The Political Economy of Pension Reform: Constraints and Strategies

Political Economy of Pension Reforms, October 31

R. Kent Weaver
Georgetown University and The Brookings institution

Pensions Core Course

1. Options

- What *__policy options__* for "difficult but necessary" reforms are available to countries in an age of fiscal austerity and demographic aging?

2. Patterns:

- What are the patterns of pension reform in an era of austerity?

3. Understanding the Politics:

a) What explains cross-national and over time differences in public pension reform policy processes and choices?

b) What are the "micro-foundations" of pension reform when politicians are at least partially accountable to citizens?

4. Strategic Lessons for Reformers:

- **What are <u>strategic</u> options that facilitate "difficult but necessary" reforms being successful in:**
  - **Adoption**
  - **Implementation**
  - **Insulation from political interference during operation**
  - **Sustainability over time rather than erosion or reversal**
- **What <u>conditions</u> facilitate their success?**

Pension Reform Policy Options:

1. Refinancing:

- Increase payroll tax base or rate
- Add additional earmarked revenues or general taxes

2. Retrenchment:

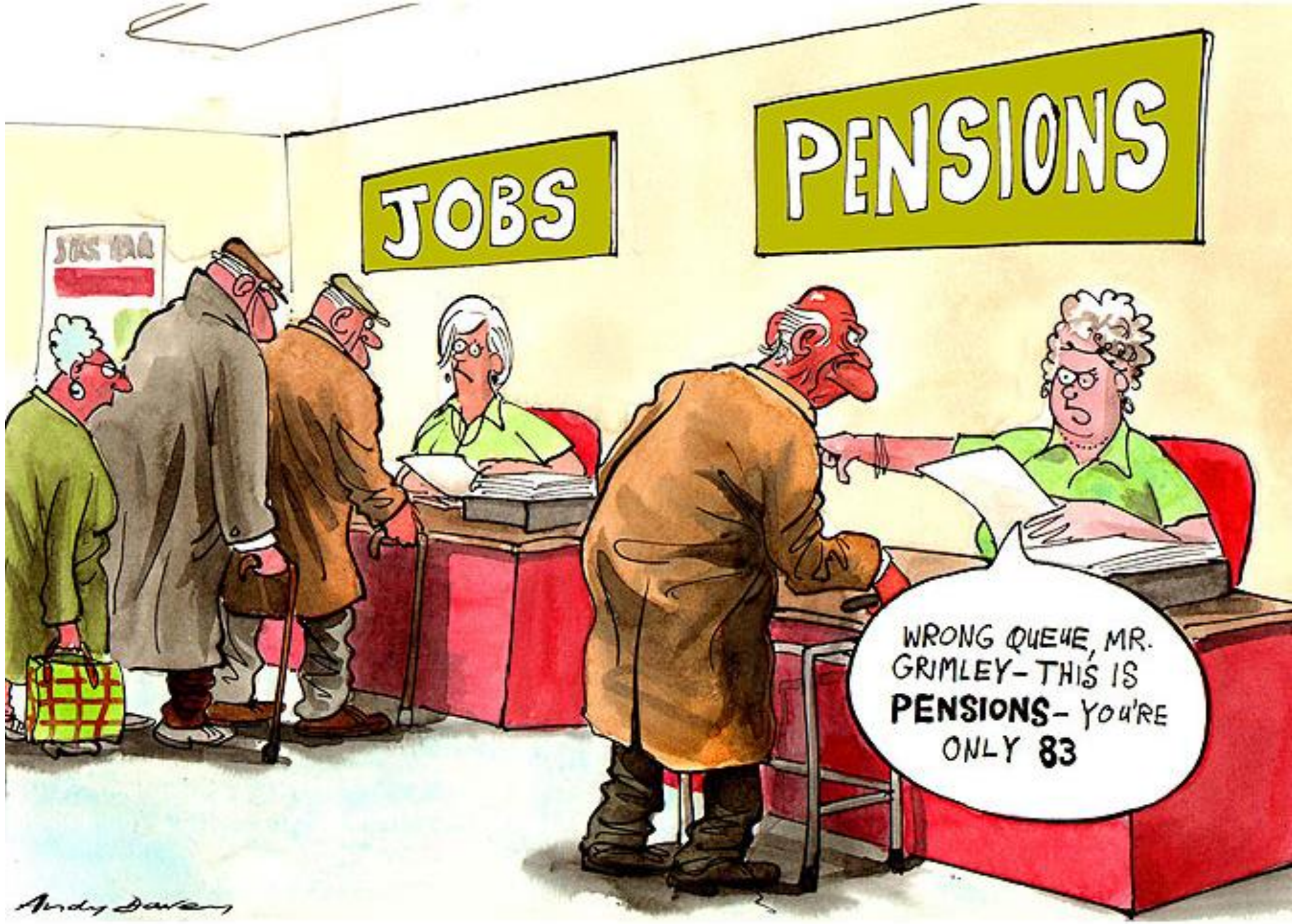
- Reduce benefits (e.g., change indexation)
- Reduce eligibility (e.g., raise standard retirement age)

3. Restructuring, e.g.:

- Add (or substitute) defined contribution tiers
- Add automatic balancing mechanisms (NDC)
- Add "boundary-straddling" automatic stabilizing mechanisms

...usually tried in roughly that order

Patterns of Pension Reform



Patterns in OECD countries:

1. In resilient economies (e.g., Germany, Netherlands, Sweden, Canada) reforms were mostly incremental or "boundary-straddling" automatic stabilizers, and frequently occurred before the Global Financial Crisis (US as outlier with no reforms)
2. In more vulnerable economies, GFC led to substantial retrenchment and some automatic stabilizers, some externally imposed
3. Pace of retrenchment and restructuring slowed down as GFC effects receded
4. Only one full NDC adoption (Norway) after 2000
5. Broader array of social criteria applied to collective investment funds

Patterns in Central/Eastern Europe and Former Soviet Union:

- In 1990s and 2000s:
  - Many countries added mandatory individual account “second pillars”
  - Two countries (Poland and Latvia) shifted from DB or points to NDC
- Some temporary or partial (Poland, Romania, Latvia) or full (Hungary) reversals of second pillar reforms in the wake of Global Financial Crisis to shore up state finances and first-tier pensions
- Backtracking on NDC reforms

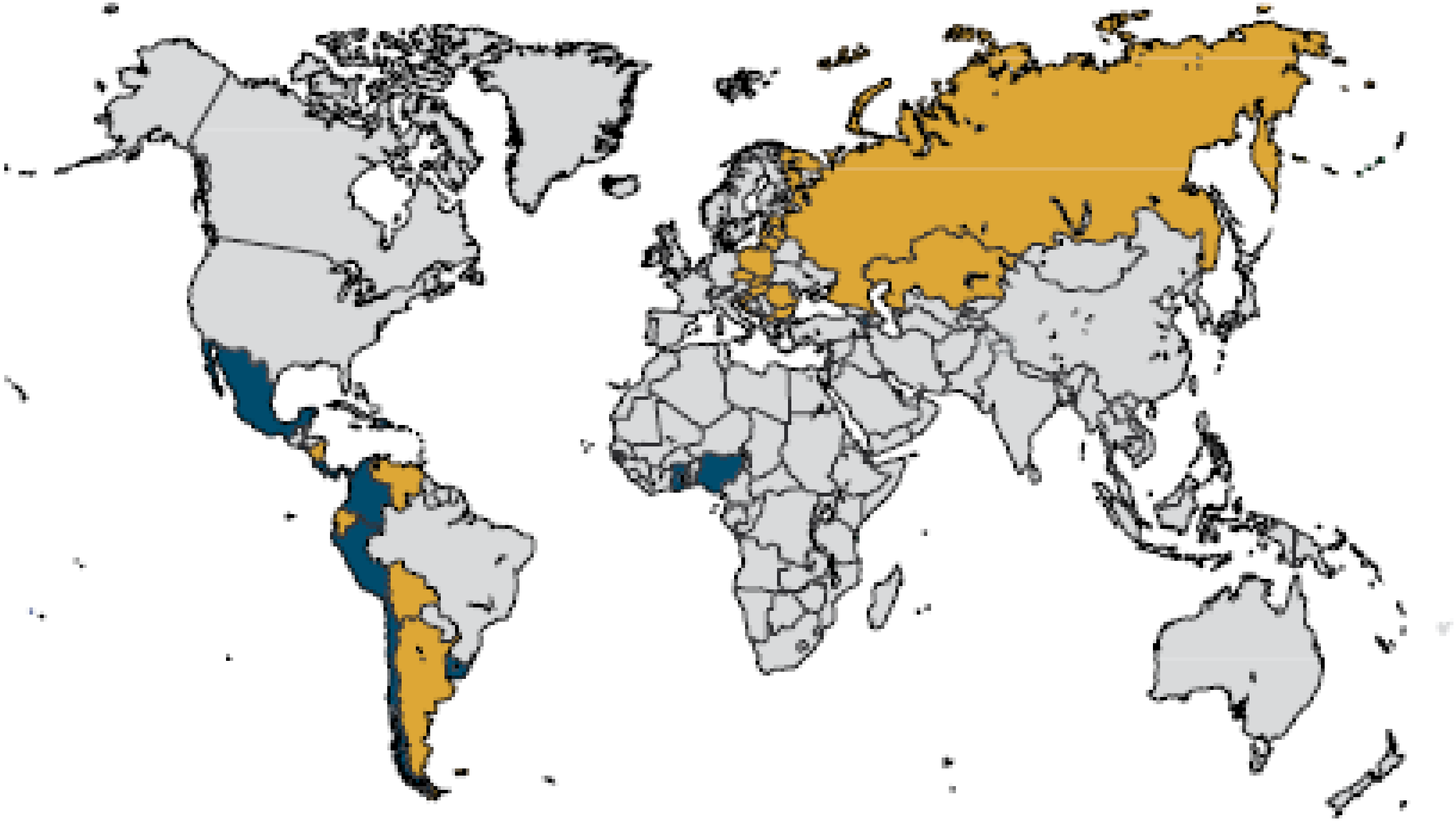
Patterns in Latin America:

1. Widespread but not universal pension privatization prior to 2000, with many variants
2. Later addition of zero pillars in some countries
3. Some reversals of privatization (e.g., Argentina)
4. “Second generation reforms” to address continuing problems of
   - Low pension coverage
   - Administrative costs and lack of competition
   - Gender inequities,
   - etc.

