



PENSION NOTES

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Voluntary pensions in emerging markets¹

Executive Summary

Rapid population aging in emerging markets, together with the typically low coverage and low benefits of their mandatory pension systems, could lead to a large percentage of their workforces lacking adequate pensions or sufficient savings in retirement. It is therefore of paramount importance that governments implement reforms that ensure adequate old-age protection for tomorrow's growing number of retirees.

According to Jackson (2017a), the success of emerging markets at ensuring retirement security will increasingly depend on their success at constructing robust voluntary pension systems. Although all 8 of the countries that the author discusses in his report have made a promising start, they all still have a long way to go if their voluntary pension systems are to play a significant role in improving retirement security. With the right reforms, voluntary pension systems could help to shore up the deteriorating retirement income prospects of formal-sector workers. They could also provide a degree of retirement security to informal-

sector workers, including self-employed workers, who constitute a very important portion of the labor force in emerging markets and who currently enjoy little or no retirement security at all.

Governments have focused their efforts on expanding the coverage of mandatory pension systems for too long - without much success - while failing to devote adequate attention to promoting voluntary pension systems. Jackson (2017a) suggests a change of strategy. In particular, he proposes a series of measures, based on lessons learned from the experience of the developed countries, that would broaden and deepen voluntary retirement savings. Implementing automatic enrollment, together with auto-escalation, is critical for increasing the enrollment of employees in voluntary pension plans. New economic incentives targeted at the broad middle class, such as government flat subsidies and matching contributions, are also crucial. Informal-sector workers must be offered special treatment, in the form of additional incentives and greater flexibility, to motivate them to enroll. Appropriate investment policies must also be designed that ensure the highest possible return on savings during the accumulation phase of the pension lifecycle. So must appropriate withdrawal policies that provide workers with suitable

¹Document based on Jackson (2017a) and the author's [presentation](#) at the 25th FIAP International Seminar, held on October 30 and 31 in Mexico City. Richard Jackson is the President and Founder of the Global Aging Institute.

alternatives for accessing their savings during the decumulation phase.

I. The Coming Crisis in Retirement Security

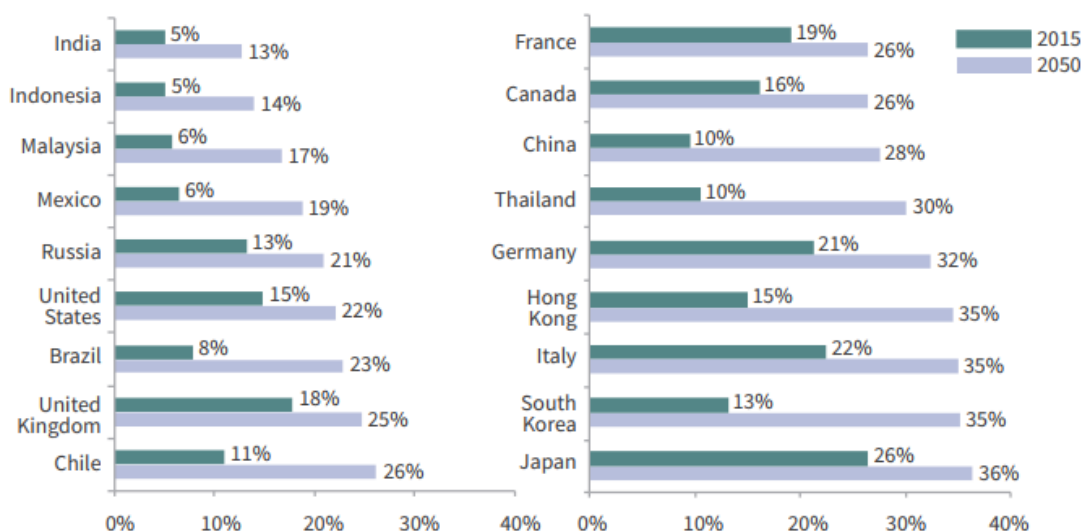
The developing world is about to undergo a stunning demographic transformation with profound implications for retirement security.

