Reforming pensions: Tales from China, Chile and elsewhere

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1 The simple economics of pensions

The objectives of pension systems

- Individual objectives
  - Consumption smoothing
  - Insurance
- Additional public policy objectives
  - Poverty relief
  - Redistribution

Ways of organising pensions

- Pay-As-You-Go (PAYG): pensions are paid out of current income
- Funded pensions: pensions are paid out of a fund built over a period of years from its members' contributions

Controversies

- What is not controversial
  - State pensions, for poverty relief, and in many countries also earning-related state pensions for consumption smoothing
  - Voluntary pension arrangements for consumption smoothing and to allow for differences in preferences
- What is controversial:
  - The balance between the objectives
  - Should funded pensions be mandatory?

The simple economics of pensions

- Two and only two ways of organising pensions
  - Store current production
  - Build a claim to future production
- Pensioners are not interested in money, but in consumption. Thus the key variable is future output.
- PAYG and funding are merely different financial mechanisms for organising claims on future output
- Thus the difference between the two approaches should not be exaggerated

The relation between contributions and benefits

- Defined contribution (DC) pensions
- Defined benefit (DB) pensions
  - Final salary
  - Longer period of measurement
- Notional defined contribution (NDC) pensions

2 The China story

2.1 Description

	Number of retired workers (millions)	Number of active workers per retired worker
1980	8.2	12.8
1985	16.4	7.5
1990	23.0	6.1
1995	30.9	4.8
2002	36.1	3.08

The system for urban workers

- Basic pension
- Individual funded accounts
- Voluntary pensions
- Other forms of poverty relief

2.2 Problem areas

- Fragmentation
- System deficits
- Problems with individual accounts
- Lack of nationwide administration

2.3 Reform directions

- Obvious reform directions
  - Extending coverage
  - Improving compliance
  - Raising retirement age
  - Ensuring accurate actuarial calculations
- Fundamental questions
  - Are fully funded individual accounts *desirable* given current and projected economic conditions in China
  - Are they *feasible* given current regulatory capacity and the current state of financial markets?

Are funded pensions desirable?

- Is a move toward funding optimal?
  - Does it increase output by
    - Increasing savings in a country that is short of saving, and/or
    - Strengthening capital markets, improving the efficiency with which savings are channelled into investment
  - Does it have desirable intergenerational redistributive effects?
- Is a move towards funding feasible? Are economic conditions and institutional capacity such that a country can implement schemes that are
    - Safe and
    - Administratively cheap?

Conclusion: individual funded accounts

- Funded individual accounts in China
    - are not necessary to encourage savings
    - may be counter-productive in assisting efficient investment, particularly since voluntary funded pensions can help to develop capital markets
    - have perverse intergenerational redistributive effects
    - are likely to strain scarce implementation capacity
- These are conclusions for China today; do not necessarily apply to China in the future

How should individual accounts be organised?

- Notional defined contribution (NDC) pensions (e.g. Sweden)
- Advantages in the context of China
  - Offers consumption smoothing to today's contributors, hence continues the purpose of individual accounts
  - But avoids the risks of funded individual accounts
    - Less risky for workers, since avoids volatility of capital markets
    - Because no fund is built up, does not require today's (poorer) workers to make larger contributions, thus avoiding unsatisfactory intergenerational redistribution
    - Does not require the considerable private-sector financial and administrative capacity of funded schemes
  - NDC can be the basis for a future move to partial or full funding

Overall reform strategy

- The strategy comprising a basic pension and individual accounts is sound; if it ain't broke, don't fix it
- But if nothing is done to improve its operation, the risk is that continuing deficits + empty accounts undermine the credibility of the system, making further implementation – enforcing compliance and extending coverage – increasingly difficult
- Bottom line: look at countries like Sweden, Latvia and Poland that have an NDC element in their pension system

Specific recommendations include

- Creating a single national system, with a national pool
- Continuing the system of basic pensions, with some reform
- Continuing individual accounts, but organised as notional accounts
- Over time increasing the age at which a worker receives a full pension, that age to be the same for men and women
- Adjusting pensions on an actuarial basis for the age at which the pension starts
- Strengthening encouragement and regulation of voluntary, supplementary pensions, both individual pensions and employer schemes

3 The Chile story

3.1 Description

- The system for formal-sector employed workers
  - Individual accounts
  - Poverty relief
  - Voluntary pensions
- Mistaken views about the 1981 reforms
  - Reduce public spending
  - Offer high rates of return
  - Get government out of the pensions business

3.2 Problem areas

- Pensioner poverty
- Incomplete coverage
- Gender inequality
- High administrative charges
- Fiscal cost
- As a result:

  'the system of individual accounts created by the 1981 reform is not capable of meeting the pension needs of all Chileans' (Chile Presidential Advisory Council 2006)

Primary lessons

- Funded individual accounts can be part of a good reform, but such a reform is not easy
- Private supply plus competition are not on their own sufficient to keep down transactions costs or charges
- Unless accompanied by a robust system of poverty relief, individual accounts are not a pension system, but only a part of a pension system

3.3 Reform proposals

The strategy:

The Council proposes 'to move from a system dominated by individual accounts to a pension system capable of balancing and integrating its various components …. Instead of giving preference to one pension scheme over another or developing parallel systems, the proposed system [will] be structured on three pillars: a solidarity pillar, a contributory pillar and a voluntary pillar. These pillars must be capable of complementing and integrating with one another to ensure that older people have a decent life in old age'.

