



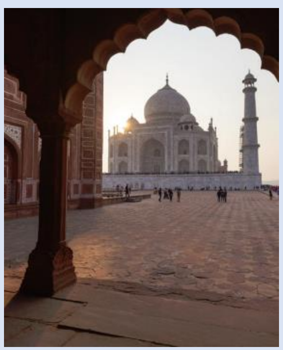


Retirement Security in Emerging Markets

Five Propositions and a Proposal

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April 23, 2018

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Washington, DC

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Proposition 1

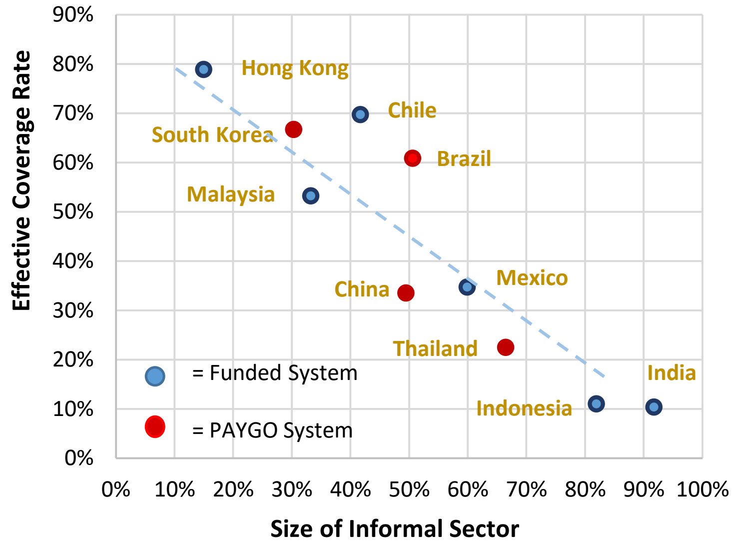
Every emerging market needs a robust tax-financed noncontributory floor of old-age poverty protection.

- Many workers in emerging markets fail to contribute to the state pension system, and even when they do contribute, they do so irregularly, which means that the benefits they receive will still be inadequate.

- Low coverage is a function of labor-market informality, not pension system design. When informality is high coverage is low and vice versa, regardless of whether the state pension system is funded or PAYGO.

- Given today's economic realities, social pensions are a social necessity.

Effective State Pension Coverage Rate and Size of the Informal Sector in the Most Recent Available Year



Note: The effective coverage rate is the share of the labor force that contributes to a country's mandatory pension system or systems in a given year. The informal sector is defined as informal employment in the nonagricultural sector plus agricultural employment as a share of total employment. Estimates of the size of the informal sector were derived by adding agricultural employment to published estimates of nonagricultural informal employment. In the case of Hong Kong, nonagricultural informal employment was also estimated by GAI.

Source: For the sources, which are too numerous to list here, see Richard Jackson, *Voluntary Pensions in Emerging Markets: New Strategies for Meeting the Retirement Security Challenge* (Alexandria, VA: GAI, 2017)

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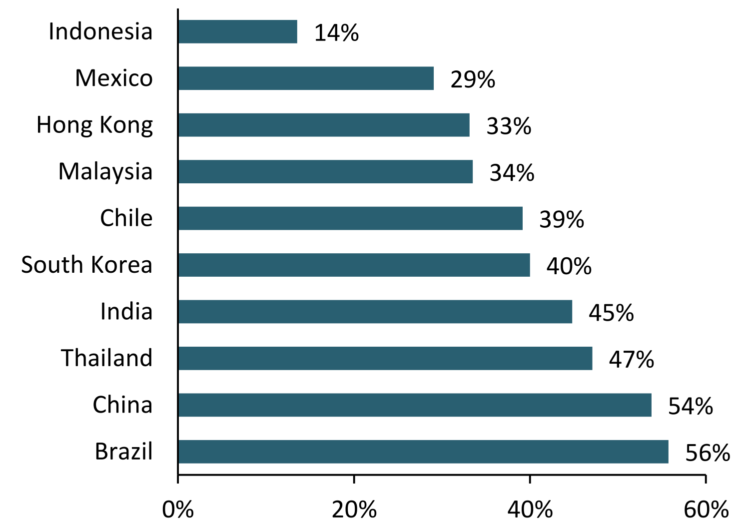
Proposition 2

Contributory pension benefits will be increasingly inadequate, even for full-career workers.

