Fiscal implications of longevity
Insights from the pension systems in the Latin American Region

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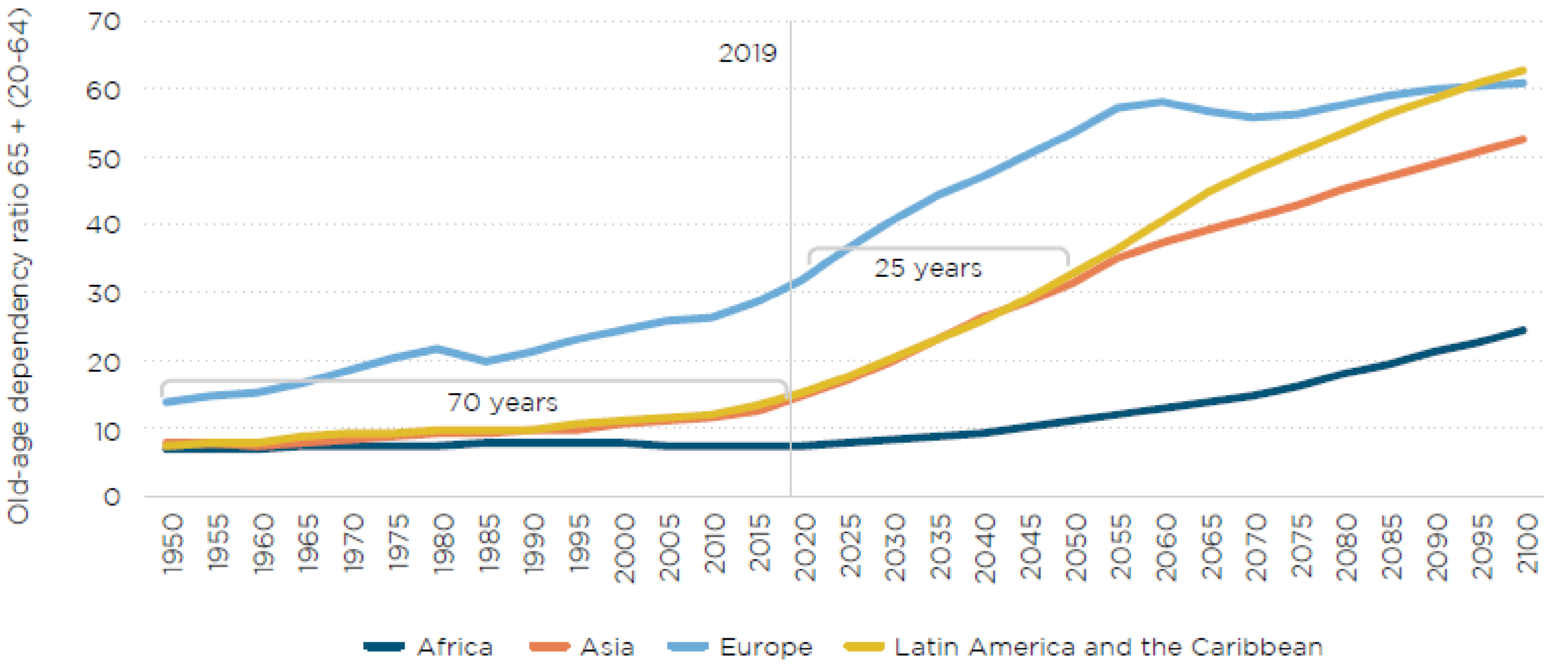
Disclaimer

The views presented in the following slides are my own, and do not necessarily represent the ones of the Independent Evaluation Group of the World Bank Group.

Latin American countries have far less time for pension reform than European countries



Source: United Nations 2019.

