Comments from ICFTU/Global Unions on *The World Bank's Perspective on Pension Systems and Reform (2004)*

A revised draft version of *Old Age Income Support in the 21st Century: The World Bank's Perspective on Pension Systems and Reform* (hereafter, *Perspective*), dated 8 May 2004, was made available to the ICFTU/Global Unions in mid-May, along with an invitation from the World Bank to submit comments. We appreciate this opportunity and, in order to avail ourselves of it, made the draft available to several trade unionists who work on pensions and social security issues, including all of the trade union and labour representatives who took part in the World Bank-trade union meeting on pension reform held in Washington on 21-22 May 2003. We received a number of comments from different colleagues. However it is important to note that, because all of the trade pension experts we have worked with in Latin America do not master sufficient English to provide comment on a text of this nature, they were unable to provide contributions. In view of the fact that Latin America has been, along with Central and Eastern Europe, the region where the World Bank has been most deeply involved in pension reforms, we invite the Bank to translate the draft document into Spanish and make it available for further comment.

This note begins with some comments on the overall approach of *Perspective* and then presents a number of specific comments. The present note was prepared using remarks received from several colleagues, but we particularly acknowledge the following for their extensive analyses and suggestions: Bob Baldwin, Eva Belabed, Elaine Fultz and Kurt Vannieuwenhuyse. However, Peter Bakvis, who compiled the comments and edited this note, is responsible for any errors or inconsistency.

Revealed policy preferences

The "Final Remarks" in *Perspective* include the point that "The report is intended to reassure client countries that the Bank does not promote only a funded, defined contribution model" (p. 101). *Perspective* is full of passages that make the same point in a variety of ways. Typically, the Bank indicates its openness to a pension system with many pillars of which a mandatory, privately administered defined contribution (DC) pillar is only a part.

But, at the same time that the Bank wants to reassure client countries and readers of the report that it is not dogmatically committed to a dominant second pillar, it says that it "… seeks to use the experience of mandated individual retirement savings system [sic] as a baseline or starting point for analysis of the outcomes of a proposed reform …" (p. 37). Even though the Bank emphasizes the mandated individual savings systems are a point of departure rather than a "prescriptive model", it is clear that the Bank's commitment to a pre-funded DC pillar is central to the whole discussion in *Perspective* and the Bank's dealing with its client countries.

Given the Bank's commitment to the second pillar as described, it is hardly surprising that *Perspective* includes many references to the potential benefits of a pension system that includes a second pillar. However many of the virtues that are mentioned in one passage are quite properly qualified in another passage to the point that they can no longer be accepted as unique contributions of a second pillar. Some important cases in point would be the usefulness of a second pillar in promoting savings, investment and growth, and in limiting labour market problems.

Having said that, there are two virtues cited for a second pillar that withstand all of the qualifications in *Perspective*. Those two virtues are: (1) that a second pillar as defined in *Perspective* can provoke the development of financial institutions and instruments that may facilitate more rapid economic growth; and (2) that a second pillar might relieve fiscal pressures on government budgets, especially if it displaces some part of publicly administered and financed pensions that form the first pillar.

Taking these two claimed virtues at face value for the moment, it is important to make the following remarks:

- The extent to which the pension system should bear the responsibility for the maturation of the financial system is surely open to debate.
- It is noted in *Perspective* that a number of national contexts do not have the institutional apparatus in place to support a second pillar, which is a backhanded way of acknowledging that the institutional benefits of a second pillar do not emerge automatically under all circumstances.
- Even ignoring problems of the transition to a new regime, fiscal gains may be limited to periods when the second pillar is delivering "good" benefits (i.e. the second privately administered pillar may involve a contingent public liability – especially given its mandatory nature).

Perspective is remarkably candid in noting that there is a price to be paid for these possible fiscal and financial market gains. In commenting on the risks associated with each of the five pillars identified in *Perspective*, it is noted of second pillar approaches that "They subject participants to financial market volatility and the risk of high transaction costs" (p.31). In context, it is worth noting that neither the predictability of retirement incomes nor administrative efficiency are included among criteria for evaluating retirement income arrangements.

