

Facing up to Low Old Age Pension Coverage

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Inter-American Development Bank

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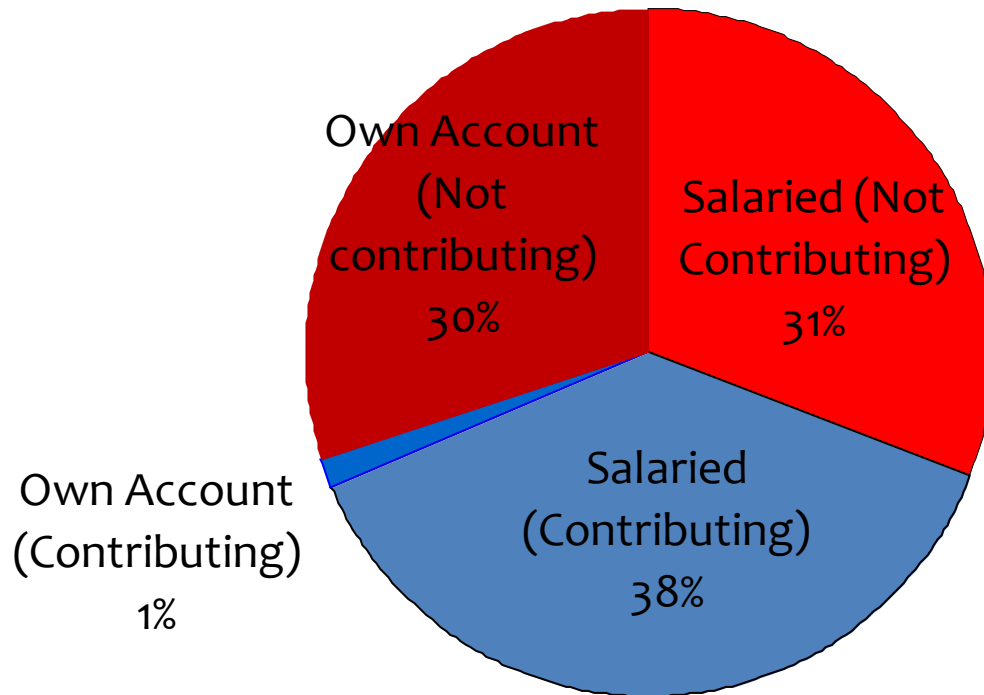
Washington DC



Road Map

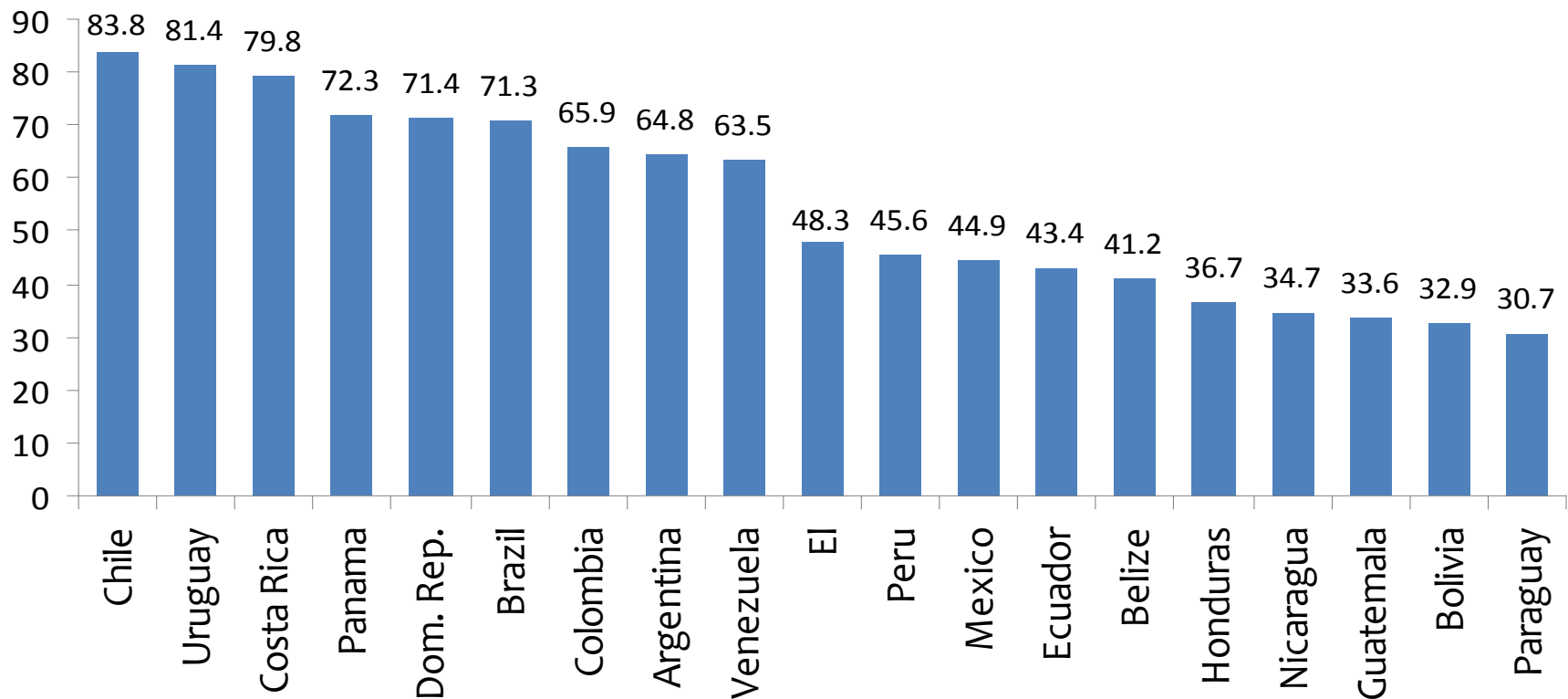
- Coverage a (the?) main problem of pension systems in LAC (public and private)
- Doing nothing may be fiscally irresponsible
- Why such low coverage?
- What to do?