By the middle of this century, the populations of many Latin American and Asian countries will be as old or older than the population of the United States (see Graph No. 1). The aging of today's emerging markets will create enormous social and economic challenges. As the demographic transformation proceeds in coming decades, businesses will face a deficit of young workers, while families will have to address a surplus of frail senior citizens. The tax burden will increase and economic growth will slow down. What is perhaps most worrisome,

retirement insecurity could increase dramatically.

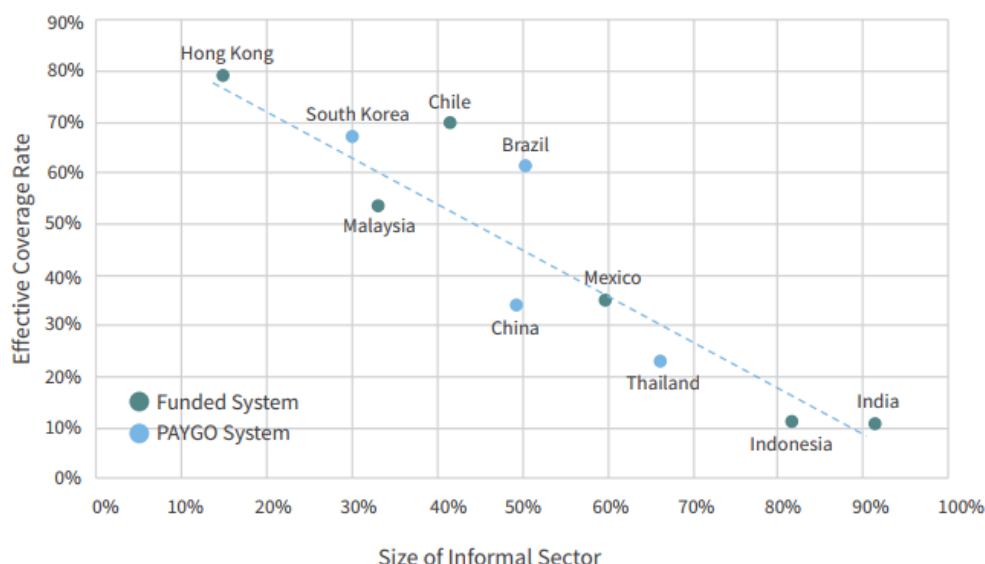
The economic vulnerability of tomorrow's retirees is due in part to the limited coverage of mandatory pension systems in countries with a high degree of informality in their labor markets. As can be seen in Graph No. 2, coverage under mandatory pension systems is highly correlated with the size of the informal sector. Even workers who contribute, moreover, often do so irregularly, which means that they will receive inadequate benefits. Participation rates are generally lower for lower-income workers, women, and employees of smaller companies. The participation of the self-employed is also very low, since they are often entirely exempt from contributing.

Graph No. 1: Elderly (65 or older), as a percentage of the population in 2015 and 2050



Source: Jackson (2017a).

Graph No. 2: Effective mandatory pension coverage rate and size of the informal sector in the most recent year for which data are available



Source: Jackson (2017a).