Perspective confronts its readers, and apparently client countries, with a choice between more mature financial institutions and instruments and fiscal probity on the one side, versus more secure retirement incomes and less economic waste (in the form of higher administrative costs) on the other. It is far from self-evident that the World Bank has made the right choice. It is particularly striking that the Bank seems willing to accept administrative waste while clinging so strongly to the view that the pension system should contribute to a more mature financial system. The modest claims that the Bank makes for the effect of its reforms on income adequacy compared to stronger claims on making systems affordable are no accident or surprise.

Bearing in mind that much of contemporary discussion on pension systems is cast in terms of "sustainability" in the face of ageing populations, the Bank's entry into the sustainability debate is interesting to say the least. Among other things, the Bank suggests that sustainability involves the idea of avoiding unpredicted reductions in pension benefits and/or increases in contributions (p. 66). These considerations weigh against the Bank's preferences for DC and pre-funding of defined benefit (DB) schemes – especially given the Bank's apparent preference for a regime of marking to market.

Impact on financial markets

As noted in the previous section, the World Bank's inherent preference for a privatized second pillar appears in large part to be predicated on the contributions that such a scheme will have on the development of the capital market. For example, even in countries where regulatory or supervisory capacities are less than perfect, *Perspective* claims that the introduction of the second pillar "creates synergies for moving toward improved financial markets" (p. 79). However despite a decade and a half of involvement in pension reform in 58 countries, it is curious that the Bank does not use the occasion of the publication of its revised perspective on pension reform to put forward factual evidence to back up this claim.

The absence of an assessment of the impact on capital markets is all the more surprising in that the Bank's Latin America and Caribbean region, which is where the Bank has the longest and most extensive experience with pension reform, did examine the question in some detail in a recently released study[1]. While noting that pension fund assets had grown in countries after the introduction of second pillars and that this probably helped financial sector development, "… it is not obvious how much of this growth in pension fund assets has taken place at the expense of other institutional investors such as mutual funds"[2]. More importantly, the Bank's Latin American study states, "… it should be noted that financial sector development can take place effectively in the absence of pension privatization"[3]. Brazil is cited as an example of the latter.

The overall impact of pension privatization on financial market development is also limited due to the fact that, as the Bank's study on Latin American pension reform notes, in all but two of the countries having introduced a second pillar, more than half of the pension fund investments are directed to government securities, such that "the main beneficiary has been the government debt market"[4]. It may be added that a similar situation exists in some Central and Eastern European countries that undertook pension reforms in the 1990s. In summary, it is difficult to conclude, on the basis of the experience of developing and transition countries with pension privatization, that the creation of second pillars has been an important driving force in capital market development or financial innovations. Despite the implicit assumption that the pension

[1] World Bank, *Keeping the Promise of Old Age Income Security in Latin America*, Washington, 2003
[2] World Bank (2003), p. 212
[3] World Bank (2003), p. 212-213
[4] World Bank (2003), p. 67

reforms the Bank has been involved in have played such a role, *Perspective* provides no supporting evidence that they have done so.

The first and second pillars

The second pillar is usually described in *Perspective* as a mandatory, privately administered, DC pillar. There is no equivocation on the mandatory nature of the second pillar, which is actually described as its basic characteristic (p. 58). However, there are passages where the private administration and DC nature of the second pillar are drawn into question.

Regarding private administration, the Bank is absolutely consistent in expressing its preference of the investment function being handled privately. However, the Bank does note the essential regulatory role of public authorities in making the second pillar work. It also notes a potential administrative role of public authorities in collecting and allocating second pillar contributions (p. 68). It is noted that this clearinghouse role can reduce administrative costs and burdens on small employers. Thus, the Bank's generalizations about the privately administered nature of the second pillar should probably be more focussed on the investment function than they usually are.

In addition, while the second pillar is almost always described as DC, *Perspective* includes a taxonomy of pillars (p. 57) that suggests that the second pillar may be either DC or DB. Clearly this is an important elaboration that needs either elaboration or elimination.

We make two additional comments on second pillar administration on the basis of the experiences in some industrialized countries. In some countries, financial regulators have produced guidelines for the operation of savings plans that employers sponsor for their employees. In brief, these are designed to ensure that employees are offered an adequate and appropriate range of choice as well as basic information and access to counselling. The latter of these issues does not emerge in *Perspective,* and the former only in the negative sense that too much choice is associated with higher administrative costs. Also, there is at least a question as to the full range of evidence that is relevant to the Bank's aversion to central public investment funds. One would think that the experience of public employee pension funds and Quebec's *Caisse de dépôt et placement* were relevant and did not support the Bank's gloomy conclusions.

