Voluntary pension schemes and the challenge of non-take-up

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What will I talk about ?

- There is not just one system for providing pensions
- Voluntary elements in statutory pensions
- Voluntary private pensions
- Examples of take up rates of voluntary pensions
- The reasons for a low take up
- What could be done to improve take up of voluntary pensions ?

What is the aim of a social security pension ?

- To prevent poverty among the elderly and smooth consumption profiles over a person's lifetime
- Secondary effects :
  - effects on national savings, the accumulation of capital, the labor market, or the fiscal situation
- Different visions / philosophical approach /ideologies

1. The principal objective should be the alleviation of poverty in extreme cases
2. A social security system has a central role in a society's income redistribution policy
3. To ensure a substitution of equitable income
4. The need to promote economic development at a macro level, eliminating factors that could produce distortions in the various markets

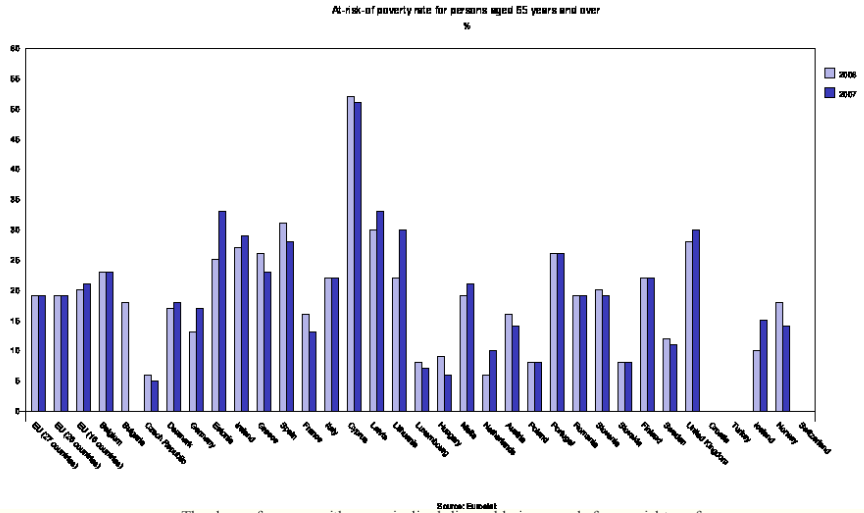
There is not just one system for providing pensions



The colour of the cat doesn't matter as long as it catches the mouse
(Deng Chao Ping)

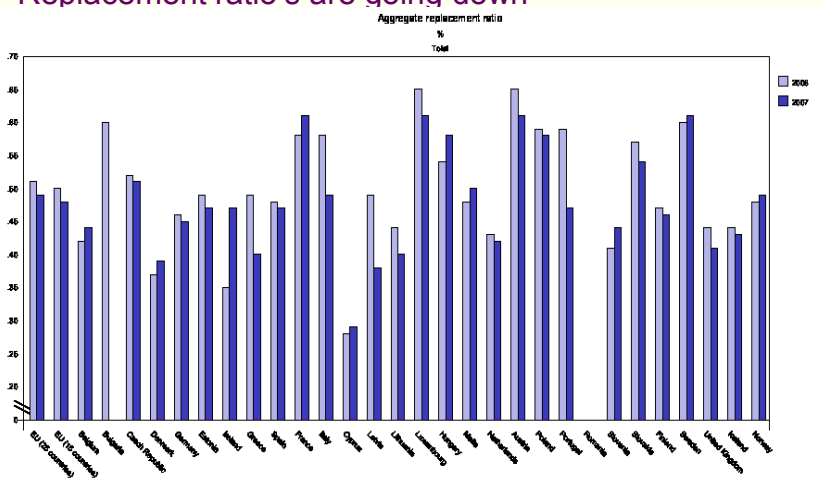
It is all about delivering pensions

At-risk-of poverty rate for persons aged 65 years and over



The share of persons with an equivalised disposable income, before social transfers, below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Retirement and survivor's pensions are counted as income before transfers and not as social transfers

