COMMENTS ON SESSION 4
PENSION REFORM AND FISCAL POLICY

Teresa Ter-Minassian[*]

1 Comments on "Social Security Reforms in Colombia: Striking Demographic and Fiscal Balances" by Sergio Clavijo

This paper presents an interesting analysis of reforms of the pension and health insurance systems in Colombia during the last fifteen years, and assesses their fiscal implications. As regards pensions, the paper finds that the introduction of a defined contribution system and parametric reforms of the public defined benefits system have contributed to a substantial reduction of the NPV of the implicit debt of the public system (equivalent to about 100 per cent of GDP), but the system remains heavily imbalanced, with a still relatively high implicit debt, and inadequate coverage of the population. The paper attributes this imbalance largely to still relatively generous provisions of the public system, both as regards the official retirement age and the replacement rate, which is well above corresponding rates in the private system, despite high historic rates of return on the portfolios of private pension funds. Accordingly, it recommends further reforms to link the official retirement age to the increasing life expectancy of the population (higher for females than males), and to align more closely the replacement rates of the public pillar to those of the private one. It also recommends a cut in employers' contributions, funded by an increase in the VAT rate and a more even distribution of the remaining burden of pension contributions between employers and employees.

I found the analysis generally careful and convincing, but have a few observations and suggestions on it.

- First, I would have welcomed some more detail on the methodology and assumptions used to project future liabilities of the public pension system, to be able to assess their realism. It would have been also interesting to see some sensitivity analysis of the assumptions.
- Second, it would be desirable to hear Mr. Clavijo's views on the political and social feasibility of his proposal to link the retirement age to life expectancy, which might imply a faster increase in the retirement age for women than men.
- Third, what further parametric changes would the author recommend to reduce the replacement rates for the public system? Would he also recommend altering the present progressivity of the system, which envisages significantly higher replacement rates for lower than for higher income groups? Also, how would he view the desirability and feasibility of moving to irrevocable choices of regimes, eliminating the current possibility of switching back and forth between them?
- Fourth, what assumption about the incidence of employers' contributions underlies his recommendation to shift a part of them to the employees? Also, could a shift in the burden of contributions (as opposed to their outright reduction) really be expected to reduce incentives to informality?
- Fifth, I am not sure whether in Colombia participation in one of the systems excludes participation in the other. If this is the case, would it be desirable, in Mr. Clavijo's opinion, to allow individuals to participate simultaneously in both systems? Would this facilitate acceptance of policies to reduce replacement rates under the public system?

[*] IMF.

- Finally, the historic rates of return on pension portfolios appear relatively high, albeit declining, in an international perspective, and especially in the current global environment. It would be interesting to extend the simulations reported in Figure 3 to assess the impact of significantly lower rates of return on expected replacement rates under the private pillar. Also, are there any steps that can be taken, in the author's view, to significantly boost again the rate of return on the portfolios once the current crisis is over?

Since the focus of this seminar is on pensions, rather than health reforms, I will not comment in detail on the second part of the paper. In brief, I found its analysis and conclusions well spelled out and generally plausible. I certainly agree with its focus on steps to improve formality, and thereby the level and density of contributions. Incidentally this applies to the pension system as well. But I wonder to what extent the quantitative estimates of the medium to long term cost of the system are biased (probably downward) by the fact that the analysis does not allow for the impact of technological developments on the cost of and demand for health services. Available research on the drivers of health spending in more advanced countries suggest that the rising cost of health care is more important than the effects of demographic developments. If data on health care costs and their relation with technical progress are, or become soon available for Colombia, assessing their influence on health spending prospects would seem a very useful extension of the paper.

2 Comments on "Pension Reform and Fiscal Policy: Some (Tentative) Lessons from Chile" by Ángel Melguizo, Ángel Muñoz, David Tuesta and Joaquín Vial

This paper presents an interesting overview of pension reforms in Chile, a country which has become an international role model in this area, as well as some reflections on the applicability of this model in other countries, particularly in Latin America. I found the analysis of the Chilean case well researched and argued. In contrast, the discussion of the cases of Colombia, Mexico and Peru struck me as too cursory and unspecific. Personally, I would drop them, and only use references to those less radical reform experiences to illustrate by contrast how the comprehensiveness of the Chilean approach was key to ensuring a major reduction of the implicit debt of the system.

The paper illustrates well both the achievements and the shortcomings of the initial pension reform in Chile, explaining the various components of its initial fiscal cost, and the difficulty of ensuring an adequate coverage and replacement rate of the contributory system in an economy which, like those of most emerging markets or LICs, is still characterized by high degrees of informality or temporary work.

These characteristics pose difficult trade offs between the social objective of preventing old age poverty, on the one hand, and the economic objectives of preserving incentives to contribute to the pension system, and minimizing fiscal costs, on the other hand.

Clearly, the balance struck in the initial reform, which may have been appropriate in the context of the early 1980s, when Chile still suffered from severe fiscal and external imbalances, became less appropriate as the country consolidated its fiscal position, reducing its net public debt to a very low level, and gained strong international credibility through consistent cautious macroeconomic management under different political regimes. It is thus not surprising that a strong priority of the new administration of President Bachelet in 2006 would be an early reform of the pension system, aiming at a substantial improvement in coverage, and reduction of the gender bias inherent in it. The paper could discuss in more detail the process of this reform, which was exemplary, in starting with a sound and comprehensive technical analysis of the shortcomings of the existing system and of possible reform options, and following it up with a lengthy and inclusive process of consensus building in the political class and in society at large.

The paper presents an interesting projection of the fiscal cost of this reform, based on available published data. While the assumptions utilized in the projections do not seem unreasonable, some struck me as possibly optimistic in the current global environment, which is impacting severely the Chilean economy. In particular, how long will it take Chile to make up the significant decline in output expected for this year, and only slow recovery projected for the next one, to achieve an annual growth rate of 3.7 per cent between now and 2025. And how realistic is it to assume an average real rate of return on pension portfolios of 5 per cent a year over the same period. Given the uncertainty about the depth and length of the current crisis, I think that a sensitivity analysis of the main assumptions underlying the projections, or at least the preparation of an alternative, more pessimistic, scenario would enrich the paper.

Another issue that could be discussed in greater detail in the paper is the foreseeable impact of a more generous solidarity pillar on the incentive for workers to affiliate to the private contributory system and to increase the density of their contributions. As the paper recognizes, the assumption of an increase in the number of affiliates and in the density of contributions is a key driver of the projected decline in the fiscal cost of the solidarity pillar after 2015.

I found interesting, and basically agree with, the conclusion of the paper that, while a fully developed capital market is not a prerequisite for the introduction of a defined contribution pension system, a strong regulatory framework and supervisory capacity with respect to the pension funds are so. I also agree with the view that, if domestic capital markets are less developed, it is more desirable to allow early on pension funds to invest significant portions of their portfolios in external markets, to avoid excessive concentration on domestic public debt.

I also agree with the focus in the paper on upfront costs of Chilean style pension reforms. While such costs should not discourage governments from undertaking reforms that, if appropriately designed and implemented, can substantially reduce the implicit debt of public pension systems over the longer run, they can pose substantial challenges to fiscal management in the short to medium term, necessitating both early reforms of the remaining public pillar and other, country-specific steps to mobilize revenue or reduce other spending. In this respect, timing pension reforms to coincide with periods of cyclical expansion can facilitate a difficult political and social task.