



# Quality at Entry for Pension Reforms

The Bank's strategy for pension reform is to support a multi-pillar framework as best practice if proper initial conditions are in place. These include (1) sound macroeconomic policies, (2) an adequate financial sector, and (3) implementation capacity. If these conditions are not met, the Bank's strategy is to improve the system through other means to create fiscal stability and protection of the aged.

Parametric reforms are recommended to complement multi-pillar reforms to improve the existing system or to precede the implementation of a multi-pillar system by helping to create the proper conditions. At the time of project design, the need for pension reform must be balanced against and/or coordinated with related social policies to protect uncovered workers from poverty in old age, as part of the Bank's overall objective to reduce poverty among the aged.

Chapter 3 uses a set of indicators to assess whether the Bank exercised due diligence in ensuring that necessary conditions were met before supporting multi-pillar reforms and whether first-pillar assistance was considered when countries did not implement multi-pillar systems. Whenever possible, these indicators are compared with the performance outcome evaluations of the Bank's assistance from the IEG case studies. The chapter also assesses whether the Bank's objective of improving the welfare of the aged was addressed

sufficiently and whether evidence substantiates the hypothesis that multi-pillar reform will increase the savings rate and enhance economic growth.<sup>1</sup>

While the Bank did not advise the provision of funded pensions in many countries with unsuitable initial conditions, the Bank acted too quickly to support multi-pillar reforms in other countries without examining options for complementary safety-net programs to protect informal sector workers from poverty in old age. The Bank also supported some reforms in which macroeconomic, financial sector, and institutional preconditions were not met. This put the reforms at risk from the start. While many, but not all, countries in Europe and Central Asia showed a readiness for reform, those in Latin America and the Caribbean were less likely to be appropriate candidates. The development outcome ratings of the Bank's activities in IEG case study countries in which preconditions were not met were often rated unsatisfactory.

### When Were Only Single Pillars Considered?

Very few countries in which the Bank supported stand-alone, single-pillar pension reform could have developed multi-pillar systems. In virtually all cases, these countries did not have satisfactory

*In nearly all countries in which the Bank supported stand-alone, single-pillar reform, the countries did not have satisfactory preconditions for multi-pillar reform.*

preconditions.<sup>2</sup> Such single-pillar support was appropriate and in concert with the Bank's strategy. While multi-pillar reforms were discussed in a number of these countries, including China, India, Korea, and Turkey, the Bank did not insist that these reforms be implemented before the economic prerequisites were in place and the political will to take such a step was firm.

Brazil was by far the largest recipient of Bank assistance for first-pillar reform in Latin America, at a time when its budget deficit was high and the inflation rate excessive. The Bank also provided first-pillar assistance to Panama, a country with a stable macroeconomic environment and a strong financial sector, but one in which pension coverage was low and the development of a multi-pillar pension system was not considered a priority.

The Bank also was cautious in its activities in many poorer and less-stable transition regimes, including most of Central Asia and the Caucasus. Both Turkmenistan and Uzbekistan had extremely weak banking systems, and Tajikistan had the

*The Bank did not always prioritize the need to expand safety nets to those outside the formal system nor fully analyze non-contributory options.*

lowest regional gross domestic product (GDP) per capita in terms of purchasing power parity. The financial sector in Belarus was also underdeveloped, and those in the Caucasus have been borderline, although regional improvements have been taking place rather quickly over the past couple of years. While conditions in Slovenia were appropriate for a multi-pillar reform, in the end, the authorities were not interested in pursuing this policy. This was also true of the Czech Republic, one of the more successful transition countries,

but one that had not sought much Bank assistance overall.

Fourteen African countries received at least small amounts of Bank assistance for first-pillar reform to restructure civil service pensions and provident funds. The largest was Zambia, followed by Senegal. These countries are characterized by high poverty rates, poor financial sectors, a high proportion of foreign aid, and, in some cases, considerable government debt and inflation. None would have been good candidates for multi-pillar reform, although the Bank discussed the option of multi-pillar reform with Cameroon, Cape Verde, Mauritius, Senegal, and Zambia.

### Were Complementary Safety Nets Considered?

While the Bank refrained from pursuing multi-pillar systems in many countries with inadequate preconditions, it also often failed to prioritize the need for developing options for old-age safety nets outside the formal pension system in low-income and low-coverage countries. Out of eight low-coverage Latin American countries<sup>3</sup> that enacted multi-pillar systems with World Bank support, only Bolivia created a comprehensive safety net, the Bonosol,<sup>4</sup> in conjunction with its multi-pillar reform. Both Argentina<sup>5</sup> and Brazil<sup>6</sup> had rural programs that provided pensions to the aged, but both had substantial weaknesses that the Bank failed to address in its operations.

Many reformers in Central and Eastern Europe, such as Latvia, have targeted safety nets for uncovered workers, and the Bank provided assistance in a number of cases. But the Bank did not analyze the effectiveness of noncontributory options in countries such as Albania, Bosnia and Herzegovina, and the Kyrgyz Republic, where coverage is low or declining. In Asia, Korea added a noncontributory emergency pension with World Bank support in the context of parametric reforms, but China has not addressed the issue of old-age rural poverty, even though the formal system covers only about 20 percent of the population. With the exception of Mauritius, coverage rates in African countries where the Bank has held discussions are less than 15 percent. In Zambia, which received significant World Bank fund-

ing to redesign its PAYG system, neither the Bank nor the country undertook an analysis to identify needs and options, as feasible, for reducing poverty among the current and future uncovered elderly, an exercise that should have been conducted simultaneously with Bank funding for PAYG redesign.

