An Overview of Global Social Security Reforms

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Organization

- Introduction
- Demographic Trends
- Recent International Developments in Social Security Reform
- Key Challenges
- Options for Increasing Coverage
- Concluding Remarks

INTRODUCTION/1

- Globalization has made social safety nets essential for

    - **cushioning the burden of restructuring,**
    - **increasing legitimacy of reforms, and**
    - **for risk taking by individuals and firms.**

- There has been considerable debate and experience with social security reform but no single idea, system or model has emerged even among the Asian countries.

INTRODUCTION/2

- Each country must therefore study relevant analytical literature and relevant international experiences carefully with a view to drawing lessons which are appropriate for the local context, institutions and policy objectives.

- The art of lesson drawing however is an extremely difficult one and requires not just technical understanding , but also sound judgment , and tactical instincts.

INTRODUCTION/3

- High quality public debate involving all stakeholders could substantially facilitate the formulation of pension policy options and implementation. Unfortunately, the quality of such debates is often poor.

- Moving Pension reform on the priority list of public policy agenda is itself a major task.

INTRODUCTION/4

- Pension reforms should be viewed as a process and not an event .

- This process should consider complementary areas such as Fiscal Systems , Labor Markets , Financial and Capital Markets, Transaction Governance Capacity (TGC).

INTRODUCTION/5

- TGC is the capacity of a society to impart transparency in the process of economic transactions and the ability to enforce commercial contracts.

- Clearly formulated laws, transparent micro regulations, appropriate social norms, and timely and uniform enforcement are all part of TGC as defined in “ The Fortune at the Bottom of the Pyramid” (Wharton School, 2005).

INTRODUCTION/6

- In many developing countries , reform of the formal pension systems is necessary though not sufficient.

- This is because the formal sector systems are relatively small in terms of coverage (as an example, in Indonesia , at most about 20% of the labor force is covered). This leaves large proportion of the labor force outside the mandated provident and pension fund schemes.

INTRODUCTION/7

- Reforming formal sector systems could permit better balance in social protection between formal (relatively small) and informal (bulk) sectors; and between different groups of the elderly.

- Options for enhancing coverage are discussed in the later part of the presentation.

INTRODUCTION/8

- Social security reform may be viewed from the perspective of pension and provident fund organizations and from a systemic perspective involving all the different components.

- In managing these organizations, the key objective should be to attain and sustain high degree of Professionalism.

INTRODUCTION/9

Five core functions of Provident and Pension Funds Organizations (Ross, 2000). These apply to both private sector and public sector organizations, including the civil service schemes.

1. Reliable collection of contribution/taxes, and other receipts.

2. Payment of benefits for each of the schemes in a correct way without any side-payments.

   In case of pre-retirement loans, ensuring their timely repayment.

3. Secure financial management and productive investment of provident and pension funds assets.

INTRODUCTION/10

4. Maintaining an effective communication network, including development of accurate data and record keeping mechanisms to support collection, payment and financial activities.

5. Production of timely and policy relevant financial statements and reports.

INTRODUCTION/11

- The core functions are interrelated.
- While lot of the attention and debate focuses on the investment function, the importance of performing non-investment functions cannot be over-emphasized.

INTRODUCTION/12

- **Much of the recent social security reform has focused on improving the performance of the core functions and benchmarking them against international best practices.**

- **From a systemic perspective, the system should be**

  - **Adequate (both in terms of coverage and level of protection against various risks).**

  - **Affordable (from individual, business, fiscal and macroeconomic perspectives)**

  - **Sustainable (should have tight strategy, but flexible implementation to financially sustain the system over a period of 70 years or more).**

  - **Robust (must be able to withstand macroeconomic and other shocks)**

INTRODUCTION/13

- The single most important Macroeconomic variable for economic security of both young and the old is trend rate of economic growth.

- World Bank’s multi-tier framework represents a way of organizing thinking about pension reforms to diversify risk and ensure wider coverage , particularly in developing countries.

- This framework is therefore NOT a blueprint.

INTRODUCTION/14

- The key message is that total retirement financing must be obtained from a variety of tiers and not from just one scheme. It also recognizes the important role of social assistance for the life time poor, financed from the budget; and of family and non-financial assets in providing retirement income security.

- Table 1 provides the World Bank’s multi-tier framework. It has five tiers.