Overall Patterns:

1. Strong regional differences in “modal” reforms and second-generation reforms
2. Significant backtracking on initial reform trends, especially outside wealthy OECD democracies
3. Automatic stabilizing mechanisms increasingly used, but they do not provide guarantees against political intervention or reversal

Figure 1. Countries that privatized social security mandatory pensions and that reversed privatization, 1981-2018



■ Privatization without reversal (12 countries)

■ Reversal (18 countries)

Source; Fabio Ortiz et al, *Reversing Pension Privatizations*, ILO , 2018

Source: Guardiancich et al, “The Politics of NDC Pension Scheme Diffusion: Contraints and Drivers”, World bank, 2019

Table 2.1: NDC policy-making outcomes in selected countries

Outcome	Countries without FDC pillars	Countries with FDC pillars
NDC Innovators		Italy (1995); Sweden (1991–1998)
NDC Adapters	Norway (2009)	Latvia (1996); Poland (1997–1998)
Boundary Straddlers		
Statutory retirement age linked to life expectancy	Cyprus; Denmark (2011); Finland (2015); Greece (2010); Italy (2010); Malta; Netherlands (2012); Portugal (2013)	Slovakia (2012)
Benefits linked to life expectancy	Finland (2005); France (2003); Portugal (2007); Spain (2011)	
Other/Multiple stabilizing mechanisms	Canada (1997) and Quebec (2011); Greece (2012); Germany (1997 and 2004); Spain (2013)	Lithuania (2016)
Dropouts	Kyrgyz Republic (1997); Mongolia (1999)	Russia (2002); Egypt (2010)
Incrementalists	Austria; Brazil; Japan; Slovenia	Hungary; Estonia

Source: European Commission 2018, 54.

Note: The year(s) of reform adoption is in brackets. Several years apply to incrementalists.

Understanding The Politics

A Politically-mediated Model of Pension Policy Change

Macro-level pressures and shocks, including:

- Demographic aging
- Fiscal pressures and economic
- shocks
- Policy fads and institutional carriers (e.g., World Bank, OECD, ILO)
- "Neighborhood effects"

Self-reinforcing and self-undermining policy feedbacks from existing pension regime, including:

•Fiscal impacts
•Societal/distributive impacts
•Political impacts
•Politically feasible incremental and regime transition options

Political Environment, including:

- Partisan-political environment
- Group environment
- Domestic political institutions

Strategic Decisions By Politicians

Direction And extent of Policy Reform & Re-reform, including:

- Retrenchment
- Refinancing
- Modified or new policy regime (restructuring)

Macro-level pressures and shocks differ across countries and over time, e.g.:

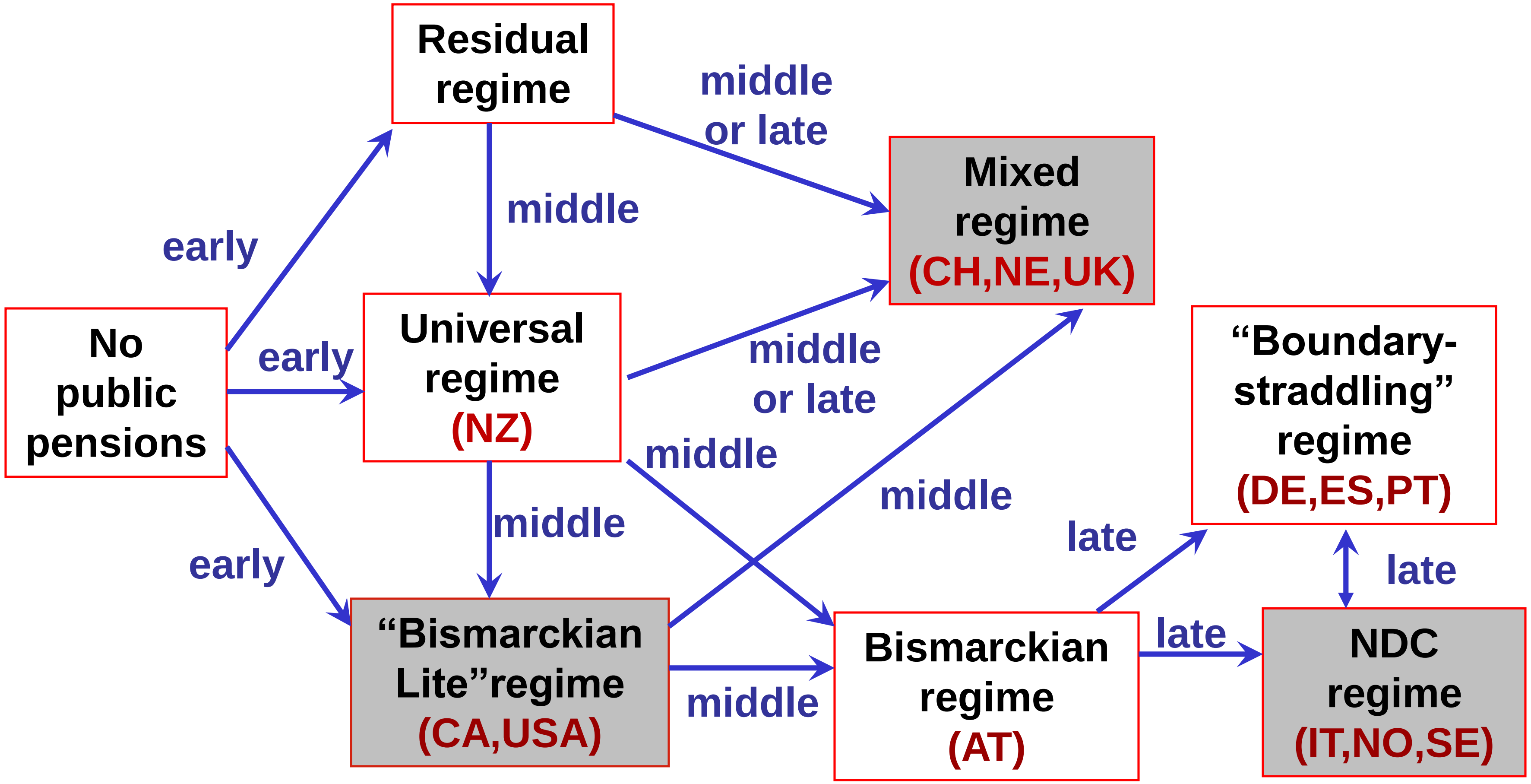
- Level of demographic pressures
- Exposure to Global Financial Crisis and EU criteria
- Vulnerability to pressure from IFIs (e.g/. IMF and ECB/ESM)
- “Neighborhood effects” of diffusion of specific pension reforms within regions, e.g.,
  - Individual account systems in Latin America
  - Mixed systems in Eastern Europe