**Is the Economy Stable?**

Large fiscal deficits, stemming in part from imbalances in pension revenues and expenditures, are often a motivation for countries to seek assistance from the World Bank in reforming their pension systems. However, switching from a PAYG system to a funded system may not be the best course for countries with fiscal imbalances that are driven by factors other than pension deficits. The transition costs of switching from a PAYG system to a funded system will temporarily increase the fiscal deficit because the government must continue to pay pension benefits while some contributions are diverted into private funds. Countries should be advised first to achieve fiscal sustainability through expenditure rationalization and revenue reform, including parametric reforms to their pension systems, before embarking on a multi-pillar reform. Countries with high levels of public debt may not be able to take on the additional debt derived from the start of funded systems. Countries whose budgets are heavily dependent on external aid also may not have sufficiently stable revenue bases to support a multi-pillar system.

Stable monetary and fiscal policies are needed if multi-pillar systems are to achieve long-run retirement-income objectives, because large macroeconomic imbalances, high inflation, and excessive debt burdens create uncertainty and destabilize financial markets. Further, high levels of government debt are likely to constrain the development of capital markets. Four indicators are used to evaluate macroeconomic readiness for multi-pillar reform: the inflation rate, the central government budget balance, public debt, and the share of development assistance in total national income.

**Inflation**

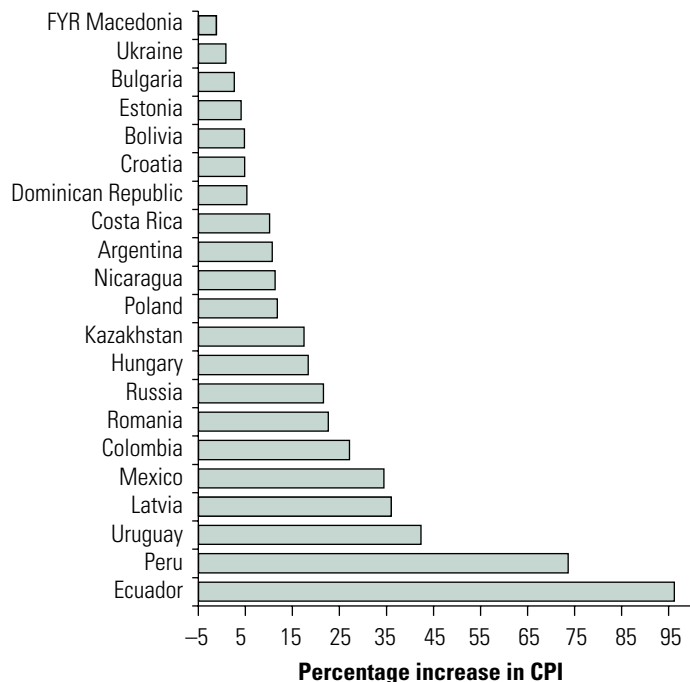
The Bank supported multi-pillar reforms in a number of countries with high inflation. High inflation

was a problem in Latin America in the early 1990s during the first round of multi-pillar reforms (figure 3.1). Ecuador, Peru, and Uruguay faced inflation rates of over 35 percent at the start of their pension reform.<sup>7</sup> Even after hyperinflation subsided in Europe and Central Asia, price increases exceeded 15 percent in several countries instituting funded pillars. Fortunately, inflation declined thereafter, so that price increases were below yields on government bonds. Seven countries with high inflation at the time of reform were included in the IEG case studies.<sup>8</sup> Of those, the development outcome of the Bank’s assistance to Peru, Russia, and Uruguay was moderately unsatisfactory. While a number of countries may have postponed their reforms, the enactment of legislation was not predicted on post-enactment decisions to delay.

