

On the Political Economy of Pension Reforms

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Motivation ...

- Reform initiation and progress of countries is weakly linked with reform needs
- Perfectly designed scheme alone seems neither necessary nor sufficient for successful reform and implementation
 - It stays on the shelf
 - It gets discussed but does not receive majority support
 - It gets implemented but is politically not sustainable
- Political economy of reforms seem crucial for success, but we seemingly still have limited understanding of the political, social, and economic determinants and requirements
- Political scientists are working on the topic what drives pension reform but few economists who are involved in pension reform

... and Structure

Motivation

- I. What triggers a pension reform?
 - II. What makes a pension reform successful?
 - III. Concluding remarks
- Selected references

I. WHAT TRIGGERS A PENSION REFORM?

1. Financial needs

- Solvency issues, i.e. Pension liability $>$ pension assets
 - Little indications that the size of liabilities (“implicit pension debt”) is linked to reform efforts or creates financial market reactions
- Liquidity issues, i.e. benefit expenditure $>$ contribution revenues
 - Many examples of short term parametric adjustments but limited examples of ensuing reform efforts
- Contamination issues, i.e. solvency & liquidity issues of pension scheme(s) impact the general budget stance and financial market credibility
 - A number of notorious examples of reforms under distress e.g.
 - Brazil 1998/99, co-triggered by civil servants pension deficit
 - Italy and Greece 2008/09 financial crisis triggered reforms, with smaller effects in Portugal and Spain

⇒ **Overall limited empirical evidence that financial variables matter to trigger reform**

2. Innovation, Peer Pressure and Crowding Effects

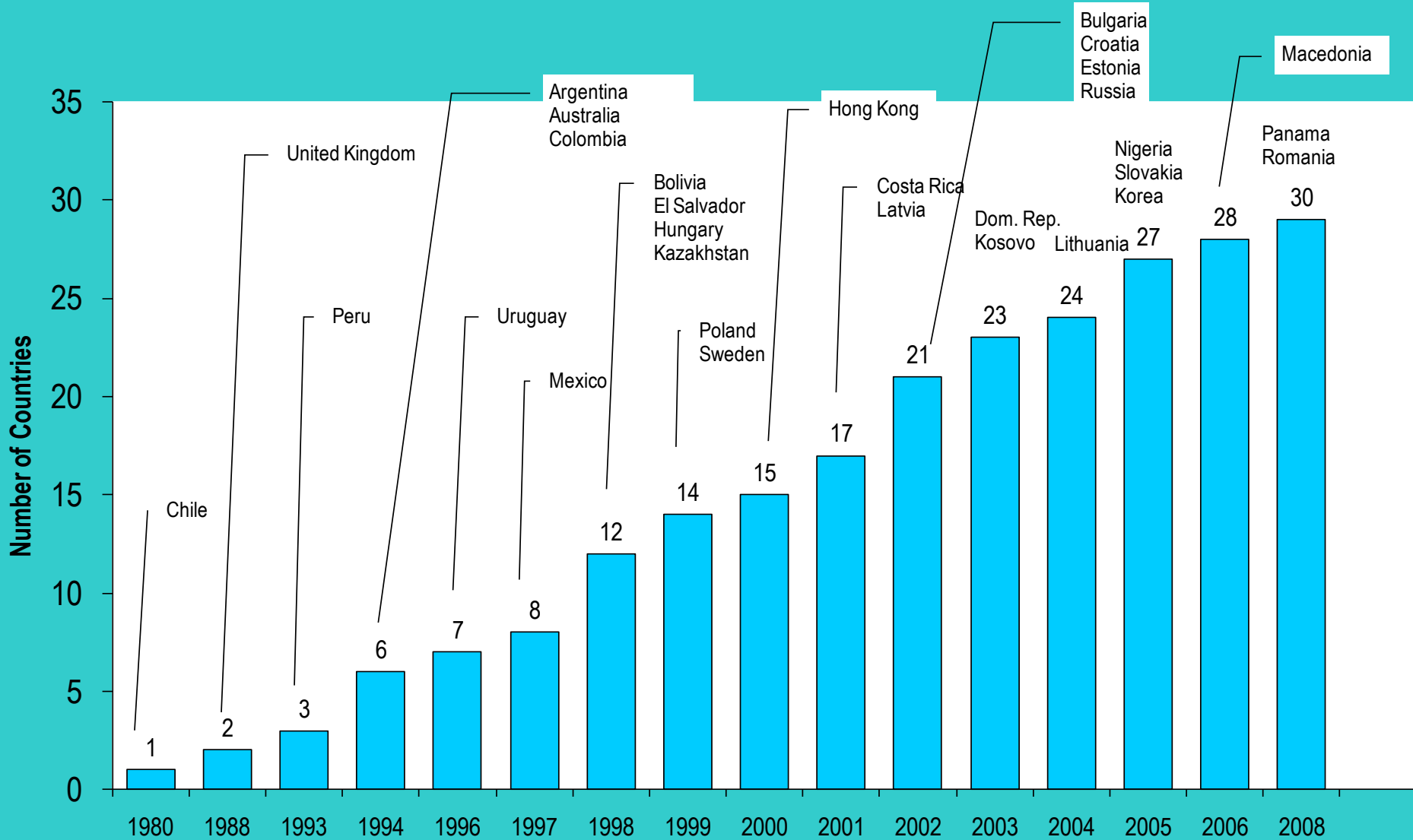
- **The Bismarck' pension reform 1889**
 - First pension system for workers world-wide
 - Marketed world-wide (e.g. St. Louis World's Fair in 1904)
 - Followers in Europe and other regions
- **The Chilean pension reform 1981**
 - First successful systemic pension reform world-wide moving from PAYG to fully funded
 - Marketed world-wide (via its minister Jose Pinera)
 - Followers in Latin America, Europe, and beyond

