Civil Servant Pensions: Challenges and Reform Options

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Pensions Core Course

Game Plan

1. What are the objectives?
2. What are existing designs & financing?
3. What are prevalent institutional arrangements?
4. What are the key challenges including fiscal affordability, labor mobility, equity & predictability?
5. What are key reform options & directions?
6. What are key takeaways?

What are the objectives of civil service pension schemes?

- **Objectives**

  Civil-service pension schemes usually set up before national programmes
  - ➢ Civil service rationale => independence
  - ➢ Justify investments in civil servants
  - ➢ Create incentives for long-term employment
  - ➢ Shift the cost of remunerating civil servants into the future

- **Context**
- Colonial histories => design & parametric legacy
- Legal & constitutional restrictions on adjusting acquired rights
- Long work histories + long life expectancies.

What are the Existing Designs?

- Historical DB & legacy parameters
  - Final basic wage
  - Generous, often non-linear accrual rates
  - Accrual from basic salary
  - Discretionary indexation
  - Sometimes low retirement age
  - Commutation & restoration
- DC schemes (publicly and privately managed)
- DC w/DB top-ups
- Government provident funds (& types of benefits)

What are the forms of existing financing and rationale for pre-financing?

Forms

- Unfunded, non-contributory
  - ➢ Simplicity
  - ➢ But Fiscal risk
- Contributory (with & without separate funds)
- Role of reserve funds (& challenges)
- Provident funds
- Funded DC schemes & unfunded top-ups

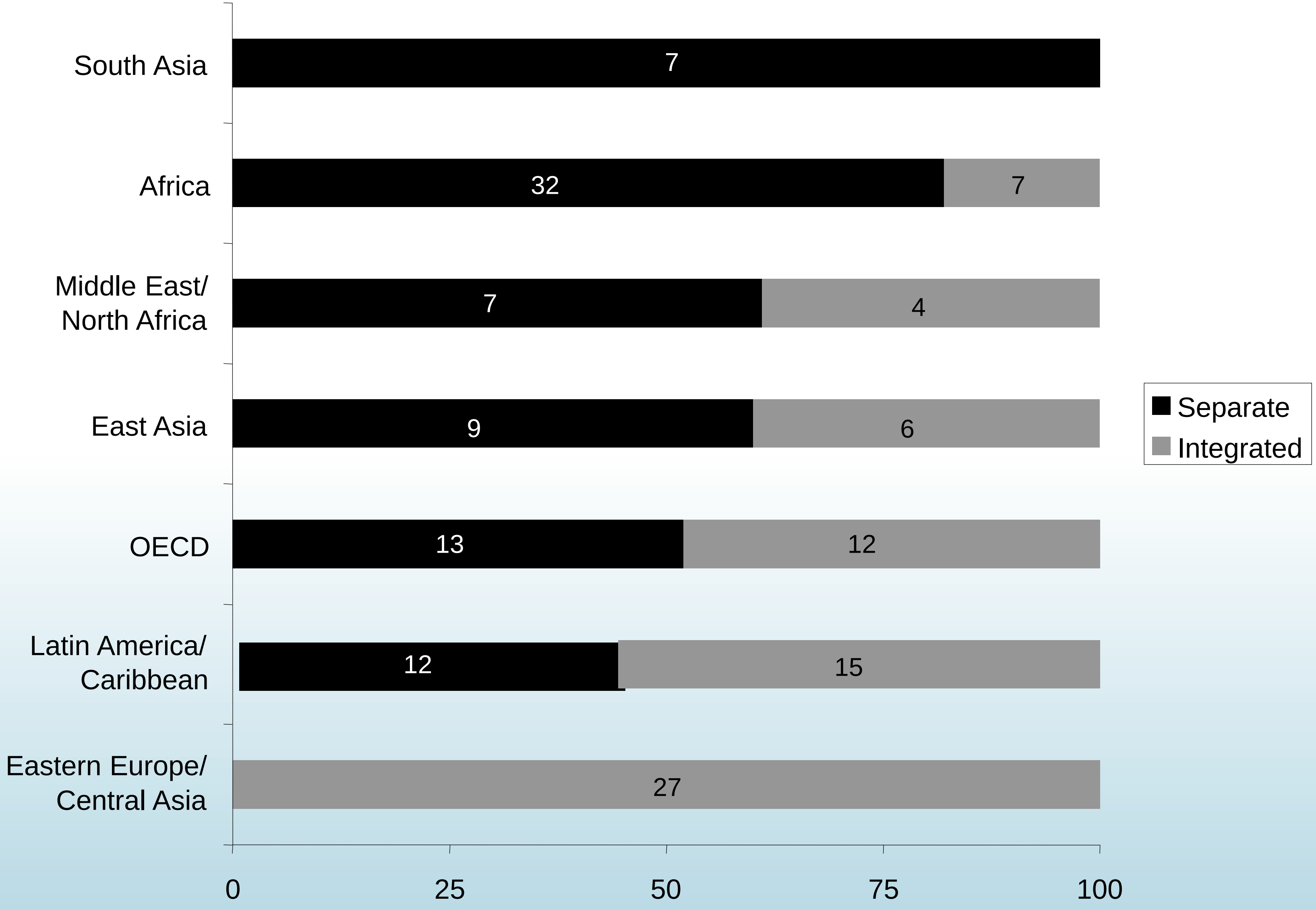
Rationale for moving from Non-Contributory to Contributory (& transitions)?