Replacement ratio's are going down

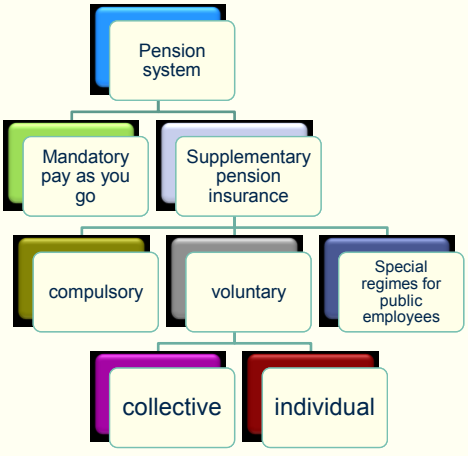


The indicator is defined as the ratio of the median individual gross pensions of 65-74 relative to median individual gross earnings of 50-59, excluding other social benefits. For 2004-2005 data, aggregate income replacement ratio is based on net income components for ES, EL, IT, LV, PT. EU aggregate figures are calculated as population-weighted averages of national values.

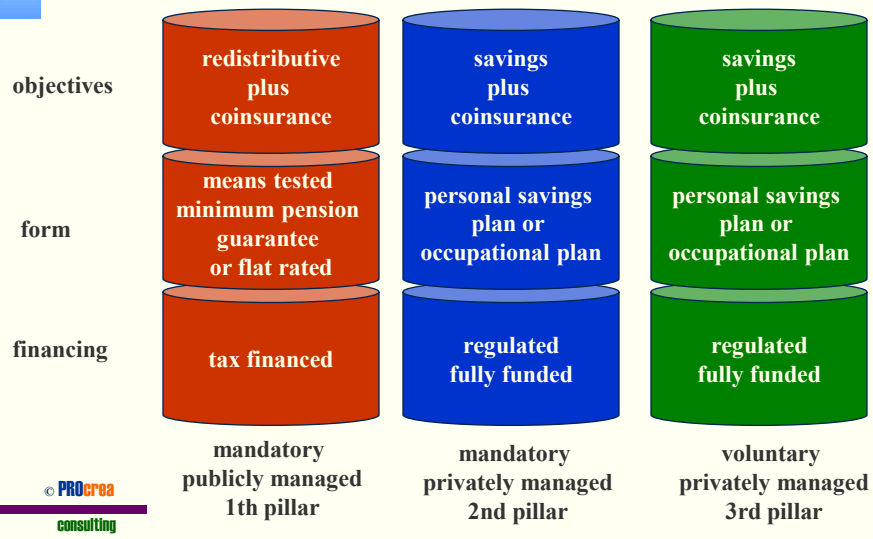
Pension system design is influenced by a lot of factors

- History
- Cultural background and values
  - More individualised or not
  - More centralised power or not
  - Law system
- Ideology
- External pressure when the economical situation of the country is weak

A possible structure for voluntary pensions



Another structure for voluntary pensions



Statutory pensions can have voluntary elements

- Often statutoty pensions are not funded but financed as “pay as you go”
- Even in such systems voluntary cover for specific periods is possible
- This is different from voluntory supplementory private pensions
- Let us give some examples

(Source : ESIP - Voluntary elements in the statutory pension systems in the European Union)

Belgium

- Old-age and survivors insurance compulsory for all employees and self-employed financed by contributions (employer, employee, self -employed) and state subsidy from taxes
- Voluntary contributions to social security pension possible for
  - periods of studies,
  - interruptions of career,
  - periods of taking care of children up to 3 years (handicapped children up to 6 years),
  - periods of receiving an disability pension from other countries for cross-border commuters and seasonal workers
- percentage of voluntary insurance: 0,13 %

Denmark

- Universal protection scheme for all inhabitants (Folkepension), old-age and invalidity cover, compulsory, financed by tax, current income financing “pay as you go”
- Supplementary pension, ATP (Arbejdsmarkedets Tillaegspension): only old-age and survivors pension, no invalidity cover, compulsory for all employees and people who receive allowances, contribution based (employee, employer)
- voluntary insurance for ATP :
  - self-employed persons, who already paid contributions in the ATP over a period of 3 years,
  - persons who draw an early pension or receive a transition benefit in case of unemployment,
  - persons, who receive a disability pension or a partial pension
- percentage of voluntary insurance : 4,4 %