Table 7.1 Global Spread of Pension System Adoption, 1889-1994

	<i>Europe/Antipodes/US/CA</i>	<i>Latin America/Caribbean</i>	<i>Africa/Middle East</i>	<i>Asia</i>
1880s	DE			
1890s	DK, NZ			
1900s	AU, AT, BE, IS, UK, CS, IE			
1910s	FR, IT, NL, SE, ES, RO, LU			
1920s	CA, BG, EE, HU, LV, LT, PL, RU, YU, GC	CL, EC	ZA	
1930s	FI, NO, US, GR, PT	BR, PE, TT, UY, BB		
1940s	AL, CH, TR, MC	AR, CO, CR, DO, GY, MX, PA, PY, VE	DZ, GQ	JP
1950s	CY, JE, LI, MT, SM	BO, HN, JM, NI, SV, BS	BI, EG, IQ, GN, IR, IL, LY, MU, MA, RW, SY, ZR, CV	CN, ID, IN, MY, PH, SG, LK, TW
1960s	AD	CU, HT, GT, BM, GD	BF, CM, CF, CG, CI, ET, GA, GH, KE, LB, MG ML, MR, NE, NG, SA, TG, TN, TZ, UG, ZM	NP, VN, FJ, FM, MH, PW
1970s		AG, BZ, DM, LC, VC, VG	BJ, TD, JO, KW, LR, OM, SD, SN, SZ, BH, SC, ST	HK, KR, PK, KI, SB, WS
1980s			GM, YE	PG, VU
1990s			ZW, BW	TH

Source: Orenstein 2003

Figure 1: Evolution of number of countries with (mandated and funded) "Second pillars" as of 2008



Note: "Second pillar" is defined here as a pension system that has "mandatory personal retirement accounts". Exceptions and other detailed information in the source. Source: Forthcoming World Bank database.