Only a minority of workers contribute to social security

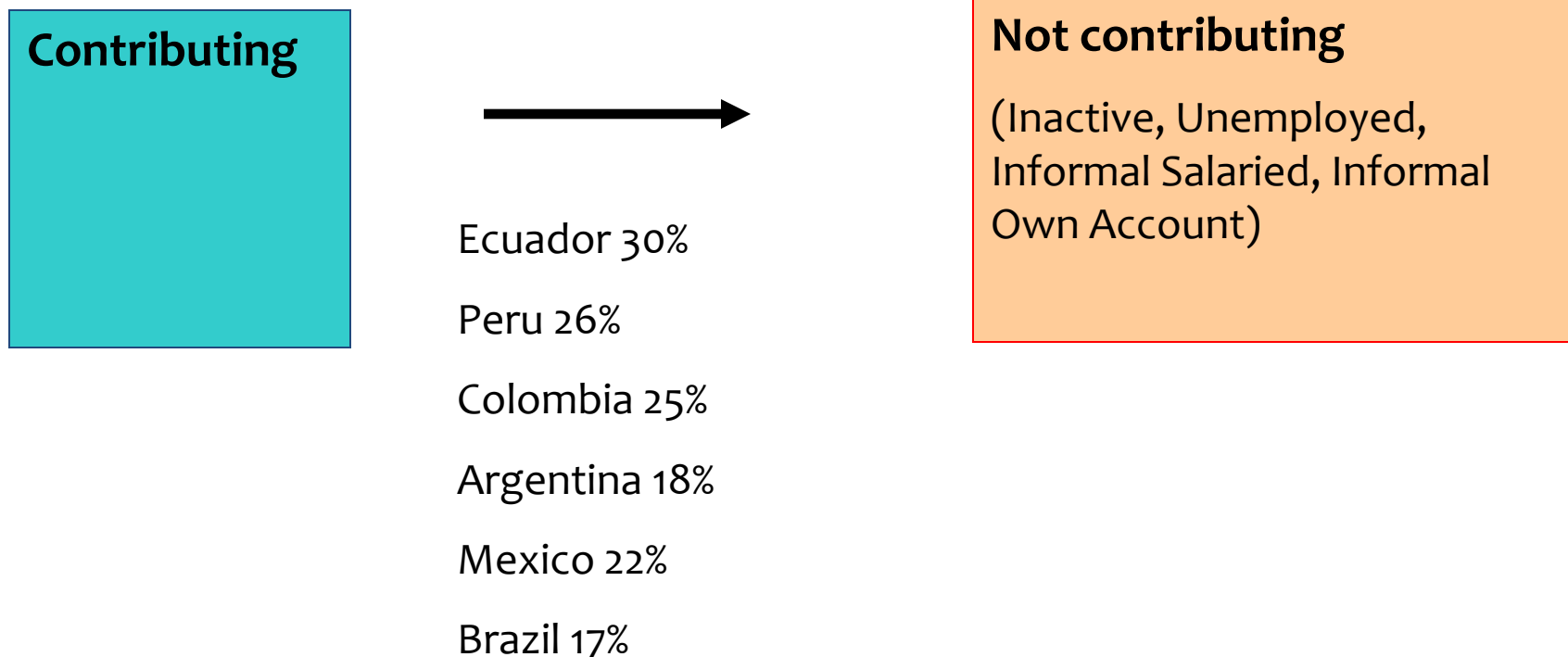


Although with variation across countries

% of salaried workers who contribute to social security



High labor market dynamism– high rotation

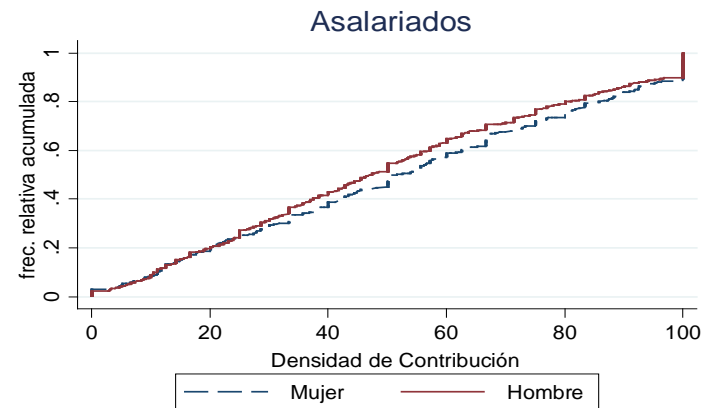
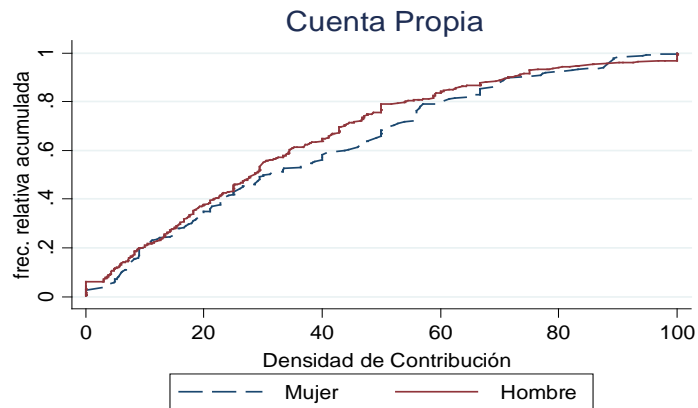
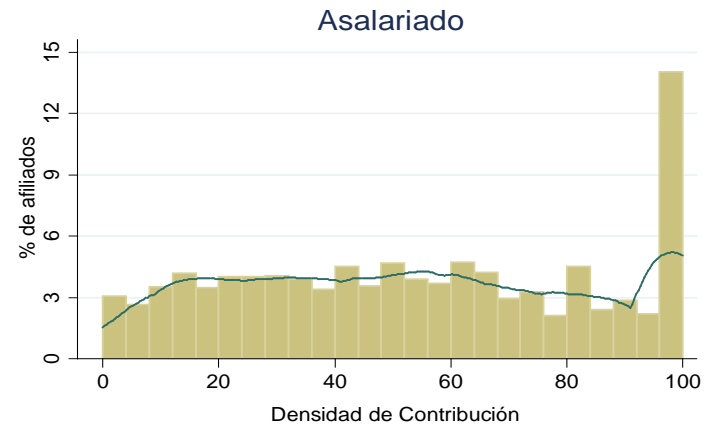
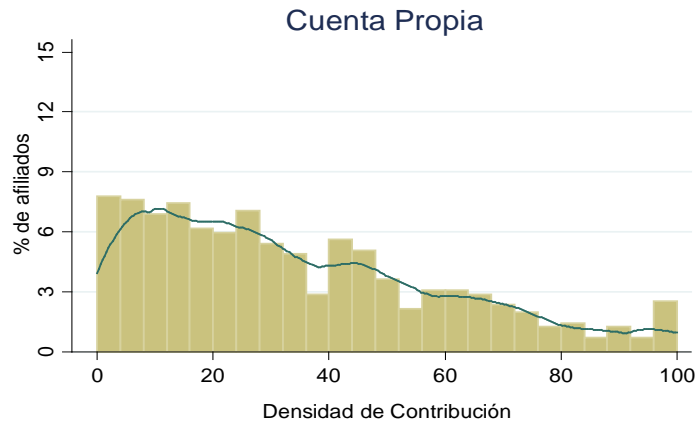


On average, 1 out of 4 contributors stops contributing within a year

This gives rise to very low contribution densities

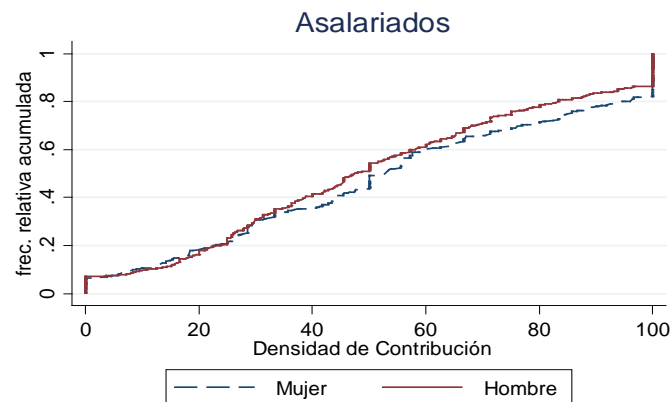
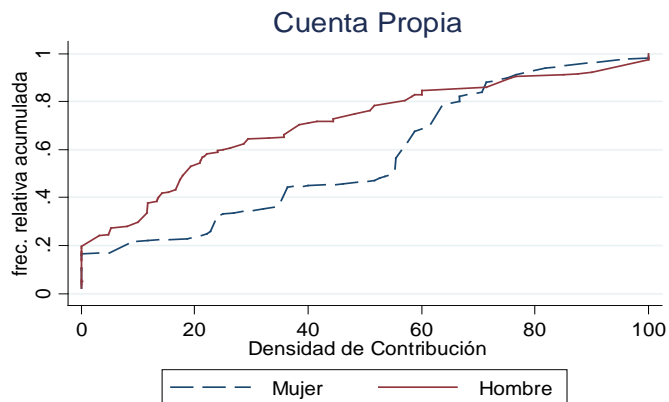
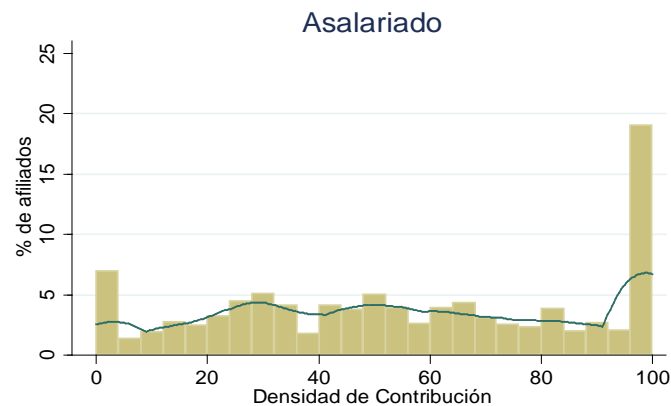
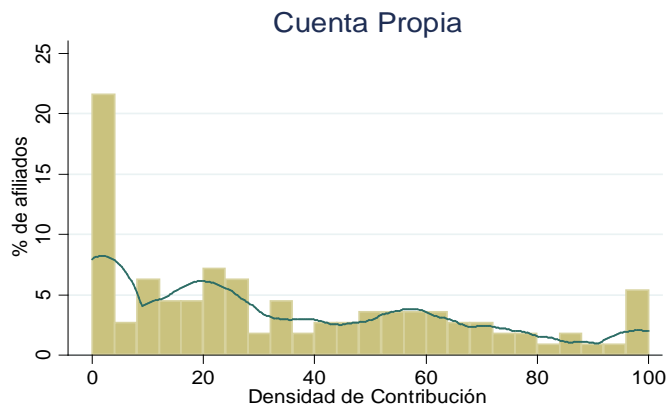
- **Mexico & Peru (IDB, Social Protection Survey).**
 - Contribution densities to individuals in working age (25-55)
- **Mexico (2009) National Social Security Survey**
 - Contribution densities of persons about to retire.