Table 1: Multi-Pillar Pension Taxonomy of the World Bank

Pillar	Target Groups			Main Criteria		
	Lifetime poor	Informal sector	Formal sector	Characteristics	Participation	Groups
0	X	x	x	“Basic or “Social pension,” at least social assistance, universal or means-tested	Universal or Residual	Budget/general revenues
1			X	Public pension plan, publicly managed, defined-benefit or notional defined-contribution	Mandated	Contributions, perhaps with financial reserves
2			X	Occupational or personal pension plans, funded defined-benefit or funded, defined-contribution	Mandated	Financial assets
3	x	x, X	X	Occupational or personal pension plans, funded defined-benefit or funded, defined contribution	Voluntary	Financial assets
4	x	X	X	Personal savings, homeownership, and other individual financial and non-financial assets	Voluntary	Financial assets

Table 1: Multi-Pillar Pension Taxonomy of the World Bank

- *Note:* The size of x or X characterizes the importance of each pillar for each target group.

- *Source*: Holzmann R. et al. “Old age income support in the 21st century: the World Bank’s perspective on pension systems and reform”, Washington DC: The World Bank, May 2004 Draft (Processed).

II. Demographic Trends/1

Three major demographic trends are apparent-

1. Fertility Rates are dropping nearly everywhere

2. Life Expectancy is rising in many, though not all parts of the world

3. Developed countries are well advanced with respect to the above two trends, reflected in their declining share in world population. The non-developed countries are farther behind, though variation among them is large.

Demographic Trends/2

Ageing Factoids

- 59% of world's elderly (249 million) lived in developing countries in 2000; this will increase to 71 % (686 million) by 2030.

- Most of the growth will take place in developing countries, over half of it in Asia and more than a quarter in China alone.

Demographic Trends/3

- The problem in the developing countries will not be just the level of elderly population but the rapid pace of ageing.

- Many developing countries will have an `old' demographic profile at much lower level of per capita income than the industrial countries.

Table 2: Population Aging in Selected Countries

	Population (In Millions)		% of Population Over 65		Population over 65 (Numbers in million)	
	2000	2030	2000	2030	2000	2030
China	1262	1483	7.0	16.0	88	237
India	1014	1437	4.6	9.0	47	129
USA	276	351	12.6	20.0	35	70
Vietnam	76	N.A.	5.8	N.A.	4.4[b]	N.A.
Indonesia	225	313	4.5	10.9	10	34
Brazil	173	203	5.3	13.2	9	27
Russia	146	133	12.6	20.5	18	27
Japan	127	117	17.0	28.3	22	33
France	59	62	16.0	24.0	9	15
UK	60	61	15.7	23.5	9	14
S.Korea	47	54	7.0	19.5	3	11
Malaysia	22	35	4.1	9.4	1	3
Australia	19	23	12.4	21.1	2	5
Singapore	4	9	6.8	14.8	0	1

Table 2: Population Aging in Selected Countries

- a data for 1999
- b 2.63 million or 60% were females. So gender issue will need to be addressed. Early retirement age for women will mean larger need for retirement resources.

Demographic Trends/4

- By 2030, 237 million people, or 16% of China's population will be over 65 years of age.

- In ASEAN, Singapore will experience the most rapid ageing followed by Thailand. Philippines and Malaysia exhibit relatively high fertility rates, population in these countries will age relatively gradually.

- For financing retirement (and for healthcare) what matters is the life expectancy at age 60 (Figure 1) Differences among countries are much smaller for life expectancy at age 60, than it is for life expectancy at birth.