Source: Holzmann 2103

Innovation, peers and crowding (2/3)

■ **The NDC pension reform approach 1990s**

- Developed independently by Italy and Sweden in early 1990s, that influenced adoption in Latvia and Poland in the late 1990s
- Imitation to smaller and larger extend in
 - = Brazil
 - = Russia
 - = Kirgiz Republic
 - = Mongolia
 - = Norway
 - = Egypt
- Serves as benchmark to all reforms of Bismarckian-type public pension schemes

Table 2: Basic system architecture by region, 2011

	Pillar 0		Pillar 1			Pillar 2	
	Targeted	Basic	NDB	NDC	PF	FDC	FDB
East Asia & Pacific	4	3	8	1	10	1	0
Europe & Central Asia	11	4	28	5	0	15	0
High income: OECD	8	9	16	2	0	3	3
Latin America & Caribbean	16	2	29	0	0	9	0
Middle East & North Africa	1	1	17	0	0	0	0
South Asia	3	0	2	0	3	1	0
Sub-Saharan Africa	3	2	30	0	4	2	0
2011 Total	46	21	130	8	17	31	3
Grand Total	67			155			34
1990 Total	20	10	140	0	17	2	3
Grand Total	30			157			5

Notes: NDB/NDC: Notional Defined Contribution Scheme; FDC/FDB: Financial DC or DB scheme; PF: Provident Fund

Innovation, peers and crowding (3/3)

■ Conceptual underpinnings of development

- Innovation with attractive concept and story-line around the new scheme
- Positive experience with new scheme and replications in other countries
- Peer pressure leads to large-scale adoption and further diffusion

II. WHAT MAKES A PENSION REFORM SUCCESSFUL?

Lessons from countries' experiences and proposed conceptualization

- Hasted pension reforms with (i) slim political majority/support, (ii) lacking enabling environment such as on labor and financial markets, and (iii) bad implementation are little likely to be sustainable
 - Suggest conceptualization is around
 - Commitment building
 - Coalition building
 - Institution building
 - Practice building
- That borrows from political science and political economy approaches

1. Political process and support

COMMITMENT-BUILDING

- Credible projections of unsustainability of current schemes
- Exposure to foreign experience
- Emergence of a reform champion
- Duration
- Coverage
- Multiplicity of actors
- Open disagreement

PHASES: Examples from Eurasia

COMMITMENT-BUILDING (PHASE 1)

Sweden:	48 months (1991-1994)
Hungary :	10 months (June 1995-April 1996)
Poland:	16 months (December 1994-April 1996)
Kazakhstan:	0 months
Latvia:	10 months (October 1994-August 1995)
Egypt:	48 months (October 2000-October 2004)
Jordan:	50 months (July 2002 – September 2006)

COALITION-BUILDING (PHASES 2-6)

Sweden:	48 months (1994-1998)
Hungary:	15 months (April 1996-July 1997)
Poland:	32 months (April 1996-December 1998)
Kazakhstan:	7 months (November 1996-June 1997)
Latvia:	50 months (August 1995-October 2000)
Egypt:	36 months (November 2004 – now) and counting
Jordan:	11 months (October 2006 – now) and counting

IMPLEMENTATION STARTED

Sweden:	January 1999
Hungary:	January 1998
Poland:	January 1999
Kazakhstan:	January 1998
Latvia:	July 2001 (NDC since January 1996)

Source: Holzmann and Rutkowski @ World Bank Pension Reform Core Courses

Political process (2/2)

COALITION-BUILDING

- **Concept preparation**
 - Governance structure of reform
 - Cutting-edge knowledge and other countries' experience
 - Analysis and projections
 - Opinion polls and focus groups
- **Concept presentation, dissemination and buy-in**
 - Key messages
 - Medias and core friendly group of journalists
 - Interest groups
 - Donors and international institutions
- **Program Building: Working on new legislation**
 - Sequencing of pillar reforms
 - MPs, trade unions, and constituencies
 - Experts and lawyers
 - Feedback into concept and lobby groups