- Cushion for periods when Government revenues fall short.
- Accumulations generate returns
- But transitions accommodating the effect on wages needs to be considered.
- And investment management infrastructure needed.
- Addressing arrears & providing oversight

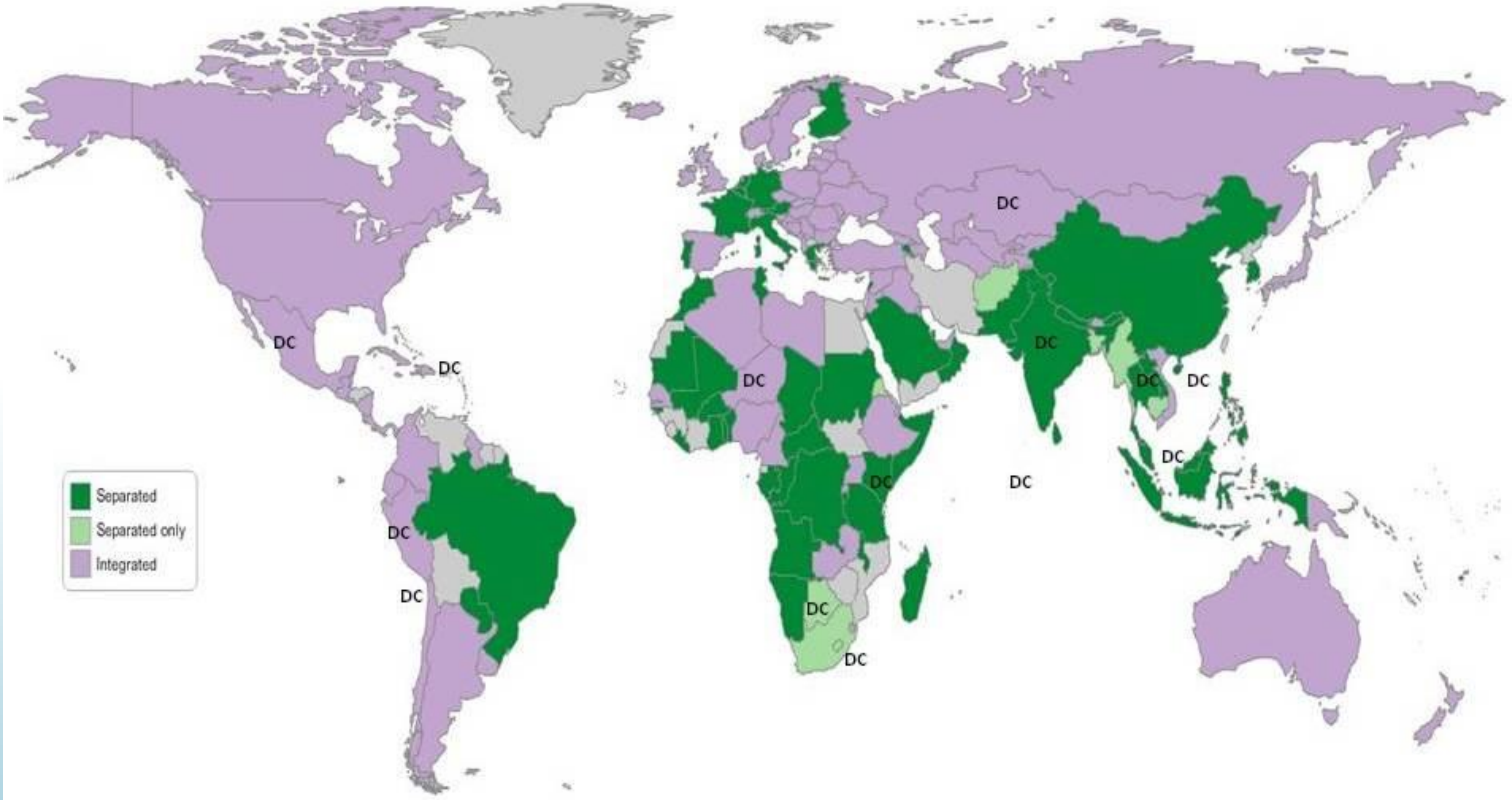
What are the Institutional Arrangements? (1)