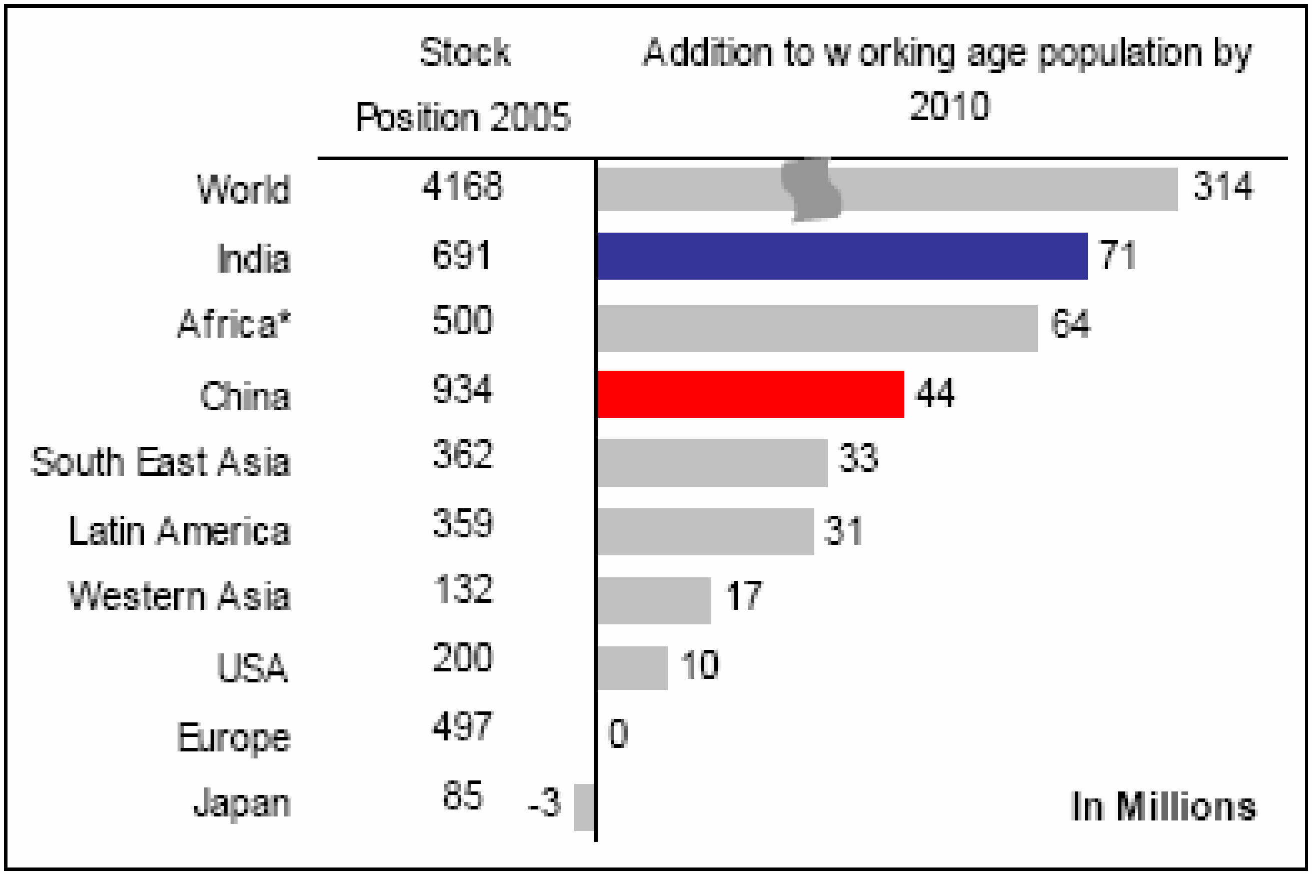
Demographic Trends/5

- The vast numbers of elderly adds a human dimension and imposes a significant responsibility on the part of those who are involved in managing retirement funds and systems
- How Asia addresses the challenge will largely determine how the world will cope with ageing.
- So the focus of pension reforms should not primarily be on OECD countries. Many Asian countries will have OECD's demographic profiles at much lower per-capita incomes and much less time to adjust than that has been the case in the OECD.

Demographic Trends/6

- **Figure 1:Demographic and Labor Force Challenge**

Growth in Global Working-Age Population (15-64)



* Note: Africa includes a group of 56 countries. Source: UN, Morgan Stanley Research

Recent International developments in pension reforms /1

1) Retirement objective or development focus?

- **The objective of any social security system is the provision on a sustainable basis, of a socially adequate and equitable retirement protection system, while simultaneously minimizing adverse effects on:**
  - **economic efficiency;**
  - **fiscal consolidation and flexibility;**
  - **incentives to work and save;**
  - **international competitiveness.**
- **The single most important macroeconomic variable in reaching this objective is the trend rate of economic growth.**

Recent International developments in pension reforms/2

- Recent trend has been towards focusing on the retirement objective (e.g. Hong Kong, Chile, and many Central European countries) rather than having a multi-objective provident or pension funds.