POLICIES BUILDING: PASSAGE OF LAWS

Celebration



2. The enabling environment: INSTITUTION BUILDING

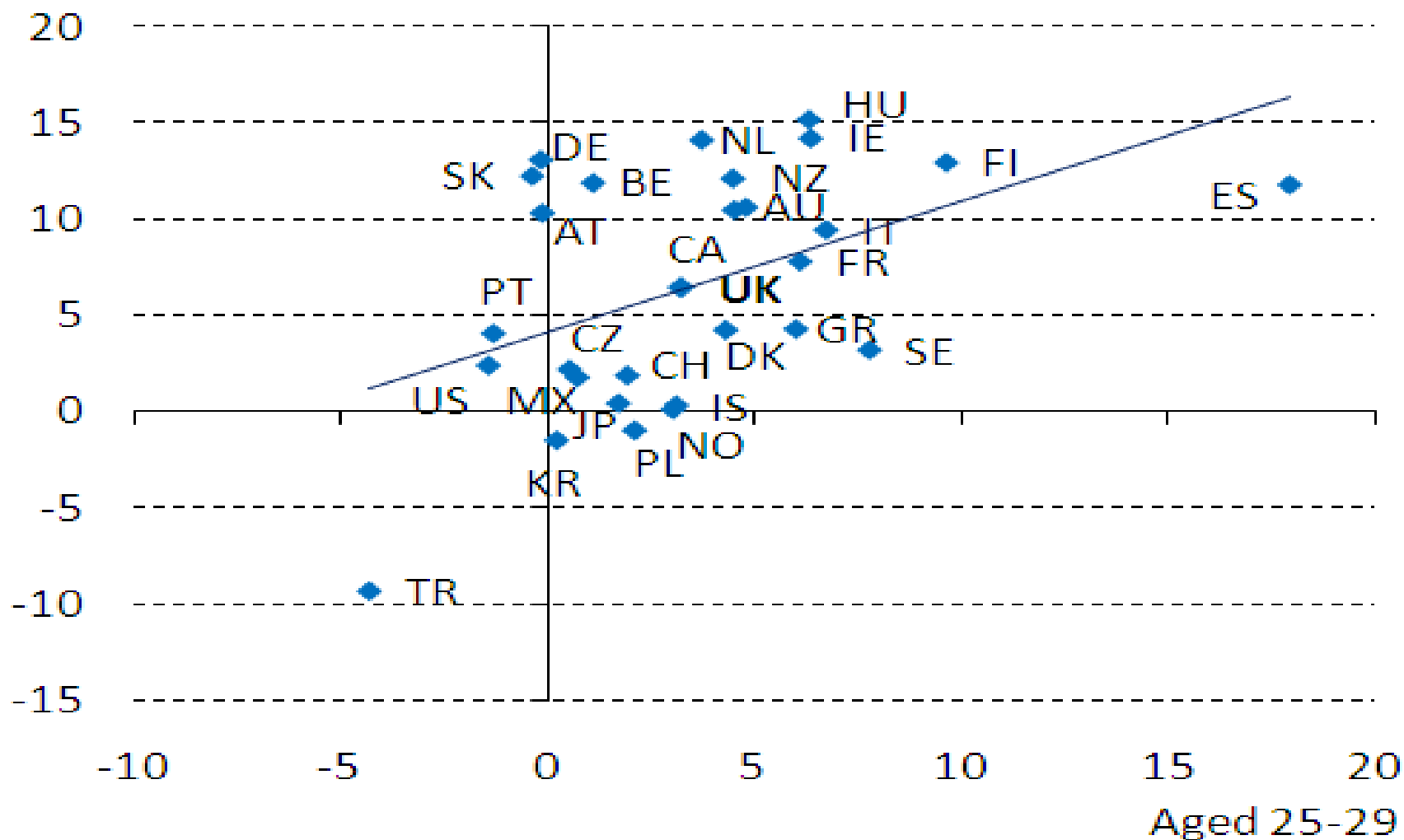
- Successful pension reforms require specific conditions in place without which they risk derailing their intentions
- The conditions/the required enabling environment for introducing or reforming a pension system/schemes are situation specific
- The critical areas are around
 - Labor market conditions
 - Financial market conditions
 - Administrative conditions

Labor market conditions, e.g.

