



## PENSION NOTES

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### Proposed guidelines for second generation reforms of the pension systems

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#### Executive Summary

The primary purpose of any pension system should be the prevention of poverty in old age. Consequently, any proposed reform must start with this objective in mind, so as not to lose sight of the horizon or get embroiled in discussions of an ideological nature that divert attention from the truly important issue, namely the welfare of pensioners.

Since several Latin American countries are currently discussing reforms to their pension systems (e.g., Chile, Brazil and Colombia), FIAP invited experts from several international agencies to its 17th International Seminar.<sup>1</sup> to deliver their perspective on the essential guidelines for any reform.

The experts were emphatic that every reform must contain several crucial elements. First of all, grant protection in old age to the neediest via a non-contributory solidarity pillar, financed through general taxes. Second, strengthen the contributory pillar, guaranteeing greater savings for a

longer period of time (i.e., increasing contribution rates and extending the retirement age). It is crucial to increase the coverage of the current pension systems, by measures to reduce the high levels of informal work of the region, and by the inclusion of self-employed workers. Third, encourage voluntary savings through appropriate incentives.

Another important point the experts made is not to raise false expectations among contributors. Hence, timely information regarding the replacement rates they will receive at the end of their working lives, if they maintain their current savings habits, is essential. The Government must play a central role in avoiding unrealistic expectations, by improving communications and the financial education of the population.

#### I. Introduction

Population aging and the rapid technological changes impacting labor markets highlight the need to rethink the way in which traditional pension systems operate. Likewise, it is evident that measures need to be introduced to increase savings, in order to cover increasingly longer retirement periods.

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<sup>1</sup> All the presentations in the International Seminar are available online at: <https://www.fiapinternacional.org/seminario/15-16-mayo-2019-xvii-seminario-internacional-fiap-santiago-chile/>

Several countries in the region (Chile, Brazil, Mexico, Colombia, Dominican Republic) are currently discussing different measures for strengthening their pension systems. However, discussions often focus on ideological matters rather than long-term strategies for effectively increasing the welfare of current and future pensioners.

In FIAP's 17th International Seminar, experts from different international agencies held in-depth discussions regarding possible reforms to the pension systems in the region. This Pension Note addresses the most important points put forward by Pablo Gottret, Regional Social Protection and Labor Manager for Latin America and the Caribbean at the World Bank, and Pablo Antolín-Nicolás, Principal Economist and Head of the Private Pension Unit at the OECD.

## **II. World Bank: Pension Reform Trends Worldwide**

As a starting point when proposing pension reforms, it is important not to lose sight of the purpose of the pension systems. The primary purpose of any pension system is to prevent poverty in old age. The second objective is to avoid abrupt changes in consumption levels. Pension systems aim to ensure that when seniors stop working, the accompanying reduction in income will not entail abrupt changes in their levels of consumption. Third, protect the elderly against the risks of longevity, i.e., retirement periods of seniors lasting longer than their retirement savings.

However, it is impossible to address multiple objectives through a single public policy

instrument, or in other words, there must be one instrument for each objective. Thus, if the aim is to prevent poverty in old age, one must resort to non-contributory protection systems (or PAYGO mechanisms), whereas if the aim is to ease consumption levels, one should resort to individually funded systems. Finally, a life annuity market must be created to protect against the risk of longevity.

The State's role in the system must be clearly defined. This role entails ensuring the proper functioning of the system, i.e. correct market failures and avoid creating false expectations.

Furthermore, one must always take the relevant economic policy factors into account when formulating public social security policies. Public debate on the pension issue has intensified over the years. The increase in the number of issues on the debate agenda has increased hand-in-hand with the increase in the number and intensity of arguments and protagonists. More opinions, rhetoric and peripheral issues have resulted in a recipe for an unproductive debate.