- It is felt that multi-objective systems tend to violate the principle that each policy instrument should be targeted towards a single objective, otherwise sub-optimal outcomes may occur.

Recent International developments in pension reforms/3

- Systems focusing on the retirement objective alone have relatively low contribution rates.
- As these are statutory levies, the impact on hiring and firing costs, and on labor market functioning are positive.

Recent International developments in pension reforms/4

- Broadly, 10% contribution rates with no wage ceiling and no pre-retirement withdrawals should be able to provide between 30-40% replacement rates, with reasonable longevity risk protection but limited inflation risk protection.

Recent International Developments in Pension Reforms/5

The recent reforms particularly in Asia-pacific have focused on

2)Civil service pension reforms

- Primarily increasing the funding through contributions, setting aside dedicated sinking funds which are then invested in the capital markets in a professional manner with high level of importance attached to fiduciary responsibility (Some aspects of this trend are evident in Malaysia, Sri Lanka, and Thailand).
- Revising the benefits formula linking it with overall Civil Service reform, including the New Employment contract.

Recent International developments in pension reforms/6

3) Occupational pensions

- The trend has been towards expanding the role of employer based voluntary occupational pension plans, with tax advantages subject to a ceiling.
- Professional management of funds through the capital markets.
- Foreign pension fund managers being invited(China) ;and international diversification is increasingly considered (Malaysia and Thailand).
- New legislation is being enacted to facilitate this tier of retirement plans (China).

Recent International developments in pension reforms/7

- The UK has proposed a National Pensions Savings Scheme (NPSS) which will begin operations in 2012(Financial Times, FM Supplement, May 29, 2006).
- It will automatically enroll all employees without access to an occupational pension plan into a low cost scheme of portable, personal accounts.
- Employees will pay half the contributions, set at 8% of the salary and can opt out of the NPSS if they choose.

Recent International developments in pension reforms/8

- The government estimates that the scheme will have between 6 million and 10 million members.
- The contributions will range from 6 billion GBP to 8 billion GBP a year.
- The government is leaning towards a single operator for the system.

Recent International developments in pension reforms/9

- Australia (Financial Times, FM Supplement, July 24, 2006).
- Since 1992, Australia has had a compulsory retirement benefit Scheme where employers are required to contribute 9% of an employees gross wage into an accredited pension- or superannuation- fund.
- Total accumulated assets are A$760 billion(US$ 570 Billion), and the fund is growing at A$1 Billion a week.

Recent International developments in pension reforms/10

- The retirement period

1. 40% of the population will spend up to 25 years in retirement.
2. 40% will spend 35 years and 10% will be retired for more than 35 years.
3. Even with good management, it appears that for an average retiree the superannuation fund will be inadequate. Estimates are that the contribution rate should be at least 12%, and preferably 15%.

Recent International developments in pension reforms/11

- This scheme permits lump sum withdrawal with no requirement for purchase of annuities.

Recent International developments in pension reforms/12

4) The importance of transition

- It is however not very easy to shift from multi-objective to retirement objective focused system and a careful transition strategy is needed.

- Fiscal costs of transition from PAYG DB scheme to a DC scheme are likely to be major (e.g.. as in Chile, and much of Latin America and Central Europe).

Recent International developments in pension reforms/13

- While analytically, making implicit debt (i.e. present value of pension benefits already earned) explicit is neutral, in market perceptions, this is not likely to be the case. So any such move should be carefully weighed.

- Companies and State enterprises also face major challenges in transiting from a DB to a DC system.

- New accounting rules are likely to require greater transparency in reporting pension and healthcare liabilities.

Recent International developments in pension reforms/14

5) Investment policies and performance

- The financial products are indeed very complex. The financial industry is oligopolistic and highly concentrated. Competition therefore may not bring down the transactions costs to the desired extent as the Latin American experience suggests.

- In Chile, mutual fund asset management fees for equity funds have stubbornly been around 5 to 6 percent of assets during the 1990-2001 period (Gill et al, 2003, p.201).

- The design of individual choice may give rise to high marketing, and other costs (e.g. Chile).