- Level of formality impact on pillar selection, structure and parameter choices
 - Zero/poverty alleviating pillar
 - Mandated earnings-related pillars
 - Voluntary pillar
- For elderly workers impact on the effectiveness of measures to increase the retirement age
 - Mechanisms to keep them healthy, skilled and motivated
 - Laws and regulations to keep firms interested in them
 - Capacity to address changing capacity and skills
- Level of youth unemployment and capability of addressing lump of labor fallacy arguments
 - Costs of early retirement is detrimental to youth employment
 - Elderly and younger workers are more complements than substitutes, also in knowledge societies

Change in Employment Rates by Age Group 1997-2007 in OECD Countries (in percent)

Aged 50-64

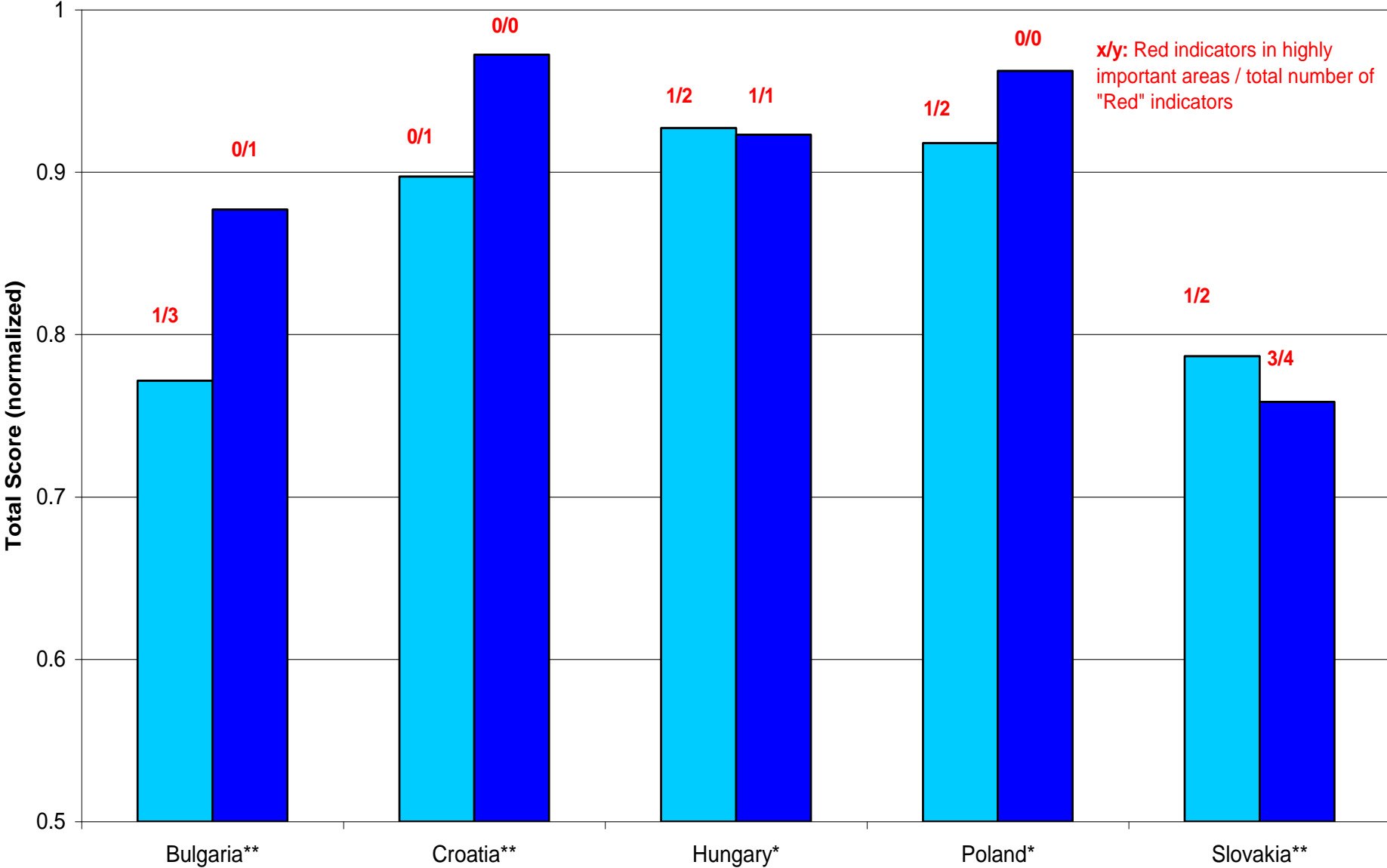


Source: Dorfmann, Holzmann et al (2013), based on OECD data

Financial market conditions

- Have a bearing on the introduction of funded pillars for accumulation and decumulation phase