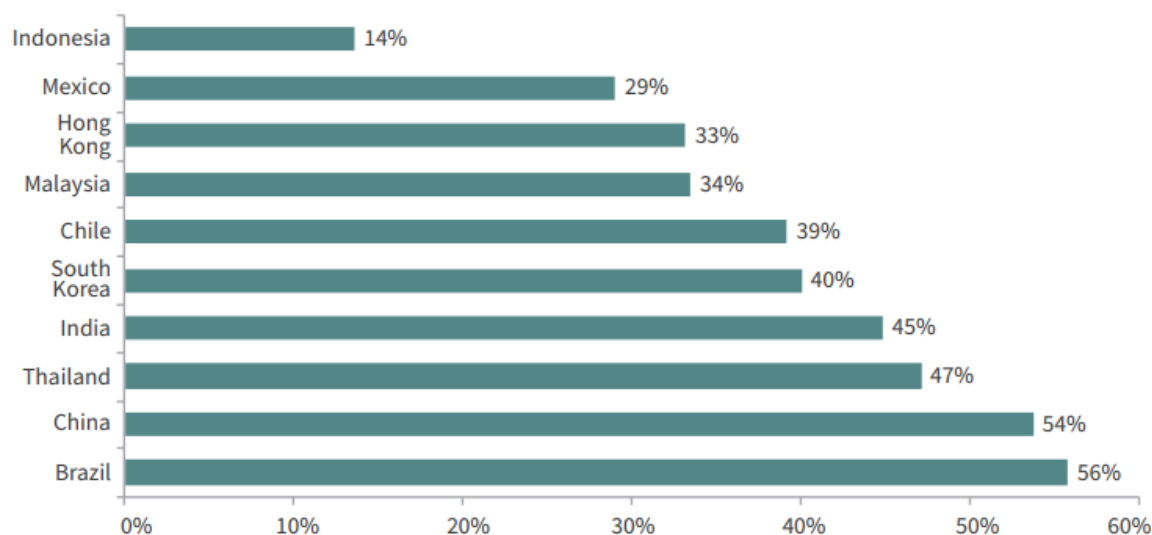
Yet even for workers who contribute to mandatory pension systems for their full careers, retirement insecurity is growing. Emerging markets with mandatory PAYGO pension systems are finding it increasingly difficult to maintain the adequacy of benefits as fertility drops and life expectancy increases, resulting in an increase in the ratio of retired beneficiaries to contributing workers. From Brazil to China, many are being compelled to make dramatic reductions in replacement rates for future retirees.

In principle, emerging markets with mandatory funded pension systems should be better prepared to deal with their approaching aging waves. Yet in practice, they may be no more successful at maintaining retirement security than those with PAYGO systems. In the individually funded personal accounts systems of countries like Chile, Hong Kong, and Mexico,

contribution rates are too low to finance adequate replacement rates (see Graph No. 3). In the centrally managed provident funds of countries like India and Malaysia, low rates of return, together with pre-retirement withdrawals and low early-retirement ages, similarly undermine adequacy.

It is unlikely that alternative sources of income can fill the void left by inadequate mandatory pension systems. With family size shrinking, tomorrow's retirees will not be able to rely on the support of their extended families to the same extent as current retirees. Employment opportunities for the elderly may also be limited in rapidly developing markets in which older workers do not have the required skills to participate in the growth sectors of the economy. At the same time, increasing life expectancy will expose tomorrow's retirees to the growing risk of outliving any personal savings they may have.

Graph No. 3: Future Mandatory Pension System Replacement Rates for Full-Career Workers



Source: Jackson (2017a).

All of the above, Jackson (2017a) argues, suggests that the success of emerging markets in ensuring retirement security will increasingly depend on their ability to build robust voluntary pension systems. Until recently, many policymakers assumed that expanding voluntary pension systems should be a low policy priority in societies where mandatory systems cover only a fraction of the workforce. But it is precisely the limited coverage under mandatory systems that makes expanding voluntary ones so important. Nor is it true, as policymakers also often assume, that expanding voluntary pension systems would merely benefit the affluent. To the contrary, they have a central role to play in improving the deteriorating retirement income prospects of middle-class workers. They can even help to improve the retirement income prospects of workers in the informal sector, who currently enjoy little or no retirement security at all.

II. Current status of the voluntary pension systems

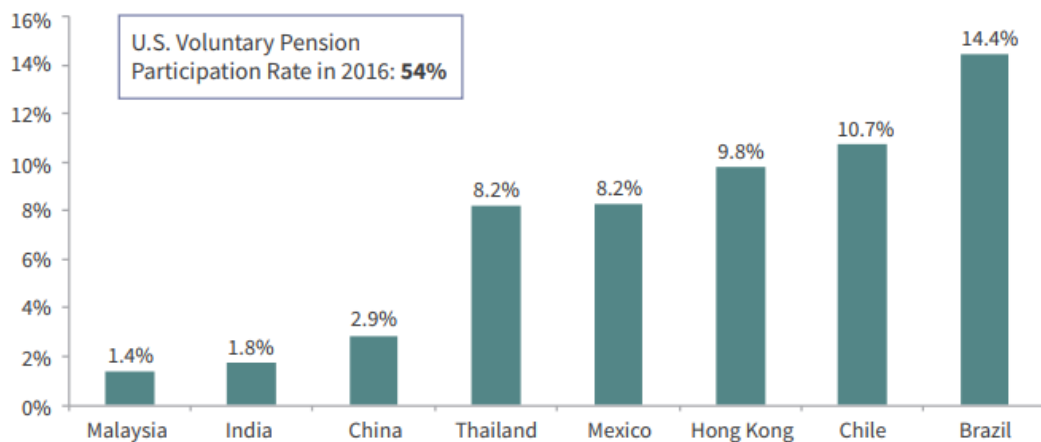
The countries covered in Jackson's report are Brazil, Chile and Mexico in Latin America and China, Hong Kong, India, Malaysia and Thailand in Asia. The existing voluntary pension systems in all of these countries have several positive characteristics in common. Most of the systems are exclusively defined contribution, which well suits them to the needs of tomorrow's mobile workforces and aging populations. Also, all of the systems receive at least some kind of favorable tax treatment designed to encourage voluntary retirement savings. They also benefit from well-developed fund management industries to invest the savings and highly professional regulators to enforce rules and standards.

