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Designing Mandatory Pension Schemes

Some lessons from Argentina, Chile, Malaysia, and Singapore

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In most countries, participation in a public pension system involving some kind of redistribution is compulsory, while participation in private pension schemes is voluntary. Public and company pensions have enjoyed high popularity as long as their promises seemed credible and generous. But there are growing fears in many countries that the value of public pensions will not be sustained. There are similar fears about company pensions. The credibility of company pensions depends on the integrity and solvency of large employers, which can no longer be taken for granted.

These problems point to a need to refine, but not do away with, compulsory saving. There is clearly more justification for a compulsory scheme providing a minimum pension than for a scheme that sets a high replacement rate for preretirement earnings. But as the real value of public pensions declines, the case for compulsory private pension schemes becomes stronger. And if retirement saving is made compulsory, tax incentives should be used to encourage compliance.

Compulsion also imposes an obligation on the state to ensure that the system works well, is simple and easy to understand, and will deliver the targeted benefits. This obligation has implications for the management and regulation of the pension system. Other important design issues include the extent of compulsory coverage, the form and rate of compulsory saving, and the extent of individual choice.

Drawing on the experiences of countries in Asia, Latin America, and elsewhere, this Note provides some guidance on how to impose compulsion and which tax incentives to offer.

Whom to compel?

The issue of who should be compelled to participate is complex. A strong case can be made for exempting some groups of workers—especially those under age twenty-five, those with very low incomes, and those above the normal retirement age. The treatment of unemployment spells, maternity leave, military service, and university education creates complications that may have a serious effect on defined benefit schemes based on final salary, though their impact on defined contribution systems is less important.

In practice, most countries with mandatory private schemes require all workers other than the self-employed to participate. Self-employed people usually are not covered because it is difficult to ascertain their incomes and monitor compliance. Among countries with mandatory fully funded second pillars, Chile and Switzerland follow this approach. Argentina has made participation compulsory for all workers, including the self-employed, though it remains to be seen whether self-employed workers will comply.

Defined contribution or benefit?

Increasingly, compulsory schemes are of the defined contribution variety with individual capitalization accounts. These defined contribution schemes tend to be fully funded, fully vested, and fully portable. Vesting and portability rights are increasingly important as employment patterns become less stable, though the performance risk of pension funds is transferred to workers. But this risk can be reduced through properly diversified portfolios and sophisticated annuity products.





Size of contribution?

How large compulsory contributions should be depends on what is considered an appropriate targeted pension level and on whether there is a separate, redistributive public pillar. Experience in Latin America suggests that a contribution rate for long-term capital accumulation of less than 5 percent is inadequate. (An additional 2 to 3 percent is required to cover operating costs and premiums for term life and disability insurance.) In Chile, the total contribution rate has been about 13 percent (10 percent plus 3 percent), and in Argentina, it is 11 percent (7.5 percent plus 3.5 percent). Ten percent for capital accumulation is adequate for a reasonable replacement rate if investment returns exceed wage growth rates by 2 to 3 percentage points (or more) and if a person's active working life is at least twice as long as retirement (calculated to include the life expectancy and benefits of dependent survivors). A higher contribution rate for long-term capital accumulation is required if the gap between investment returns and wage growth is smaller, if allowance is made for interrupted careers and therefore for a lower ratio of active years to retirement years, or if a higher replacement rate is desired.

Who should manage the funds?

Experience in both industrial and developing countries shows that private decentralized (competitive) management has achieved higher real returns than public centralized management. Under centralized schemes, even in countries with high growth and low inflation, such as Malaysia and Singapore, the investment returns to individual accounts have been poor. In many countries, especially in Africa and Latin America, the investment performance of central agencies has been disastrous. In OECD countries, private pension funds have generally achieved higher investment returns than public pension funds.

The weakness of decentralized, non-employer-based funds such as those in Argentina, Chile, and other Latin American countries is their high operating costs. What matters, however, is the

net investment return after deducting operating costs, and on this score the Chilean and other Latin American pension funds generally have done very well. The high costs stem mainly from high selling commissions and other marketing costs related to workers' freedom to switch their accounts among competing pension fund management companies. Employer-based pension funds have much lower operating costs. A compromise solution is to allow employer-based schemes as long as they offer fully vested, fully funded, and fully portable benefits. Allowing group contracts with independent fund managers could achieve the same result, especially if employers negotiated the contracts and offered them to their employees on an optional basis.

What types of regulation?

The main focus of regulation should be prudential norms and fiduciary standards. Rules legally separating the assets of the pension fund from those of the management company are essential so that the pension fund does not suffer if the management company becomes insolvent. Proper custodial arrangements are necessary to prevent fraud, as are rules to discourage insider trading and self-dealing.

Detailed investment rules setting upper limits on different assets by type and by issuer may be necessary to ensure diversification in countries with less developed capital markets (see Note 71). Investment rules should emphasize safety and profitability and should not direct funds into projects merely because they are politically or socially desirable. Other structural rules that have been used in Latin American countries—such as one account per worker, one fund per company, and one price (non-discrimination between workers)—have aimed to protect workers by ensuring simplicity and transparency. But they may go too far in restricting choice. In industrial countries, detailed investment and structural rules are not necessary. Reliance on the “prudent man” rule and benchmark portfolios (see below) should provide adequate protection.