- **General readiness indicators** include
 - Macroeconomic stability
 - Sound financial infrastructure
 - Adequate regulatory and supervisory capacity
 - Government commitment for continued structural reforms
- **Proposed quantifiable indicators** (Holzmann et al 2009)
 1. Prudent Fiscal Approach to a Funded Reform
 2. Tax Administration and Collection
 3. Legal and Institutional Framework
 4. Availability and Quality of Information
 5. Transaction Security
 6. Availability and Quality of Critical Financial Services
 7. Availability of Financial Instruments
 8. Governance
 9. Historical Context
 10. Communication and Financial literacy/education

Chart 4.1: Score of Readiness Indicators: In Year of Reform, and 5 Years later* (or 2006)**



Source: Holzmann et al 2009

Score in Year of Reform Score in 2005

Missing markets to address longevity risk via private sector or political will?

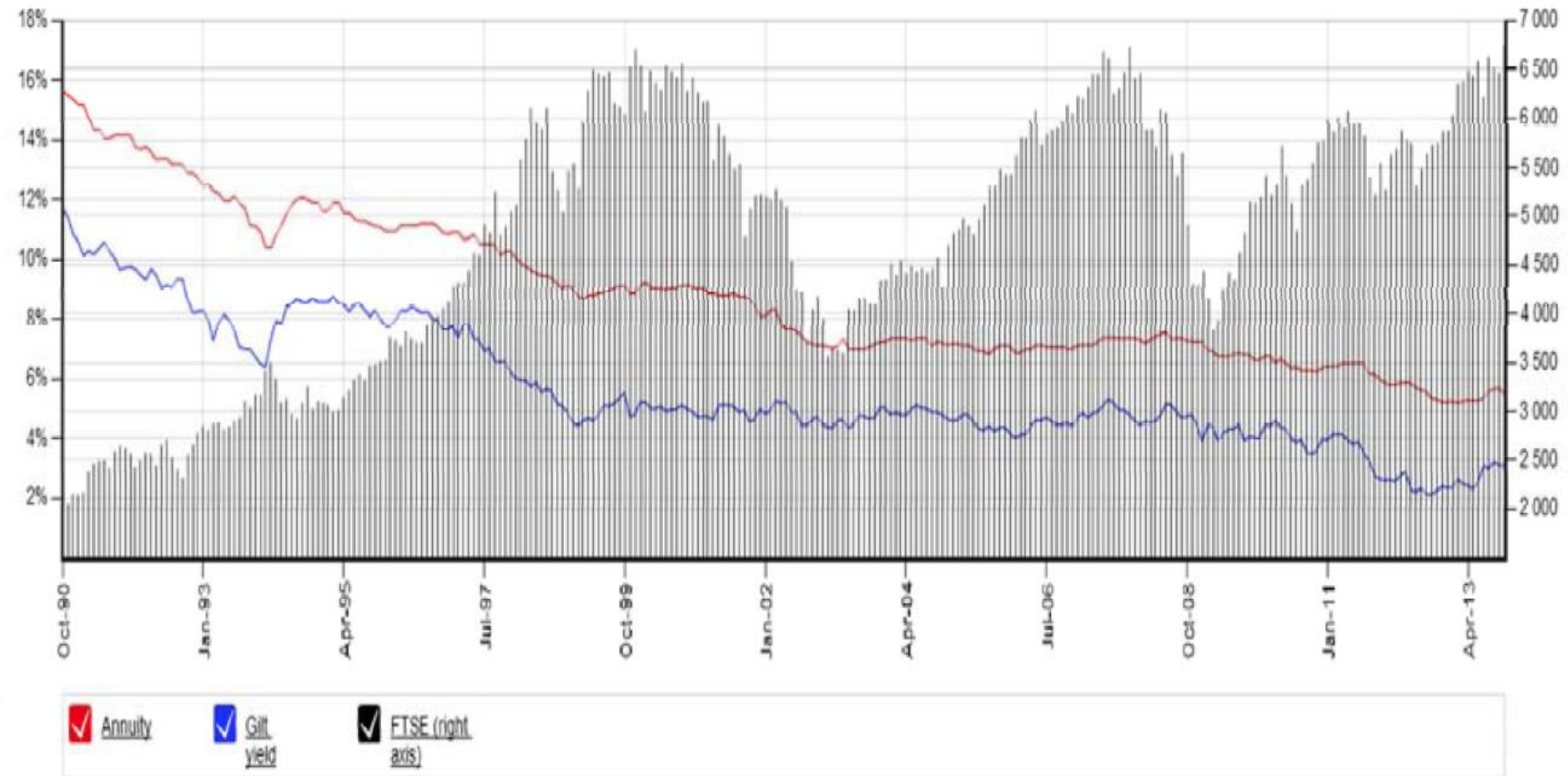
■ **Can financial markets truly offer life annuities?**