Nonetheless, there is also a negative common denominator in the voluntary pension systems of all 8 countries: their low

level of coverage. As can be seen in Graph No. 4, among the countries in the sample Brazil, with 14.4% of the workforce participating, has the highest coverage rate, followed by Chile, with 10.7% participating. These participation rates are very low compared to those in the United States, where 54% of the labor force is enrolled in voluntary pension plans.

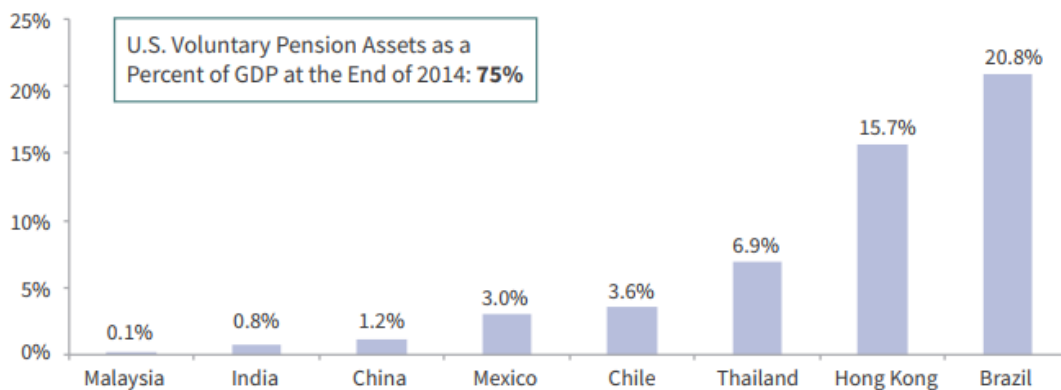
In addition to low enrollment, the voluntary pension systems of the countries studied have very low amounts of assets under management in relation to their GDPs. Indeed, these amounts exceed 15% of GDP in only 2 of the 8 countries (see Graph No. 5).

Graph No. 4: Contributors to voluntary pension systems for formal-sector workers, as a percentage of the labor force in 2015 or 2016



Source: Jackson (2017a).

Graph No. 5: Assets under management in voluntary pension systems for formal-sector workers, as a percentage of GDP in 2015 or 2016