Peru: All Ages



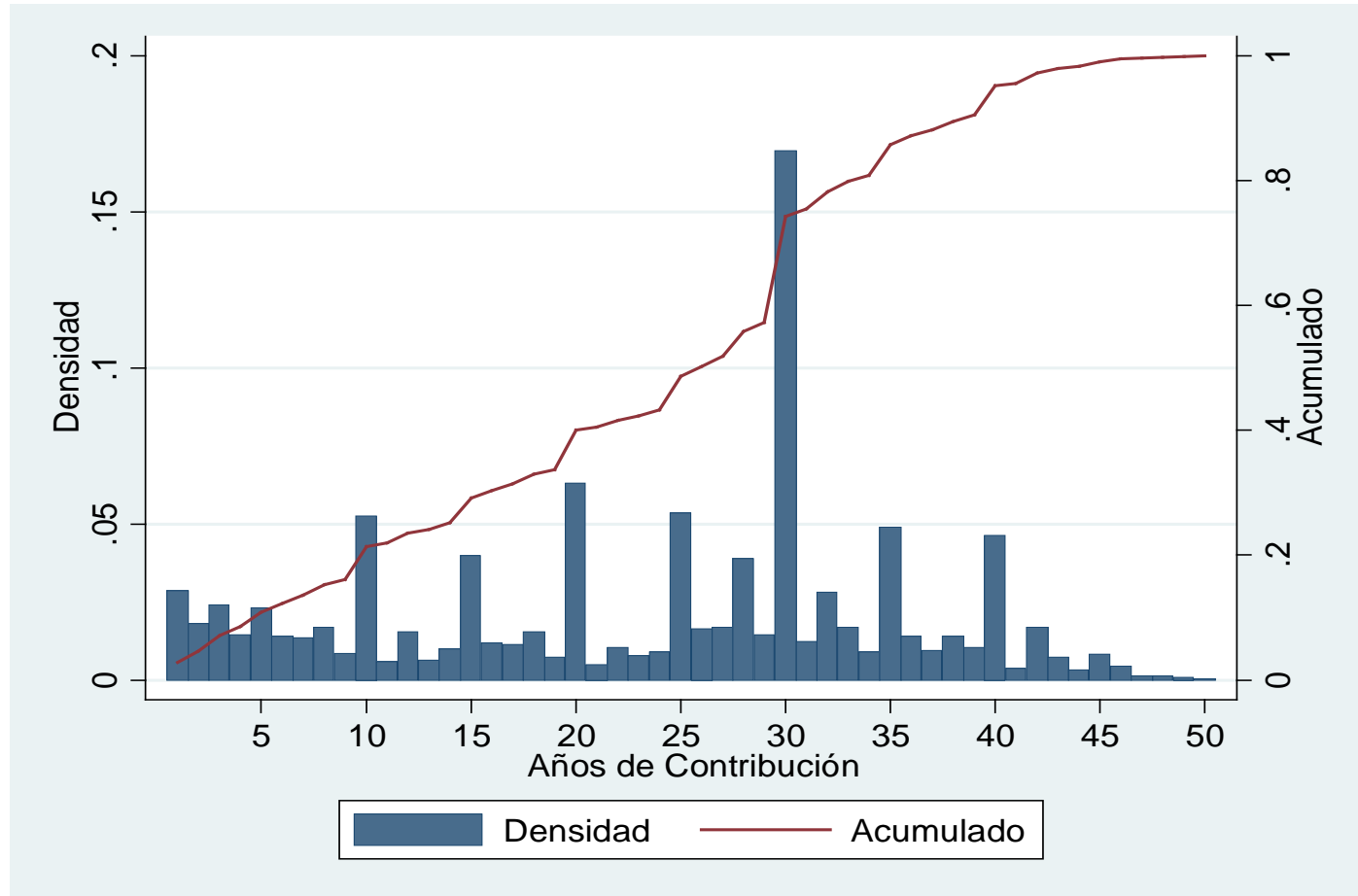
Source: IDB, Social Protection Survey 2008

Mexico: All Ages



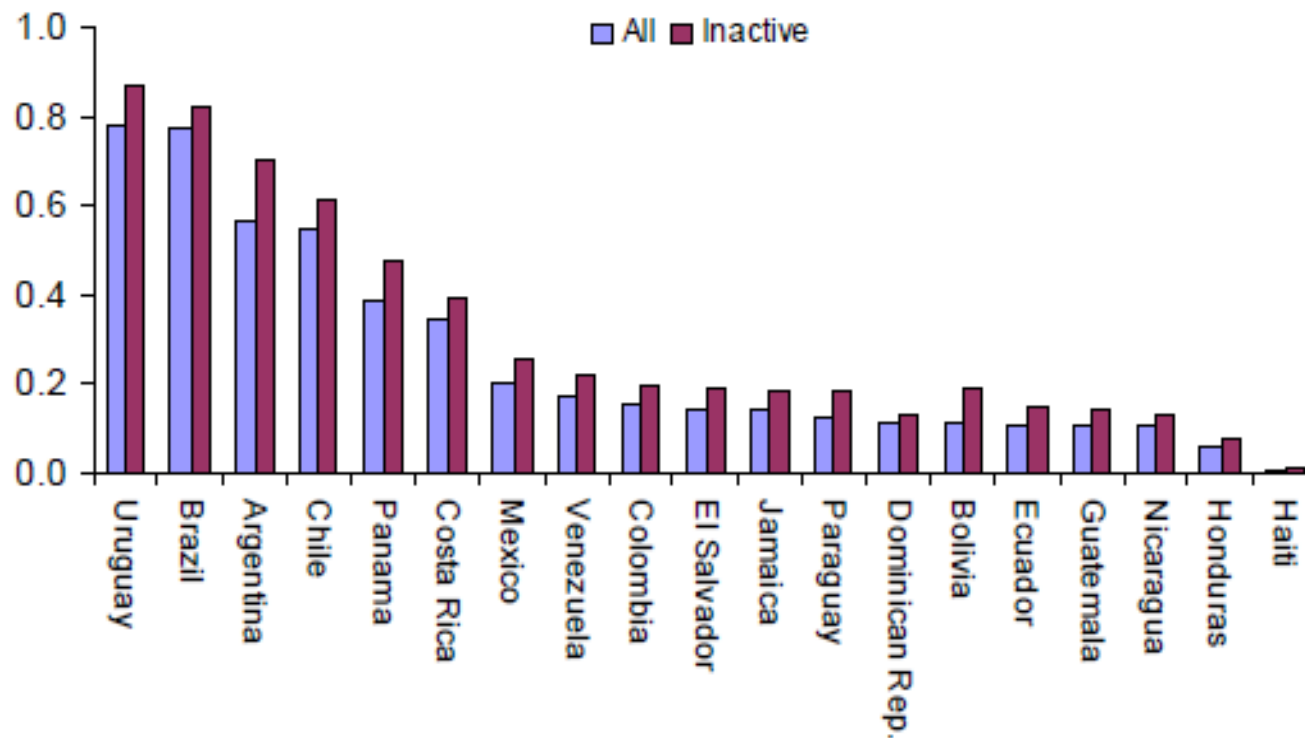
Source: IDB, Social Protection Survey, 2008

Mexico: Men 60-65



Source: National Social Security Survey, 2009

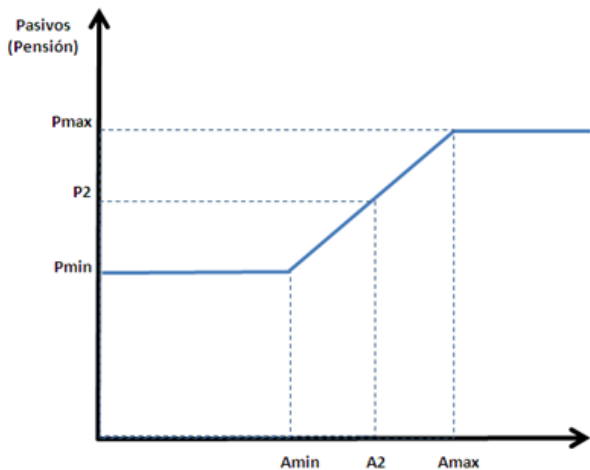
As a result, in most countries only a minority of workers are receiving an old age pension.



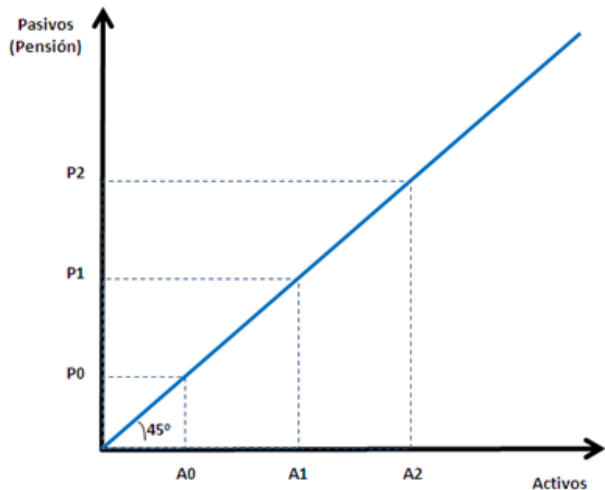
Source: own calculations based on SEDLAC.