### **Dissatisfaction with the pension systems**

There is a high degree of dissatisfaction with the pension systems among the population, who believe that pensions are too low, aggravated by the fact that within the sector, there is talk of granting adequate pensions. It is therefore logical to ask what an "adequate" pension level is. In its Convention 102 on social security and Convention 128 on disability, old-age and survivors' benefits, the International Labor Organization (ILO) states that an adequate pension should be at least

40% of the worker's income after 30 years of contributions. The figures for Latin America show that this criterion is met in most countries. The average replacement rate in the region for those who contribute for more than 30 years, is 57%.

What then are the factors that lead to the current dissatisfaction with pensions? The main factor is the lack of adequate coverage of the pension systems. The percentage of the population covered by the pension systems in Latin America is very low, with levels below 30% in countries like Peru, Mexico and El Salvador. This low coverage is mainly explained by the high levels of informality within the region, which are as much as 65%.

Furthermore, individual pension contribution rates are quite low (with average levels of 10% of income). The relatively low retirement ages in Latin America have also negatively affected efforts to increase coverage.

Despite progress in the granting of non-contributory pensions, fewer social pensions are provided in lower income countries, which leads to less coverage in these societies.

Unfortunately, the necessary fiscal margin for granting higher social pensions is lacking. The necessary funds for subsidizing contributory systems are also lacking, which often leads to them being funded through indirect taxes, which are, in turn, regressive.

## **Changes in the workplace**

Technological and demographic changes undoubtedly constitute the greatest impacts on the labor market.

Technological advancement will have an enormous impact on the labor market, but this does not necessarily entail a reduction in the number of jobs. What *is* going to change is the type of jobs available and who will be able to access them. In Europe, for example, non-routine cognitive tasks (i.e., the ability to learn, manage and analyze data) have increased. People who meet these requirements, usually the most educated individuals with the highest income in any society, are the ones who get these new jobs. Manual jobs (routine, non-cognitive tasks), on the other hand, are in full decline.

Employment contracts are also experiencing significant evolution. Whereas traditional long-term contracts are decreasing, short-term employment contracts have snowballed. The latter phenomenon is clearly due to the proliferation of online work platforms. Short-term contracts, as well as an increase in the frequency with which workers enter into and exit employment contracts, are replacing the traditional scenario where people expected to continue working in the same place until retirement. New economically active generations, on the other hand, are much more inclined to start their own projects. All this has led to expectations of a marked growth in self-employment.

The second major global trend is population aging, especially predominant in Latin America, with the aggravating circumstance

of high ongoing levels of poverty in the region.

These two trends pose challenges for traditional social security systems, which were designed for more stable and homogeneous labor markets. Hence, a new approach is needed to understand social risk management and the type of social security systems our countries require. Nonetheless, pension reform discussions always end up focusing on whether PAYGO systems are more appropriate than individually funded systems, for example, instead of exploring new approaches.

### **The World Bank proposal**

The World Bank recommends considering the following criteria in any pension reform.

First, a basic solidarity pillar that grants social assistance, financed with public resources, is needed. The second pillar is a mandatory contribution pillar. The third component is a voluntary savings pillar. The fourth aspect concerns the State's responsibility in ensuring the transparency of the financial market.

Societies are facing enormous technological, economic, demographic and social changes. Unfortunately, the pension systems we have in place are incapable of evolving in the face of these challenges. When analyzing the above proposal, we must ensure that the objectives - as well as the indicators for measuring them - are always in sight. The main objective here is to avoid creating false expectations.

In this case, the central and fundamental indicator is the so-called *adequate pension*,

i.e. an adequate retirement replacement rate. It is very important to ensure that the public is also permanently focused on this objective. Hence, people must be constantly reminded that their respective replacement rates will not improve if they do not change their saving habits.

As a consequence of these changes in the labor market, it is more urgent than ever to design mechanisms that encourage individual retirement savings. Self-employment is a rapidly growing trend.