Recent International developments in pension reforms/15

- **Even the U.K., with sophisticated capital markets, has had to impose a cap on expenses of private pension providers.**

- **Another important issue concerns investment diversification across asset classes and across geographical areas.**

- **The international experience suggests that international diversification, and investments abroad need to be calibrated with institutional and regulatory structures and development of financial and capital markets (Table 3).**

Table 3: Gross Real Returns to Pension Fund in Selected Countries

Country	Time period	Real Return (percentage per annum)
Malaysia	1990-2004	3.4
Singapore	1987-2004	1.3
Argentina	1994-2002	10.4
Chile	1994-2002	10.3
Colombia	1994-2002	9.9
Costa Rica	1994-2002	7.0
Mexico	1994-2002	10.4
Peru	1994-2002	6.6

Note: Returns to members of the fund may be lower than to the fund

Sources: Gill (2003) for Latin America; Asher (2004).

Recent International developments in pension reforms/16

6) The Role of Administration and Compliance Costs

- The administrative cost refer to the cost of administering the provident or pension fund scheme by the concerned agency or organization. These costs are usually charged to members. So lower these costs are, the better it is for the members.

Recent International developments in pension reforms/17

- The importance of specialist background in investments in managing large pension funds is illustrated by Japan's Government Pension Investment Fund (GPIF),(Financial Times June 14,2006).

- Its total assets are nearly US$ 900 Billion, its 11 member board however lacks expertise in picking good external asset managers. Its own staff also lacks fund management expertise.

Recent International developments in pension reforms/18

- Compliance cost refer to the cost of complying by establishments and members with the rules and regulations set by the agency or organization. These also need to be minimized. But these are more difficult to estimate than the administrative cost.

Table 4: Indicators of Administrative Efficiency in Malaysia and Singapore, 2004

Variable	Central Provident Fund (CPF), Singapore	Employees Provident Fund (EPF), Malaysia
Operating cost as % of income	3.52	3.11
Operating cost as % of Funds Under Management (FUM)	0.11	0.15
Operating cost as % of contributions	0.88	1.68
Number of employers registered per employee	55.7	78.4
Number of members registered per employee	2,156	2,124
Number of active contributors per employee	946	1,067

Sources: Calculated by the Authors based on official sources.

Recent International developments in pension reforms/19

7) Issues in Decumulation Phase.

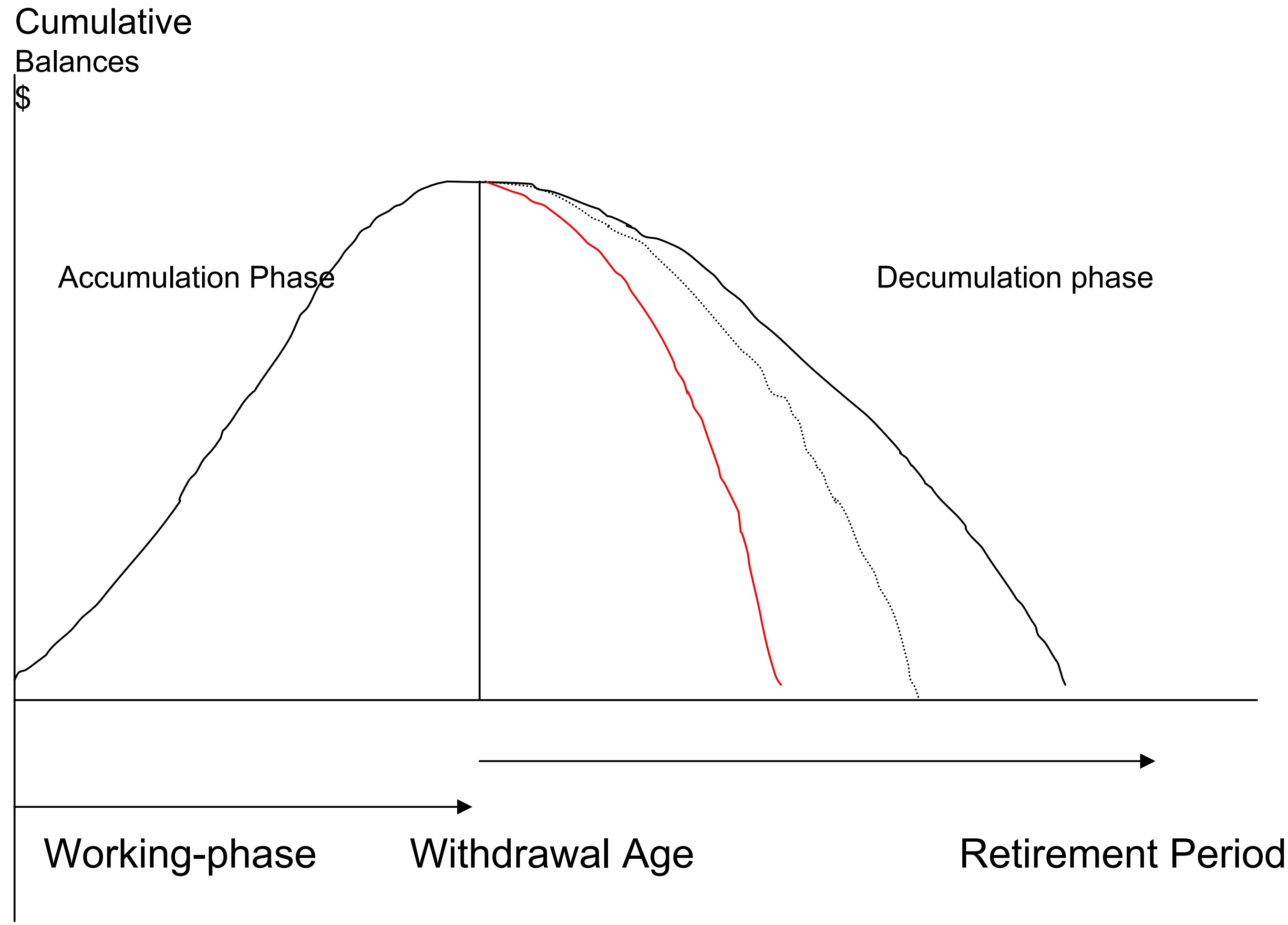
In any defined contribution system , the two phases are 1) Accumulation 2) Decumulation phase.