- Relation with national pensions
  - No mandated pension schemes
  - Separate from private sector schemes
  - Separate (but harmonized & coordinated)
  - Integrated (with top-up)
  - Fully integrated
- Management
  - Separate arrangements for different departments; Federal vs. State & local
  - Mgmt by Civil Service Pension Fund, Ministry of Finance, Separate Departments

What are the institutional arrangements? (2)



Civil Servants
Separated vs. Integrated



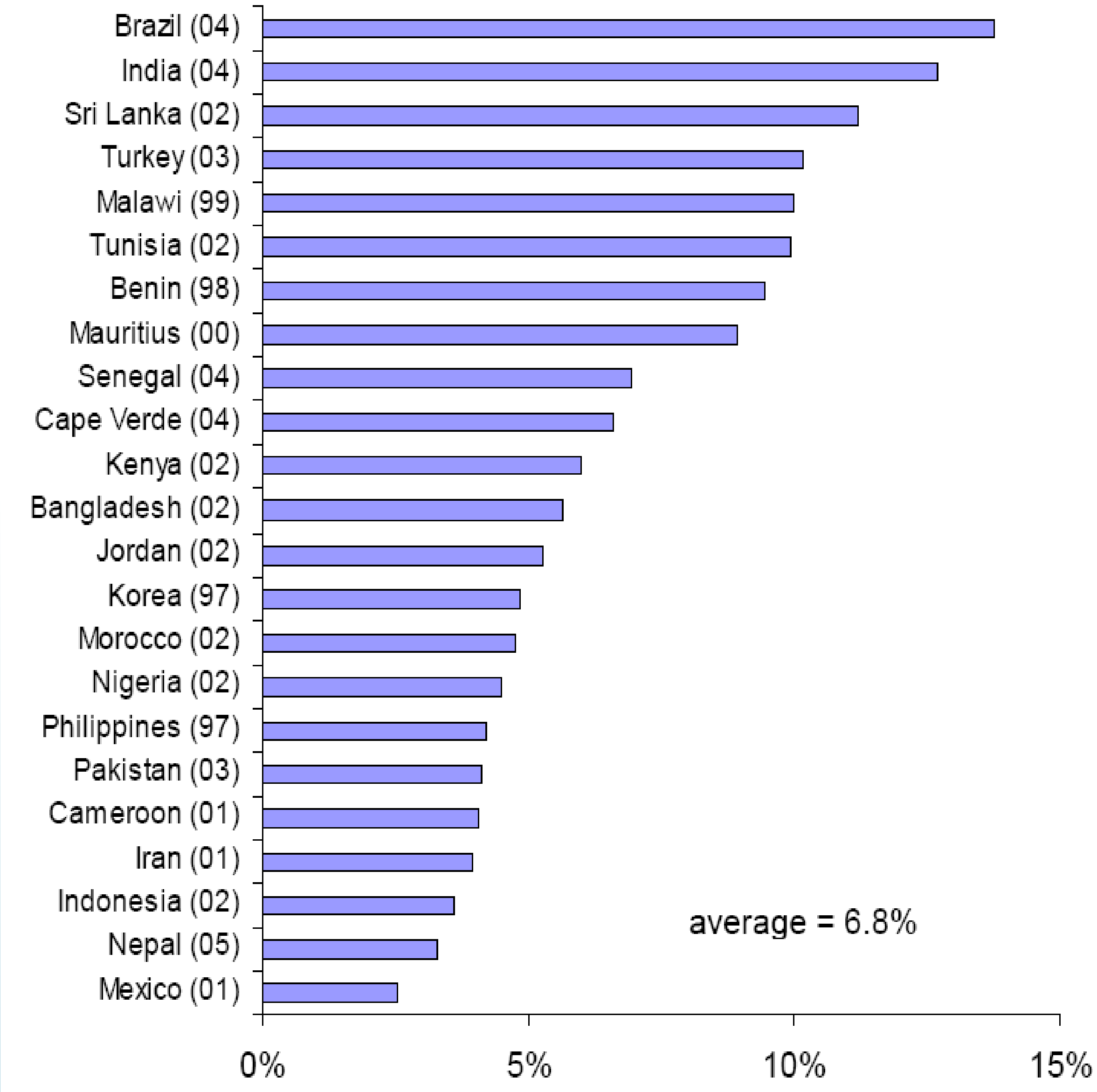
Rationale for Integration or Harmonization