- From Brazil to China, emerging markets with PAYGO pension systems are making deep reductions in the generosity of state retirement provision as their populations age.
- In countries like Chile, Hong Kong, and Mexico with privately managed personal accounts systems, contribution rates are too low to finance adequate replacement rates.
- In countries like India and Malaysia with centrally managed provident funds, low returns on worker contributions, together with preretirement withdrawals and early retirement ages, mean that replacement rates will also be inadequate.

Future State Pension System Replacement Rates for Full-Career Workers



Note: The projections refer to final salary replacement rates for average-earning workers entering the labor force today at age twenty and retiring at their state pension system's normal retirement age. In countries where replacement rates differ by gender, the projections are male-female averages. For Brazil, the projections refer to the RGPS; for Chile, the AFP System; for China, the Basic Pension System for Urban Employees; for Hong Kong, the MPF; for India, the EPF and EPS; for Indonesia, Old Age Security; for Malaysia, the EPF; for Mexico, SAR; for South Korea, the National Pension System; and for Thailand, the Old Age Pension System.

Source: For the sources, which are too numerous to list here, see Jackson, *Voluntary Pensions in Emerging Markets*

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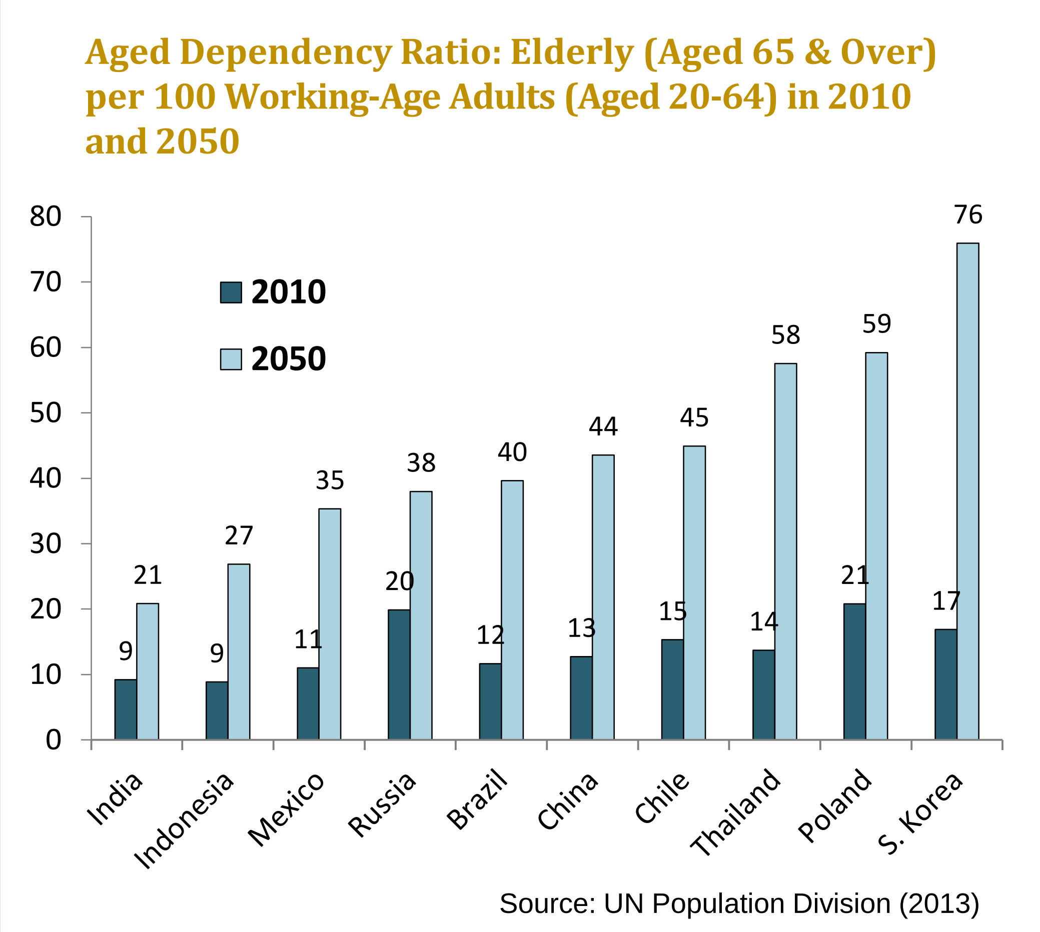
Proposition 3