- These are depicted in figure 2.

Recent International developments in pension reforms/20

- In the decumulation phase, essential to address longevity and inflation risks.
- Longevity risks refers to accumulated funds being exhausted before death.
- Inflation risks refers to maintaining real value of the pension benefits throughout the retirement period.

Figure 2:Accumulation and decumulation phases of DC schemes



Cumulative Balances = Net contributions (contributions minus withdrawals), plus interest credited on accumulated balances.

Decumulation phase: the funds accumulated can be spent rapidly or slowly. Death may occur before the funds are exhausted or reverse is also a possibility. So need to protect against longevity risk. As it is the purchasing power of the funds that is relevant, protection against the inflation risk is also desirable.

Source: Author

Recent International developments in pension reforms/21

- The decumulation phase has not received sufficient attention in many countries.

- Social risk pooling arrangements need to be considered, though the timing and extent of risk pooling may vary.

- Concept of rolling annuities needs to be further researched.

- Matching assets and liabilities is crucial.

Recent International developments in pension reforms/22

The relatively neglected areas are:

- Governance structures
- Regulation
- Systemic perspective.
- Tax treatment of pension and related products , and of providers.
- Informal sector coverage.
- Human resource development
- Managing organizational change.
- Modernization of relevant laws and implementing regulations.
- Empirical evidence based policies.

Key Challenges

- Relatively lower weightage to fiduciary responsibility.
- Finding trustees and Board members who are both capable as well as independent minded.
- Limited access to outside expertise at the Board level, and in investments.
- Absence of pension regulator.

Key Challenges

- Lack of systemic perspective.
  Over-reliance on a single pillar.
- Limited transparency and accountability.
- Use of information as strategic resource.
- Limited progress in corporate governance.
- Limited indigenous research capacity.
- Limited financial literacy.
- Limitations of high transaction costs and capital markets.

Key Challenges

- Addressing them may involve risk sharing among all the stakeholders, including governments, insurance companies, individuals and employers (in case of occupational pension).

Options for increasing coverage/1

- The coverage in many countries is relatively low.
- The demographic and labor force challenges will simply increase the complexity of providing social security coverage.
- Table 3 provides the coverage in selected Southeast Asian countries.