Investment in human capital is crucial if we are to avoid aging before enrichment. Individuals with greater access to education are more likely to generate the income required for increasing their retirement savings levels. Hence, investing time and resources to strengthen our national training and education systems is an investment in the future of our countries, as well as our pensions.

### **III. OECD: Proposed guidelines for comprehensive pension reform in Latin America**

According to the OECD, comprehensive pension reform must consider the following seven aspects: (i) diversify sources of income for retirement; (ii) complement the aforementioned sources; (iii) separate sources of financing; (iv) highlight the importance of a strong social network for all, financed with the general budgets of the State; (v) establish automatic mechanisms for actuarial adjustment of pensions; (vi) identify the amendments and costs associated with pension reforms; and (vii)

improve the design of defined contribution individually funded systems.

**i. Diversification**

The OECD deems that it is recommendable sound practice to diversify the sources used for financing retirement, while taking advantage of the respective benefits of the different pension systems available.

In the OECD's opinion, a PAYGO system provides a basic pension within a solidarity pillar (i.e. that this basic or minimum pension is distributed through this type of system). The notion of "sharing" between different generations and individuals is materialized in the basic pension (the solidarity pillar or a minimum pension, whatever one wishes to call it). In this regard, the OECD is of the opinion that countries like Chile or Australia, which operate their pension systems with individual accounts together with a solidarity pillar, do have a PAYGO system in place.

**ii. Complementation**

The OECD's second point is that the PAYGO and individually funded pension systems must complement one another. There must be public PAYGO systems coexisting with individually funded systems. The individually funded and PAYGO pension systems must therefore be designed from an overall perspective that considers the coexistence of these parallel systems. In other words, individually funded pensions must be designed taking into account the demands, shortcomings and strengths of public pensions - and vice versa. In an ideal scenario, people would receive a pension funded by both systems.

Above all, any competition between the two alternatives must be eliminated.

**iii. Separate funding sources**

It is very important to separate the sources of funding of the public pension system. In fact, this has been relevant since the 1990s and has been implemented in the vast majority of OECD countries. The names assigned to the non-contributory public pensions systems, comprising a solidarity pillar, social protection and a minimum basic pension - are different across countries. But the central idea is the same: all individuals in a society are entitled to a guaranteed basic pension amount, aimed at fighting poverty and redistributing wealth.

It is also important to mention that the OECD has never indicated what the basic pension amount should be, since these types of regulatory decisions are the responsibility of the respective governments. What the OECD does say is that a minimum pension is mandatory, and that measures aimed at addressing this issue should be funded from the general budget of the State, and not via contributions.

The purpose of contributory pensions, on the other hand, is to save to finance retirement.

**iv. Social safety net for all**

The OECD seeks to emphasize that all countries must have a strong old-age social safety net covering all members of society, and financed with the general budget of the State.

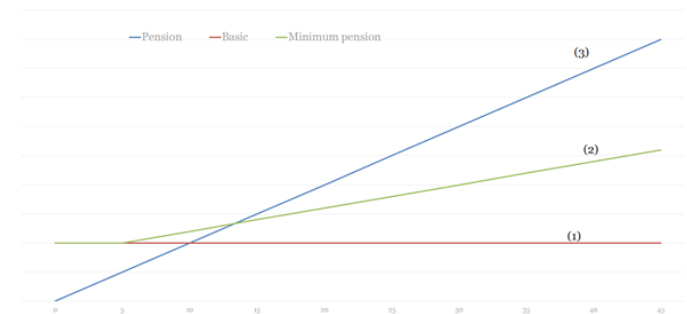
Hence, the agency also argues that any pension reform should include a strong,

universal social safety net for all, financed with the general budget of the State (a solidarity pillar, with a minimum or basic pension). It is a universal measure, but not in the sense that all individuals receive it. The universality of the effort implies that all members of a society have *the right* to access the benefit, which does not mean that *they will all receive* that minimum pension.