Germany

- Old-age, invalidity and survivors pension insurance: compulsory for all employees and certain groups of self-employed persons financed by contributions (employer, employee, self -employed) and state subsidy from taxes
- Voluntary contributions possible for:
  - persons who have reached the age of 16, who are not compulsory insured and living in Germany,
  - Germans living abroad,
  - persons of foreign nationalities living abroad,
- Arrear payments for studies and trainings, German citizens who have retired from serving an international or supranational organisation, other very limited groups of people
- Compulsory insurance possible for all self-employed and insignificantly employed persons who are not compulsory insured by law
- percentage of voluntary insurance: 2,26 %

Finland

- National pension (Kansaneläke): guaranteed minimum old age, survivors and invalidity pension for all inhabitants between 16 and 65, employers respectively self-employed contributions plus state subsidy, pay as you go
- Employment pension (Työeläke): statutory earnings-related pension scheme, covers old-age, invalidity and survivors pension, all economically active persons, contributions of employers, employees and self-employed, additionally state subsidies for farmers', self-employed persons' and seamen's pension schemes, mixed system partly funded and partly „pay as you go"
- Voluntary scheme only for persons working abroad, very few members

Greece

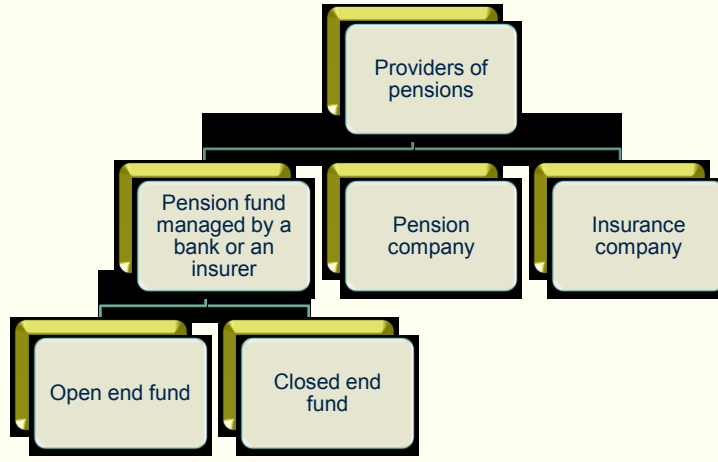
- Basic protection scheme old age, survivors and invalidity: compulsory for all employees, self employed and others, „pay as you go“ -system, financed by contributions (employer, employee, self-employed) and state subsidies
- Supplementary protection (IKA-Team or others, large variety of funds): compulsory for employees, self-employed and others, “pay as you go ”, contributions by employer, employee and self - employed
- Voluntary insurance in IKA and IKA-Team:
  - for all persons who have been insured but are no longer compulsory insured
  - for Greek citizens orof Greek origin, who live abroad
  - for persons who are not compulsory insured

Most Western European countries have some form of voluntary pensions

- Tax incentives
- Caps

- Consequence :
  - Mostly for higher income earners
  - Earners of low and replacement income do not participate

The law can mandate different types of institutions to provide voluntary pensions



Recent pension reforms are often inspired by the World Bank's recommendations

- The WB evoluated from a 3 pillar to a 5 pillar approach
- A non contibutory zero pillar
  - social pension, or general social assistance
  - financed by the local, regional or national government
- A mandatory "first pillar"
  - Pay as you go
- A mandatory second pillar
  - individual savings account
- A voluntary "third-pillar"
- A non-financial "fourth pillar"
  - access to informal support (e.g. family support), other formal social programs (e.g. health care and/or housing), other individual financial and non-financial assets (e.g. home ownership)

Drastic reforms in the systems

- The change of system hides reductions in pensions
- Such change would otherwise be politically difficult
- A shift to more individual responsability

Some pension reforms in Central and Eastern Europe are similar to those in Latin America

- Latin American governments that have undertaken structural overhauls to their national pension systems have
  - improved their budget position
  - made public pensions more equitable
  - encouraged savings and investments
- Despite the improvements, coverage of social security and private pensions remains stubbornly low across the region
- Old age poverty remains a significant risk for the region's citizens