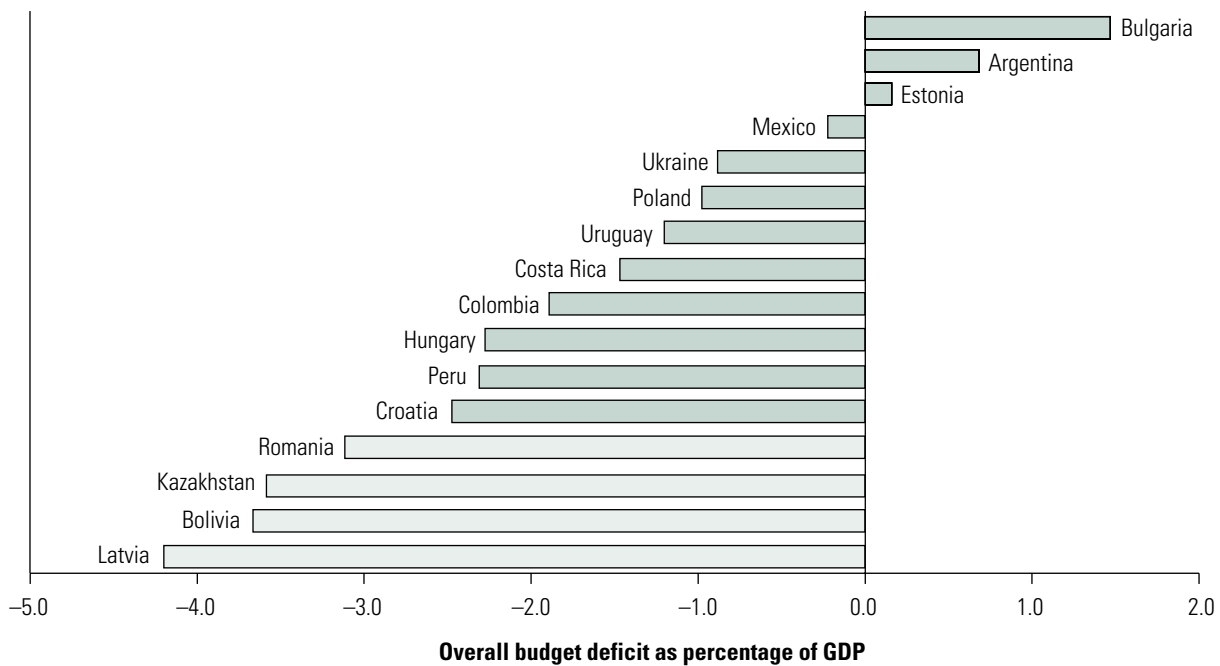
*Multi-pillar systems require a strong macroeconomic environment.*

*Most countries starting systemic reforms did not have large budget deficits.*

**Figure 3.1: Many Countries Had High Inflation at Reform**



Source: World Development Indicators (World Bank 2005).

**Figure 3.2: Several Countries Had High Budget Deficits at the Time of Their Pension Reform**

Source: World Development Indicators (World Bank 2005).

### **Fiscal balance**

Most countries initiating multi-pillar pension reforms had “moderate” fiscal deficits. Bolivia, Kazakhstan, Latvia, and Romania had budget deficits over 3 percent of GDP, an indicator that fiscal conditions for implementation of a funded system were not ideal (figure 3.2). Although Latvia’s deficit was initially high when the funded tier was implemented in 2001, the deficit had fallen to 1.4 percent of GDP. As for Kazakhstan, a favorable

### *Governments need to finance the transitional debt resulting from multi-pillar reform.*

prognosis for the energy sector was realized, which provided economic stability and increased government revenues. Bolivia, Latvia, and Kazakhstan were included in the IEG case studies. Of those, the development outcome of the pension reform activities in Bolivia was rated moderately unsatisfactory.<sup>9</sup>

### **Government debt**

Under stable economic policies, governments may restructure expenditures, raise taxes, or use government debt to finance the transitional deficit from multi-pillar pension reform.<sup>10</sup> Countries in

Latin America with lower coverage, other things being equal, face less transitional debt than countries in Europe and Central Asia, since past pension promises are smaller. Because the size of the funded pillar is related to the size of the transition deficit and its method of funding, the Bank was prudent in supporting larger PAYG pillars in Central and Eastern European countries, and even pillars that were related to earnings and contributions. This support was consistent with the flexibility of pension design proposed in *Strategy*.

Nonetheless, countries with low pension coverage can also have problems implementing funded systems if they have a limited tax base and high levels of government debt. As a benchmark, public debt of over 60 percent of GDP is generally regarded as extremely high. Nicaragua and Bolivia both enacted Chilean-style reforms and received support from the Bank. Both are highly indebted poor countries (HIPCs), and their indebtedness will remain a problem for a multi-pillar pension reform even if some obligations are forgiven. Bolivia, an IEG case study country, was rated moderately unsatisfactory on overall development outcome. Senegal and Uganda have

recently been studying multi-pillar reforms, but they are also HIPC countries. So far, the Bank has not been sufficiently proactive in trying to defer multi-pillar reforms in highly indebted countries.

### *Development assistance*

Countries receiving a high proportion of development assistance relative to gross national income (GNI) are unable to function independently without donor resources and are not fiscally independent. Further, if substantial development assistance is needed, poverty is likely to be high, and a poor population does not have sufficient income for discretionary saving through a pension system. In the Europe and Central Asia Region, although Georgia received substantial development assistance relative to GNI, the Bank still promoted a multi-pillar reform. Bank support to FYR Macedonia was conditioned on the implementation of a multi-pillar reform, even though it was heavily dependent on donor assistance at 7.4 percent of GNI, but the Bank eventually supported the suspension of the reform.<sup>11</sup>

Two countries in the Latin America and Caribbean Region that enacted multi-pillar reforms, Bolivia and Nicaragua, are heavily dependent upon donor assistance—at 9.0 and 13.6 percent of GNI, respectively.<sup>12</sup> The Bank's activities for the Bolivian re-form were rated moderately unsatisfactory in the IEG case study. Eventually the Bank helped place the Nicaraguan multi-pillar reform on hold, but only after initially encouraging the reform. More recently, the Bank has supported Senegal, which has been considering multi-pillar reform, despite having 9.3 percent of its GNI in development assistance funds.

### **Is the Financial Sector Sound?**

According to Vittas (1998), countries starting a funded system need “at least a small number of sound and well-functioning banks and insurance companies coupled with a willingness to implement capital market reforms and openness to foreign expertise.” Impavido, Musalem, and Vittas (2001) also warn that systemic multi-pillar pension reform is unlikely to succeed in countries in which the dominant banks are state-owned, financially insolvent, and operationally inept.