It is remarkable that so little attention is given to the structure of the first pillar, the mandatory public pillar. In one passage the potentially negative impact of means-tested benefits on the operation of earnings-related programmes is noted (p. 61), but the possibility of the same type of negative interaction with the second pillar is only noted in passing as a concern in Latvia (p. 99). The apparent disinterest in this issue is surprising.

It is also somewhat surprising that so little is said about the possible role of a flat rate benefit financed from general government revenue. This type of benefit avoids the perverse interactions just noted, it addresses the desire to have higher replacement rates at the low end of the earnings spectrum and it avoids some of the labour market problems associated with earnings-related, pay-as-you-go (PAYG) schemes. Indeed, for all of the anxiety that the Bank shows for the issue of pre-funding versus PAYG, it is remarkably uninterested in the tax base that is used to finance publicly administered pensions.

The Bank also suggests that "… for a typical full career worker, an initial target of net-of-tax income replacement from mandatory systems [pillar 1 and 2 combined] is likely to be around 40 per cent to maintain subsistence levels of income in retirement". There is no doubting that a 40 per cent replacement rate net of taxes will provide only a subsistence income and, thankfully, the Bank notes that many of its client countries have higher targets. It behoves the Bank to say more about why such a low target is appropriate.

In *Perspective*, the Bank creates bookends for the three-pillars it introduced in *Averting the Old Age Crisis* by introducing a zero pillar (social assistance) and a fourth pillar (informal, intra-family services including health care and housing). Having noted the significance of services in the real standard of living of the elderly, it is curious that nothing is said about public services in this regard. In some contexts, public service provision might be as important as income provision. If one wants to address service provision in the fourth pillar, public as well as informal provisions should be addressed.

Pre-funding, demographic change and related issues

The Bank remains committed to pre-funding of pensions as it was in *Averting the Old Age Crisis*. As was noted, the case for pre-funding now rests much more on the potential for pre-funding to spur the development of the financial sector. To the extent that the Bank is promoting DC plans, there is no need to speak to the funding targets that the Bank has in mind. But, to the extent that the Bank is promoting the pre-funding of DB plans, the funding targets it has in mind are important. In operating DB plans with specific funding targets, there is a tension among: providing benefit security by meeting the target; minimizing contribution rate volatility; and, achieving the lowest contribution rate on average over the long term. This tension shows up in financing policy and related actuarial assumptions, investment policy and regulatory regimes. These issues are very much alive in countries in which pre-funded workplace pensions play an important role in the retirement income system. The fact that the Bank says nothing about these issues is striking.

There are a number of passages in *Perspective* in which the Bank alludes to the fact that demographic change will have similar impacts on pre-funded and PAYG regimes. This is a point with which we concur. It represents a significant departure from *Averting the Old Age Crisis* and other more recent World Bank publications on pension reform, where the privatized sector pillar was presented as a providing "better safeguards against an ageing population" than the public first pillar[5]. We believe that it would be helpful for readers if the Bank were to explain how it came to making this conversion.

[5] World Bank, *Social Protection Sector Strategy: From Safety Net to Springboard*, Washington, 2001, p. 32

Unfortunately, it is more difficult to find any hint in the text of *Perspective* that pension portfolios are likely to shift to holding more secure assets as populations age, or that in countries with more mature funded pension systems and ageing populations, the pension systems themselves may become a source of dis-saving. These issues should be addressed.

The Bank seems confident that pre-funded contribution rates will be lower than PAYG rates going forward because net rates of return on financial assets will exceed rates of aggregate wage growth. The last twenty years of the twentieth century may have created the impression that the Bank's view on this matter was beyond doubt. Going forward, this relationship is subject to doubt.

Much of the discussion in *Perspective* is cast in terms of social risk management. Yet, it is striking that very little of the discussion in *Perspective* deals with the way in which different types of pension arrangements divide economic and demographic risk between the retired (older) population and the active population. Longevity risk gets quite a bit of attention, but the way in which the elderly do or do not share in economic growth and its impact on elderly incomes and pension costs gets far less attention.