Path dependence:

1. creates self-reinforcing policy feedbacks—e.g., supportive constituencies of beneficiaries
2. Creates both self-undermining policy feedbacks—e.g., unsustainable budget demands
3. Limits options for pension regime restructuring—some “reform paths” are more feasible than others

Common pension regime transitions in OECD Countries

(Most common timing of pension regime transitions is shown next time to the corresponding arrow. Pension regimes with a low probability of regime exit in the current "late" period of public pension development are shown with a shaded background)



Generalizations about pension reform politics are difficult because there are many actors….

Political Actors
- Governing parties
- Opposition parties

Civil Society Actors
- Labor Unions
- Pensioner organizations

Government Ministries
- Finance Ministry
- Labor/Social Affairs
- Central Bank

International Actors
- IFIs
- National donor agencies
- ILO, OECD, EU, etc.

….whose influence varies widely across countries

Some Propositions About Politicians:

1. Politicians:
   - have heterogeneous mixtures of office-seeking, policy and fiscal objectives, with office seeking usually dominant
   - priritize the short term (to the next election)
2. A political economy analysis must include both political executives and political oppositions

3. To meet office-seeking objectives:

- Current officeholders seek to avoid blame by distancing themselves from unpopular changes
- Opposition politicians find it difficult to resist blame-generating opportunities to attract unattached voters

Some Propositions About the Public:

1. They are “boundedly myopic”—e.g.
   - They pay attention to the highly visible (e.g., “My benefit check this month is lower in nominal kronor than it was last month”)
   - They discount future pension income in their labor market decisions (e.g., whether to be in formal or informal labor market)
   - They underinvest in financial literacy or managing their retirement funds

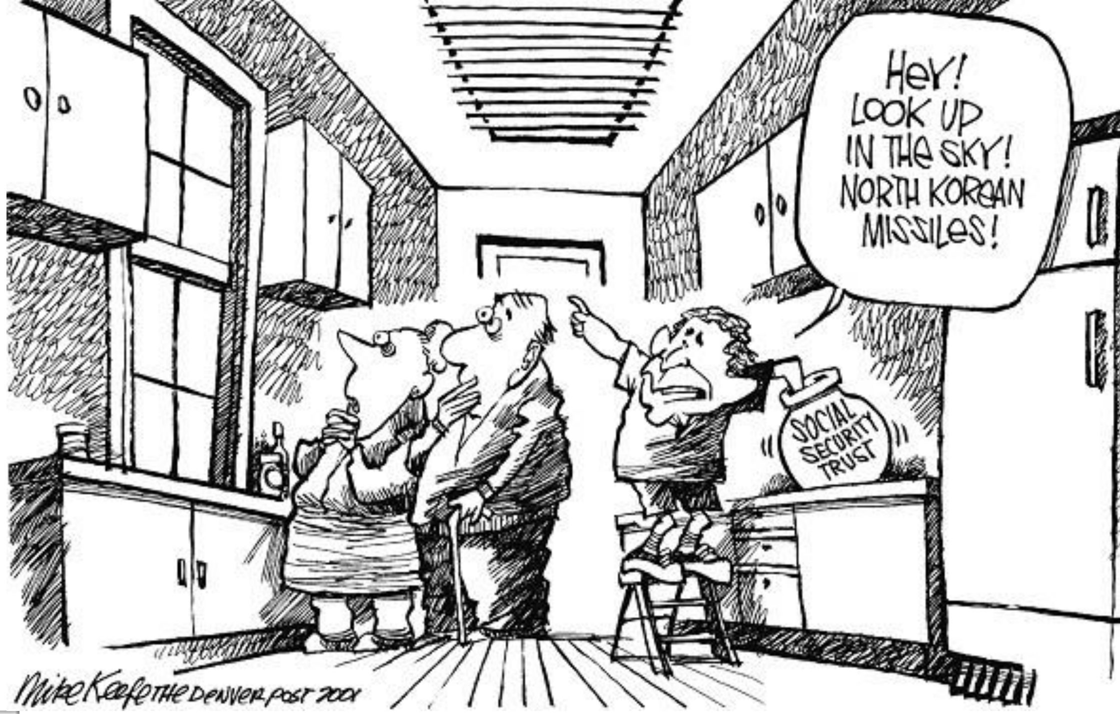
2. They base their pension expectations on past benefits
3. They are more sensitive to potential losses rather than equivalent gains
4. Constituencies grow up around the status quo (self-reinforcing policy feedbacks)
5. They pay more attention to negative information than positive information
6. Most are inattentive to pension issues except when “primed” by politicians or interest groups
7. The elderly and near-elderly are more attentive to pension issues than younger voters

Political Actors' Strategic dilemma in Pension Reform a simplified two-player model:

PLAYER	POLITICAL INCENTIVE	FISCAL/ SUSTAINABILITY INCENTIVE	PENSION POLICY INCENTIVE
Governing party(ies) holding executive power	Delay loss-imposing actions or avoid blame for them	Move toward pension system sustainability	Obtain mixture of refinancing, retrenchment, restructuring and selective enrichment close to your own preferences
Opposition parties or interest groups	Generate blame against government when it proposes loss-imposing initiatives	Move toward pension system sustainability	Obtain mixture of refinancing, retrenchment, restructuring and selective enrichment close to your own preferences