..and many people “covered” by different pension systems could still face serious risks

NPS (Law 19990)

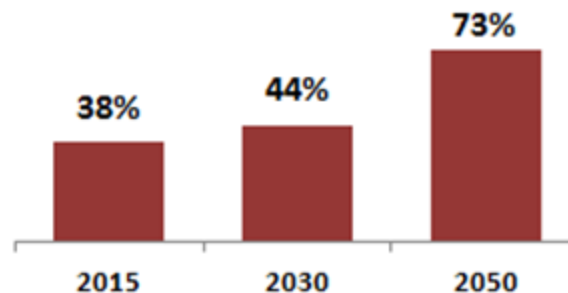


PPS

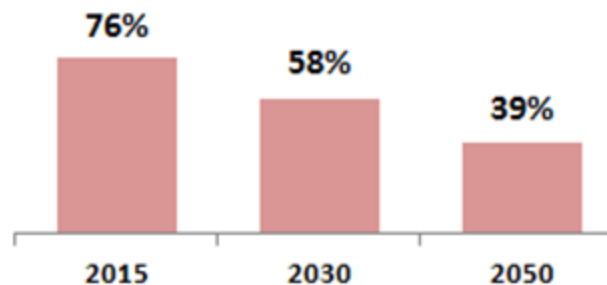


Peru: Private and Public Pension systems

Retirees with no right to a minimum pension (NPS)



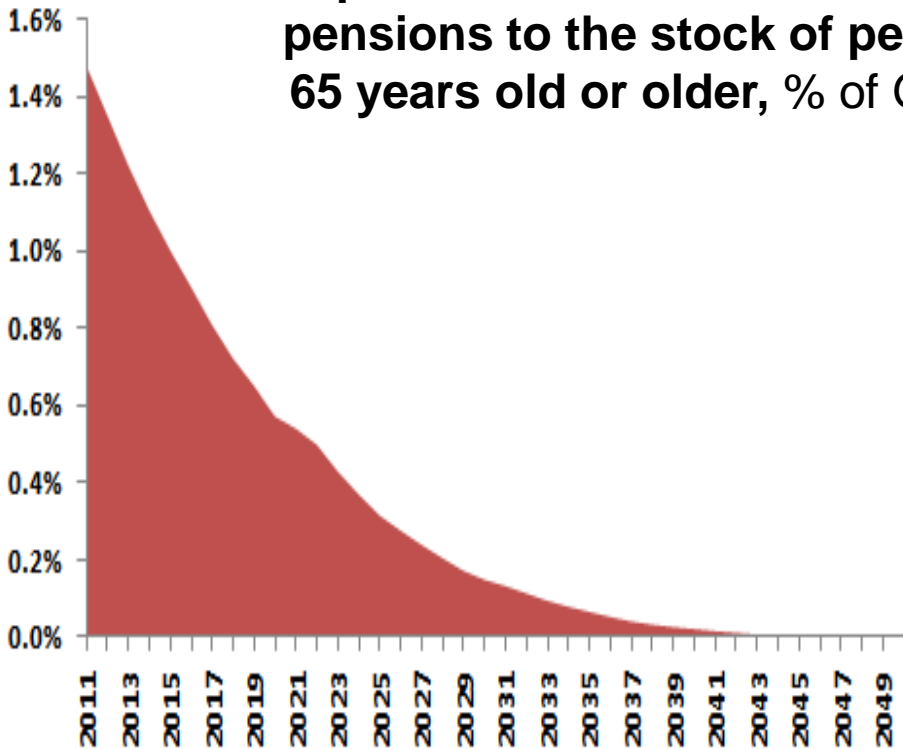
Retirees with life annuities lower than poverty line (PPS)*



*/ Poverty line = 208 soles in Lima prices of 2010

Doing nothing is an expensive option

Peru: Estimated cost of public expenditure in non-contributive pensions to the stock of people 65 years old or older, % of GDP



Cost of a monthly pension of 250 soles –inflation adjusted— for all who in 2010 were 65 or older

PV_{4%} = 14.2% of GDP 2010

Source: Herrera and Vargas, 2011



The demands of people on the state are increasing...

- **Rapid population aging**
- **Democratic governments that are more sensitive to the needs of large majorities**
- **Developing welfare state LAC style: CCTs and non contributory health and pension program are already a reality in many countries.**
- **High probability that low coverage will become a liability for the state, with large fiscal costs involved.**
- **Doing nothing might be fiscally irresponsible.**

Why such low coverage?

- **Low willingness & ability to contribute**– particularly among low income workers.
- **Structure of labor markets** –large share of workers in small firms & independent employment of low productivity
- **Evasion** –low capacity of the state to enforce compulsory contributions.

What to do?

- **Two options:**
 - **Addressing the structural reasons for why the contributory system has low coverage**
 - **Reforming the contributory system:**
 - Establishing non-contributory pillars
 - Incentivizing Contributions
 - Shifting tax base from labor income to consumption
- **Each has its own benefits and costs, which should be weighted in carefully by country**
- **Combination of strategies**

Addressing the structural causes of low coverage

- ***Rising ability to contribute:*** rising productivity and with it incomes
- ***Rising willingness to contribute:*** increasing financial and pensions literacy
- ***Rising capacity of state to collect and enforce mandatory contributions:***
 - ↑ data sharing among state entities
 - Flexible payment systems,
 - Tie labor “formality” to other forms of formality to increase incentives to being formal.

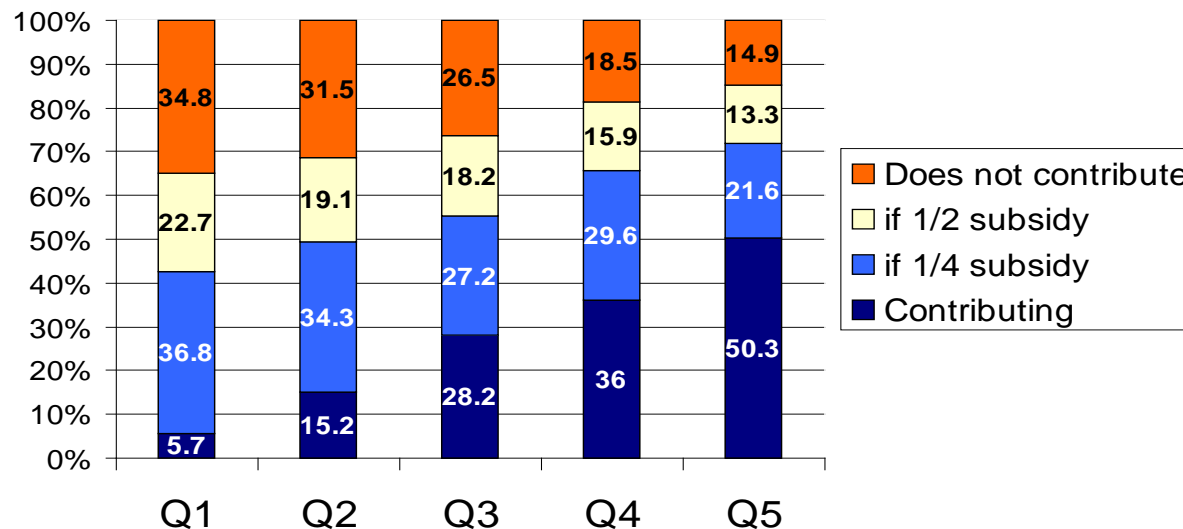
Creating non-contributory pillars

- **Addresses the safety net issue.**
- **But, evidence suggest that they may create important disincentives to contribute to SS or to participate in the labor market.**
- **With potentially large fiscal and distortionary costs**

Incentivizing Contributions

- Self-reported data on willingness to contribute if subsidized suggest that subsidies may need to be very large for low income people.
- Little empirical evidence yet of the efficacy of contributions subsidies or matching contributions.

Perú: % contributing by amount of subsidy & income quintile



Source: EPS, Peru, IDB 2008.



Shifting the tax base from labor income to consumption

- **Levy (2008, 2011) proposes state making fixed contributions to individual accounts for all workers or for all workers of less than certain income (W), paid with higher VAT taxes, while eliminating labor taxes for all, or for workers of less than W .**
 - Full contribution density
 - Promotes individual savings intermediated by private financial system
 - Safety net but no consumption smoothing ability
 - Need to assess how to address consumption smoothing in this setting, link with current system, and possible disincentives to contribute.

Conclusions

- **Low coverage a (the?) main problem of pensions systems in LAC (private and public)**
- **Doing nothing may be fiscally irresponsible**
- **Need to put in place a strategy to address coverage shortage ASAP (even if solution is achieved progressively).**
- **Need to carefully weigh in benefits and costs, and estimate fiscal liabilities of different solutions, country by country.**



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The Challenge of Increasing Coverage of Pensions