What state guarantees?

State guarantees can take three forms: a minimum pension, a minimum return, and protection from insolvency. A minimum pension guarantee is essential if there is no separate public pillar and any social assistance is low. Chile offers a minimum pension guarantee of about 25 percent of the average wage to workers who have contributed for at least twenty years. Argentina, which has a separate public pillar paying a basic universal pension of about 30 percent of the average covered wage, does not offer a minimum pension guarantee for the private pillar.

If not properly formulated, minimum pension guarantees may encourage strategic manipulation by workers—that is, workers may try to contribute for the minimum period and for the minimum amounts that would entitle them to draw the minimum pension. A better alternative is to guarantee an accrual factor of, say, 0.75 percent of the average wage for each year of contribution, with a minimum no lower than social assistance.

A minimum return guarantee should not be expressed in absolute terms. This could distort incentives and encourage management companies to adopt risky investment policies at the expense of the state. Guaranteeing the minimum return relative to the average for the industry makes more sense because it would protect workers from large deviations in returns. But it would also imply more uniform, and perhaps more conservative, investment policies. Guaranteeing relative minimum returns leads to a need for minimum solvency requirements and investment reserves. These rules tend to increase the cost of entry for management companies, but they may be essential when a new system is introduced in a developing country with rudimentary capital markets.

For more advanced countries, other solutions may be needed to protect workers from excessive fluctuations and deviations in returns. One

alternative is to require management companies to spell out clearly the investment policies of the funds they promote and to assume liability for any shortfalls that result from deviating from those policies. Using benchmark portfolios and detailed investment guidelines may be a better approach in industrial countries, where the only constraint on fund management companies is potential loss of reputation and business. But these penalties offer no consolation to retiring workers who suffer large losses because fund managers fail to comply with their own investment guidelines.

Protecting workers from the insolvency of fund management and insurance companies (which provide term life and disability coverage as well as annuities) is essential and unavoidable in a mandatory retirement saving scheme. To prevent moral hazard problems and excessive risk taking, regulators need to ensure that such companies have adequate capital and reserves for the risks they assume.

Individual choice and competition

In an apparent oxymoron, individual choice is essential in a compulsory saving scheme. In Malaysia and Singapore, workers can decide how to invest their own balances, provided that they choose among approved instruments and maintain a minimum balance in their account. Approved instruments used to be limited to owner-occupied housing, but in recent years they have been extended to investments in both domestic and foreign securities. In Argentina, Chile, and other Latin American countries, workers can choose their fund management company and can switch their account from company to company. In fact, account switching has become a big problem in these countries: it happens on a large scale (about a third of active accounts are switched each year in Chile) and seems to be motivated more by the interests of selling agents than by those of the workers.

Improvements could be made in these countries by increasing individual choice and thus



enhancing efficiency while retaining compulsory saving for retirement. Some of these improvements could also make compulsory retirement saving schemes more palatable in more advanced countries.

First, group contracts could be allowed that offer discounts to group members and are arranged by employers (or other groups with a common bond). Workers could be allowed to opt out of company-based group schemes, though they might be discouraged by the higher operating costs they might have to incur by doing so. Still, the right to opt out would ensure that group schemes earn net investment returns as high as those of nongroup schemes.

Second, workers could be given the right to invest in pension funds subject to less regulation (especially fewer and less draconian investment rules), though they would not be covered by government protections and guarantees. Thus, workers who value the minimum pension and minimum relative return guarantees could stay with the (heavily) regulated funds, while those who do not desire such protection could opt for less regulated funds. A system based on benchmark portfolios could offer similar choices.

How to offer tax incentives?

A distinction is usually drawn between regimes that exempt contributions and investment income from taxes but tax pensions (the EET regime) and those that tax contributions but exempt investment income and pensions (the TEE regime). These two regimes have different cash flow effects because of differences in the timing of tax payments, but their long-term effects are the same.

Many countries use the TEE concept for compulsory public pension pillars and the EET approach for voluntary company or personal pension schemes, though some countries (for example, Switzerland) apply the EET approach to both public and occupational pen-

sion schemes. Although not perfect, the EET approach is the better option for both types of schemes. One problem is that if the tax exemption is offered at the marginal tax rate, it favors high-income workers. So most countries that operate an EET regime limit the exemptions to minimize the regressive impact and protect the tax base. Another problem is that the exemption provides no benefit for non-tax-paying workers.

A more equitable solution is to replace tax exemption with a tax credit system that produces a uniform tax incentive effect for all workers—for example, by providing a direct state contribution to workers' retirement saving accounts. The Czech Republic has introduced a scheme that comes close to this ideal—although because the scheme fails to link the tax credit to a minimum contribution (or saving) rate, it has encouraged small amounts of saving rather than adequate saving for retirement. This general approach, which could be referred to as the CET regime, would be superior from the social point of view. It would eliminate the preferential treatment of tax-paying workers and could contain the tax cost of these exemptions or achieve greater redistribution in favor of low-income workers for a given tax cost. It would also encourage saving by low-income workers. Compliance by high-income workers might decline, but high-income workers are less likely than others to require either compulsion or inducement to save for their old age.

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