- Longevity increase is always underestimated and prone to technology-induced shocks
- Aggregate (systemic) risk that cannot be diversified and longevity bonds are not taking off
- Capability to hedge investment risks of life insurers decreases with fall in government bond returns

■ **Differences in life annuity coverage across countries**

- US: around 1% of 401(k) plan retirees purchase (EBRI 2011, LIMRA 2013)
 - Immediate life annuities 2012: US\$ 7.7 billion
 - Equity indexed annuities 2012: US\$ 35 billion o/w 75% bought with guaranteed lifetime benefit
- AUS: 100 policies per year in market of a few millions (Plan for Life 2012), i.e. less than 1/100% of flows
- Switzerland: around 80 percent of accumulated balances
- Chile: around 70 percent of accumulated balances, rest Phased Withdrawal (PW)

Chart 1: Annuity Rate, Gilt Yield, and FTSE 100 since 1990



Male age 65, £10,000 purchase, Single Life, Guaranteed 5 Years and Level Payments.

Yield on 15 year gilts.

The FTSE 100 Index is a share index of the 100 most highly capitalised UK companies listed on the London Stock Exchange.

Source: <http://thisismoney.brgl.co.uk/ratetables/key.aspx>

Administrative conditions

- Public pension schemes rely on elaborate mechanism to collect contributions and keep evidence about them, and to calculate the initial pension benefit and to pay pension benefits
- Reforms may change each of these elements and typically establish parallel benefit calculations to address equity issues and political concerns across different cohorts
- Doing so implies typically major changes in computer software and business process as well as information and training of staff down to the lowest administrative level
- All this requires time to prepare and test and process is often mixed with acquisition of new hardware
- If not well done, and the new reform is accompanied by technical glitches, the substance of the reform may be called into question
- As there have been costly country experiences on this (such as in Austria, Latvia, Poland)

3. Implementation: PRACTICE BUILDING

■ **Readiness and timing:**

- Decide law when politically opportune and start implementation when administratively ready

■ **Administrative preparation and communication:**

- Introducing ICT is 5% technology and 95% management
- ICT requires a rethinking of the business process and a strong communication with staff, and their training
- Communication of changes with the public is key

■ **Holding the fort – dealing with enemies and dissents:**

- Be flexible but stubborn

III. Concluding remarks

- The political economy around pension reforms is still an area in development that would warrant more attention
- The proposed and presented conceptualization has a universal appeal but requires empirical deepening (under development)
- An largely under-investigated approach to initiate reforms and adjustments happens in the EU by influencing member countries' pension reforms through the European Semester, the peer review process, and elements of a reform template, including the periodic Adequacy Report and Ageing Report. But this is for another presentation ...

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