



# Executive Summary

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 are a mechanism to reduce the risks of old-age poverty and a means to smooth lifetime income to maintain living standards in retirement.

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. Over the past two decades, the need for pension reform has become more pressing in client countries, because demographic aging and the mismanagement of pension systems have put a strain on government budgets, which threatens to undermine macroeconomic stability and retirement income security.

Countries with high coverage rates and increasingly high percentages of the population reaching retirement age are most likely to face severe future fiscal imbalances. Countries in the Bank's Europe and Central Asia Region are prime examples. Even countries with lower coverage and younger populations, including countries in the Latin America and Caribbean Region, face fiscal issues similar to those in countries with serious demographic problems, particularly when employment in the covered sector is declining relative to an increasing number of retirees. In

countries in other Regions, pension reform has been less of a priority.

This report is the first comprehensive, independent evaluation of the Bank's involvement in pension reform. It assesses the Bank's pension reform strategy and the resulting development outcomes for Bank assistance between 1984 and 2004. During this period, the Bank assisted 68 countries with reform of their pension systems with more than 200 loans and credits. In addition, the Bank issued more than 350 papers and publications on pension reform.

This report analyzes the Bank's assistance to determine whether the strategy was relevant and whether it was followed. More specifically, the evaluation assesses whether pension reform operations reflected best-practice guidelines at entry, and whether the reforms achieved their social, macroeconomic, and financial objectives. The report also evaluates the Bank's assistance in building institutional capacity, as well as ad-

*Demographic aging may lead to severe fiscal imbalances in the future.*

ditional factors that could affect reform outcomes. Finally, the evaluation summarizes these findings and presents specific recommendations for going forward.

### The Strategy for Pension Reform

The Bank's strategy for pension reform is presented in *Social Protection Sector Strategy: From Safety Net to Springboard* (2001) (hereafter, *Strategy*). Because this document is the only official Board-approved strategy for pension reform, it is the basis of the evaluation. Of course, many Bank publications have influenced the direction of Bank assistance, in particular, the Bank's earlier publication *Averting the Old Age Crisis* (1994) (hereafter, *Averting*). In effect, *Strategy* ratified many of the precepts established in *Averting*.

*Strategy* recommends the establishment of flexible multi-pillar pension systems, consisting of three pillars based on different forms of income support, as long as proper initial conditions prevail. The first pillar consists of a publicly managed, unfunded plan; the second pillar is a mandatory, privately funded plan; and the third pillar is a voluntary, privately funded plan. It also recommends complementary retirement income provisions for uncovered workers and the poor.

Based on the Bank's strategy, the Independent Evaluation Group (IEG) used the following criteria to judge the soundness of pension reforms: (1) impact on the income of the aged, (2) the nature of the fiscal policy and financial sector environment, (3) the capacity of the administrative structure to operate a multi-pillar system, and (4) the soundness of regulatory and supervisory arrangements. The report evaluates the extent to which these criteria have been met, based on statistical indicators, assessments from Implementation Completion Reports (ICRs) and Project Performance Assessment Reports (PPARs), assessments from the Financial Sector Advisory Program (FSAP), interviews with Bank staff and external stakeholders, and 16 IEG case studies.

### The Bank's Support for Pension Reform

The World Bank supported a variety of pension systems, both unfunded and funded, through

lending operations and analytical and advisory activities, including economic and sector work, policy dialogue, training, and dissemination. The Bank provided \$5.4 billion in pension-specific lending from 1984 to 2005, with more than half of this amount issued during the fiscal 1998–2001 period. Of the countries receiving Bank support for pension reform, The Europe and Central Asia and Latin America and Caribbean Regions dominated, with a combined total of 40 countries.

The Bank's papers and publications on pensions provide a substantial foundation for the Bank's operations, policy dialogue and overall approach on pensions. The breadth of analytical work is considerable, with a preponderance of studies on countries in the Europe and Central Asia Region, followed by those in Latin America and the Caribbean, paralleling the pattern of lending. Fiscal and regulatory issues have been the focus of substantial analysis because fiscal imbalance has been the leading reason for countries to undertake pension reform and seek the Bank's assistance. The Bank has undertaken numerous studies on complicated technical issues such as the regulation of funded pensions and the administrative costs of the funded pillars. Bank thinking on pensions has evolved over time, reflecting broader discussion and accumulated country experience.

While the Bank's analytical contributions represent a critical expansion of knowledge on pension reform, economic and sector work often failed to provide country-specific guidance to assist in project development. For example, while the Bank has conducted poverty assessments in many countries, all too few offer a detailed profile of the living conditions of the aged. Similarly, while low pension coverage is frequently mentioned as a problem, little empirical research has been conducted to identify policies that encourage its growth. In addition, studies to improve public pension administration have been underrepresented in Bank work, despite the importance of program implementation for PAYG and mandatory, funded pensions alike. Economic and sector work has been limited in a number of other areas, as well, including disability and

survivor's pensions and the political economy aspects of reform.