Source : World Bank - Keeping the Promise of Social Security in Latin America

Percentage of workers contributing to social security in Latin American systems

15 to 64 years old working more than 5 hours a week

	All workers	Salaried workers	Private sector salaried	Self-employed
Argentina		65	65	
Brazil	54	73	72	16
Chile	65	77	77	19
Colombia	35	54	47	8
Costa Rica	66	74	68	37
Mexico	50	64	60	0,09
Nicaragua	20	32	25	1,09
Peru	16	29	19	1,47
Paraguay	16	30	19	1,06
El Salvador	39	54	46	3,36
Venezuela		65	56	

Source: Auerbach, Genoni and Pagés : Social security coverage and the labor market In developing countries, 2005

Across countries, the pattern for non contributing is strikingly similar

- Social security programs are less attractive than for the average worker for
  - the unskilled,
  - the young,
  - married women,
  - workers living in large households with many active members,
  - workers without other members of the household contributing to social security,
  - workers with low wages and workers in rural areas
- Not all non-compliance decisions are the result of workers' choice
  - part time workers earning wages below the minimum wage
  - some workers employed in small firms

Reasons for low participation

- The low coverage of social security programs is often attributed to
  - large rates of informal employment and unemployment
  - to precarious financial situation of households
- Implicit in this view is that workers are rationed out of social security against their will
- For salaried workers, participation in these programs is linked to employment in good jobs with benefits
- In absence of compulsory savings many people do not save enough for retirement
- Many employers fail to enroll their workers in pension schemes

There is probably more that can explain low take up

- More in cities, less in rural areas
- Lack of trust in the financial and pension system
- Cultural factors and values, e.g. reliance on the community, compliance of pension funds with religious prescriptions
- ...

One of the reasons for low participation : an important informal sector

- Informal sector workers account sometimes for an important part of labour force
- Informal workers receive less income, are less educated, and older than the formal sector workers
- This group is vulnerable and subject to several aspects of risk
- They are less likely to shift back and work in the formal sector
- They receive only the government's universal programs
- The old-age pension plan for informal sector should be set up as a social safety net

Adressing poverty : minimum guarantees

- The benefit structure of minimum pension guarantees introduces deterrents to the participation of poorer households as well as perverse incentives and moral hazard
- A poverty trap may be created when poorer households do not expect to qualify for the formal minimum pension guarantee and decide not to participate.
- The minimum guarantee can also create incentives for workers to participate only until they have complied with vesting requirements and to evade thereafter
- The strongest motivation to regularly contribute to a second-pillar retirement account is not only old age income security, but also to gain access to health insurance and better health care

Universal non means tested schemes

- Different forms :
  - Universal benefits
    - Age is the only targeting device
    - But wasting resources in the non-poor elderly, and in excessive transfers to some of the poor who are close to the poverty line
  - Targeted social assistance :
    - Only the poor elderly who are closer to the poverty line receive a transfer
    - Only the minimum amount needed to reach the poverty line
  - Fixed supplementation : only the poor elderly receive a transfer of a fixed amount, independent of income
- Effective in addressing old-age poverty
- Often expensive and inefficient

Means tested schemes

- Potentially efficient
- Difficult to administer to be effective

Alternative : local community

- Working through community support and non-government organizations
- Targeted to the elderly poor
- There is little evidence of the effectiveness and long-term sustainability of relying on organized civil society

Benefits from increasing coverage

- What the literature tells:
  - Formalized work relations promote better labour conditions, enforceable labour rights and access to formal social risk management
  - Moving from the informal to the formal sector may affect economic growth
  - Expanded coverage and formal labour force participation will further strengthen the overall revenue position of the government

Low take up of voluntary pensions is not linked to the stage of development of economies