The First-Mover Problem:

Pension reform design and effects are complex, but blame-generating messaging is simple and effective



Blame-generating opportunities and temptations to engage in it:

- **Keeps loss-imposing policy initiatives off the agenda, especially when prospects for enactment are low**
- **Lowers the probability that they will be enacted, entrenched and sustained**

So adopting and sustaining reforms is likely to be facilitated by *muting blame generating* or its effectiveness through:

A. Formal or informal reform <u>Processes</u> that limit inputs into reform process

- "Policy cartels" of parties and/or social interests that limit the scope of debate
- Negotiation behind closed doors
- Changes by decree
- Changes by legislation that are rushed through with no time for public debate

B. Pension reform <u>mechanisms</u> that make loss-imposition less visible, at least temporarily, such as:

- Changes in benefits
  - indexation mechanisms (e.g., to shift in lower of wages or prices)
  - Increase in years of contributions required to earn “full” benefits
- Changes in taxes that take effect with a delay
- NDC or quasi-NDC Automatic stabilizing mechanisms (may be visible when they hit, but unclear effects when they are enacted)

Reform Processes: Strategic options for initiating reform in a two-player political game:

TYPE OF POLICY INITIATIVE	OPPOSITION OR POTENTIAL VETO PLAYER RESPONSE
1. No Initiative	A. None
2. Seek cooperation on joint or autonomous initiative	A. Accept
	B. Reject
3. Initiate alone but tailor initiative to minimize blame and gain acceptance from opposition	A. Accept and endorse
	B. Acquiesce
	C. Reject and respond with blame generating
4. Initiate alone and blame opponents for inaction and/or lack of cooperation	A. Agree to cooperate
	B. Reject and respond with blame generating

TYPE OF POLICY INITIATIVE	OPPOSITION OR POTENTIAL VETO PLAYER RESPONSE
1. No Initiative	A. None

- **Path 1 (No initiative) is the most common pattern, especially in minority or divided governments, where prospects for policy ”wins” are limited**

TYPE OF POLICY INITIATIVE	OPPOSITION OR POTENTIAL VETO PLAYER RESPONSE
2. Seek cooperation on joint or autonomous initiative	A. Accept
	B. Reject

Path 2: Sharing or deflecting blame

Examples of successful "Path 2" reform processes:

- Blame diffusing "policy cartels"
  - Pension working group in Sweden
  - Social Security Reform Commission in U.S. (1981-83)
  - Multi-party pension consensus (Germany)
  - Canadian finance ministers' working group on Canada Pension Plan reform
- Pacts between social partners (employers and unions)

Path 2 works best when:

- Divergence on substantive policy preferences is low between government and opposition
- Perception that all will be blamed if no agreement is reached
- ”Behind closed doors” negotiations are possible that lessen perceived risk of blame
- Key political and social actors are willing at least to acquiesce in reform, and can make a credible commitment not to renege and begin generating blame
- Intransigent and extreme parties are excluded from negotiations

Path 2 policymaking is less feasible when:

- **Political oppositions:**
  - **See electoral advantage in opposing reform**
  - **Have credibility and access to criticize**
  - **See no preferable strategies to win power**
- **There are multiple stages and veto points in the policymaking process**

TYPE OF POLICY INITIATIVE	OPPOSITION OR POTENTIAL VETO PLAYER RESPONSE
3. Initiate alone but tailor initiative to minimize blame and gain acceptance from opposition	A. Accept and endorse
	B. Acquiesce
	C. Reject and respond with blame generating

- **Path 3 (tailoring initiatives to minimize blame) is risky unless opposition has sent signals that it will accept certain types of reforms**

TYPE OF POLICY INITIATIVE	OPPOSITION OR POTENTIAL VETO PLAYER RESPONSE
4. Initiate alone close to your preferences and blame opponents for inaction and/or lack of cooperation	A. Agree to cooperate
	B. Reject and respond with blame generating

- Path 4 is likely to fail because:
  - Opposition usually cannot be persuaded or coerced into cooperating
  - Initiators may retreat if threat of blame grows
  - Reform can be blocked if multiple veto points exist
  - Potential for reversal after blame-generating by opposition

Closed versus inclusive processes in pension reform: Advantages and disadvantages

Closed Processes:

+ may avoid policy stalemate
- may lead to mistrust in:
  - government
  - pension system
- privilege actors with greater information and access
- may lead to policy reversal when effects become visible or control of government shifts

Stealth <u>mechanisms</u> for loss-imposing pension reforms confront a fundamental dilemma:

- **Clarity–** if workers are to adapt successfully to new pension policies, they must be given clear signals early about changing their savings and retirement behavior

versus

- **Obfuscation/Stealth–** sending clear signals about future cutbacks
  - Causes politicians to fear electoral or social retribution
  - Makes it less likely that a reform will be adopted if opponents mobilize against it