While the Bank's lending operations have helped reform many publicly managed, unfunded plans, the Bank has provided greater resources to countries developing multi-pillar systems. In Latin America and the Caribbean, the Bank provided lending support for mandatory, privately funded pillars, which, in one form or another, were implemented in most countries where the Bank engaged in dialogue. In Europe and Central Asia, the Bank also undertook operations to assist the development of mandatory, privately funded pillars. In a number of these countries, however, reforms were slow in coming or were never implemented. With the exception of a limited number of countries that offered social pensions, particularly in Europe and Central Asia, the Bank provided little support to develop social assistance for the aged poor, even though this was a stated element of the Bank's strategy on pension reform.

In its financial support of multi-pillar systems, the Bank has not taken a one-size-fits-all approach. Systems supported by Bank lending varied in size and design. However, it is difficult to document whether this variation was the result of the Bank's taking into account specific country conditions, the task team's preference for a particular structure, or the country's preference for a particular reform.

Over three-quarters of the Bank's ratings for pension components, and projects that included pension components, had satisfactory outcomes. Based on project ratings, the Bank appears to have been more successful in its pension reform activities in Latin America and the Caribbean than in Europe and Central Asia.

While satisfactory ratings for individual loan activities are important, the success or failure of an operation may not correspond to the success or failure of a Bank pension program overall. IEG case studies of particular countries, which analyze the Bank's assistance to pension reform comprehensively over time, indicate that development outcomes depend on multiple factors. In particular, successful outcomes depend on at-

tention to initial conditions, effective institutional capacity, and political commitment to the reform.

### Was Bank Support Consistent with Initial Conditions?

While the primary objectives of pension reform are to reduce old-age poverty and smooth lifetime consumption, *Strategy* indicates that additional objectives of multi-pillar reforms may also be achieved, including greater worker participation in the pension system and higher economic growth through increased savings and the promotion of capital market development.

The Bank's strategy to implement multi-pillar pension reforms was intended to apply to countries that satisfied certain preconditions, including (1) sustainable macroeconomic policies, (2) a sound financial sector, and (3) sufficient implementation capacity. This evaluation uses a set of indicators to assess whether the necessary conditions were in place before Bank support of multi-pillar pension reform. IEG case studies were more likely to rate the Bank's performance satisfactory in IEG multi-pillar reform countries when these preconditions were met.

The Bank only supported PAYG improvements in some countries that did not meet these preconditions, rather than advancing multi-pillar reforms. In some cases, however, the Bank supported multi-pillar systems in countries with high fiscal deficits, weak financial systems, and ineffective implementation capacity.

Although pension shortfalls undermine fiscal stability, the transition costs of immediately switching from a PAYG system to a funded system will temporarily increase the fiscal deficit further, because the government must continue to pay pension benefits while some contributions are diverted into private funds. Thus, countries should first be advised to achieve fiscal sustainability through expenditure rationalization and revenue reform, including parametric reforms to their pension systems, before embarking on a multi-pillar reform.

Despite *Strategy's* recommendation, the Bank's pension reform agenda in client countries

often did not include policies to protect the vulnerable elderly who are ineligible for public pensions. From a poverty reduction standpoint, countries with low pension coverage rates need to explore options to expand participation in the formal system and/or provide complementary social safety nets to improve the welfare of the aged. For example, in Latin America and the Caribbean, where coverage is low, pension reform will assist far fewer future retirees than in Europe and Central Asia, where a high proportion of workers are covered by formal plans.

### What Has Been the Impact of Reforms?

Pension reform requires many years of implementation before its impact can be fully evaluated. Most reforms are too recent for a longer-term assessment. Consequently, it is necessary to use indirect indicators to gain insight into the progress toward achieving the Bank's objectives for pension reform.

Large fiscal deficits, stemming in part from imbalances in pension revenues and expenditures, motivated many countries to seek Bank assistance in reforming their pension systems. While the Bank's reforms improved the financial balance of many PAYG systems, additional reforms often were needed, but not enacted, to ensure full fiscal sustainability.

One advantage of a multi-pillar system is to reduce financial risk to future pensioners through portfolio diversification, including the existence of public and private components. In many countries with multi-pillar systems, however, investments in privately funded pillars are not well diversified, although rates of return are high as a result of investments in government bonds. While these bonds offer high returns, they often just compensate for macroeconomic and investment risk. In addition, privately funded systems remained open to political influence, just like PAYG plans, particularly in times of economic crisis.

Empirical evidence suggests that the secondary objectives of privately funded pension plans to increase savings, develop capital markets, and increase worker participation in the pension

system have remained largely unmet. There is little evidence that privately funded pillars have succeeded in increasing national savings or in developing capital markets. Furthermore, multi-pillar reforms have not increased pension coverage in most reforming countries.