Solange Berstein Jauregui

Pensions Supervisory Authority of Chile

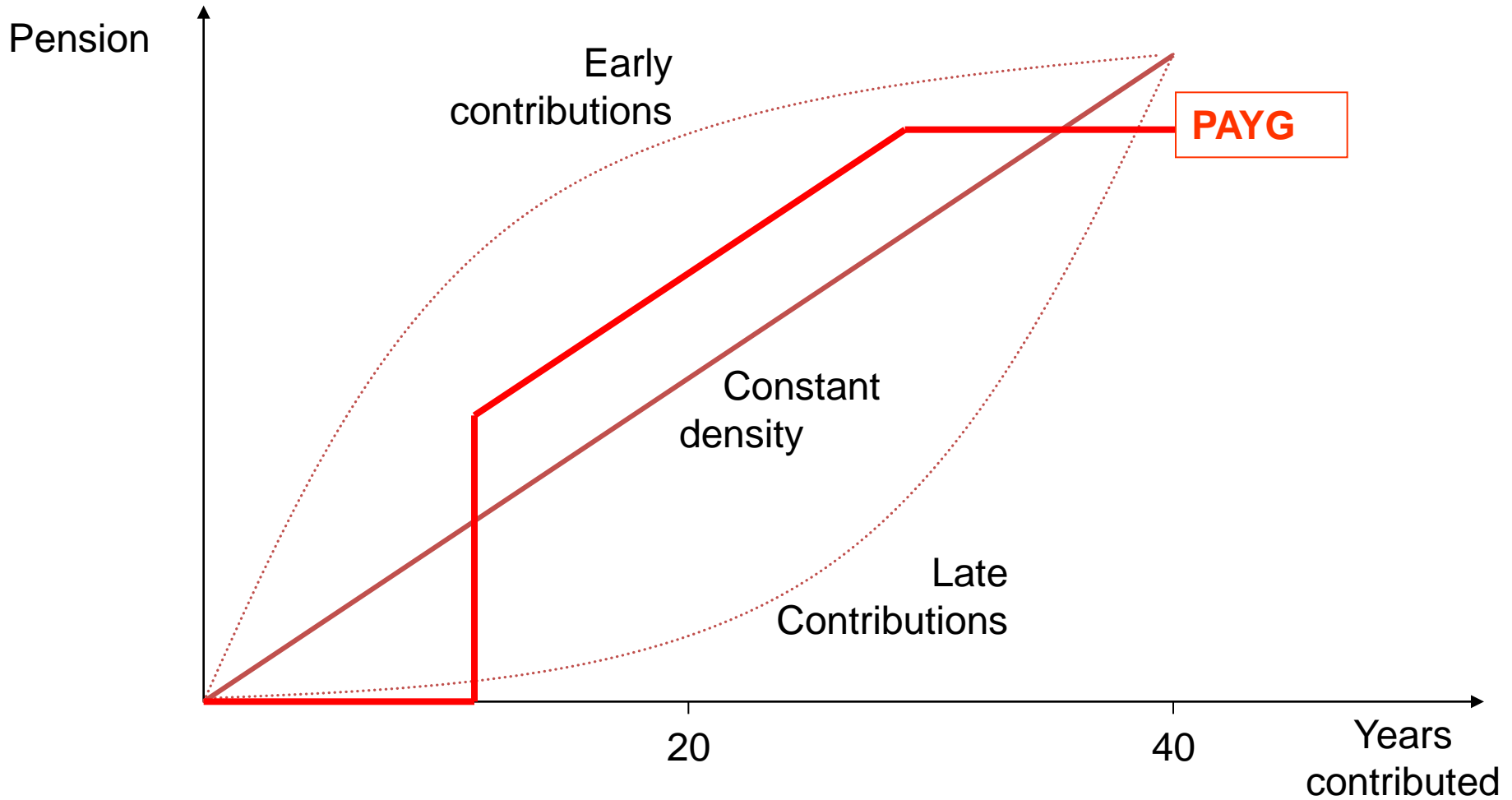
“Contractual Savings Conference”

World Bank, Washington 2012

Building adequate pensions is not an easy task

- **Increasing life expectancy**
- **Decreasing expected returns**
- **Increasing volatility**
- **Low financial literacy**
- **High expectations**

Density and timing of contributions



Mientras + Joven ahorres, + plata cuando jubiles

Tus primeros ahorros ganan intereses por más años. De hecho, la mayor parte de tus ahorros al pensionarte corresponderán a los aportes que realices entre los 20 y 30 años.

Si esta moneda representa tus ahorros al pensionarte, lo que aportaste en cada etapa de tu vida es:



Este cálculo considera el ahorro efectuado entre los 20 y 60 años, remuneración creciendo al 2% anual y ganancia de los ahorros de 5% al año.

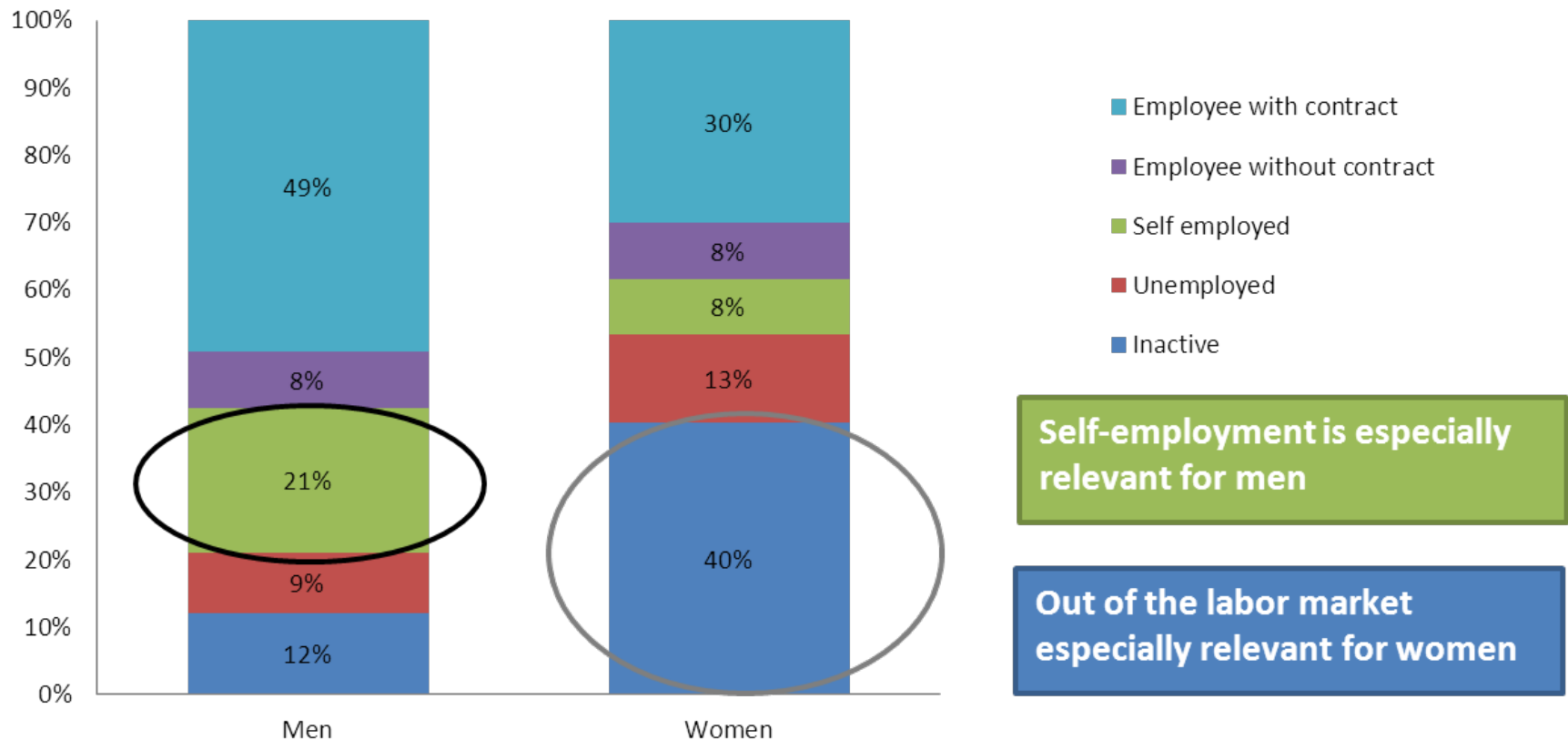
Early contributions,
between 20 and 30 years
of age,
are very important

- Preocúpate que tu empleador pague tus cotizaciones todos los meses por el total de tu remuneración. Revisa tu cartola de AFP
- Si eres independiente, cotiza directamente en tu AFP
- Al cotizar, además, tú y tu familia están protegidos por un seguro de invalidez y muerte. Infórmate de su cobertura y beneficios.

Occupational status by gender

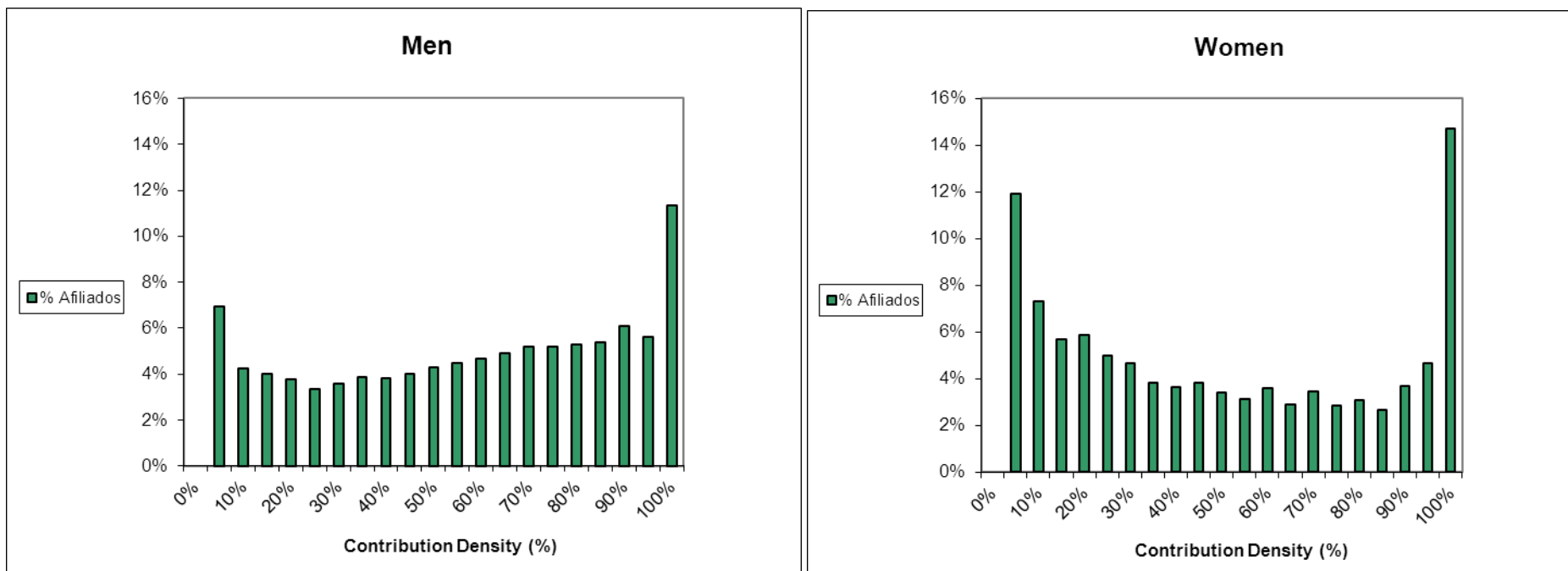
Percentage of active life, by occupational status

