Main Points from World Bank Report on:
Averting the Old Age Crisis

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Summary: Systems providing financial security for the old are under increasing strain throughout the world. Changing demographics have led to an increased proportion of old people in the general population. Traditional means of support for the old, such as extended families, are weakening. Meanwhile, formal systems, such as government-backed pensions, have proven unstable. For these reasons economists, policymakers, and government officials are exploring ways to address such issues as:

1. How to ensure financial security for the old and the best ways of paying for such security

2. The roles of the public and private sectors when systems are used to enhance rather than detract from economic growth.

This book, the first comprehensive and global examination of old age security, addresses such issues. It identifies three functions of old age financial security programs–redistribution, saving, and insurance. It evaluates the policy options for meeting these functions using two criteria: their impact on the aged and their impact on the economy as a whole. The study suggests that financial security for the old and economic growth would be better served if governments relied on three systems. These are:

1. A publicly managed system with mandatory participation and the limited goal of reducing poverty among the old

2. A privately managed mandatory savings system

3. A voluntary savings system.

These three systems would ensure against the many risks of old age. The study concludes that a combination of different income security policies is more effective than any single approach and that all countries should begin planning for their aging populations now.

Chapter 1: Overview Summarizes forecasts of a worldwide demographic transition and makes the case that there is a looming "old age crisis":

1. In 1990 almost half a billion people, just over 9% of world population, were over 60 years ago. By 2030 the number will triple to 1.4 billion. Most of this growth will take place in developing countries, over half of it in Asia, and more than a quarter in China alone.

2. Because of the broad diffusion of medical knowledge and declining fertility, developing countries are aging much more rapidly than industrial countries. In Belgium it took 100 years for the share of population over 60 to double from 89 to 18 percent. In China the same transition will take only 34 years and in Venezuela 22 years.

3. In some LDCs, publicly managed social security funds can be dissipated by poor management. In Zambia, the public provident fund invested exclusively in public securities lost 23% per year between 1981 and 1988. More than half the contributions in 1988 were used for administrative expenses.

4. High payroll taxes distort labor markets and reduce growth. In Hungary more than 25% of the population is retired, the average age of retirement has fallen to 54, and the payrool tax needed to pay public pensions is 33%.

5. Pensioners in some LDCs are subject to severe inflation risks. In Venezuela, real pension benefits fell 60% during the 1980s largely because social security benefits were not indexed to the high inflation rates during that period.

6. High government spending on social security crowds out other public goods and services. In 1989 Austria's pension funds cost 15 of GDP and old age benefits absorbed 40% of public spending.

7. Despite seemingly progressive benefit formulas in public pension plans in Netherlands, Sweden, UK and US, studies have not found significant redistribution of lifetime income from rich to poor. This is partly because the rich live longer and collect benefits for more years.

Book argues that less developed countries in Africa and Asia primarily rely on *informal systems* for providing for old age security. These informal systems are typically based on *family transfers* including extended family relationships where children support and often live with their parents and grandparents. The movement from farm to factory and from country to city during the industrial revolution lead to the demise of informal systems in most of the now-industrialized countries. In the mid 1800s *formal systems* for old age security were developed in these countries. Currently about 40% of the world's population and more than 30% of its old are covered by formal arrangements for old age. Formal systems take three main forms:

1. **Public pay-as-you-go plans.** This is by far the most common formal system, mandatory for covered workers in all countries. Coverage is almost universal in high income countries and widespread in middle income countries. This systems are typically *defined benefit plans* where the pension benefit is is an indirect function of the individual's earnings history, with provisions for both intragenerational and intergenerational redistribution.

2. **Occupational Plans.** These are privately managed pensions offered by employers to attract and retain workers. They are often facilitated by tax concessions and are increasingly regulated by governments. These plans have tended to be defined benefit and partially funded in the past, although in the U.S. the recent trend has been towards defined contribution, fully funded plans due to changes in tax deductiblity of employer contributions and retiree benefits. More than 40% of workers are covered by occupational plans in Germany, Japan, Netherlands, the UK and the US, but far fewer in the developing countries.

3. **Personal savings and annuity plans.** These are fully funded defined contribution plans. Workers save when young to support themselves when old. Since benefits are not defined in advance, workers and retirees bear the investment risks on their savings. However these plans are portable, so there is lower risk of loss of benefits due to job mobility, as is more typically of some defined benefit occupational plans. Voluntary personal retirement saving is found in every country, often encouraged by tax incentives. Some countries have made such saving mandatory as part of some form of *privatized social security system.* A key distinction is between mandatory savings plans managed by the government (e.g. Malaysia, Singapore and several African countries) and those managed by multiple competing private countries (e.g. Child, Argentina, Columbia and Peru).

Key Policy Issues:

1. Should the system be voluntary or compulsory? At what levels should benefits be set?

2. What should be the relative weight put on savings vs. redistribution?

3. Who should bear the risk of unexpected outcomes — pensioners or others in the society?

4. Should the system be fully funded or pay-as-you-go?

5. Should it be managed centrally or decentrally and competitively?

Functions of a Formal System: One of the prime policy issues in the design of old age security programs is the relative importance of *saving*, *redistribution* and *insurance* functions, and the role of government in each.

1. **Saving** involves income smoothing over an individual's lifetime.

2. **Redistribution** involves shifting lifetime income from one person to another.

3. **Insurance** involves income transfers between individuals but to pool risks, effectively reducing or eliminating them at the individual level due to the operation of the "law of large numbers." redistribution?

Towards a Multi Pillar System: The book recommends separating the savings, redistributive and insurance aspects of formal systems and placing them under different different financing and managerial arrangements in two different mandatory pillars — one publicly managed and tax-financed and the other privately managed and fully funded — supplemented by a voluntary pillar for those who want more. Thus the three pillars of old age security are:

1. **Mandatory publicly managed pillar** whose main objectives are redistribution and insurance providing defined benefits via a payroll tax that finances a means-tested pension with a minimum pension guarantee,

2. **Mandatory privately managed pillar** whose main objectives are savings and insurance, providing defined contribution benefits via personal saving (IRA) or occupational savings plan (401K) that are regulated and fully funded.

3. **Voluntary Pillar** whose main objectives are to supplement the retirement benefits from the other two pillars via personal retirement savings.

Benefits of a Multi Pillar System It can help countries to:

1. make clear decisions about which groups should gain and which should lose through transfers in the public mandatory pillar, both within and across generations. This should reduce perverse or capricious redistribution and poverty.

2. achieve a close relationship between incremental contributions and benefits int he private mandatory pillar. This should reduce effective tax rates, evasion, and labor market distortions.

3. increase long term saving, capital market deepening, and growth through the use of full funding and dencetralized control in the second pillar.

4. diversify risk to the fullest due to the mix of public and private management, political and market determination of benefits, the use of wage growth and capital income as a basis for finance, and th ability to invest in a wide variety of securities — public and private, equity and debt, domestic and foreign.

5. insulate the system from "political risks" including political pressures for design features that are inefficient as well as inequitable. the retirement benefits from the other two pillars via personal retirement savings.