Table 5: Key Provident and Pension Fund Organizations and Indicators in Southeast Asia

Country	Organizations	Contributors as Percent of Labor Force[a]	Contribution Rate (2004)	Wage Ceiling (2004)	Member Balances (USD Billion), Percent of GDP
Malaysia	Employees Provident Fund (EPF)	50.6 (March 2006)[b]	23.0	No	72.2, 52.8 (March 2006)
	Government Pension Fund, Malaysia (GPF)	NA	NA	No	NA
Philippines	Social Security System (SSS)	20-25[c] (2003)	8.4 (5.07/3.33)	P 15,000 per month	3.3, 3.8 (June 2005)
	Government Service Insurance System (GSIS)	4.5 (2003)	21.0 (12/9)	No wage ceiling	3.7, 4.3 (early 2005)
Singapore	Central Provident Fund (CPF)	58.3[d] (December 2005)	30.0[f]	$4,500 per month from January 2006	74.8, 61.6 (December 2005)
	Government Pension Fund, Singapore (GPF)	NA	NA		NA
Thailand	Social Security Organization (SSO)	21.2[e] (2003)	6.0	B15,000 month	20.0, 11 (early 2005)
	Government Pension Fund, Thailand (GPF)	3.5(2003)	6.0	Yes	7.8, 4.6 (2005)

Table 5: Key Provident and Pension Fund Organizations and Indicators in Southeast Asia

- A) Figures in brackets refer to year to which data refers.
- B) Includes 4017 foreign workers.
- C) Membership in the SSS is 23 million but the active contributors are 6-8 million.
- D) Foreign workers are around 25% of the labor force and are excluded.
- E) The SSO coverage is overstated as the figure refers to members rather than active contributors. If the provident funds of SOE's are included, the coverage rate may be as high as 25%.
- F) This rate applies to those below 55 years of age. Lower rates apply to those above 55 years.

Sources: Information obtained for official sources in each country.

Options for increasing coverage/2

- This however does not imply that all those that are covered will satisfy the second and third aspects of coverage mentioned earlier.
- Given this huge challenge, what are the options?

Options for increasing coverage/3

- **<u>OPTION 1</u>**:
  - Element 1:

    Increase the capacity of formal provident and pension fund organizations to cover larger proportion of those in the formal sector. For example, in India, the provident fund organization can improve its capacity to effectively cover firms with less than 20 employees.

    This element can provide non-trivial increase in coverage though would still leave out large proportion of those in the informal sector.

Options for increasing coverage/4

- Element 2:

  Provide decentralized voluntary schemes with effective regulation for all individuals to participate.

  The role of group-schemes, including by Self-Help Groups (SHGs) becomes critical.

Options for increasing coverage/5

- Element 3:

  Undertake fiscal reforms to increase the coverage of social assistance programmes, financed directly through the budget (Zero pillar of Table 1).

Options for increasing coverage/6

- **OPTION 2**

  - Centralized mandatory social insurance-based schemes to cover health, pension, and other aspects.

    This is the approach taken by Indonesia in its recently passed legislation. Similar legislation is pending in Vietnam. In India, some groups have also recommended such a scheme covering more than 300 million people.

Concluding Remarks /1

- The pension economics and management is complex and subtle requiring sustainability over many decades.

- While political leadership and decisions are important, the key is to ensure that there is high degree of professionalism and systemic perspective.

Concluding Remarks /2

- There is a strong case for a multi-tier system under which retirement finance is obtained from many different sources, including participation in labor force, family and community and conversion of non-financial assets such as housing and gold into income flows.

- No single pension model has emerged as clearly superior in all circumstances. Therefore, contextual adaptation of general principles and best practices is essential.

- The importance of non-investment core functions cannot be over-emphasized.

Concluding Remarks /3

- There are considerable variations in the philosophy, coverage, investment policies and performance, design of schemes, governance structures, degree of professionalism and adequacy of benefits among Asian countries.

- The pensions sector requires strong government regulation. For most Asian countries , given their level of development there is a strong case for dedicated pension regulator.

Concluding Remarks /4

- However as distinctions among financial service providers becomes more blurred, greater coordination among regulators will be needed and eventually , a super regulator covering the whole financial and capital markets sector, may become necessary.

- In countries such as China, transition (and legacy) issues are a major challenge.

- This is also the case with civil service reforms in countries such as Malaysia, India, Sri Lanka and Indonesia where existing civil servants do not contribute towards their pensions.