Moreover, in discussing private financial instruments, it is recognized that security or predictability has a price attached to it that people are willing to pay. However, the same logic does not seem to be accepted by the Bank for pension systems as a whole. Thus, running through much of the text of *Perspective* is an implicit view that lower contributions and lower predictability of incomes are clearly superior to higher contributions and greater predictability, i.e. no price should be paid for predictability of income. This is a critical consideration as one contemplates shifting the source of retirement income from pillar 1 to pillar 2.

Finally, to turn to the point made above about the tax base: if one assumes that the potential tax base of governments includes all of GDP, then the general tax base of governments includes all of the diversification that is achievable in an economy, while pre-funded pensions rely exclusively on contributions and property income for which there is a public market. The one source of diversification that generally cannot be achieved through the public tax base is foreign income. But, as is recognized in *Perspective*, this source of income carries with it exchange rate risks that cannot be fully hedged in all countries, a clear mismatch with the liabilities of the pension system, which are usually all denominated in local currencies. *Perspective* also mentions that it entails political controversy, but the nature of this is given no elaboration in the report. One might well conjecture that it relates to concerns that pension savings generated in a particular jurisdiction should support economic growth and development in that jurisdiction, in much the same way that the Bank believes that pension savings should contribute to the development of financial institutions and instruments.

The process of reform

Pension reform is an inherently political exercise in the broadest sense of the term, and in order to generate reform that is broadly accepted and enduring, the reform process should engage labour and other social partners, as well as governments. There is some recognition of this in *Perspective*. Thus the following suggestion is one that we obviously support: "… it is desirable to include many actors in the debate, even at the expense of consensus…. Key players include the parliamentarians, trade unions and the national press" (p. 85). The same comment applies to the recommendation that "Involvement of trade unions and other stakeholder organizations" should be among the criteria for whether a country is prepared to undertake reform (p. 87). These statements are a welcome change from a few years ago, when a World Bank pensions expert told an international trade union delegation that "Unions have nothing useful to say on pension reform".

However, in order for serious debate to take place and equitable consideration to be given to all option, it is imperative that the World Bank and other international expert bodies provide the wider public with insight into the range of options available and the consequences of choosing each. The World Bank should see part of its job as developing domestic capacity, and certainly not act as the decision-maker. As we noted above, the capacity-building function on pension reform is not emphasized in *Perspective.*

As to the idea that the World Bank should favour wide public debate on pension reform rather than pushing one particular option, some suggestions in *Perspective* seem to go in the opposite direction. We are referring, for example, to suggestions of "using professional public relations firms" and of "building a core group of journalists who understand the reform process and are sympathetic to its goals" (p. 86). As will be mentioned in some country-level examples below, advertising campaigns to build public support for particular reforms have frequently resorted to misleading claims and have tended to drown out some legitimate concerns raised by groups who did not have access to paid publicity.

It should be noted that divergent interest groups have wildly unequal resources, and if the final determinant of policy choices depends on who has access to the best advertising or the heaviest political clout, it is far from certain that this will lead to optimal choices, whatever be the criteria one uses. As the World Bank's study on Latin American pension reforms observed, "It may well be that the administrative and political demands associated with the installation of the second pillar – which generally has powerful champions in the form of the bankers and financiers – actually divert attention from efforts to set up the arguably more important poverty prevention pillar, whose main beneficiaries are the un-championed poor"[6]. Whether or not World Bank resources are used to finance public relations campaigns to "sell" second-pillar reforms, it is difficult to understand why the Bank would encourage them in the place of genuine debate on the important issues concerning pension reform choices.

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[6] World Bank (2003), p. 214

Experience with pension reform in Latin America

A six-page section of *Perspective* (pages 90-95) deals with the twelve Latin American countries that have introduced some form of multi-pillar pension system. As we noted in the introduction to this note, our Latin American trade union colleagues will not be able to comment *Perspective* until it is made available in Spanish. Our comments on this section are therefore limited and have not benefited from the insight of these colleagues.

Perspective briefly evaluates the Latin American reforms from the point of view of adequacy, affordability and sustainability. The report observes that “many of the Latin American systems do not cover the full breadth of the population” (p. 91). Given that coverage is as low as 9 per cent of the working age population in some of the countries that have introduced the multi-pillar system, this statement is certainly not an exaggeration. The report on pension reform of the Bank’s Latin America and Caribbean Region goes much further, and talks of the “failures” and “disappointments” represented by “the exclusion of more than half of all workers from even a semblance of a safety net during their old age”[7]. The Latin America study talks of this as a policy failure, because, as it rightly notes, going back to *Averting the Old Age Crisis* in 1994 and in many other Bank pension policy documents since then, “increasing coverage is both an objective and predicted result of implementing a multi-pillar system with a large private funded component”[8].