### Has Adequate Attention Been Given to Institutional Capacity?

World Bank operations have supported countries in building institutional capacity throughout the pension reform process. Out of more than 200 loans and credits, 129 have supported institutional capacity, including improving the administration of unfunded systems, actuarial forecasting, and regulation of privately funded plans.

The need to develop effective pension administration, however, has been greater than the assistance provided. The Bank underestimated institutional weaknesses because of incomplete needs assessments, reluctance on the part of some agencies to open a dialogue with the Bank, and insufficient Bank expertise on the administration of publicly managed, unfunded plans. In addition, administrative projects that were undertaken would have benefited from better Bank and client supervision, particularly in countries with capacity constraints.

Bank loans to establish regulatory systems for privately funded pensions have been limited in number and scope. In particular, in Latin America and the Caribbean, investment restrictions may have created an additional investment risk for future retirees. But in some cases successful administrative and regulatory reforms were supported by policy dialogue rather than investment projects or technical assistance. This was true in some Europe and Central Asia and Latin America and the Caribbean countries.

The Bank developed a long-term forecasting model for pensions, the Pension Reform Options Simulation Toolkit (PROST), as an in-house tool for policy analysis to help client countries develop financially sustainable pension systems. However, the Bank's technical assistance did not develop sufficient local expertise to assess the fiscal balance of pension programs on an ongoing

basis or to update policy reforms. Some countries could not implement PROST because of too few trained professionals. Others found PROST data requirements prescriptive or too inflexible to use for country-specific applications.

### Has Support Been Well Coordinated?

The World Bank's internal and external relationships have affected the outcomes of Bank activities and the success of the reforms, through (1) coordination among Bank units and teams, (2) coordination with other donors and international organizations, and (3) relationships with clients. The Bank has yet to develop a decision-making process that is well-coordinated across the three primary networks involved in pension reform (Human Development, Poverty Reduction and Economic Management, and Finance). Without consistent guidelines and benchmarks for pension activities, staff changes within the Bank and in client countries led to inconsistent advice and support over time. Furthermore, the Bank has not always been steadfast or efficient in its provision of funding, resulting in over-funding or under-funding of particular pension reforms.

Improved cooperation with international agencies and bilateral donors over the years has resulted in stronger pension reforms. But the Bank could still benefit from finding further common ground with its international partners, despite differences in perspective. The Bank's own stop-and-go tactics—that is, lack of sustained within-country attention over several CASs—tended to reinforce discontinuities in the progress of reform. While the Bank worked successfully with many governments, it needs to ensure that it involves all relevant ministries and stakeholders.

### Summary and Conclusions

The Bank's multi-pillar strategy is well documented with a strong legacy of operational work, economic and sector work, training, and seminars. Reforms have differed regionally and by country, as a result of client concerns and Bank experience. Nonetheless, the Bank's advice has not always been effective. While formal pension systems in many countries contributed to bal-

looning budget deficits, the Bank's preoccupation with fiscal sustainability tended to obscure the broader goal of pension policy, that is, to reduce poverty and improve retirement income adequacy *within a fiscal constraint*.

To improve this process, IEG recommends that the Bank:

#### *Develop Guidelines to Design Pension Reforms and Pay Greater Attention to Parametric Reforms*

- a. *Pay greater attention to parametric reforms* to ensure fiscal sustainability and to the macro-economic, financial, and institutional sector *preconditions necessary for a multi-pillar reform*. This would involve preparing and implementing *guidelines* to ensure well-tailored assistance to country conditions and consistent policy prescriptions including statistical indicators and in-depth assessments.
- b. *Be more realistic in presenting the benefits of the secondary objectives of pension reform* in dialogue with client countries, as there is insufficient empirical evidence to support the claims that funded systems have, or can, improve savings and capital market development.

#### *Build Client Capacity*

- c. *Develop a checklist for client capacity requirements* (including contribution collection, contributor database development, actuarial and policy analysis, and regulation of multi-pillar operations) to assess client requirements and determine how best they can be met. *This would involve ensuring that a plan for technical assistance is put in place for reform initiatives so that client capacity is developed.*

#### *Conduct Research on Outstanding Issues*

- d. *Ensure that adequate analysis is conducted on key issues* such as income of the aged, the impact of corruption and governance on the feasibility of effective pension regulation, methods to foster competition among pension funds, guidelines for investment alloca-

tion, the design of noncontributory systems, and ways in which capital markets develop, as well as research offering cross-country evidence on these topics.

***Improve Internal and External Coordination***

e. *Develop a process to ensure that cross-sector issues are considered, including financial is-*

sues identified by the FSAP, and maintain closer coordination between the Development Economics Vice Presidency, the networks, sector units, and country units.

f. *Develop a strategy to play a greater role in consensus building among stakeholders, in particular, other international organizations and client agencies.*