### *Banking systems in Europe and Central Asia<sup>13</sup>*

A number of Europe and Central Asia countries assisted by the World Bank in multi-pillar reforms had financial sectors that did not have sound financial systems. At the time their pension reforms were enacted, four countries—Kazakhstan, Romania, Russia, and Ukraine—had financial sectors that, as evidenced by the European Bank for Reconstruction and Development (EBRD) financial system rating (figure 3.3), did not exhibit: (1) substantial progress in bank solvency, (2) a framework of prudential regulation and supervision, (3) full interest rate liberalization with little preferential access to cheap refinancing, (4) significant lending to private enterprises, and (5) a significant presence of private banks.<sup>14</sup> Three other countries—Bulgaria, Latvia, and FYR Macedonia—met these criteria but did not have: (1) significant movement in banking laws to meet Bank for International Settlement standards, (2) well-functioning banking regulation and effective prudential supervision, (3) significant term lending to private enterprises, and (4) substantial financial deepening. The banking systems of Croatia, Estonia, Hungary, Poland, and the Slovak Republic were effective, according the EBRD standards.

Countries that have not implemented multi-pillar pension systems in Europe and Central Asia are more likely to have weak financial sectors (figure 3.4). The Bank encouraged a multi-sector reform in Georgia in 1996 and 1998 through adjustment loans, despite a weak financial sector.<sup>15</sup> By contrast, the Bank has been trying to discourage the Kyrgyz Republic from inaugurating a multi-pillar system.

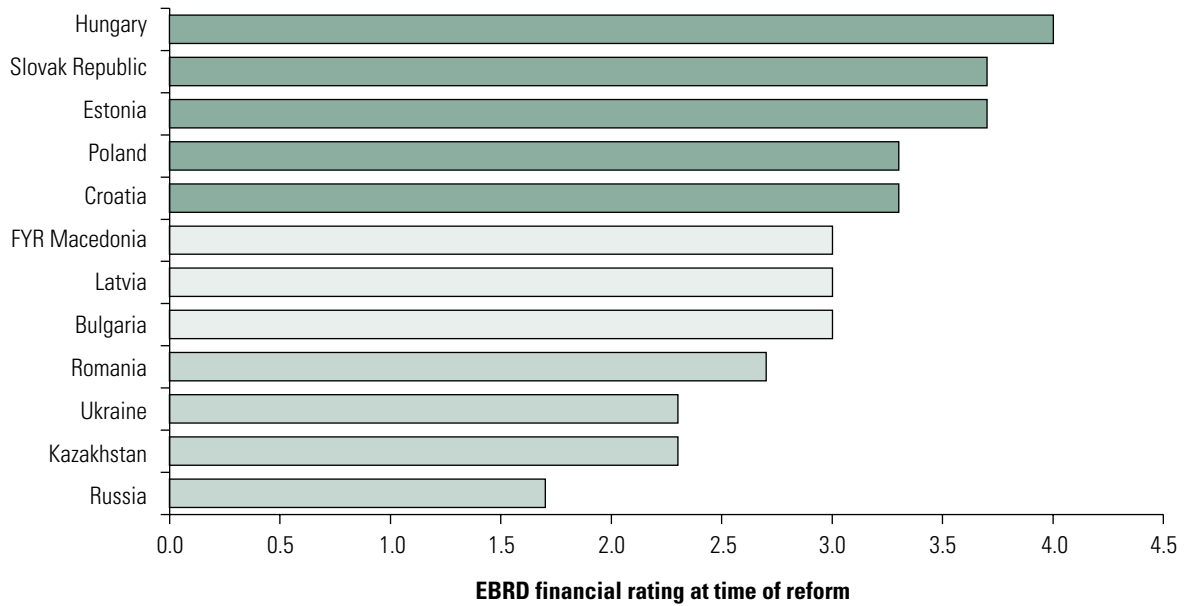
The Czech Republic and Slovenia, which have strong financial sectors, have exhibited little interest in multi-pillar reform.

Among multi-pillar reformers in Latin America and the Caribbean, Argentina, Colombia, and Peru had financial sectors that met the minimum conditions for a multi-pillar reform. Their systems were characterized by declining margins, increasing levels of intermediation, and an increasing range of financial products and services. However, these

*Countries dependent on development assistance are not good candidates for multi-pillar reform.*