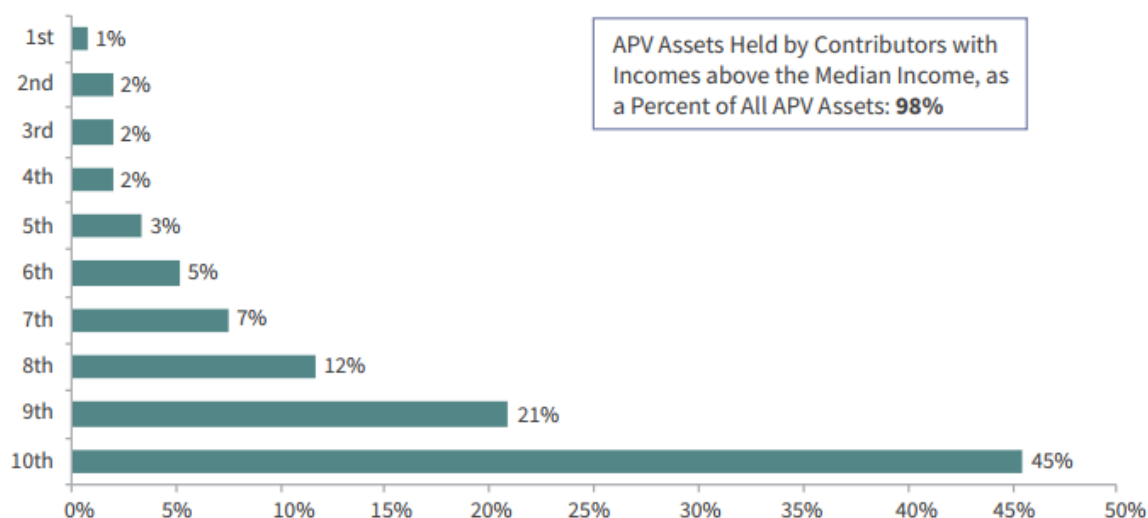


Source: Jackson (2017a).

As things stand, enrollment in voluntary pension systems is not only restricted to a relatively small fraction of the labor force, but it also tends to be very skewed by income. Excluding special voluntary systems for workers in the informal sector, the majority of enrolled members are high-income workers, who benefit more from the preferential tax treatment and often have salaries that exceed the tax ceiling of the mandatory pension system. Although some countries have recently taken modest steps to make their voluntary pension systems more attractive to lower- and middle-earning

workers, these measures still fall short of what is required. Even in Chile, whose Voluntary Retirement Savings system (APV, by its Spanish acronym) includes some special incentives targeted at the middle class, participation is limited largely to workers in the upper levels of the income distribution. In 2016, two-thirds of APV contributors had incomes in the top income quintile, and nearly half of them had incomes in the top decile (see Graph No. 6). The distribution of APV assets is even more skewed, with 98% being held by workers with incomes higher than the median income.

Graph No. 6: Chile: APV contributors per income decile in 2016, as a percentage of all APV contributors



Source: Jackson (2017a).

III. Strategies for strengthening voluntary pension systems

Achieving meaningful progress in the expansion and deepening of voluntary pension systems for formal-sector workers will require far-reaching reforms. As

emerging markets consider reform strategies, it will be important to look at the experience of developed countries that have successfully managed to increase enrollment. To succeed, they will have to take advantage of the lessons of behavioral economics in order to overcome the inertia

and myopia of workers. They will also need to put in place new economic incentives targeted at lower- and middle-earning workers, as well as follow global best practices during the accumulation and decumulation phases of the pension lifecycle. The main lessons learned from the experience of the developed countries are as follows.

1. Soft compulsion: automatic enrollment and auto-escalation

The experience of the developed countries shows that it is important to change the means of enrollment in voluntary pension plans sponsored by employers from an opt-in to an opt-out model. In other words, all workers should be automatically enrolled in the plans sponsored by their employers. If they do not wish to participate, they would then have to actively choose to opt out.

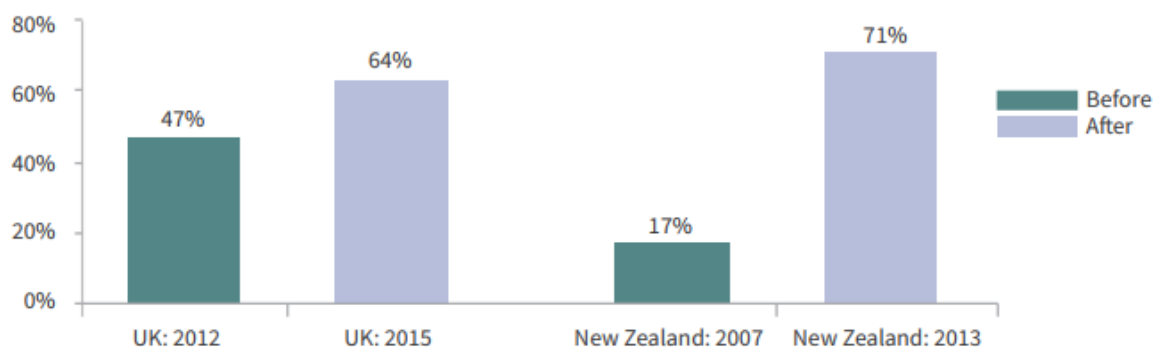
In the U.S., some employers have taken automatic enrollment a step further, applying a mechanism known as “auto-

sweeping” in which workers who have opted not to participate in voluntary pension plans are periodically re-enrolled. On each occasion, those workers who do not wish to be enrolled must again decide to opt out.