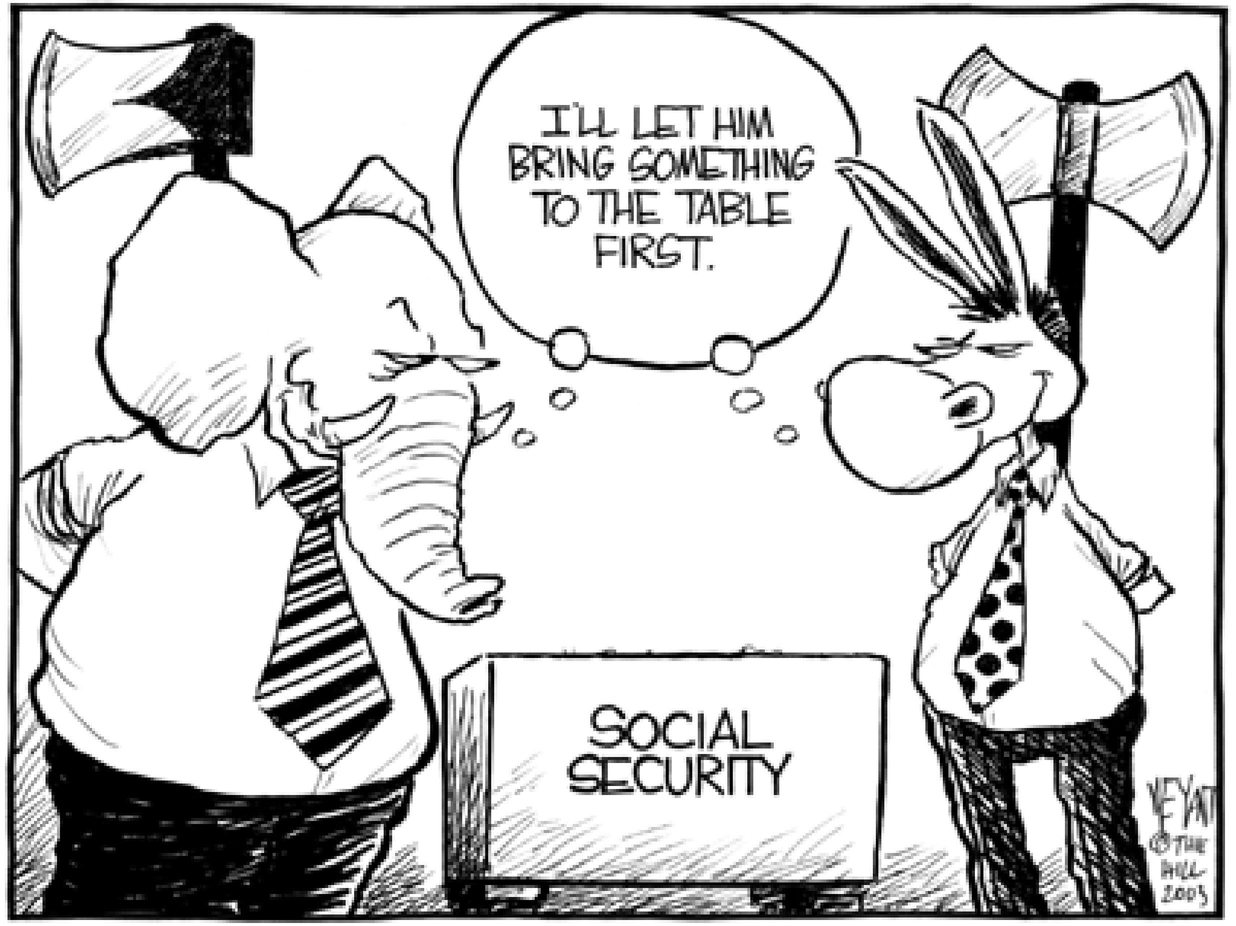
Can Automatic Stabilizing Mechanisms increase the sustainability of pension reforms?

- Automatic mechanisms constrain interventions by politicians, but do not prevent them completely
- In Western Europe, ASM reforms have been fairly resilient:
  - Especially when political elites in countries are able to keep them out of electoral contestation
  - But some adjustments/erosion under electoral pressure (Sweden and Germany)
- Outside Western Europe, survival rate of ASM reforms has been low due to:
  - Political instability (both political unrest and governing party turnover)
  - Low elite understanding and commitment to NDC and similar reforms

The "Bottom line" on Automatic Stabilizing Mechanisms:

- Overall, ASMs <u>may</u> add significantly to the resilience of government efforts to improve pension system sustainability.
- But they are only as strong as the broader political system's capacity to resist popular pressures and politicians' electoral/stability fears

Strategic Lessons



How can politicians be motivated to support reforms with short-term costs and long-term benefits?

- **Deflect blame to the previous government(s)**
- **Act early in term, when:**
  - Electoral concerns are less paramount for opposition parties
  - Myopic voters are less likely to punish you
- **Insulate government from blame through an expert or multi-stakeholder policy formulation process**

But recognize that none of these mechanisms may be effective, so be realistic about what options are viable

Have a stakeholder management stakeholder strategy

- Identify policy alternatives
- Identify key stakeholders, especially those that have effective veto power
- Identify their preferences, resources and concerns
- Develop strategies for winning coalitions, which may involve
  - Managing perceptions (e.g., issue framing
  - Managing participants
  - Managing participants (e.g., mobilizing previously uninvolved groups
  - Managing payoffs (e.g., grandfathering current retirees)
- Eliminate the politically “non-starter” options

Develop a Stakeholder Preference Matrix

Stakeholders

Ratings (+3 to -3)