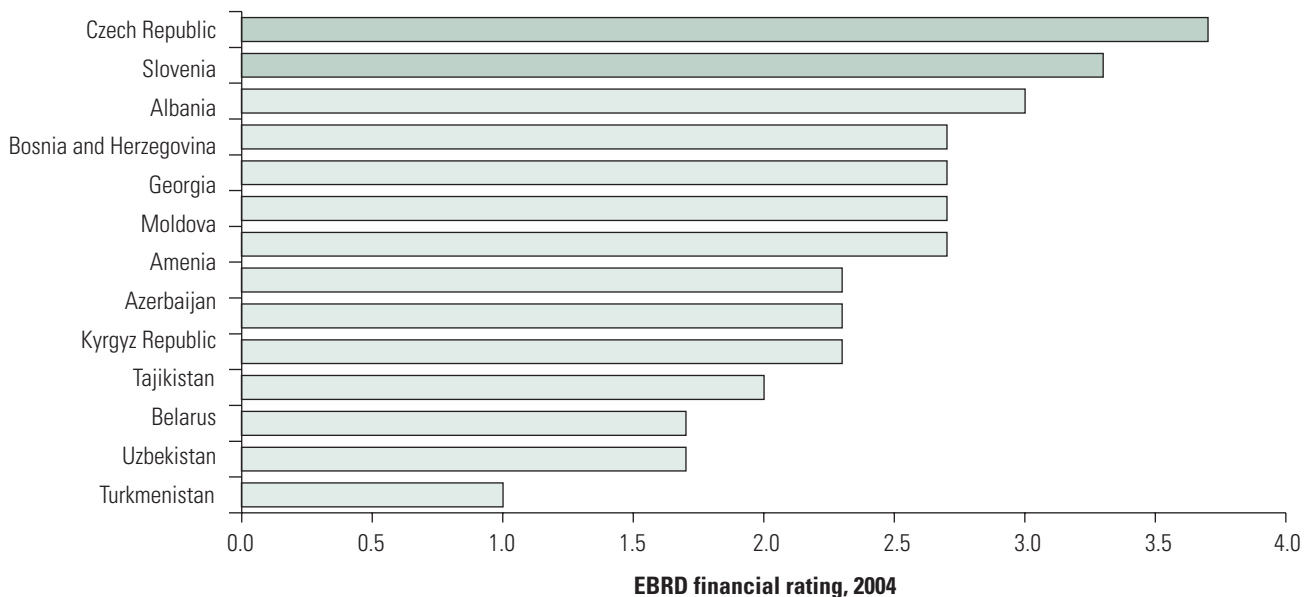
*Countries starting funded systems should have a well-functioning financial sector.*

**Figure 3.3: Poor Financial Sectors Characterize Some Europe and Central Asia Multi-Pillar Reformers**



Source: European Bank for Reconstruction and Development (EBRD).

**Figure 3.4: Europe and Central Asia Countries without Multi-Pillar Reform Are More Likely to Have Weak Financial Sectors**



Source: EBRD.

countries also had a relatively high proportion of state ownership in the banking sector at the time of their reforms.

Among the reformers in Latin America and the Caribbean enacting multi-pillar legislation after 2000—Costa Rica, the Dominican Republic, Ecuador, and Nicaragua—only Costa Rica had a well-developed financial sector at the time of reform.<sup>16</sup> While Bank support through policy dialogue, credits, or loans in these countries was considerably less than that provided to earlier reformers such as Peru and Argentina, the Bank did not discourage the latter set of reforms because of unsatisfactory financial sector performance. The reform in Nicaragua was eventually put on hold, in line with Bank guidance, as subsequent analysis found the country unprepared for such an ambitious undertaking.

In Latin America and the Caribbean, the Bank is currently working with Brazilian officials to help the federal and state governments introduce a new and complementary defined contribution pension fund for new civil servants, providing a complementary funded benefit on top of the PAYG benefit. The Brazilian financial market is satisfactory, and the equity market, with significant occupational funds, is better developed than in many countries with mandatory funded pillars.

### ***Banking systems in other Regions***

Except for Mauritius, no African country considering multi-pillar reform has a strong enough financial sector to support a multi-pillar reform.<sup>17</sup> This is consistent with the World Economic Forum's (2000) ratings of confidence in financial services in southern Africa, in which only Botswana and South Africa had higher ratings than Mauritius. Based on best practice, the Bank appropriately advised against a proposal for a multi-pillar reform in Nigeria, where the financial sector is characterized by high margins, low levels of intermediation, and few financial products or services. Despite the government's inclination to adopt multi-pillar reform, the Bank considered supporting the Nigerian pension system in a way that did not include multi-pillar reform.

In East Asia, Korea's financial markets are sufficiently developed to support a multi-pillar reform.<sup>18</sup> In contrast, the Chinese financial sector

remains weak. Four state banks account for about two-thirds of all deposits, and lend primarily to state-owned enterprises and not to the booming private sector.<sup>19</sup> While the Chinese have not yet started a multi-pillar system, China's gradual approach to all reform appears to have been instrumental in moving slowly, because the Bank's advice did not adequately stress financial market readiness, but focused instead on actuarial projections and general information on reform.