Funded pension systems will enjoy a growing rate of return advantage over PAYGO systems as today's emerging markets age.

- The rate of return on contributions to a PAYGO pension system is equal to the rate of growth in worker payroll, while the rate of return in a (well-designed) funded system is equal to the global return to capital.

- As both workforce and wage growth slow in aging societies, funded pension systems will be able to deliver the same replacement rate at a lower contribution rate than PAYGO systems can—or, conversely, a higher replacement rate at the same contribution rate.



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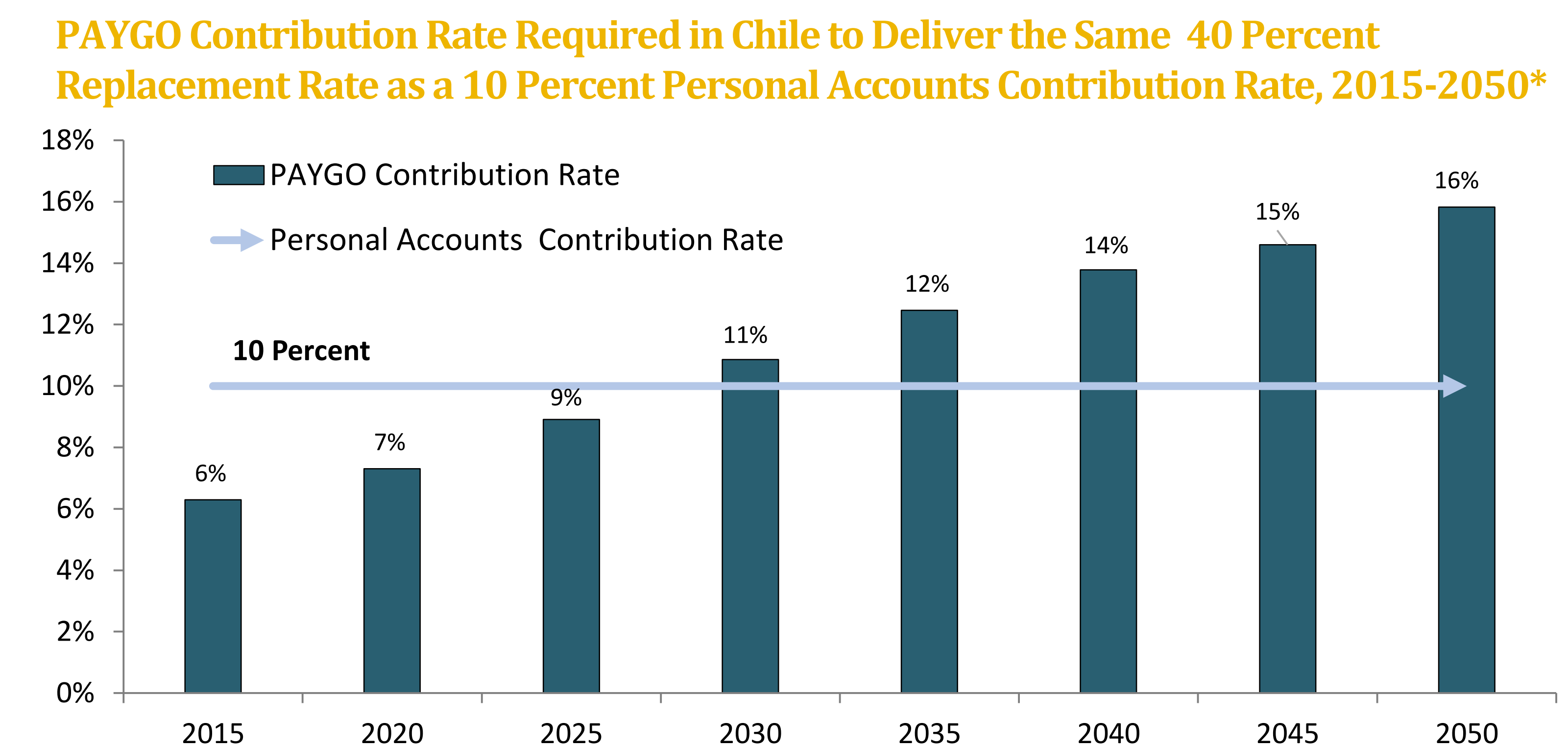
PAYGO pension systems may seem affordable while societies are still young and growing, but their cost rises by leaps and bounds as they age.