New Zealand (KiwiSaver in 2007) and the United Kingdom (since 2012) have gone even further, implementing automatic enrollment nationwide. Governments require employers to enroll their employees in an occupational pension plan, though workers can still opt out. In practice, voluntary pension plans are mandatory for employers and voluntary for workers.

Automatic enrollment has been successful in countries that have implemented it, the most notable examples being New Zealand and the United Kingdom. Enrollment in voluntary pension plans sponsored by employers rose from 17% of the labor force in New Zealand before automatic enrollment to 71% after it. In the United Kingdom, enrollment rose from 47 to 65% (see Graph No. 7).

Graph No. 7: Percentage of the workforce enrolled in an employer-sponsored pension plan in New Zealand and the United Kingdom, before and after automatic enrollment



Source: Jackson (2017a).

Behavioral economics can not only be used to increase the proportion of employees enrolled in employer-sponsored pension plans, but also to increase their savings by means of “auto-escalation” once they are participating. The evidence suggests that if workers are enrolled at a high contribution rate, they will tend to opt out of the plan, whereas if the initial rate is set lower and then automatically raised over time, more workers will remain in the plan. Together with automatic enrollment, auto-escalation is now a part of global best practice.

2. Economic incentives

Economic incentives are also important for encouraging voluntary pension savings. Traditionally, these have taken the form of tax benefits or preferences. In the usual arrangement, contributions can, up to certain limits, be paid out of pretax income, investment earnings accumulate tax-free, and benefits are taxed in retirement, when income (and hence marginal tax rates) will presumably be lower.

Because income tax systems are usually progressive, traditional tax benefits disproportionately favor higher-income workers, precisely the group with the highest enrollment in voluntary pension plans in emerging markets and with the least need of government subsidy. To encourage voluntary retirement savings among middle- and lower-income workers in these countries, other kinds of economic incentives, such as fixed government subsidies and/or matching contributions, should be offered in addition to traditional tax benefits. Again, the experience of the United Kingdom and New

Zealand shows that these types of economic incentives can help to promote VPS.

3. Accumulation phase

Encouraging enrollment is only the first challenge faced by countries when building robust VPS systems. Once workers are enrolled, it is essential to have measures in place that, to the extent possible, maximize the returns earned on their savings and ensure that their savings is preserved for retirement.

First of all, for any VPS plan to be successful, it is essential that assets be invested in a globally diversified pension portfolio. Government regulations limiting foreign investment are particularly harmful.

Another critical design issue involves the degree of discretion that should be granted to workers regarding the way their savings are invested. Although mandatory retirement savings systems can strictly limit the investment alternatives they offer members in order to maximize returns, international experience shows that in the case of VPS systems it is important for savers to have greater discretion in order to encourage participation. The key is to strike the right balance between paternalism and choice.

Global best practice is moving toward combining default funds that incorporate life-cycle investment principles with a limited number of additional fund options. There are two basic life-cycle fund models: target-date funds and target-risk funds, or multifunds. In the former, workers are assigned to a default fund whose risk profile is suitable for people with their expected retirement date. As that

date approaches, the combination of assets in the fund gradually switches from riskier to more conservative assets. In the latter, the risk profile of each fund remains unchanged, but workers are transferred to new and more conservative funds as they get older. Although each model has its advantages and disadvantages, the target-date fund model is preferred in the developed world.

Another area where it may be necessary to make compromises is investment guarantees. Although such guarantees can be costly and counterproductive, in some countries there is a widespread popular feeling that workers should receive at least some degree of protection against the risk of investment losses. Guarantees on the rate of return are a particularly bad idea, since it would encourage fund managers to switch investment portfolios to lower-risk and lower-return assets, and members would assume the cost in the form of lower benefits. The least costly and damaging option is to offer a nominal capital guarantee, which in effect promises a zero rate of return during the working lives of participants. Nominal capital guarantees are especially valued by workers, who are comforted by the promise that they will always get back at least what they paid in.