### **Can Implementation Be Effective?**

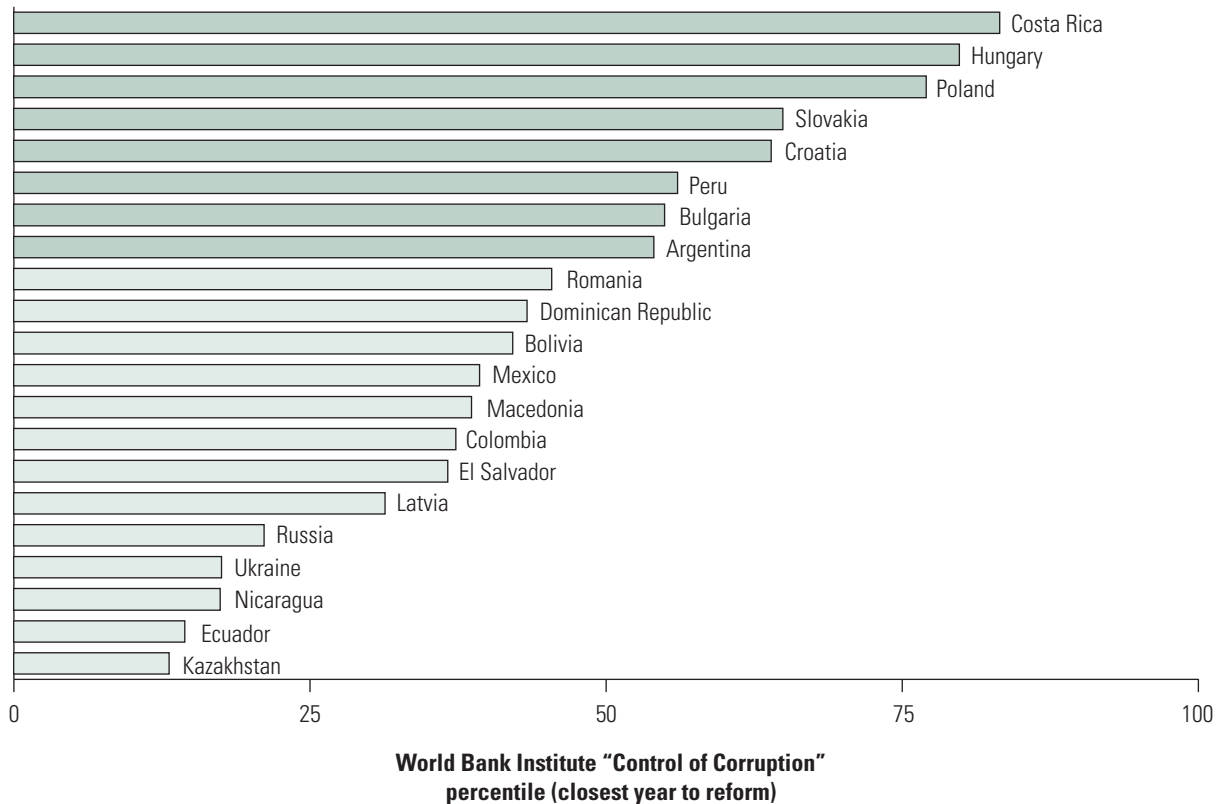
One reason to shift to a privately funded pension system is to eliminate the potential for government interference. While funded pillars can provide autonomy from government, they are vulnerable to corruption and weak governance within the private sector. As a result, strong regulation and supervision of the pension funds, asset managers, and other financial intermediaries is essential if multi-pillar systems are to operate prudently and effectively. Although the presence of a private system can provide some balance against public power, a weak regulatory system may yield insufficient protection for pensioners in some countries, especially in funded systems where participants bear the risk of financial failure.<sup>20</sup> In Africa, Asia, and the Middle East and North Africa, provident funds and/or partially funded PAYG pension plans have received below-market rates of return because of high commissions, dubious investments, and outright theft, depending on the circumstances. So far, there has not been documentation of any instances of fraud and abuse in multi-pillar systems the Bank has supported.<sup>21</sup>

One signal of government commitment to regulatory reform is the World Bank's index of control of corruption, which can be used to assess the *potential* for regulatory effectiveness. Even if regulators are honest, they will be hard-pressed to regulate financial assets in a country in which business dealings are highly corrupt.

*A number of Europe and Central Asia countries undergoing Bank-assisted multi-pillar reform had weak financial sectors.*

*Countries shifting to private pension funds need to ensure they have strong regulatory systems.*

**Figure 3.5: Many Reformers Had Poor Corruption Indexes at the Time of Reform**



Source: Kaufmann, Kraay, and Mastruzzi 2005.

*A number of Bank-assisted multi-pillar reformers had a high risk of corruption.*

The Bank supported the enactment of legislation for funded pillars in 13 countries that had corruption ratings below the second quartile (50th percentile); five countries were in the lowest quartile (25th) during the year of their reform (figure 3.5).<sup>22</sup>

The sustainability ratings of IEG case studies were associated with corruption index ratings. In Latvia, where implementation was delayed, the corruption index moved into the positive range by the time the funded pillar started. The multi-pillar systems in Romania, Russia, and Ukraine are not yet fully in place, although the Bank has supported systemic pension reform vigorously in all three countries for many years. These countries all have negative corruption indices. While the Bank has had a lesser role in the Dominican Republic and Ecuador, where reforms