*Personal accounts projections assume real wage growth of 2.0 percent, a real rate of return of 4.5 percent, a 40-year career, retirement at age 65, and administrative fees equal to 0.5 percent of assets. PAYGO projections assume 2.0 percent real wage growth, retirement at age 65, and price indexation of benefits in current payment status.
Source: GAI calculations

Proposition 4

Improving the adequacy of mandatory pension systems may prove to be an elusive goal.

- Over the past few decades, government efforts to increase participation in mandatory pension systems have been largely a failure. Indeed, in some emerging markets informality is growing and coverage is shrinking.

- Countries with PAYGO state pension systems have little scope to increase the generosity of benefits. Contribution rates are already high in most countries, and in many current benefit promises are already unaffordable.

- Most countries with funded state pension systems could and should raise contribution rates. But much of the public in these countries views mandatory contributions as a tax and is likely to resist significant increases.

- Although more generous social pensions would help, this is not a long-term solution. It is one thing to have half of the elderly dependent on noncontributory benefits when the elderly comprise 5 percent of the population. It will be another thing entirely when they comprise 25 percent.

Proposition 5

Broadening and deepening voluntary pension systems is an important part of the solution.

- All of this suggests that the success of emerging markets at ensuring retirement security will increasingly depend on their success at building robust voluntary pension systems.

- Until recently, most policymakers assumed that expanding voluntary pension systems should be a low priority in societies where mandatory systems cover just a fraction of the workforce. But it is precisely the limited reach of mandatory systems that makes expanding voluntary ones so important.

- Nor is it true that expanding voluntary pensions need merely benefit the affluent. To the contrary, they have a crucial role to play in shoring up the deteriorating retirement income prospects of the middle class. They can even help to improve the retirement security of informal-sector workers.