Alternatives	A	B	C	D	E	F	G
1							
2							
3							
4							
5							

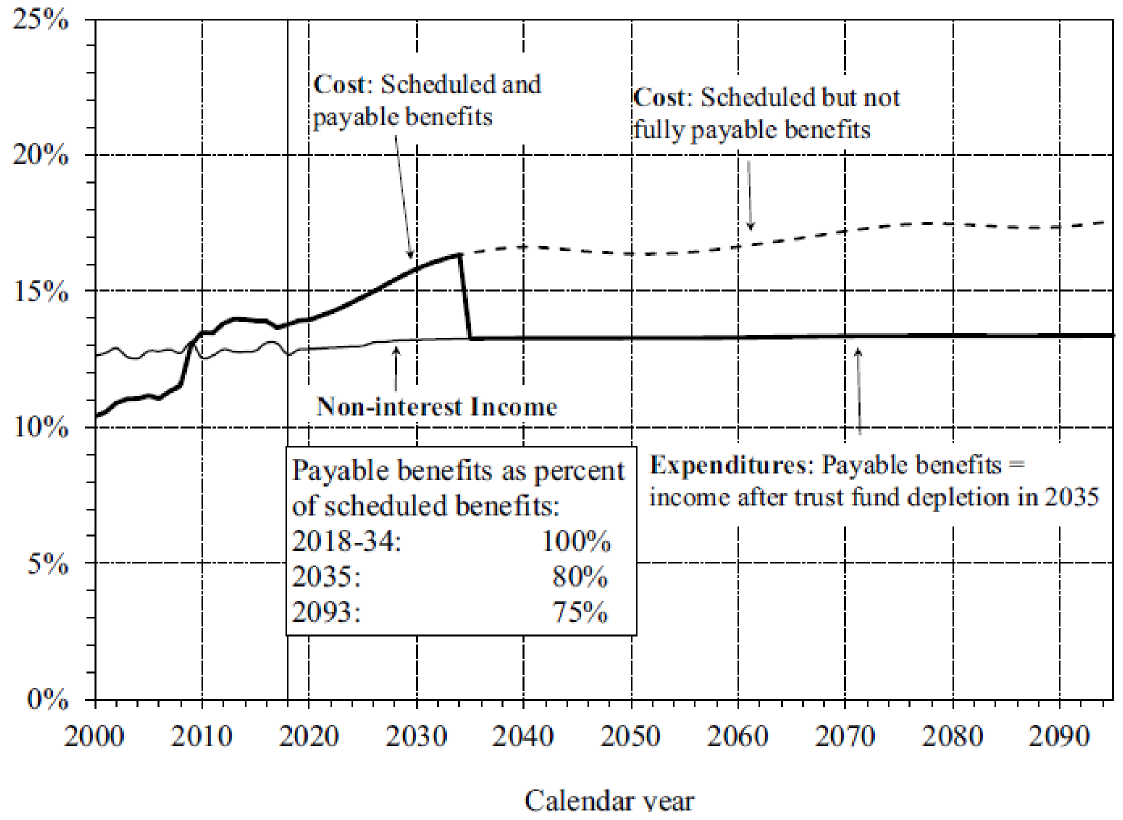
What is the best balance between inclusive consultation and a more streamlined decisionmaking process?

- Broad <u>consultation</u> is desirable, but poses a risk that groups will feel that being consulted gives them a riight of veto
- The more that government constrains the parameters of ”acceptable” options, the less likely it is that neutral or opposition groups will accept the process and recommendations

How can politicians be motivated to sustain difficult reforms during fiscal good times?

- Create highly visible indicators of long-term pension system viability
- Create independent “watchdogs” of pension system viability
- Minimize program provisions where politicians have to have to exercise discretion

Figure II.D2.—OASDI Income, Cost, and Expenditures as Percentages of Taxable Payroll
[Under Intermediate Assumptions]



How sustainable are automatic stabilizing mechanisms?

- Most middle- and lower-income countries do not have the information and technical expertise needed to design and operate an automatic stabilizing mechanism system that produces most of the benefits promised by advocates without offsetting problems
- In many middle and lower income countries, ASMs are also vulnerable due to
  - Political instability and governing party turnover
  - Low political commitment to reforms

Can IFIs and other donors contribute to “difficult but necessary” pension reforms? Yes, by:

1. Providing expertise on both design & implementation of reforms
2. Providing short-term financing to build coalitions for reform
3. Providing political cover for reforms that domestic elites want to impose anyway, but fear political costs of imposing
4. Introducing an actor not subject to blame can shift “option set” toward retrenchment and restructuring

But:

5. IFIs lack expertise on the likely political consequences
6. May have ”default preferences” that are ill-suited to the country’s capacity or political constraints

So:

7. Consider several information sources
8. Build domestic capacity with local knowledge
9. Examine multiple ”most comparable cases” in detail

How can takeovers of privatized individual accounts be avoided during times of fiscal stress?

1. Don’t overpromise in a way that undercuts their credibility
2. Be clear about how funds will be paid out—e.g., annuity or lump-sum
3. Have well-managed funds
4. Have frequent, transparent reminders of account balances and their eventual income effects