Latin America is aging three times faster than Europe. Most European reforms began in the 1980s or slightly earlier, and some are still in progress 40 years later. Latin American systems will have to accomplish these changes three times as fast

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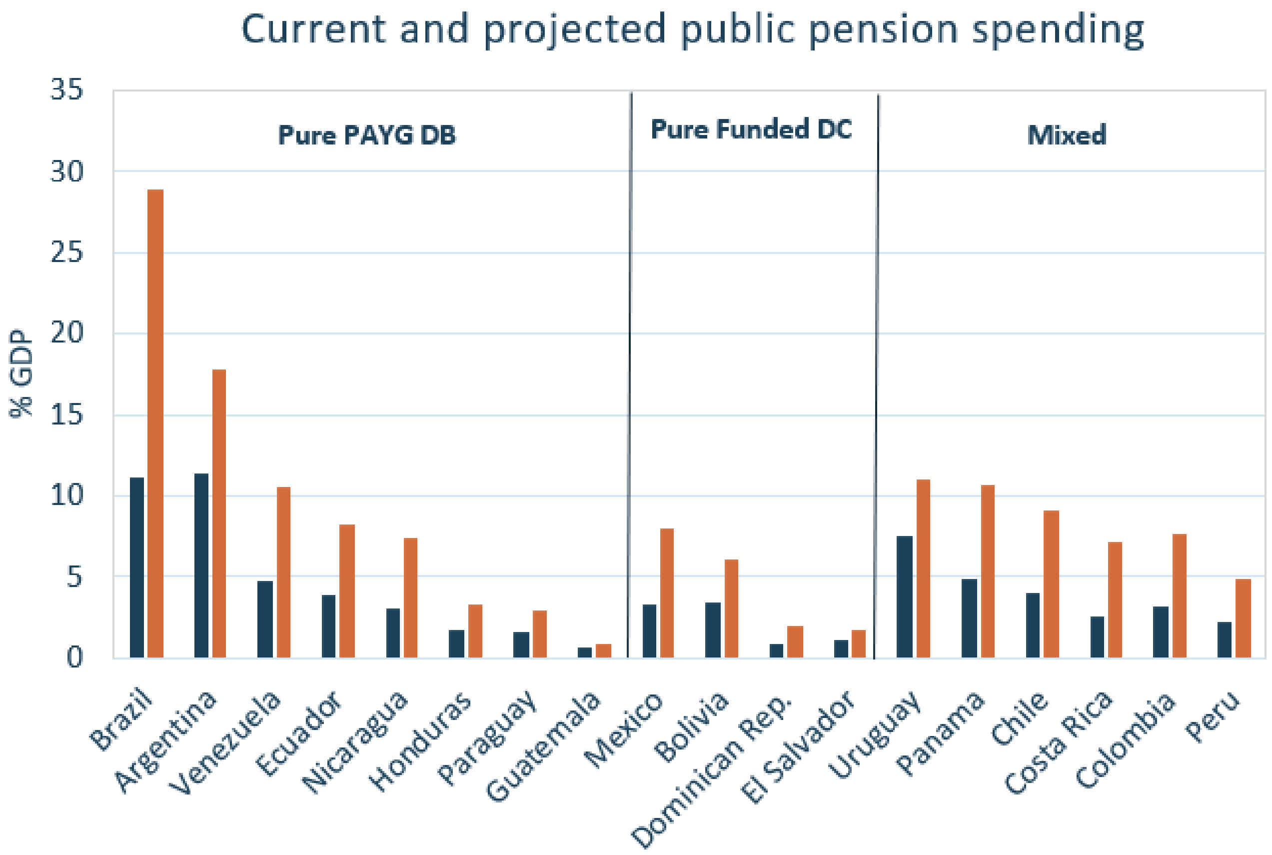
Aging has significant implications on pension expenditure



Source: World Bank. 2020. When We're Sixty-Four.