GAI REPORT

- **Chapter 1**

  The Coming Crisis in Retirement Security

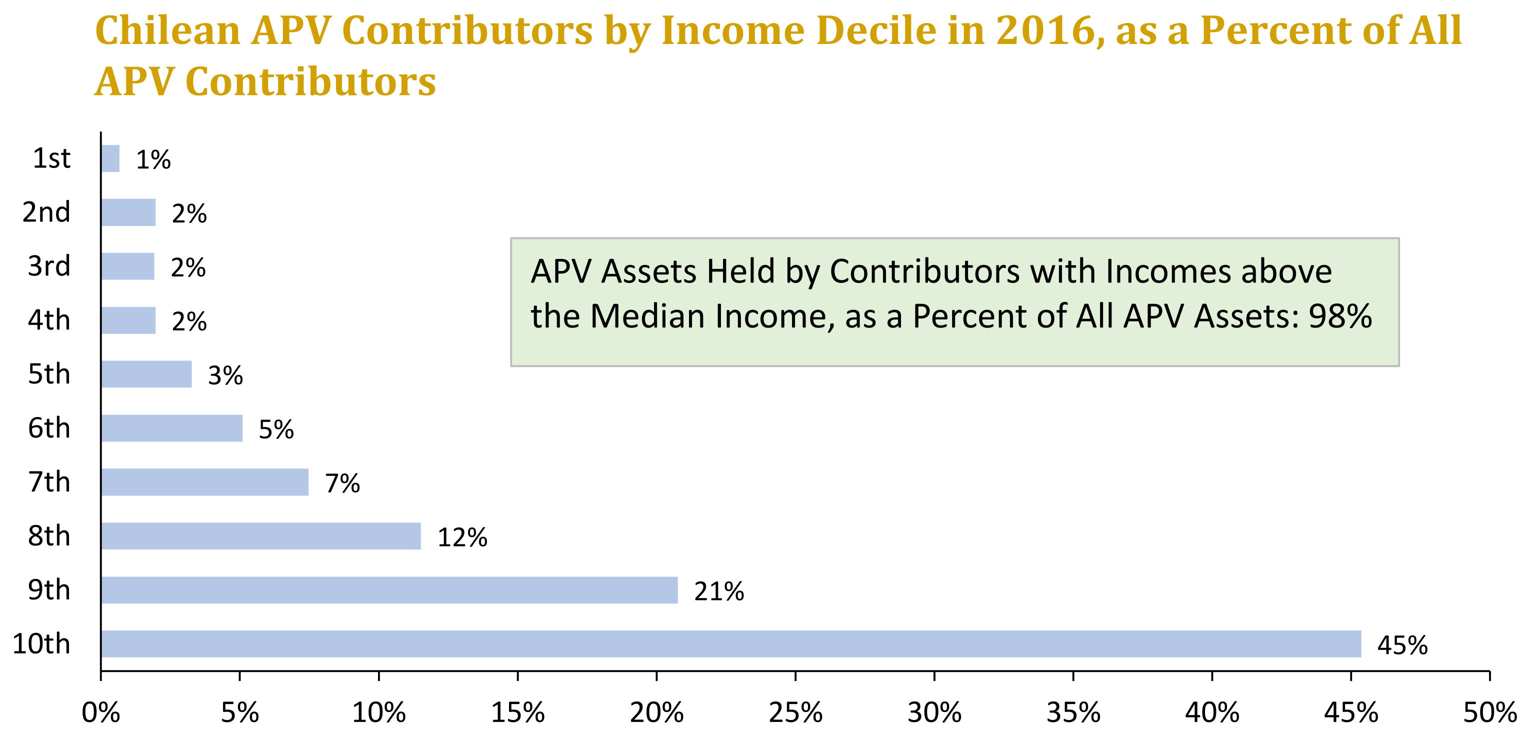
- **Chapter 2**

  Best Practices for Voluntary Pension Systems

- **Chapter 3**

  Lessons for Emerging Markets

As things stand, participation in Chile's APV system is not only limited, but is also highly skewed by income.



Note: The data refer to APV contributors to AFPs and exclude contributors to other qualified providers. Contributors are workers who made at least one APV contribution during the calendar year; income deciles refer to the income distribution of all AFP contributors; income refers to contributable wages.

Source: Unpublished data provided by the Chilean Superintendency of Pensions

Key Strategies: SOFT COMPULSION

- The experience of the developed countries teaches that switching enrollment from an "opt in" to an "opt out" model can increase participation in voluntary pension systems.