- Gives civil servants interest in the plan
- Economies of scale
- Mobility and portability
- Equity

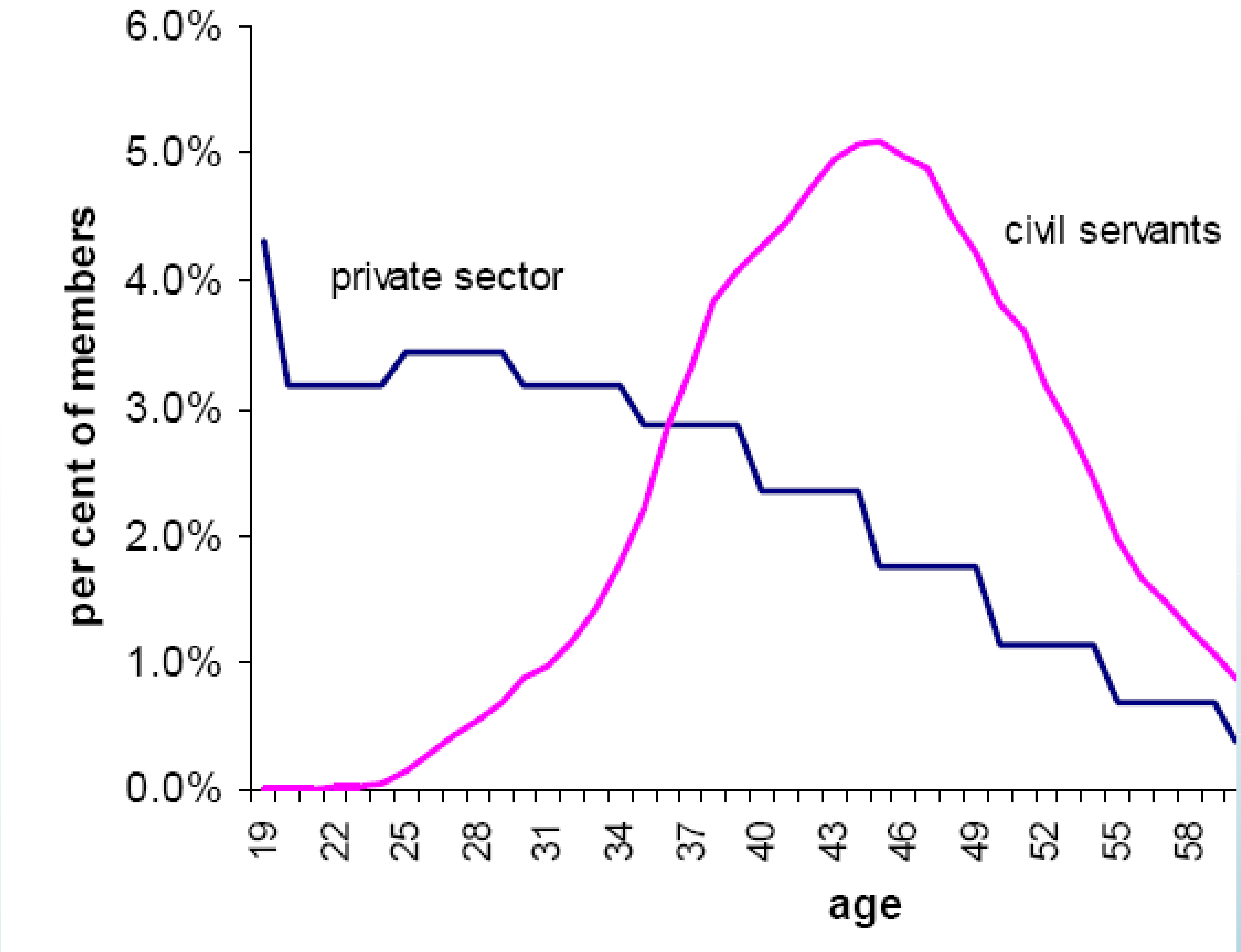
- **Recommendation**: => Long-term integration of civil-service and national pension schemes