In the case of Brazil, the present value of the pension system deficits more than double the current government debt-to-GDP ratio (~70% of GDP)

Countries are at different stages in the demographic transition and unevenly prepared to face the fiscal impact of longevity

a. Europe
    i. Flexible indexation of pensions
    ii. Retirement age moves according to life expectancy (with exceptions).
b. Latin America and the Caribbean (LAC)
    i. Adjustments in many LAC countries are challenged by the acquired rights discussion:
        1. low statutory retirement age,
        2. wage indexation of pensions
        3. linking minimum pension with minimum wage
c. Most importantly, solutions are geographic and time-dependent.
    i. While linking retirement age with life expectancy in Northern European countries is feasible due to better lifestyles and health care systems, in most EMDE, keeping workers in the labor force over 65 might be challenging
    ii. In the 1990s, debt financing of the transitional deficits of funded pension reforms was common, a decade later, it was unthinkable.
    iii. While until a decade ago, messages about reducing the pensions of retirees were not well received, now it is within the menu of options in most countries in the LAC region

Simple math

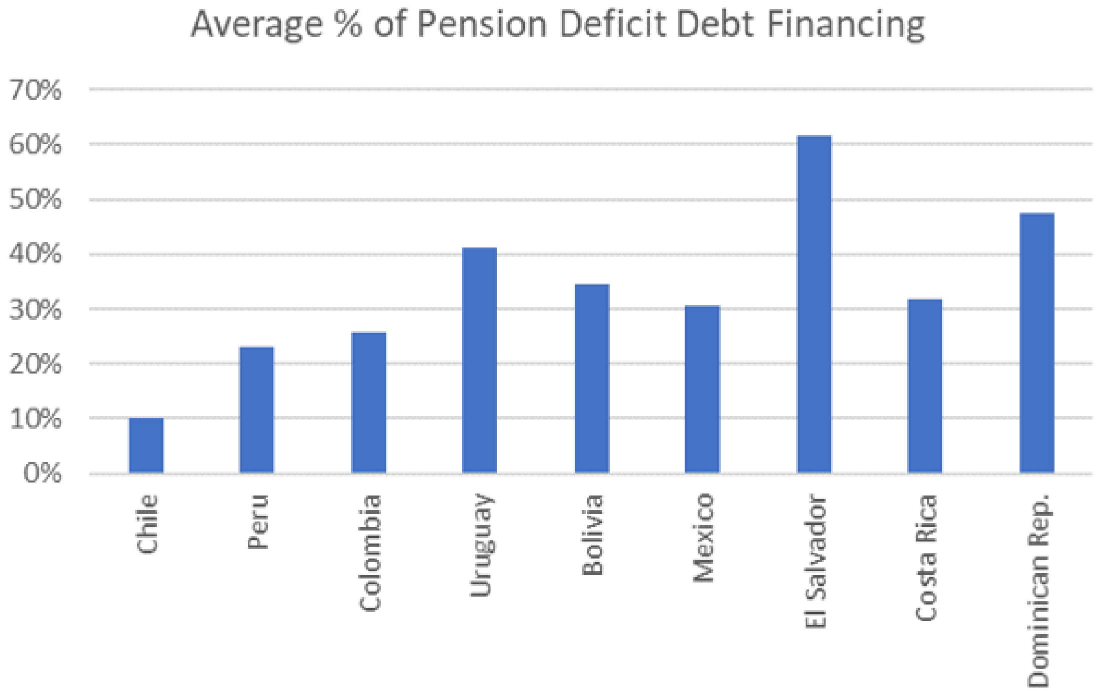
- Reducing from 7 to 3.5 the number of active workers per retiree imposes significant pressure on contributors / public finances in the region
  - How are countries going to pay for it?
- Pension reform is about the intergenerational allocation of the financing burden
  a. Future working generation (debt financing)
  b. Current working generation (fiscal space financing)
  c. Former working generation (income redistribution)

Deliberate prioritization on how to share the financing burden

a. Debt financing
   i. Bounded by the country’s credit rating
   ii. Credit risk increases governments’ cost of funding and consequently has long-term fiscal consequences
b. Fiscal space financing
   i. It correctly finances permanent expenditures with permanent sources of funding
   ii. However, taxes create distortions and inefficiencies
   iii. It potentially reduces the rate of return on projects
c. Social equity financing
   i. Encourages everybody to contribute
   ii. Need to ensure poverty alleviation and fairness