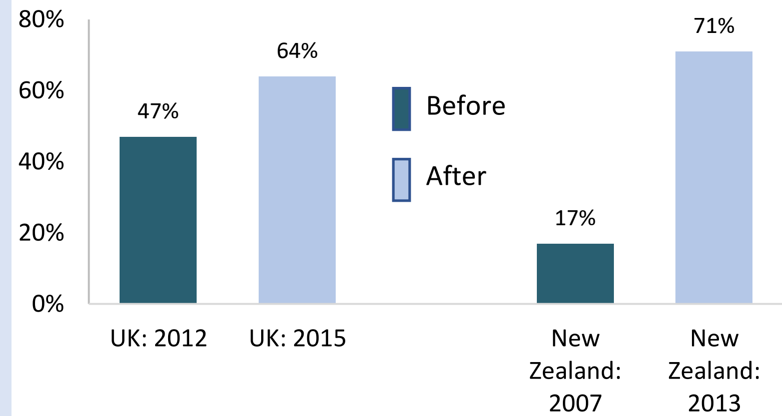
- At a minimum, emerging markets should require employers who sponsor a pension plan to implement autoenrollment. More ambitiously, they could require all employers to sponsor a plan in which their workers would then be autoenrolled.

- Autoenrollment can also be implemented in personal pension systems, provided they can use employers' existing payroll infrastructure.

- Countries with funded state pension systems could autoenroll all employees in those systems' existing voluntary tiers. Those with PAYGO systems could establish voluntary tiers of funded "add on" accounts in which workers would be automatically enrolled.

- The experience of the developed countries also teaches that auto-sweeping, in which workers who opt out of a pension plan are periodically reenrolled, and auto-escalation, in which contribution rates are raised over time, result in greater participation and greater savings.

Percent of the Labor Force Participating in an Employer Pension Plan in New Zealand and the UK, before and after Autoenrollment



Source: *OECD Pensions Outlook 2014* (Paris: OECD, 2014); Office for National Statistics, *Annual Survey of Hours and Earnings Pension Tables: 2015 Provisional and 2014 Revised Results* (London: Office for National Statistics, March 2016); and GAI calculations

Key Strategies: ECONOMIC INCENTIVES

- Beyond leveraging the lessons of behavioral economics, emerging markets need to do much more to incentivize retirement savings among middle- and lower-earning workers.

- Global best practice calls for combining standard tax preferences, which mostly benefit higher-earning workers, with government subsides and/or matching contributions, which tilt the other way.

- Along with automatically enrolling workers in the voluntary tiers of state pension systems, governments should provide generous supplements to their savings.

- Governments could also supplement the savings of workers in employer pension plans, as both New Zealand and the UK do.

- Although all of this will be expensive, in the long run the cost of more generous government subsidies for voluntary retirement savings will be far less than the cost of social pensions for workers who arrive in old age destitute.

- In New Zealand's KiwiSaver Scheme, autoenrollment and government matching contributions helped to boost participation from 17 percent of the workforce in 2007 to 71 percent in 2013.

- In Germany's Riester Pensions, government savings subsidies have helped to achieve broad participation among workers at all income levels.

A New Approach to Retirement Security in the Informal Sector

- Many experts are concluding that voluntary pensions are a better long-term response to the problem of old-age insecurity in the informal sector than social pensions.

- While social pensions are a necessary near-term palliative, they encourage labor-market informality. They also leave a large share of the elderly dependent on government social assistance—and vulnerable to benefit cuts as societies age and fiscal pressures grow.

- Voluntary retirement savings does not have these drawbacks, which is why a growing number of countries, especially in Asia, are designing special voluntary pension systems for the informal sector.

- Among the eight countries covered in the GAI report, China, India, Malaysia, and Thailand have recently launched such systems.

- Extending voluntary retirement savings to informal-sector workers poses major challenges, starting with how to collect and route pension contributions.

- Economic incentives also need to be more generous than those for formal-sector workers, at least relative to participants' incomes. Most voluntary pension systems for the informal sector therefore include sizeable government matches.

- If workers are to be persuaded to participate, these systems must also allow for considerable flexibility in everything from contribution requirements to withdrawal rules.

- Although it is too soon to gauge the success of most of the new informal-sector pension systems, the results in at least one country have been spectacular: China.

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