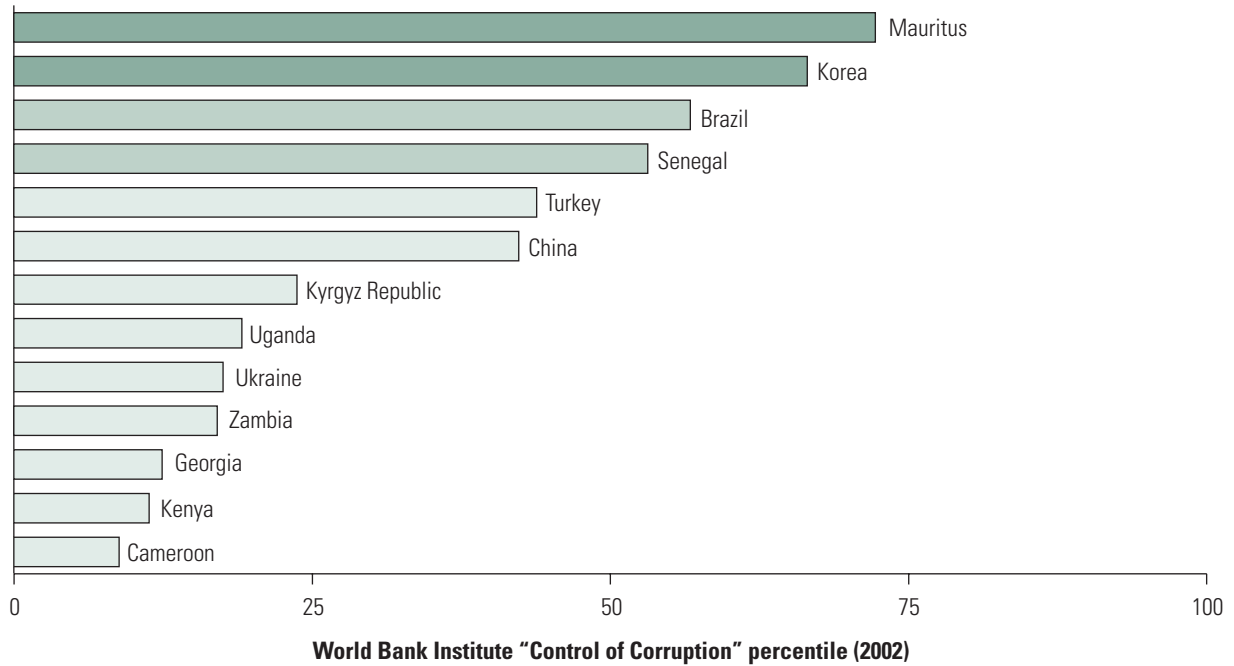
were adopted in 2003 and 2001, respectively, immediate steps are needed to determine whether effective regulation is possible.

Regulatory problems are likely to arise among future reformers as well (figure 3.6). Georgia, the Kyrgyz Republic, and Turkey all have ratings of corruption below the second quartile. The Bank has assisted Turkey and Georgia in taking preliminary steps toward implementing a multi-pillar reform, but not the Kyrgyz Republic. Among the potential African reformers, only Mauritius has a corruption rating above the 50th percentile.

**Are Higher Saving Rates Needed to Encourage Growth?**

*Strategy* argues that the adoption of a multi-pillar system can increase national savings, and increased savings may improve economic growth.<sup>23</sup> In developing a pension strategy, policy makers

**Figure 3.6: Corruption Ratings Are Poor among Some Potential Reformers**



Source: Kaufmann, Kraay, and Mastruzzi 2005.

need to assess the need for improved savings. In low-savings countries, this argument can be compelling, but not so in high-savings countries. East Asian countries with high savings rates include China, Malaysia, Thailand, and Vietnam. If high savings rates are combined with low returns to assets, PAYG pensions can provide better rates of return than funded plans.<sup>24</sup> Eight countries enacting funded reforms had savings rates in excess of 20 percent of GDP at the time of their reform (figure 3.7). China, Korea, Mauritius, and Turkey, all potential reformers, have savings rates of over 20 percent (figure 3.8).

Low-income countries with negative savings rates also may prefer a PAYG pension system. Nicaragua and Cape Verde face negative savings rates, with external transfers supplementing domestic consumption. This may be the situation in Senegal and Uganda as well; coverage is low and saving is negligible. The reasons for negative saving should be fully understood before deciding on a multi-pillar reform, because forced savings for covered workers may be inappropriate.

### Summary and Conclusions

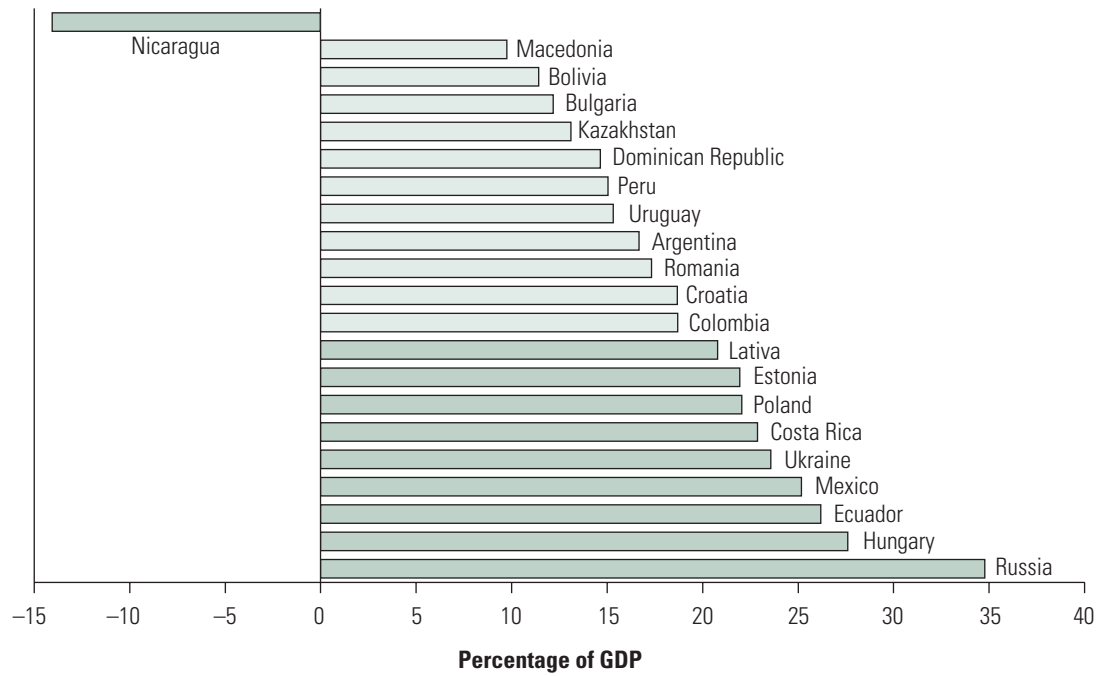
In a number of countries, such as Peru and Nicaragua, the Bank did not assess the needs of the elderly before providing support for proposed multi-pillar reforms. In contrast, in other countries, such as Bolivia and Latvia, considerable attention was paid to old-age protection for those outside the formal system. In some instances, multi-pillar reforms were supported in countries that did not need higher savings to stimulate development. These included Ecuador and Russia, countries that also did not meet the Bank's standards for successful multi-pillar implementation based on macroeconomic and/or financial sector readiness.