% of active life, by occupational status



Source: Social Protection Survey 2002-2009

Contribution Density by Gender in Chile



Source: HPA 2009

Initiatives in Chile to Increase Coverage



Create a **New Solidarity Pillar**

- **Basic Solidarity Pension** for individuals who could not contribute
- **Solidarity Complement** for individuals who financed small pensions

Keep incentives to contribute

- Subsidy for contributions of **young workers**

Provide equal conditions for **men and women**

- **Survivorship** eligibility
- **Insurance fees** adjusted by morbidity
- Redistribution of savings in case of **divorce**
- **Bonus per child**, equivalent to 1 year contributions

Mandate self-employed workers to contribute and improve contribution enforcement

+ Solidarity Pillar

Automatic Enrollment for self-employed and mandate in the future



Year	% of Rent	Status
2012	40%	Auto-enrollment
2013	70%	Auto-enrollment
2014	100%	Auto-enrollment
2015	100%	Compulsory

How will it work?



- Tax Revenue Service will compute the amount that should be contributed and take it from the eventual annual tax refund and send it to the corresponding Pension Fund Manager
- The self-employed worker might contribute on a monthly basis and have coverage from disability and survival insurance starting the month after
- During the auto-enrollment period the person might decide not to contribute by communicating the decision through the available mechanisms

- **Pension design must consider incentives or compulsory contribution**
- **The impact on incentives of increasing protection has to be monitored**
- **Financial literacy is critical but requires long term efforts**
- **Coverage is a major challenge that has to be addressed**

Thank you

Policy Options to Strengthen Coverage in DC pensions

Pablo Antolín

OECD DAF/FIN Pension Unit

World Bank Conference on Contractual Savings

Washington 9-11 January 2012

Background

- The OECD has been working for a few years on improving the design of DC pension plans in order to strengthen retirement income from these plans.
- We are now compiling (taking stock) the lessons learnt into a set of policy options - messages to be conveyed to regulators and policy makers in different countries.
- OECD Committees to endorse them

Policy messages: guiding principles

- **The policy options - messages based on three guiding principles:**
 - **Coherence**
 - **Adequacy**
 - **Efficiency**

Coherence

- **Policy messages to strengthen retirement income in DC plans need to assess these plans in the context of each country overall pension system, they are not in a vacuum.**

Adequacy

- DC pension plans are complementary to other sources to finance retirement (e.g. PAYG-financed pensions).
- DC plans need to be designed (e.g. contribution rates, contribution periods, payout phase, etc.) taking into account that they may provide a ret. income that complement other sources.
- What is an adequate ret. inc. is highly controversial. But assuming that for example, one can get by on 70% of pre-retirement income $CR=5\%$ to get 20-25% if PP 45-50%.

Efficiency

- **Efficiency: reducing risks for retirement income or saving for retirement (de-risk).**
- **E.g. choosing investment strategies (many in the return-risk spectrum) that reduce the impact of extreme negative outcomes on retirement income**
- **Efficiency also required to properly structure the payout phase: allocate assets efficiently. Strike out a balance btw liquidity and flexibility, and protection from longevity risk**

Main Policy Messages

Main policy messages

1. The design of DC pension plans needs to be coherent (globally, internally, monitoring all risks)
2. Ensure effective communication and address financial literacy
- 3. Encourage people to contribute and contribute for long periods**
- 4. Improve the design of incentives to save for retirement to increase contributions and coverage**

Main policy messages

- 5. Promote low-cost retirement savings instruments**
- 6. Consider the pros and cons of investment guarantees**
- 7. Establish default investment strategies with appropriate risk exposure**
- 8. Establish life-cycle investment strategies as defaults**

Main policy messages

9. Combine programmed withdrawals with deferred life annuities indexed inflation
10. Allow any provider of annuities as long as they are sufficiently regulated and fair competition is guaranteed
11. Promote the demand for annuities by, for example, changing framing (investment vehicles to insurance product)

Main policy messages

- 12. Facilitate supply of annuities by further developing risk-hedging instruments**
- Longevity indexed bonds, ultra long-term bonds, swaps, etc.
 - Life tables should be updated regularly and include improvements
 - Government encourage development of a market for longevity hedging products by developing a reliable longevity index

Measures to promote *contributions and participation* in DC pension plans

M3. Encourage people to contribute and contribute for long periods

- Best way reduce uncertainty about achieving a target retirement income is to contribute large enough amounts and for long periods.
- Long contribution periods allow for higher retirement income for given level of contributions (compound interest)
- Lengthening contribution period by postpo. retirement more efficient approach of increasing retirement income.

Encourage people to contribute and contribute for long periods

- Δ contributions or the contribution period
 Δ the probability of reaching the target retirement income (RR).

	Prob (RR \geq 30%)	Prob (RR \geq 70%)
5% C – 40 years	61.6	13.9
10% C – 40 years	91.7	52.8
5% C – 20 years	2.8	0.1
10% C – 20 years	33.0	1.3

M4. Improve the design of incentives to save for retirement to increase contributions and coverage

- Contribution could be Δ through mandates or with the help of “nudge” measures.
- “Nudge” measures include matching contributions (employer or state), and auto-escalation (e.g. SMTP).
- Also important to increase the number of people saving for retirement in DC plans

Improve the design of incentives to save for retirement to increase contributions and coverage

- **Compulsion**
- **Soft compulsion: auto-enrolment with an opt-out clause (Italy, New Zealand, UK). Take advantage of behavioural financial literature stressing the role of inertia or passive decision.**
- **Strengthen the value of tax incentives for mid to low income people: tax credits or matching contributions instead of tax deductions.**
- **Better communication and improve fin-ed**