Debt Financing

- High government debt in most countries in the region
  - Most countries have reached an inflection point
- Debt financing was the Achilles tendon of (failed) pension reforms in Central and Eastern European countries
  - Mandatory pension reforms were financed with debt, which triggered reversals after the global financial crisis.
  - Subsequently, countries like Poland started offering tax incentives for voluntary savings for retirement



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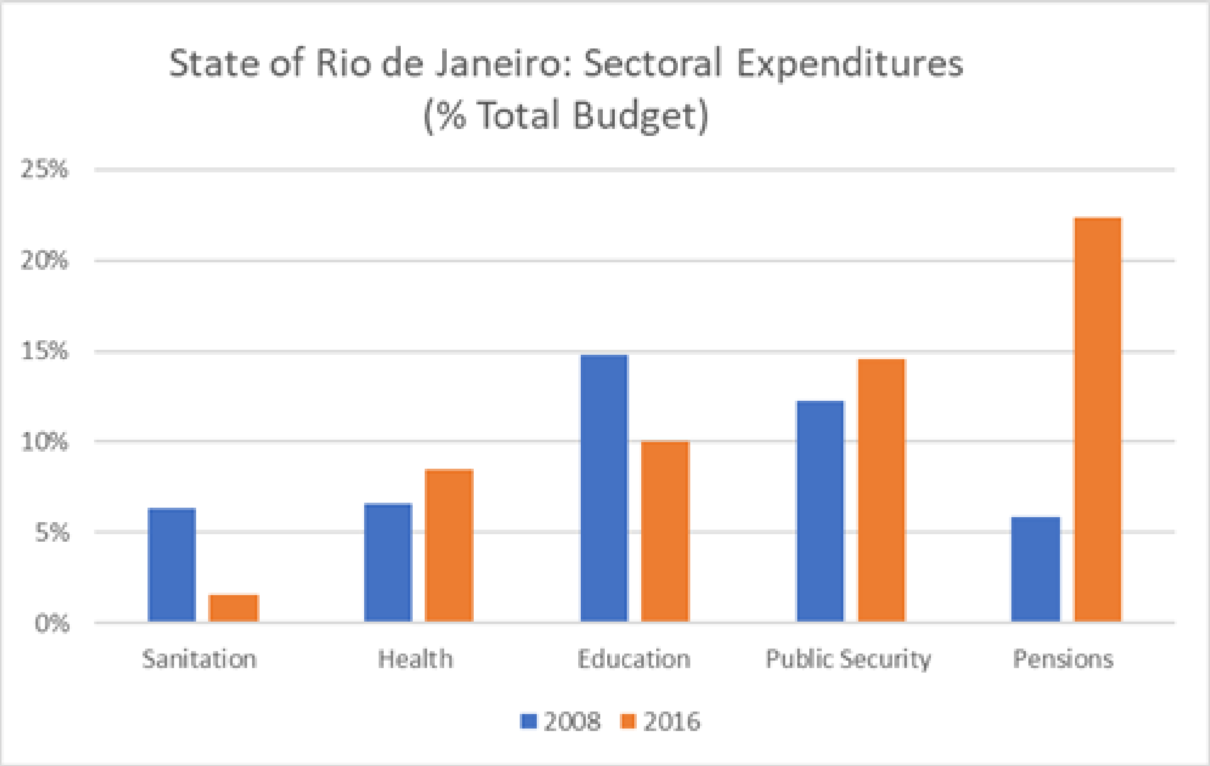
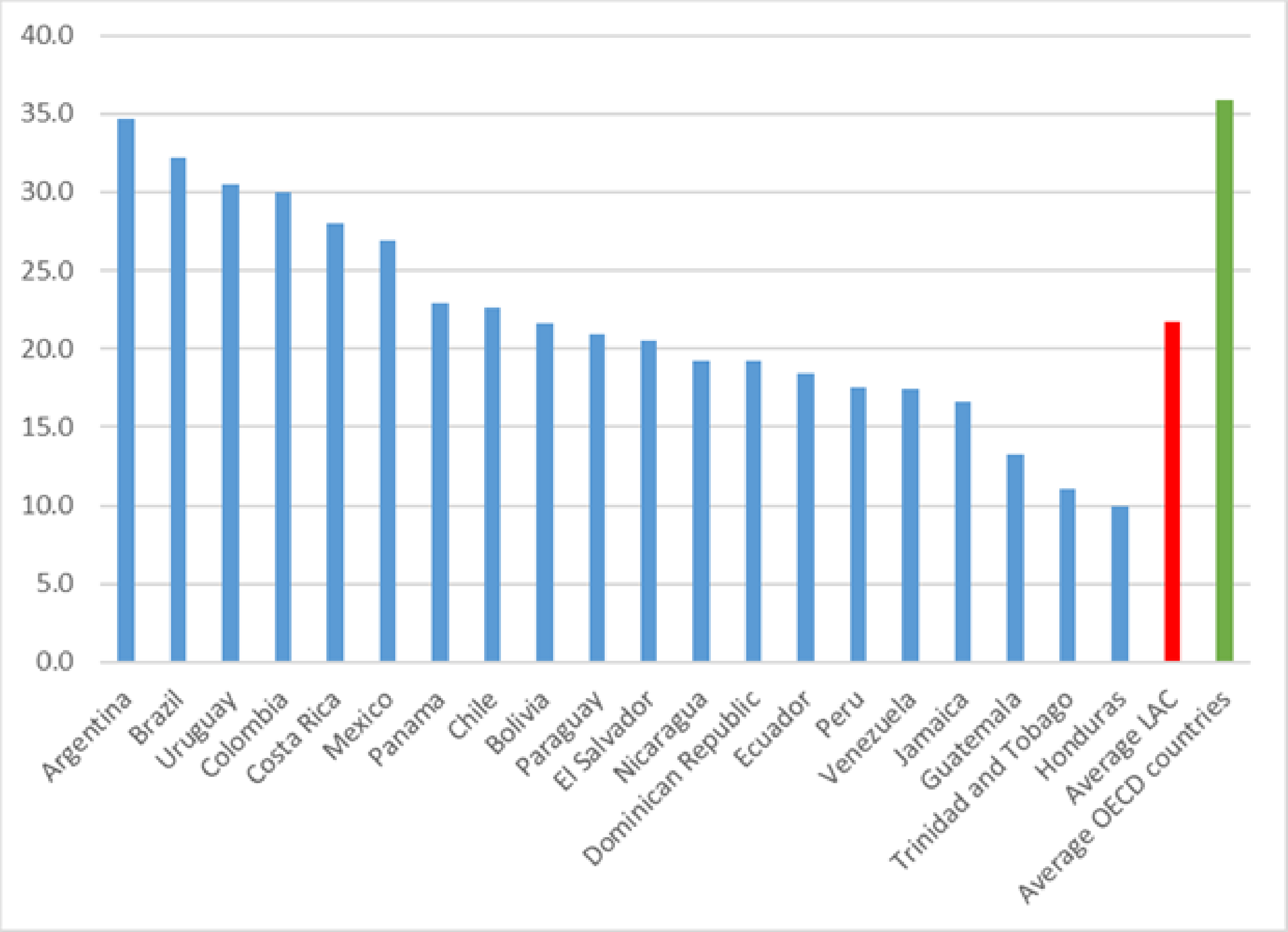
Fiscal space financing: The status quo