At the very least, one would have hoped that the analysts who prepared *Perspective* would evaluate the success of reforms on the basis of the objectives the Bank itself enunciated. However they decline to do so, stating that “The complexities involved in such an assessment are daunting” since one does not know “what would have occurred if the reform had not happened” (p. 91). Despite this, *Perspective* concludes this section with the rosy appraisal, and without further elaboration, that “Overall, the Latin American reforms have made substantial progress toward more reasonable pension systems” (p. 93).

The World Bank’s Latin American regional team, in an extensive study of pension reforms in the region, comes to a number of more negative conclusions, which are either not mentioned in *Perspective* or treated as minor issues. One of these concerns the gender impact of the reforms: in all but two of the countries where the Bank was involved in multi-pillar reforms, “… women earn lower returns from the new systems relative to the return of men”[9]. Concerning the administrative costs and commissions of the private funds, that unions have regularly criticized but are not mentioned in the section of *Perspective* on Latin America, the Bank’s regional study found that the second-pillar accounts “are faced with steep commissions that reduce their accumulated balances drastically”[10]. On the question of the fiscal impact of the reforms, dealt with summarily

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[7] World Bank (2003), p. 11
[8] World Bank (2003), p. 7
[9] World Bank (2003), p.71
[10] World Bank (2003), p. 111

in *Perspective* – "After the initial transition period, all of the systems are expected to generate savings relative to the pre-reform period" (p. 92) – the Bank's Latin American paper has a far less sanguine view: "… fiscal sustainability is far from assured…. A positive impact on pension reform on solvency is not as obvious as theoretical models claim. Further, pension reforms can create new implicit and explicit liabilities. And finally, empirical evidence shows that pension reforms can produce severe cash-flow problems in excess of initially projected transition costs, and hence seriously constrain public sector liquidity"[11].

Given all of these failures of second-pillar reforms identified by the Bank's own Latin American region, which echo many criticisms trade unions in Latin America have expressed about pension reforms in their countries, it is not surprising that the regional study advices countries to either maintain their PAYG system with some parametric changes or give their priority to instituting "a robust first pillar" if they do not have one[12]. A response from the authors of *Perspective,* both to the critiques formulated in this study and the proposals it puts forward, would be appropriate.

Experience with pension reform in Central and Eastern Europe and Central Asia

A brief section of *Perspective* (pages 96-101) provides an overview of the changes in pension schemes in Central and Eastern Europe and Central Asia during the 1990s and a classification of countries according to reform strategy. The second subsection on "Reform Issues" identifies some of the most serious problems facing multi-pillar systems today and makes an appropriately bleak assessment of the options for addressing these and the difficult path ahead. However, this section contrasts sharply with the following one, "Overall Reform Assessment", as if written by different pens. The Assessment concludes, quite surprisingly in light of what came earlier, that the reforms have led to systems that are "adequate, affordable, sustainable and robust…". The support offered for each of these claims is very brief, and its content ranges from baseless to incorrect.

Adequacy – The section states, "As far as adequacy is concerned, the target replacement rate remains quite high, clearly above 50 percent." Yet in Poland, the 1999 reform will cause replacement rates (both first and second pillar) to drop from 65% for a man and 50% for a women born in 1949 to 40% for a man and 30% for a woman born in 1974.[13] These rates fall below the ILO minimum standards and are far below the 50 percent "target" claimed. What is meant by "target replacement rates" here? Are these numbers pulled out of the air? Is the 50 percent a factual mistake or a marketing device?