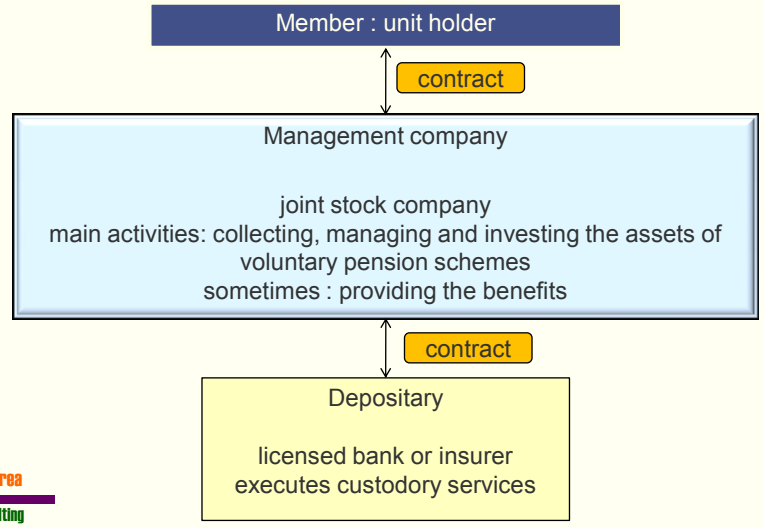
- Example : UK
- "Worryingly, the report also reveals that more than half (55 per cent) of non-retired UK adults say they do not contribute at all to a private or company pension scheme "
  - 63 per cent of women, compared with 44 per cent of men say they do not pay into a private or occupational pension.

Source : Prudential, april 2008

Voluntary pensions in the "World Bank model"

Contents	• a pool of assets • derived from voluntary contributions + return on investments, • less fees and charges
Structure	• a contract • between a member (+ possibly his employer) • and a management company
Ownership	• by the members • but without voring rights

A possible structure of voluntary pensions



Example of a legislation

- Voluntary pension funds are based on the following principles:
  1. Voluntary nature of membership;
  2. Distribution of investment risks;
  3. Equality of voluntary pension fund members;
  4. Publicity of its operation;
  5. Accumulation of funds

What could be done to improve take up of voluntary pensions ?

- People may act in a short-sighted way, and fail to save enough for their retirement needs
- Thus : provide incentives to retirement savings.
- The most common incentive is the preferential tax treatment of pension plans
  - Only effective for people that pay taxes
  - The tax advantage should be substantial
  - Cost for public finances : the scheme should encourage individuals to increase their retirement savings in a way that is in the “public” interest

Tax as a pension savings incentive

- Personal savings must be sufficiently elastic to the net rate of return
  - If yes, it can then produce a net flow of additional savings
- There can be degrees in the tax advantage :
  - When income taxes are flat :
    - Contributions not imposable in the income taxes
    - Deduction of contributions : more important effect
  - When income taxes are progressive :
    - Up-front deduction of contributions and tax-free accumulation in pension plans benefits people with higher marginal tax rates more than it does others
    - Alternative : equal tax credit favours relatively more the lower income brackets

Pensions are long term, direct needs are short term

- Pension saving is not a perfect substitute for others forms of saving
  - Pension savings are illiquid
- Life-cycle hypothesis :
  - Voluntary pension savings are not always affordable for younger people with less purchasing power and more needs
  - Targeting policies

Further incentives

- Education
  - The promotion of greater public information and financial education
  - Explanation of the risks of short-sighted behavior with regard to the needs of old age
  - Benefit less educated, less well-off people more, people who have more problems in getting and decoding economic information
- Permit individuals to access their funds before retirement
- Matching contributions

Further incentives

- Education
  - The promotion of greater public information and financial education full and clear
  - Explanation of the risks of short-sighted behaviour with regard to the needs of old age
  - Benefit less educated, less well-off people more, people who have more problems in getting and decoding economic information
- Permit individuals to access their funds before retirement
- Matching contributions
- Compulsion... Carrots  or sticks ? 

Administration costs are often critisised

- Sources
  - High sales cost
    - Sales commissions
  - Management fees for management company and custodian
    - Front loadings
    - Transfer costs
    - Annual loading on assets under management
- Alternatives?
  - The control of the administrative cost of pension plans

The crisis undermines the confidence in a capitalised pension system

- Most systems are rather young
  - Small amount of people yet in the distribution phase
- Measures taken elsewhere
  - Minimum guarantees
    - Leads to other asset distribution
  - Where mandatory annuitization exist :
    - Install a framework for phased or deferred annuitization
    - Receiving benefits through phased withdrawals on reaching retirement age
  - Adapt the valuation rules for pension fund assets to the extreme current volatility in financial markets
  - Allow partial withdrawings as an unemployment insurance measure

That's it so far…

Thank you for your kind attention

BUT MAYBE YOU HAVE OTHER QUESTIONS