- The key strategic reform is the proposal to introduce a solidarity pillar

The solidarity pillar

- Above the poverty line, phased in to reach 75,000 pesos/month by the end of the Presidential term
- Payable to lowest 2/3 of population
- Husband and wife in poor families each gets full basic pension
- Tax financed
- Replaces the minimum pension guarantee and welfare pension

Individual accounts: Recommendations include

- Extending the mandatory system to self-employed workers
- Assisting low-income workers in accumulating funds
- Addressing gender disparities
- Improving the operation of individual accounts
- The dog that did not bark: a state-run fund

Comparator countries

- The old system in Chile has much in common with Singapore, based heavily on individual saving
- The reforms bring Chile much closer to
    - Australia: tax financed pension for all but the best off, plus mandatory individual accounts
    - New Zealand: tax financed pension for all, plus voluntary individual accounts
    - Netherlands: tax financed citizen's pension plus de facto mandatory private, funded pensions

4 What about Europe?

4.1 The problem

Public pension spending, % GDP

	2000	2030	2050
Denmark	10.5	14.5	13.3
France	12.1	16.0	n.a.
Germany	11.8	15.5	16.9
Greece	12.6	19.6	24.8
Netherlands	7.9	13.1	13.6
Sweden	9.0	11.4	10.7
UK	5.5	5.2	4.4
Source: UK Pensions Commission (2004, Table D2)			

Roots of the problem

- The ratio of pensioners to workers is increasing
    - More pensioners
        - More people live to retirement age
        - People retire earlier
        - Life expectancy at retirement is higher
    - Fewer workers
        - Declining birth rates
        - Working life starts later because of longer education
- Finance is constrained
    - Medical advances and the need for more education and training increase demands on tax revenues
    - Global economic pressures make it harder to increase taxation

4.2 The range of options

- The UK Pensions Commission (2004, 2005) rightly argues that there are four and only four ways to improve the finance of a pension system
    - Lower pensions
    - Higher public spending
    - Higher saving
    - Longer working lives

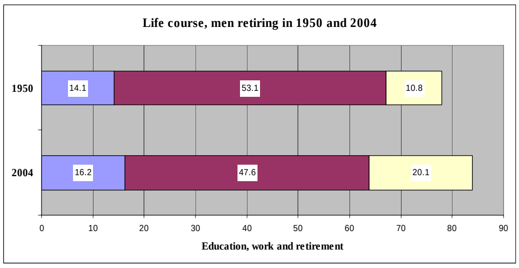
China and Chile revisited

- Lower pensions: rejected
- Higher public spending
  - China: mainly through expanding coverage and de facto recognition that individual accounts are not funded
  - Chile: an explicit element in reforms that introduce a tax-financed solidarity pension
- Higher saving
  - In China via voluntary pensions
  - In Chile by extending mandatory savings to self-employed workers and by making current savings instruments more attractive
- Later working lives
  - An explicit recommendation in China
  - Chile: through gradual equalisation of retirement ages

4.3 A central policy direction in Europe: Later and more flexible retirement

- There is neither an ‘ageing problem’, nor a ‘pensions crisis’
- People are living longer – the great untold good news story
- Not a problem but a triumph
- However, creates problems of pension finance
- The solution: pensionable age should rise in a rational way as life expectancy increases

The life course in the UK



Retirement: later and more flexible

- A higher average retirement age
  - To contain costs, making it possible to finance an adequate pension
  - Phased in, rising in some sensible way with life expectancy
- A variable retirement age
  - Desirable for its own sake
  - Increased choice about when to retire, and whether fully or partially

Towards an operational strategy

- An initial retirement age that makes it possible to provide a genuinely adequate state pension
- A subsequent retirement age rising in line with life expectancy in a rational and transparent way
- Facilitating adjustments to pension design
- Facilitating adjustments to labour market institutions, allowing people to move from full-time work towards full retirement along a phased path of their choosing

5 Conclusion

The packages proposed for China and Chile directly address strategic problems in the existing system

- Mandatory funding was introduced prematurely in China. The recommendation of NDC accounts is for now, not for ever
- The 1981 reforms in Chile gave insufficient weight to poverty relief. Introducing a basic pension addresses the problem

- Recommendations of the Pensions Commission address the UK’s strategic problems
- Much of the rest of the EU is still coming to grips with these issues

Some final tub thumping

- Economic theory is important in designing pensions: policy makers should
  - be aware of the multiple objectives of pensions
  - consider the pension system as a whole, not just its individual parts
  - look at output, and not obsess with financial variables
  - treat retirement age as a variable not a constant
- The capacity to implement policy is equally important
  - It is sad when a good policy is discredited by bad implementation
  - Chile managed to introduce individual accounts in the 1980s only because it had (and continues to have) government that is unusually effective for a middle-income country
  - Government in China is still developing the capacity to run a modern mixed economy
- One size does *not* fit all: successful countries have very different pension systems

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