Affordability and sustainability – The section states, "From actuarially bankrupt systems that required year to year budget subsidies, the countries … have moved to systems that

[11] World Bank (2003), p. 42
[12] World Bank (2003), p. 217
[13] See Agnieszka Chlon, "The Polish Pension Reform of 1999" in Elaine Fultz, editor, Pension Reform in Central and Eastern Europe, Volume 1, Restructuring with Privatization: Case Studies of Hungary and Poland, ILO: Budapest, 2002, Chart 8, p. 128.

are both within the capacity of individuals and governments to finance, and that are sound financially in the short and long run." In fact, by privatizing these countries have *increased* the need for budget subsidies, *reducing* the financial soundness of their systems in the short and long term (50 years). The *greater* subsidies are required in order to cover the loss of contribution revenues diverted to the second pillar. The resulting "hole" in the financing of the public pension systems is enormous and enduring: in Poland, it amounts on average to about 2 percent of GDP per year for each year over the next 50 years.[14] Under this scenario, two or three generations of workers will have to tighten their belt before achieving the Bank's "financial soundness." In fact, the financial strength of these systems is deteriorating now as a result of privatization, leaving them less able to cope with the demographic pressures ahead.

Robustness – The section claims that the systems are "diversified … and somewhat immunized to political shocks by their market oriented nature." Yet the earlier section (para 13) notes with concern the very high rates of investment of private pension funds in government bonds and questions its sustainability.[15] Concentration in government bonds means that in reality the privatized systems continue to operate on a PAYG basis, recycling worker savings back to the government, but minus substantial private administrative charges. Contrary to this claim, the goal of diversification has not been achieved.

Issues omitted from the Bank's analysis: The Bank's list of concerns about privatization omits some serious issues. First, it makes no mention of governments' neglect of the private benefit package. In Poland, more than five years after the privatization law was enacted, workers still do not know how their savings will be converted to an annuity at retirement, how gender will figure in this calculation, or what sort of cost of living increases will be provided by private pensions. In Hungary, while the 1998 reform legislation addressed these issues, the arrangements laid out there are so novel that they are sure to be costly for workers and some are clearly unworkable. Does the Bank not see it as unfair to require workers to make a one-time choice of whether to join a private fund or not without specifying the benefits? Asking people to make choices without information is contrary to the most basic requirements of the free market. Are these problems on its radar screen?

In addition, most countries have failed to address mismatches between the design features of the new individual savings schemes for old age and the pre-existing social insurance schemes for disability. These schemes must be coordinated to assure that workers with similar earnings and contributions receive similar pension amounts and that those who transfer from disability or survivor pensions to retirement pensions, or vice versa, do not experience arbitrary gains or losses. The differing principles on which individual savings

[14] Chlon in Fultz (2002), p. 172.

[15] In Poland and Hungary, the portion of such investments exceeds 65 percent; in Bulgaria, 60 percent; and in Croatia, 80 percent. Agnieszka Chlon, "Funded Pensions in Transition Economies of Europe and Central Asia, Design and Experience," a study prepared for the International Federation of Pension Funds Association (FIAP), in cooperation with the World Bank, 2004, p. 66.

accounts and social insurance operate make such coordination difficult. Across the region, it continues to be incomplete or absent in the new mixed pension systems.[16]

Finally, the analysis does not address the question of suitability of the privatization strategy for different economic and political environments. It reports without comment that Kosovo has privatized its pension system and, lacking any domestic financial markets at all, is sending 100% of worker savings to be invested overseas. Does the Bank regard this as a desirable strategy for a war-torn region with a great need for capital investments to restart its economy and create employment?

Paragraph by paragraph:

Para 2, sentence 2 can be taken to read that most countries raised their retirement ages suddenly. This of course is not correct.

Para 3, "breaking the state pay-go monopoly" is quite an ideological formulation; a gratuitous bad-mouthing of the public system without pointing to a better alternative. Echoes of *Averting the Old Age Crisis* here.

Paras 4 and 5 should clarify that there is a third group of countries in Central Europe that neither has reverted to flat rate benefits (group one) nor a mandatory second pillar (group two).

Para 5, states that governments "facing prospects of a worsening dependency ratio … adopted a multi-pillar benchmark" This may indeed have been the logic of these governments, under the guidance of the Bank. But this logic has since been recognized as faulty by analysts of all ideological persuasions: the high transitional financing costs of privatization make it more difficult, not easier, for governments to cope with rising dependency rates in the short and medium term. More echoes of *Averting the Old Age Crisis*.

Paras 6 & 7 – the contribution rates to the second pillar are out of date for Hungary and Bulgaria.

Para 7 – The second pillar in Lithuania is voluntary.