The Bank supported multi-pillar reforms in quite a few countries that met its fiscal and financial sector standards, including Croatia, Hungary, Latvia, and Poland, which had favorable

*The Bank should first assess whether a country has a need for increased savings.*

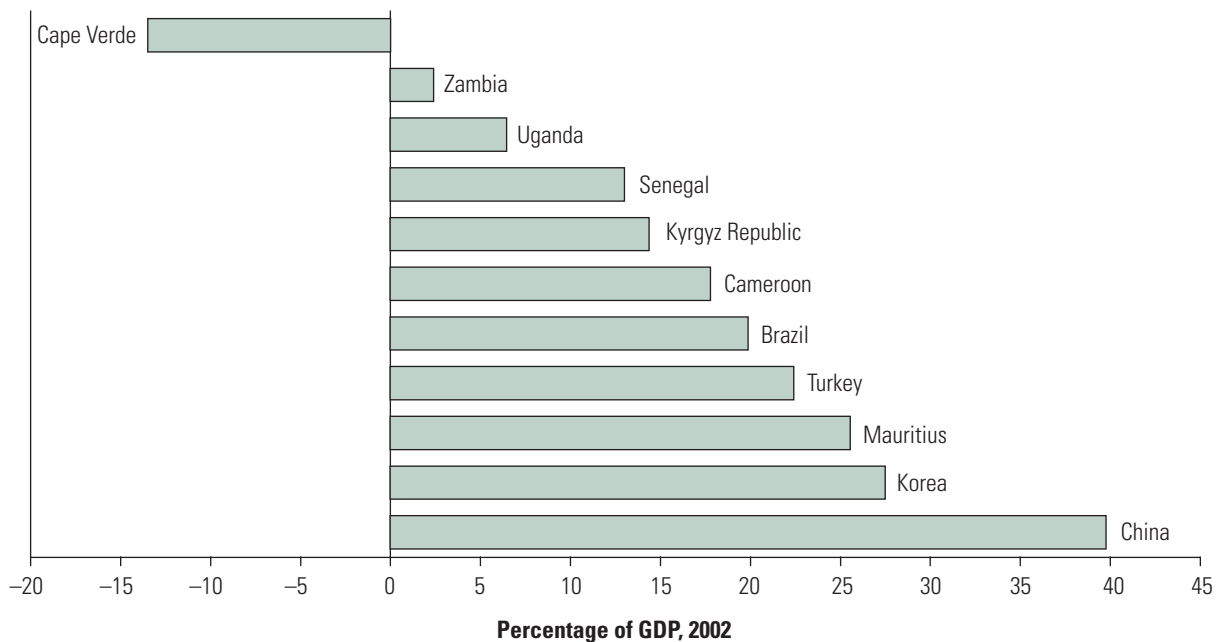
*Countries with low savings may opt for a PAYG system.*

**Figure 3.7: Some Multi-Pillar Countries Already Had High Savings Rates**



Source: World Development Indicators (World Bank 2005).

**Figure 3.8: Saving Rates Require Review before Deciding on Multi-Pillar Reform**



Source: World Development Indicators (World Bank 2005).

macroeconomic and financial market preconditions at the start. Their multi-pillar systems are more likely to be successful than others. The pace of reform in Latvia was particularly prudent, as the funded pillar was postponed until all the economic and financial preconditions were in place.

Nonetheless, quite a few countries started reforms without macroeconomic stability, banking sector readiness, moderate indebtedness, and low-to-moderate levels of corruption. Russia and

Ukraine still have weak financial sectors and ratings, below the 50th percentile for control of corruption. FYR Macedonia receives a high proportion of development aid. In Latin America, multi-pillar reforms were enacted in a number of countries with weak financial sectors, including Bolivia and Mexico, and four later reformers—Costa Rica, the Dominican Republic, Ecuador, and Nicaragua. Most of these countries are characterized by poor ratings of corruption control, below the second quartile.