Tax incentives

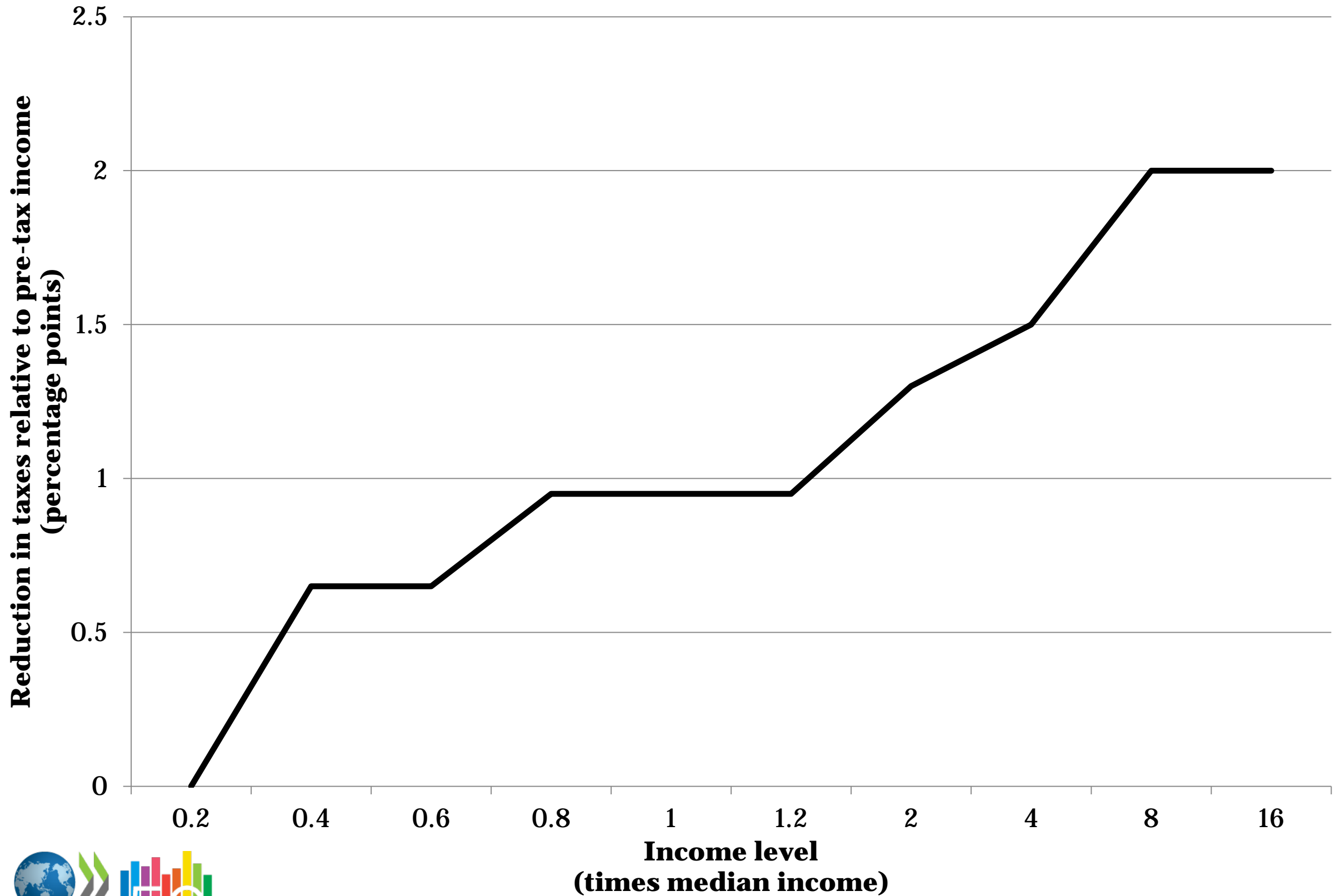
Tax form – tax incentives

- **Earned income**
- **Deductions, exemptions, reliefs (e.g. charity)**
- **Taxable income**
- **Applied tax rates by income brackets**
- **Tax due**
- **Tax credits (e.g. credits per child)**
- **Tax payments**

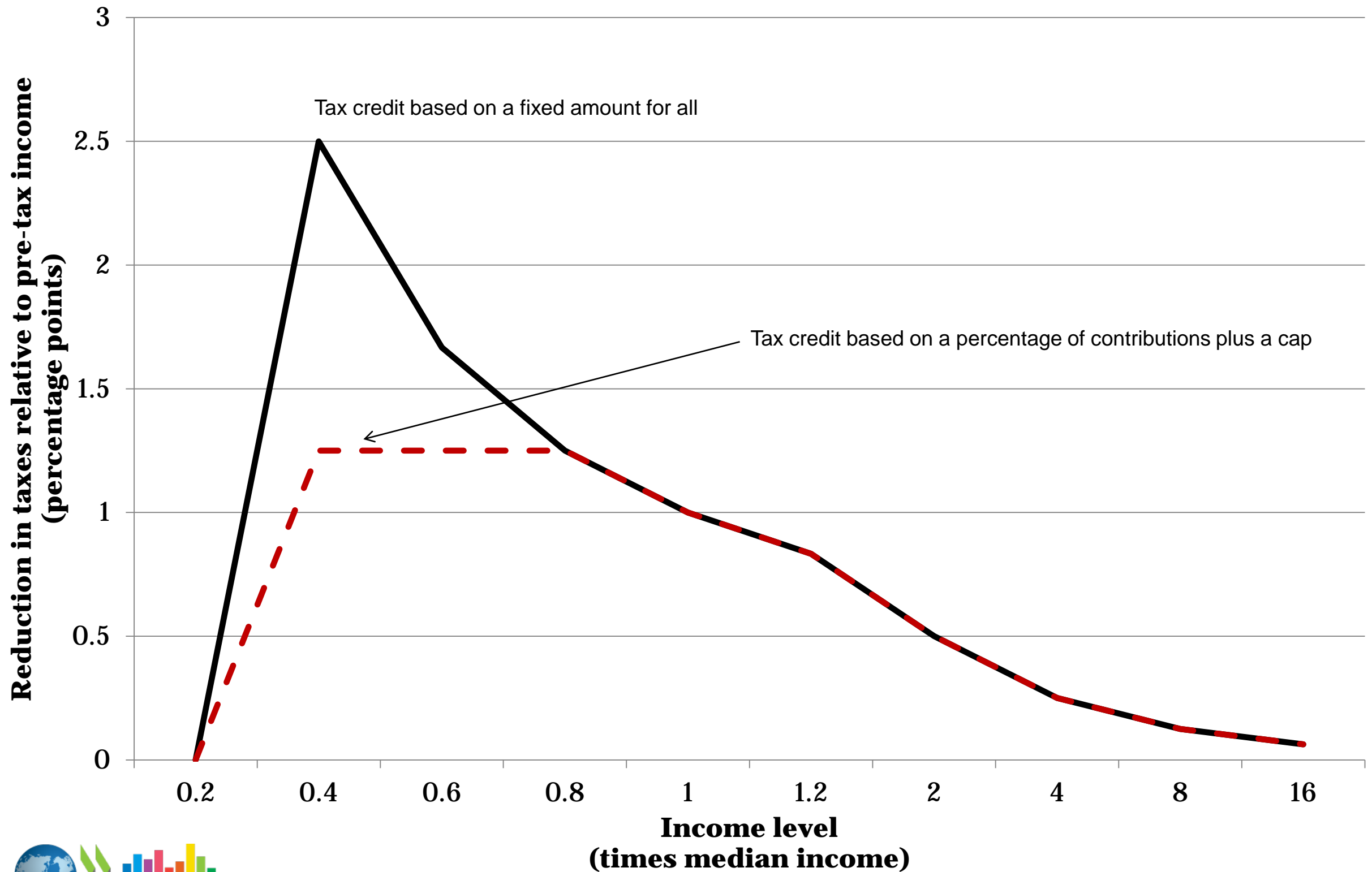
Tax incentives

- **Most common: deductions on income**
→ Tax deductions (incentives increase with income)
- **Alternatively, tax credits (inversely related to income)**
- **Matching contributions**

