all else remaining unchanged, threatening macroeconomic stability and undermining retirement income security.⁴ For those outside the formal pension system, the Bank’s strategy recommends designing policy to either increase coverage or to offer noncontributory schemes to allow better risk management for uncovered workers.

Formal public pension programs are more important in some Regions than in others. For this reason, the recognition of the need to reduce poverty among the nonpensioned aged is an important component of the Bank’s strategy. For example, pension coverage is greatest in the Europe and Central Asia Region, at an estimated 60 percent of the working-age population, compared with Latin America and the Caribbean and the Middle East and North Africa, where it is closer to 30 percent; East Asia and the Pacific, where it is a little over 15 percent; and Sub-Saharan Africa and South Asia, where it is less than 10 percent.⁵

Countries that have an increasingly high percentage of their populations reaching retirement age may face severe future fiscal imbalances. These countries are also more likely to have high pension coverage rates, and as a result, the Bank’s strategy on pension reform will likely affect a large portion of the population. Countries in Europe and Central Asia are a prime example. Even countries with lower coverage and younger populations, including countries in Latin America and the Caribbean and other Regions, face fiscal issues similar to countries with serious demographic aging problems, particularly when employment in the covered sector is declining relative to an increasing number of retirees. In those countries, the relevance of the Bank’s strategy is also evident. In Regions such as Africa, pension reform has been less of a Bank priority.

Pension reform continues to be a topic of some contention among researchers both inside and out-

side the Bank from a theoretical and practical perspective (see Appendix A). Since 1994, World Bank thinking on pensions has continued to evolve as pension issues are debated, and experience on the topic has become more expansive. This is evidenced in the edited volume *New Ideas about Old Age Security* (World Bank 2001b), which contains an evaluation highly critical of *Averting*, and the 2005 report *Keeping the Promise of Old Age Security in Latin America* (hereafter *Promise*), an assessment of pension reform in Latin America and the Caribbean with recommendations for a Regional strategy. Pension policy also received attention in the 2004 report *Economic Growth in the 1990s: Learning from a Decade of Reform* (hereafter *Learning*). Most recently, in 2005 the Bank released a major research report devoted to pensions, *Old Age Income Support in the 21st Century: The World Bank's Perspective on Pension Systems and Reform* (hereafter *Perspective*).⁶ The topics, emphasis, and findings of these reports differ, indicating the nature of the debate within the Bank and reflecting a diversity of conclusions about the outcome of Bank-supported pension-reform activities over time.

The Structure of the Report

Subsequent chapters use statistical indicators, assessments from IEG reviews of Implementation Completion Reports (ICRs) and Project Performance Assessment Reports (PPARs), assessments from the Financial Sector Advisory Program (FSAP), interviews with Bank staff and external stake-

holders, desk reviews, and 16 case studies to evaluate the quality at entry and development outcome of the World Bank's pension strategy.⁷

Chapter 2 assesses whether the Bank followed its strategy by reviewing its lending operations and non-lending activities, including economic and sector work (ESW), policy dialogue, and training and dissemination. The chapter also examines the outcome ratings for projects with pension components. Chapter 3 assesses whether Bank lending decisions were based on best practice guidelines. Chapter 4 analyzes whether Bank-assisted reforms have achieved their primary objective of providing a fiscally sustainable pension system and their secondary objectives of increasing savings and developing capital markets. Chapter 5 examines the Bank's assistance in building capacity for administration, regulation, supervision, and actuarial analyses. Chapter 6 evaluates the Bank's internal and external coordination, as well as the influence of exogenous factors on project outcomes. Chapter 7 summarizes the findings and presents specific recommendations for the future, including the establishment of formal guidelines to create an objective and coordinated method to evaluate Bank strategies for pension reform.

Bank strategy on pension reform is relevant to poverty reduction among the aged.

The report evaluates Bank strategy, whether it was followed, and how well Bank operations were implemented.