Para 7 – Macedonia and Romania are incorrectly lumped together as having decided in principle to adopt multi-pillar systems. Both statements are incorrect. Macedonia has passed a privatization law, and Romania has made no decision. The government of Romania has (once again) proposed privatization in an election season, but there has been no action by Parliament.

Para 9 – The section states, "When given a choice, participants are happy to take part in a funded pillar". Workers did indeed join the second pillar in greater numbers than

[16] Problems in Hungary and Poland are described in Fultz (2002), p. 15. Problems in Bulgaria and Estonia (as well as Hungary and Poland) are described in Chlon (2003), p. 53-56.

predicted in Hungary, Poland and several other countries. But this was due in large part to misleading advertising by private pension firms and, in Poland, by the Security through Diversity campaign, which exaggerated rates of returns in making individual projections of the benefits that workers could expect and, even more seriously, failed to take demographic ageing into account in making these calculations.[17] In addition, as noted earlier, workers had no information on the features of the private benefit package, which still have not been decided in Poland. Yes, workers were happy to switch but many were uninformed or misinformed, a problem which should concern the Bank.

Para 9 – The section says, “The funds’ rates of returns are encouraging…”. No support is provided. Presumably this means gross rates of returns rather than net rates, after administrative charges. These charges are high in Central Europe, as noted elsewhere in the analysis. They are consuming more than 20 percent of gross returns in the larger funds of Hungary and are projected to consume more than 25 percent of worker assets in Croatia.[18] Gross returns are of little importance when they are being eroded by high administrative charges. The Bank should take as its measure the net returns that workers actually receive.

Para 10 states that governments adopted privatized systems in order to “increase savings and growth”. There is a confounding of purpose and reality here. There is no evidence whatsoever that these systems have increased growth. Again, echoes of *Averting the Old Age Crisis.*

Para 10 states that there “appears to be an increase in the depth of financial markets”. Again, no evidence is provided. It seems especially important to support this claim since most of worker savings are in government bonds.

Para 11 states that “The transition typically imposes some initial welfare losses to some parts of the population that some countries may not be prepared to assume because of limits on how much of a shift to funding can be debt financed to match those losses over time to economic gains”. This sentence obscures some major issues. These same issues are formulated in a more readable way by Chlon, who said of the Polish reform --

> To summarise, introduction of the funded tier is quite expensive in the long run. Most of the financing of the public system deficit resulting from the creation of the funded tier is covered by savings generated in the public system itself – by lower indexation of benefits, increases in retirement age, and lower replacement rates in the reformed scheme. It means that the costs of privatization will be borne by pensioners in the lengthy transition period, who otherwise could enjoy better pensions. The initial part of financing comes from privatization sources. This means that privatization revenues are not used to finance other of social needs. About a quarter of transition costs, according to projection, will be financed by debt, which will require additional financing in the form of interest paid. This financing burden is placed on the shoulders of the

[17] Chlon in Fultz (2002), p. 129

[18] In Hungary, the larger, international pension funds in Hungary charged their members 23.8% of the gross investment return in 2000. See Augusztinovics et al. in Fultz (2002), Table 15. In Croatia, Chlon has estimated that management fees will reduce a worker’s assets by 26.8 percent over his or her career. See Chlon (2003), Table 15.

current and future generations of working persons, who will have to generate income to finance the debt.

The Bank should adopt more transparent language in addressing these negative aspects of privatization. The choice of words rather obscures these issues.

Para 12 reports that "most countries are increasingly concerned about administrative costs of the second pillar" but offers no comment on these concerns. Is the Bank concerned? If so, what should be done?

Para 12 reports that Latvia is concerned by the work disincentives created by the minimum pension guarantee, but again makes no comment on the seriousness of this concern. This has proven to be a major problem in Chile after two decades of experience with a privatized system. Does the Bank see it as a problem?

Para 12 states that "old pension schemes constitute a serious burden in countries that have not adopted a multi pillar approach". This statement is both obvious and misleading. Of course the old systems are more costly in countries that have not scaled them down, either in favour of individual accounts or for any other reasons. But those countries that have diverted a portion of scheme revenues to individual savings accounts are providing large and burdensome state subsidies to fill the "hole" in the financing of the public pension system – or they are cutting public pension benefits to compensate for this hole, making a generation of pensioners poorer in retirement. Under either scenario, the burden has not decreased.

PB – 17-06-05