Source: SEPLAG, Estado do Rio de Janeiro

Fiscal space financing: Taxes and policy tradeoffs

Tax wedge in OECD countries, 2013 (% labor cost)



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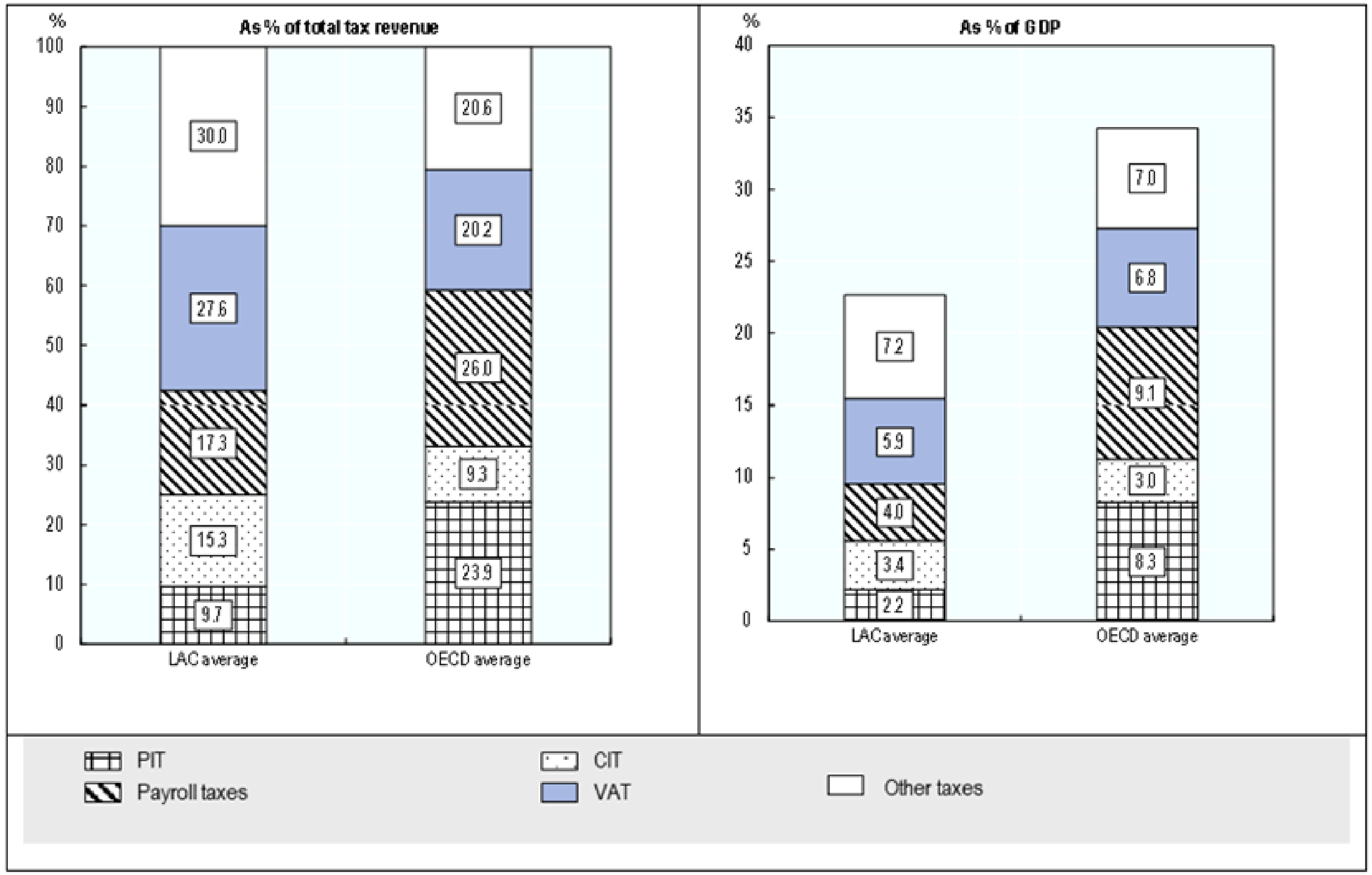
Source: OECD