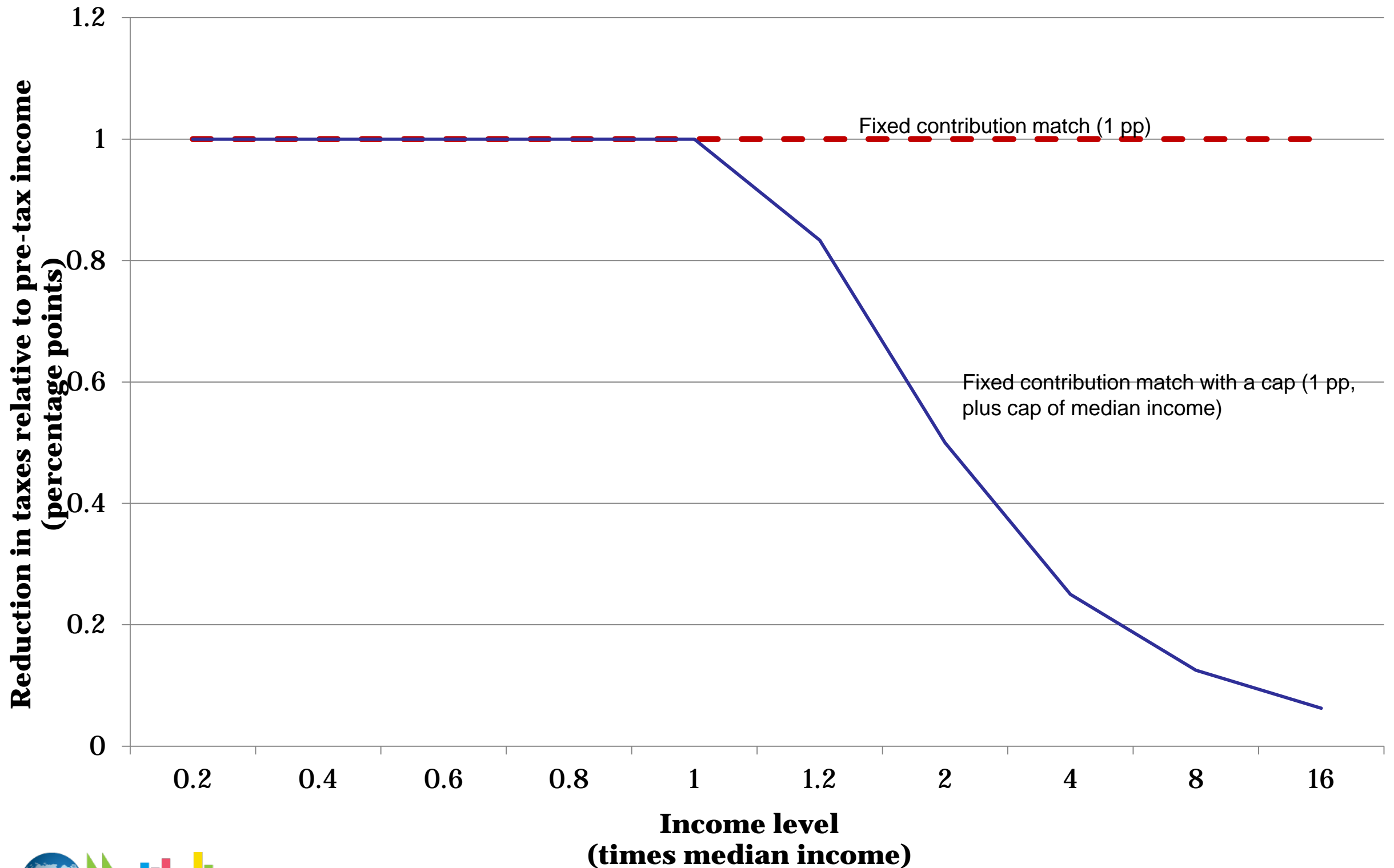
Tax incentives - Tax deductions



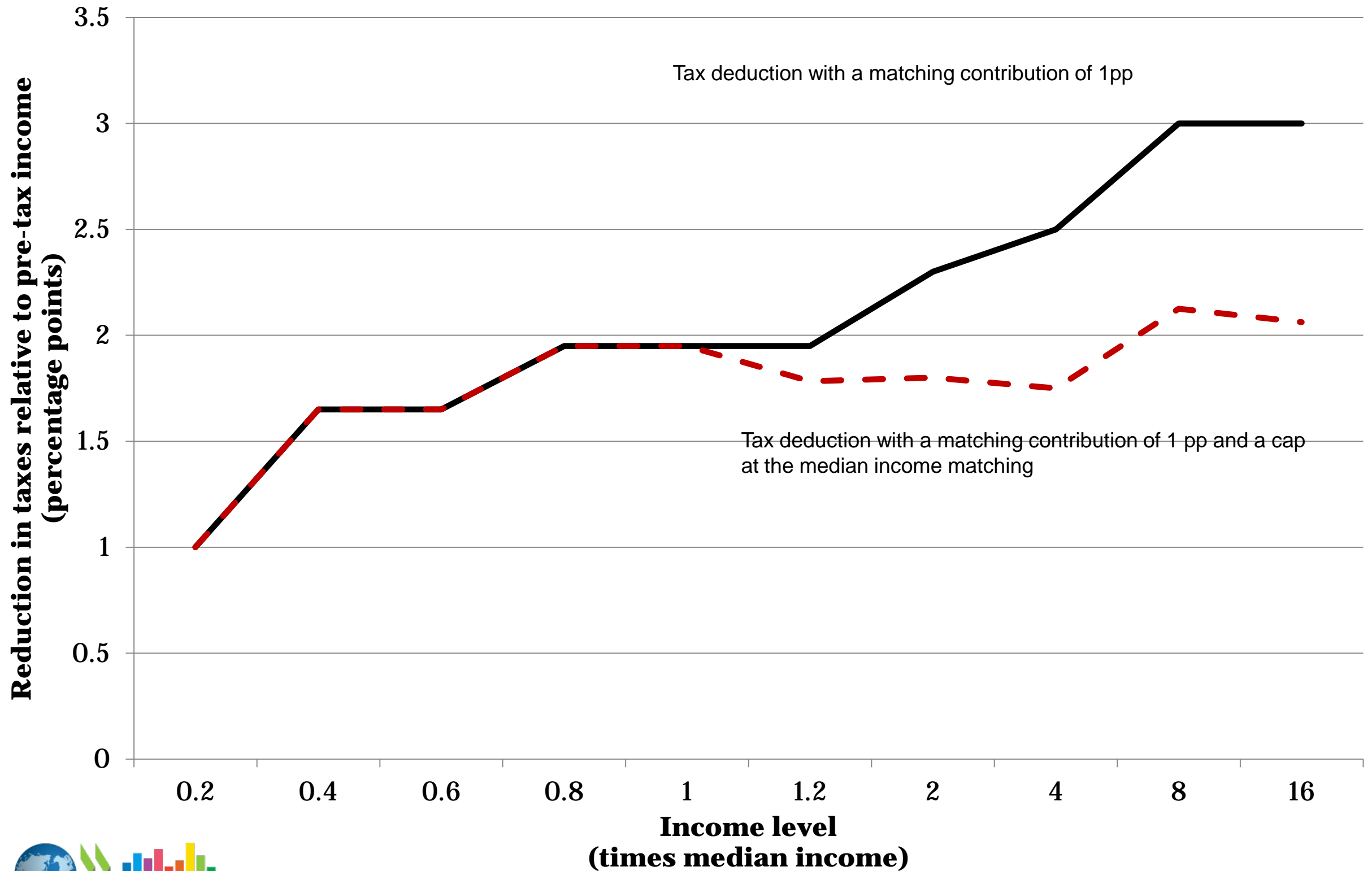
Tax incentive – Tax credits



Incentive – Matching contributions



Tax deduction + matching contributions



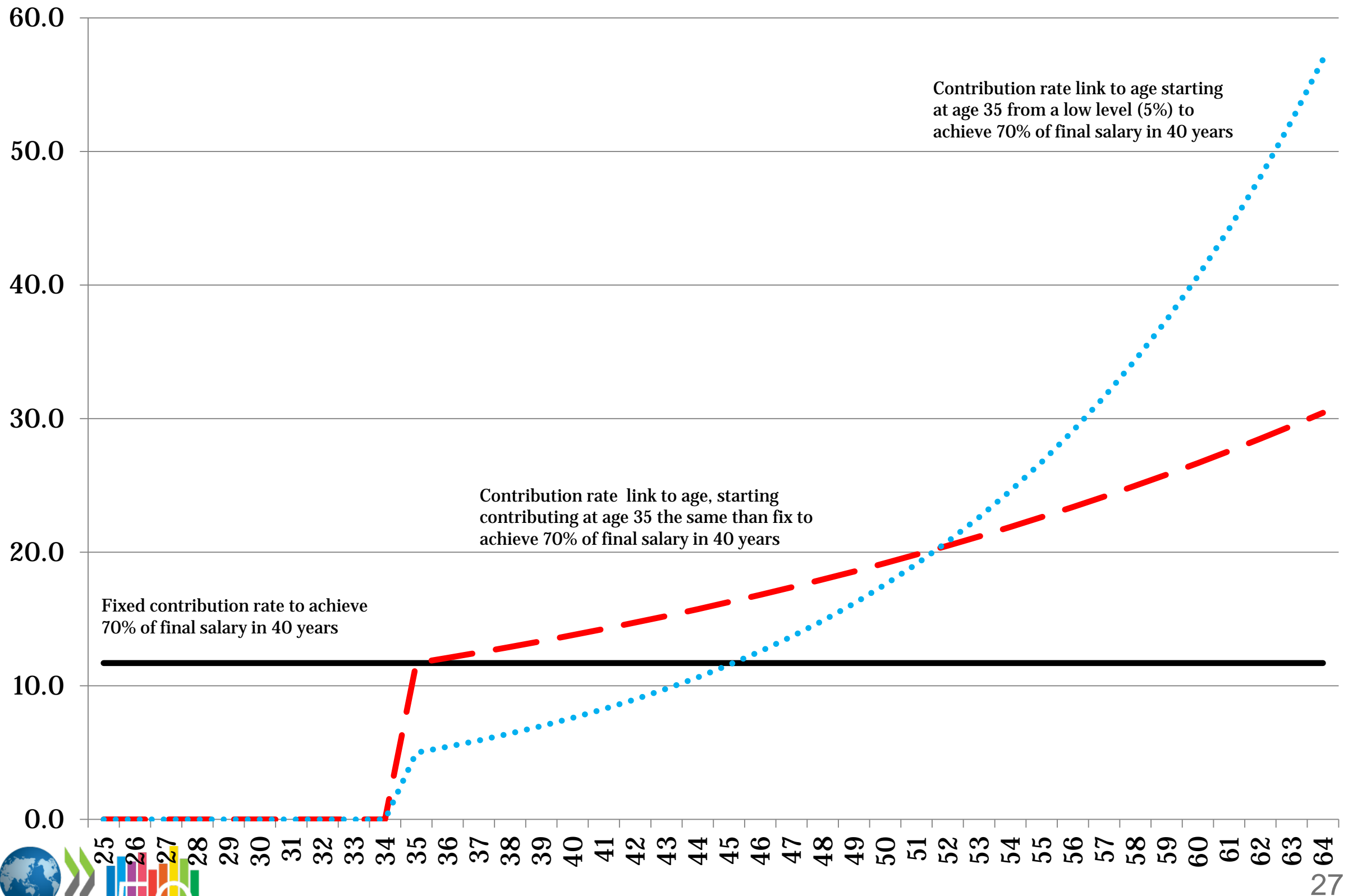
Work in preparation

- OECD developing project to examine tax rules on pensions systems
- Tax rules on contribution, returns & benefits
- Tax rules on the accumulation, on the payout phase and on different products (annuities, PW, lump-sums)
- Assess the impact of tax incentives (country specific)
- Assess the impact of alternative ways of introducing incentives (country specific)

Thank you
very much

Contributions link to Age

Contribution rates linked to age



Contribution rates linked to age

- Reasonable to have contribution rates increasing with age. Young people lower income and more expenses (housing, kids)
- Contribution rates would have to increase to high levels at the end of one's career to achieve the same target retirement income (Blake, 2011).
- Time inconsistency problem: would people be willing to pay such high contributions levels?