Challenges (1): Fiscal affordability – Keeping the promise

- High & growing costs crowd out other essential public expenditures.
- Generous accrual rates defer costs.
- Headcount growth & real wage growth leads to unaffordable costs
- Civil service working age profile older than general population + civil servants often live longer
- Actuarial projections can inform parametric reforms



Older worker age profile: Example: Brazil



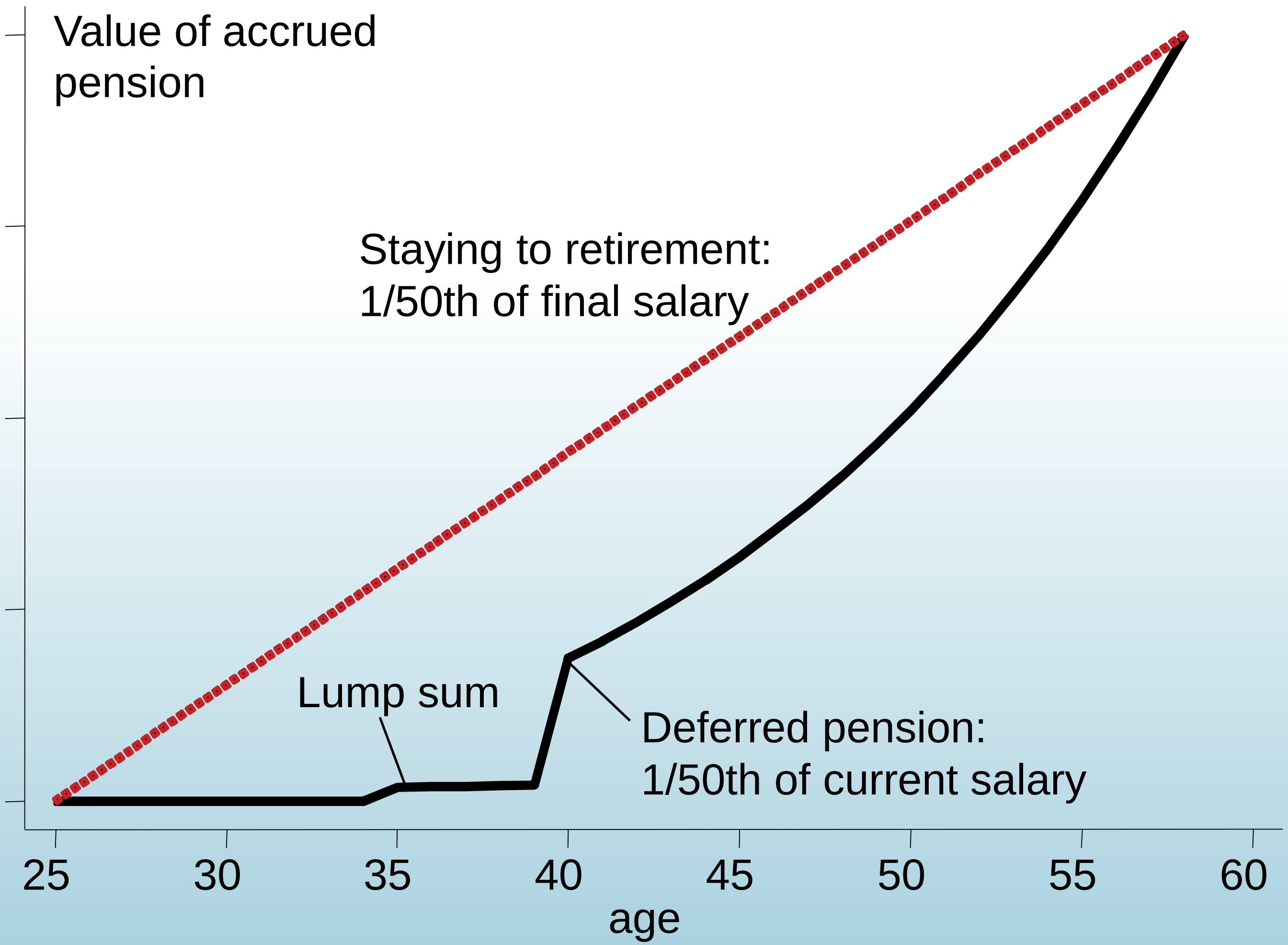
What are the Effects of Raising the Retirement (benefit eligibility) age in Civil Service Schemes?