Fiscal space financing: Taxes and policy tradeoffs

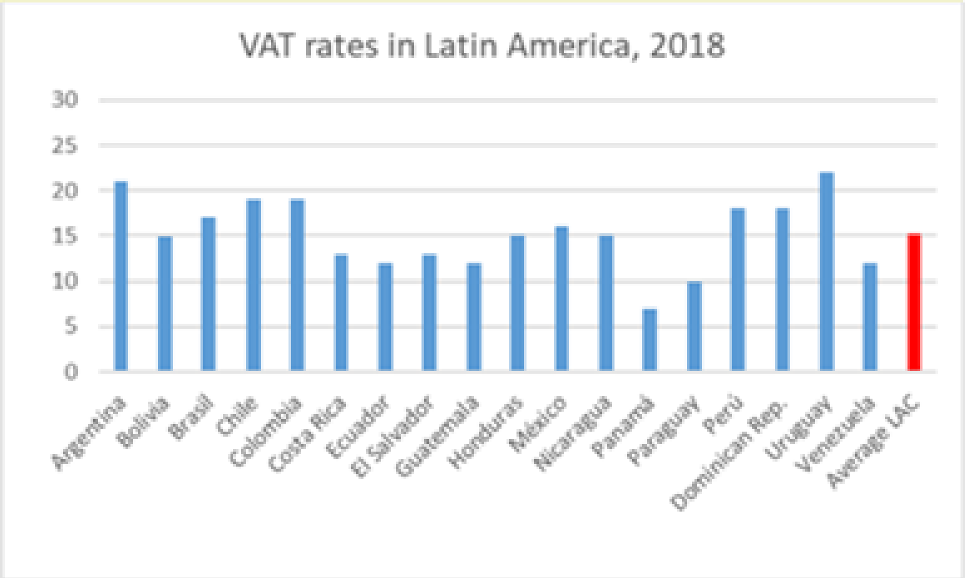
Tax structure in the LAC and OECD regions, 2017

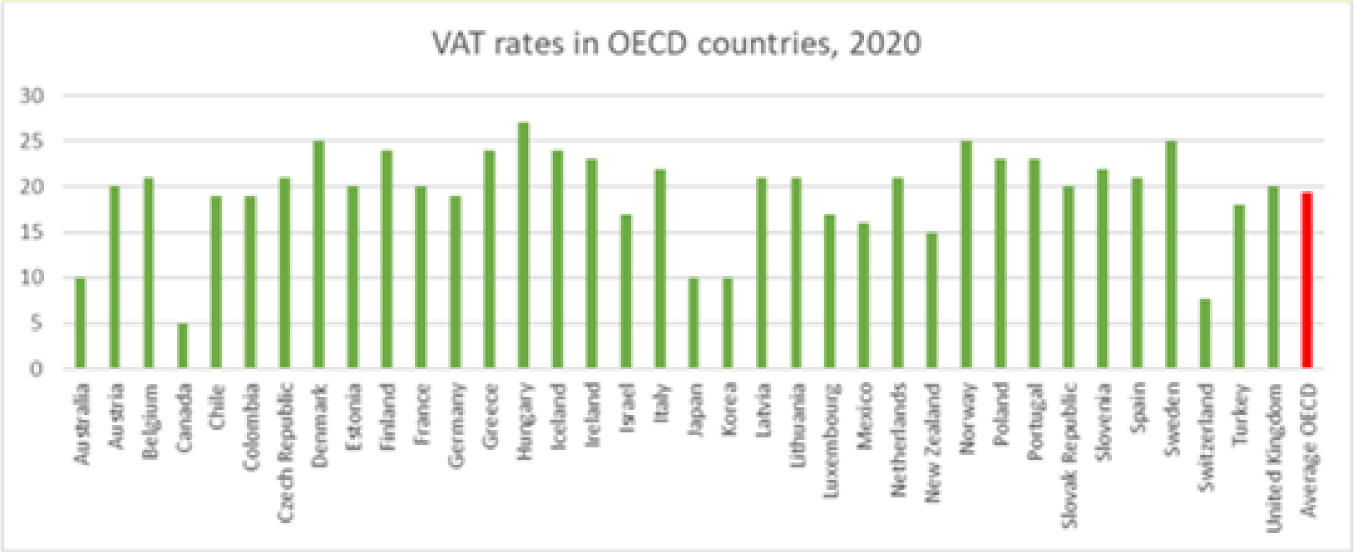


Source: OECD.