In addition, the above can operate depending on whether some individuals contribute. In most of the OECD countries, the minimum pension (solidarity pillar) has faced problems in terms of generating incentives. Thus, it might be productive to peg the basic pension to a minimum pension that grows as people contribute more.

Graph 1 shows what one would receive by saving in individual accounts. Line (3) shows the amount saved over a number of full years, whereas line (1) indicates the lack of growth of the solidarity pension amount. Once again, the basic pension is financed from the solidarity pillar and all members of a society are entitled to said benefit. As previously mentioned, this does not mean that everyone will receive it. The essence of the idea is that, as the amount of the individual account increases, the need to divert funds from the solidarity pension to the individual account diminishes. The OECD clearly believes that each nation has the right to determine at what point this will occur. The point of intersection between lines (1) and (3) is where there are no incentives to save in the individual account. Line (2) shows the minimum pension.

**Graph 1: Individual account, social and minimum pensions**



**Source:** Antolin (2019).

Individuals tend to think that their income will not increase, so they choose to settle for the solidarity pension amount. The way to resolve this situation, in terms of incentives, is to offer a minimum pension linked to the ability and willingness to make contributions. The fact that the amount of this minimum pension grows over and above the amount available under the minimum pension system, encourages individuals to make the aforementioned contributions. The dynamics of the three alternatives is represented by the triangle formed by the three lines indicated in Graph 1.

The fundamental issue here is to emphasize that, in the opinion of the OECD, all members of a society are ensured the right to receive a pension above a certain threshold.

**v. Actuarial automatic adjustment mechanisms**

The next message from the OECD is that actuarial automatic adjustment mechanisms must be used. This basically implies that the pension amount has to be automatically adjusted to macroeconomic realities (i.e. growth, wages, interest rates, returns on

investments and inflation), as well as to demographic variables (life expectancy). The big problem with the PAYGO and individually funded systems is the liability issue. The point is not whether a system is a PAYGO or individually funded system, in itself. The problem has always been that a benefit was promised in a specific historical context, based on parameters that are no longer necessarily valid. This is because societies and economies tend to evolve over time. Thus, in a changing world, the parameters involved also have to change.

If society does not take measures designed to adjust individual expectations, it is generating a liability by default, and clearly, someone will have to cover the cost of that liability. This issue is the driving force behind all current discussions regarding who will pay that liability.

We always encounter this great challenge in defined-benefit systems as well. So, we need automatic actuarial adjustments in both the PAYGO and individually funded systems. The Netherlands is one of the countries that has introduced the most reforms within a defined-benefit individually funded system and in terms of introducing automatic actuarial adjustments.

Many societies have also introduced reforms aimed at improving their PAYGO systems. The need to adjust pension amounts against economic growth and wages, or to adjust the retirement age to address the challenge of

changes in life expectancy, has been discussed in all European Union countries. All of them are automatic mechanisms.

**vi. Identify the adjustments and costs associated with pension reforms**

In the last two decades, most OECD countries have introduced or increased the proportion of individual funding in their pension systems. The OECD believes that it is very important to introduce individually funded systems very gradually. This is especially important when contributions replace part of the PAYGO system. Thus, economies have time to respond to this new diversification of their respective pension sectors.

**vii. Improve the design of the defined-contribution individually funded systems**

The individually funded systems have several aspects that require improvement. First, contributors must contribute more for longer, which entails increasing both the contribution rate and the retirement age. Second, align the commissions that pension funds charge with the cost of the services provided. Third, share risks, as there are factors that are intrinsically uncertain (such as periods of unemployment and the real wages or returns growth curve) that have a significant impact on retirement income and adequacy. Finally, communications and financial education must be improved.

## References

Gottret, Pablo. Pension Reform Trends Worldwide. Presentation at the 17th FIAP International Seminar. Available online: <https://www.fiapinternacional.org/seminario/15-16-mayo-2019-xvii-seminario-internacional-fiap-santiago-chile/>

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