- Civil service schemes are ‘closed’ systems - increasing retirement age has different effects than in “open” national schemes
- Increase in retirement age cuts duration of benefit payments, but benefit values increase
- Pay bill will increase during the transition (depends upon adjustment for new hires)
- So all-in costs (pay and pension) increase during transition
- Costs reach a new equilibrium after the transition.

Challenges (2): Liberating Labor Mobility

- Civil service schemes are inflexible - flexible schemes can improve productivity:
- ‘revolving doors’: cross-fertilisation of skills & experience between public and private sectors
- Can improve labor market efficiency.
  - Civil service design & rules create barriers to labor mobility:
- Vesting rules (linked to minimum pensions)
- Weak preservation
- Weak or non-existent portability
- Deferred wage compensation through pension promises

Example of preservation: Mauritius



Challenge (3): Weak predictability & fairness

- Indexation generally discretionary.
- Final wage basis for pensions
- Relationship between *basic wage* and non-pensionable *allowances* for equity.
- Commutation factors & restoration not actuarially fair.
- Early & late retirement not subject to actuarially fair reductions/increases

What are Suggested Reform Directions? (1 – Design)

1. Parametric' reforms to defined benefit plans
    - reduce accrual rate (+ linear)
    - index pensions to prices
    - introduce/increase member contributions
    - raise pensionable age & adjust for early retirement
    - extend income averaging periods + valorize

2. 'Systemic' reforms
    - DC reform (& top-up?)
    - Link to national pension scheme

What are Suggested Reform Directions?
(2 – Reforms to improve labor mobility)

- Integrate or harmonize with private sector schemes (+ portability)
- Shorten vesting periods
- Preserve pension rights of early leavers
- Extend averaging period
  - career average creates basis for portability
  - deals with incentives for abuse
- Introduce defined contribution scheme (eg. India, Maldives, US, UK, Aus)

What are Suggested Reforms (3): predictability & fairness

- Automatic price indexation
- Lifetime wage base, valorized
- Gradual inclusion of allowances into wage base (with decrease in accrual rate)
- Actuarial fairness in commutation
- Early & late retirement subject to actuarially fair reductions/increases
- DC reforms, with lifecycle adjustment in the risk of funds, 3rd party oversight, indexed annuitization

Conclusions

Parametric & structural reforms of civil service reform essential for:

- Fiscal sustainability,
- Improving predictability & fairness, and
- Removing barriers to labor mobility

A single national scheme can be more administratively efficient, equitable and increase labour-market flexibility

Takeaways

- **Deliver the promise** – Long term, fiscally affordable, diversified risk, predictable, equitable
- **Benefit design** – DB (linear accrual rate, lifetime income averaging, valorization, CPI indexation, reductions for early ret.); DC (efficient, supervised, transparent).
  - **Put most allowances** in pensionable wage base (+ transitions)
  - **Commutation (& restoration?)** – Limited & actuarially fair
- **Financing** – Contributions & reserve funds reduce fiscal pressure & est accountability.
- **Institutional design** – Unified or at least harmonized w/national scheme.
- **Portability & preservation** - Yes + indexed
- **Vesting** – Reduce vesting (linked to minimum pension).
- **3rd Party Oversight** – Investment management, account management; disclosure; data management
- **Leverage DC Civil Service Scheme for private sector workers**