It is also important to establish reasonable rules regarding preretirement withdrawals of VPS savings. Ideally, of course, all VPS savings would be preserved until retirement. If such a rule were enforced, however, it would greatly undermine incentives to participate by workers with liquidity constraints. Here the compromise that most developed countries make is to authorize advance

withdrawals, but to limit, penalize, or otherwise discourage them.

Last but not least, there is the issue of limiting administrative fees. The best approach is to promote competition among fund managers. Global best practice frowns on regulatory caps, which may distort investment decisions and have unintended and self-defeating consequences.

4. Decumulation phase

Many experts believe that voluntary pension systems should require the annuitization of account balances, at least up to some minimum threshold. Others, however, argue that the need to protect retirees against longevity risk must be balanced against their need to have funds on hand in the case of an emergency and/or their desire to leave a bequest. The optimal solution, and the one recommended by the OECD, may be to combine programmed withdrawals with a deferred lifetime annuity beginning at age 80 or 85.

Another very important issue to consider is the age at which VPS balances can be accessed without penalties. This age is currently as low as the mid-fifties in some countries, which is not in accordance with the needs of rapidly aging populations.

5. The role of employers

In the majority of developed countries, voluntary pension plans sponsored by employers (also known as collective voluntary pension savings, or CVPS) have been the most effective and efficient way of expanding the VPS coverage of middle-income workers. These types of pension

plans may not always be the best alternative in emerging markets, however, since they cannot be extended to the informal sector and work better in economies dominated by large employers than ones dominated by small and medium-sized enterprises.

Nonetheless, emerging markets should encourage CVPS wherever possible. There are two proven ways to do this short of making coverage mandatory. The first is to require automatic enrollment and the second is to offer more favorable tax treatment to employer pension plans than to personal plans. Together with the implementation of automatic enrollment, governments should establish minimum contribution and matching contribution thresholds for employers, as well as maximum thresholds for vesting periods. At the same time, they should link more favorable tax treatment to non-discrimination tests, which require that some minimum percentage of a firm's workers be enrolled in the plan.

While non-discrimination tests are important, if they are too strict they may end up discouraging CVPS. A reasonable balance might be to set initial tax benefits and minimum enrollment rates at relatively low levels, but increase the generosity of tax benefits if employers attain higher enrollment rates. Similarly, setting very high minimum contribution rates for employers could lead them to reduce wages, which would in turn lead workers to resist the implementation of CVPS plans. As for vesting periods, policymakers need to balance the goal of preserving savings with the desire of employers to enhance employee retention.

While a 2 year vesting limit might be optimal, perhaps 5 years is acceptable.

6. Special treatment for the informal sector

A growing number of experts are concluding that voluntary pension systems are a better long-term response to the problem of retirement insecurity for informal workers than non-contributory social pensions, since the latter encourage informality. Non-contributory pensions also make a sizable portion of retirees dependent on social assistance and vulnerable to reductions in benefits due to mounting fiscal pressure as populations age and the number of elderly grows.

Because VPS systems do not have these disadvantages, many countries (particularly in Asia) are designing special programs for informal workers. There are considerable challenges involved in extending VPS to the informal sector, beginning with how to collect contributions. Economic incentives may also need to be more generous than for formal workers, and should include significant matching contributions by the government. Furthermore, in order to encourage workers to enroll, they should be offered greater flexibility in everything from contribution levels to the rules governing preretirement withdrawals.

7. Financial literacy

Finally, whatever specific reforms emerging markets implement, they should be accompanied by a broad financial literacy campaign, involving both the government and financial industry providers. Workers in emerging markets have very low levels of

financial literacy, which will undoubtedly limit their ability to understand the importance of VPS for their futures. As part of this effort, workers must be informed of the level of pension benefits they will receive through the mandatory pension system in

order to discourage unrealistic expectations and draw attention to the need for voluntary retirement savings. To be effective, financial literacy campaigns must obviously conform to the institutional and cultural realities of different countries.

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