Fiscal space financing: Taxes and policy tradeoffs

VAT





Source: OECD

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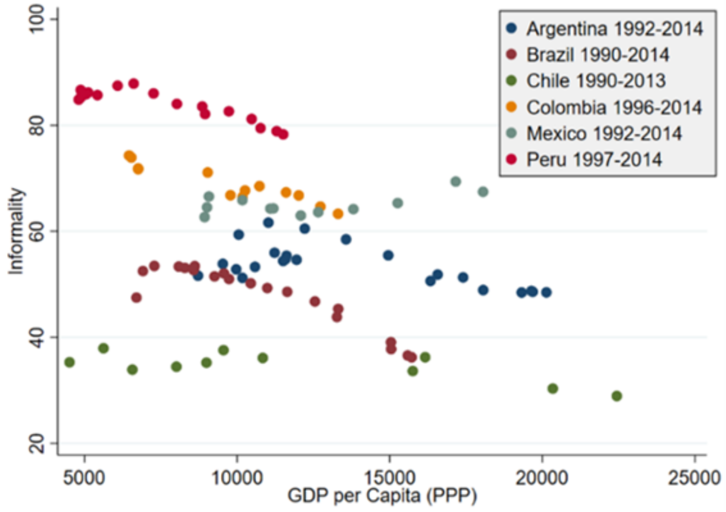
Social equity financing

- **Foster increases in labor force participation**
  - Increases in retirement age and transition
    - Bounded by the physical and intellectual capacity to perform tasks
    - Gradual phasing into retirement
  - Increases in density of contributions
  - Formalization of the labor force
  - Women in the labor force
  - Immigration (politically sensitive topic)

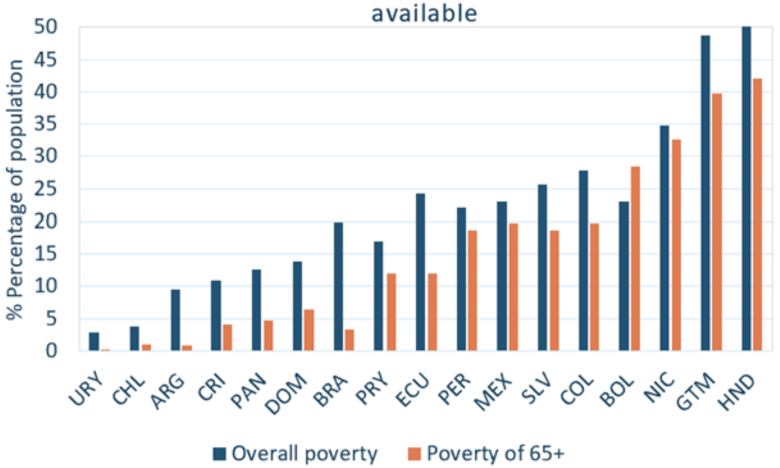
- **Keeping the elderly out of poverty**
  - Noncontributory pensions in the LAC region are significant
  - Elderly in the LAC region are not poor

Labor informality and GDP per capita in selected countries in LAC



Source: Lambert, Pescatori, and Toscani (2020).

Poverty rates at US$5.5 per day of all population versus elderly (65+) population, 2018 or latest year available



Source: World Bank Socio-Economic Database for Latin America and the Caribbean.

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Pension savings can change the math equation

- By using scarce public resources to keep the elderly out of poverty
- By using pension fund assets to invest in projects that foster economic growth
- By helping the private and public sectors to lift potential credit constraints
- By supporting local currency financing of projects

- There is room for supporting policies that promote pension savings
  - The effectiveness of savings is time-sensitive: Meaningful asset accumulation takes at least two decades
  - Some countries with PAYGO run the risk of an intergenerational break: Younger generations may oppose the idea of taking the burden of paying good pensions to current retirees and not expecting reciprocity in the future
- Lessons from the pandemic: Retirement savings versus long-term savings
  - Ringfencing retirement savings is important
  - Permanent effects of early withdrawals in Chile
    - Long-term impact on the mortgage rates

Thanks!

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