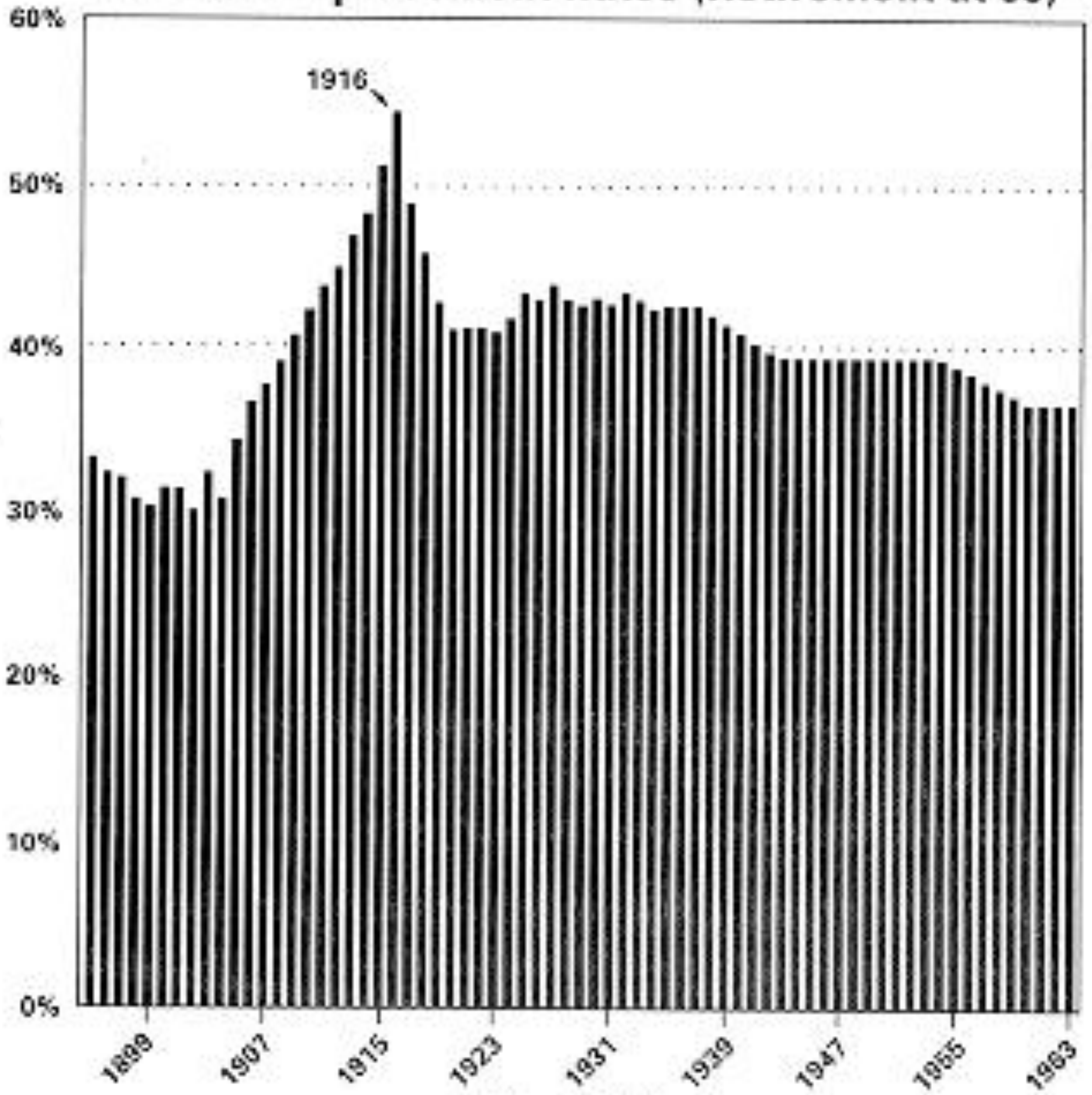
But there are no ”magic bullets”

Designing Pension Reform Mechanisms: Some Specifics

1. ”Grandfather” existing pensioners and near retirees as much as possible, since they are the most attentive and most sensitive to cutbacks
2. Avoid benefit and eligibility ”cliffs” and ”notches” as reforms are phased in

Year of Birth

Chart 3: Replacement Rates (Retirement at 65)



Represents retirees who always earned average wage. Source: Congressional Research Service.

2014

3. Give clear signals of desired behavior, or behavior that will be rewarded or punished

How much will you get per month?

Forecast for your National Public Pension

Retirement age	age 61	age 65	age 68 and 3 month	age 70
Amount SEK/month	10 300	13 100	16 000	18 500

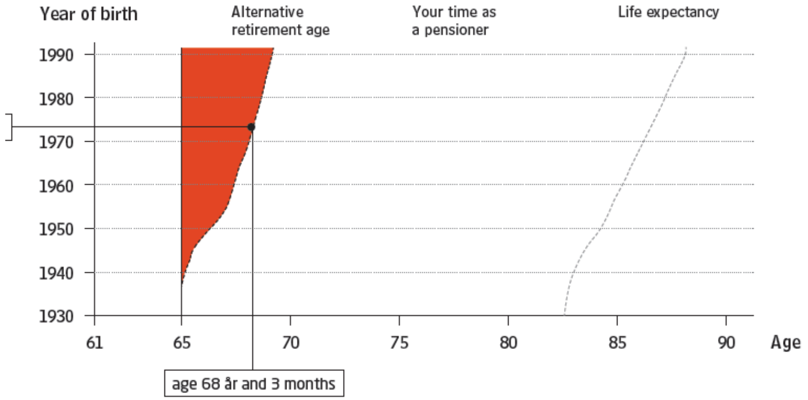
Your national public pension from age 65 (SEK 13 100 per month before tax) is estimated at SEK 9 800 in income pension and SEK 3 300 in premium pension. The pension will be paid out for the rest of your life.

We calculated as follows. The forecast is based on the SEK 1 025 977 you have earned towards your national public pension so far and your annual income until you retire. We have assumed that you will have the same pensionable income per year as in 2012, that is SEK 303 300.

The forecast is calculated in todays value. This means that you can compare the amounts in the forecast with your current earnings. The forecast is developed in accordance with the pension industry forecast standard. Read more on www.pensionsmyndigheten.se /prognosstandard.

Why 68 years and 3 months? The life expectancy in Sweden is rising. You, who were born in 1973 need to work until the age of 68 years and 3 months to receive the same pension amount you would have received at age 65 if life expectancy had remained unchanged. Your pension is calculated as your account value divided by the average remaining life expectancy of your age class.

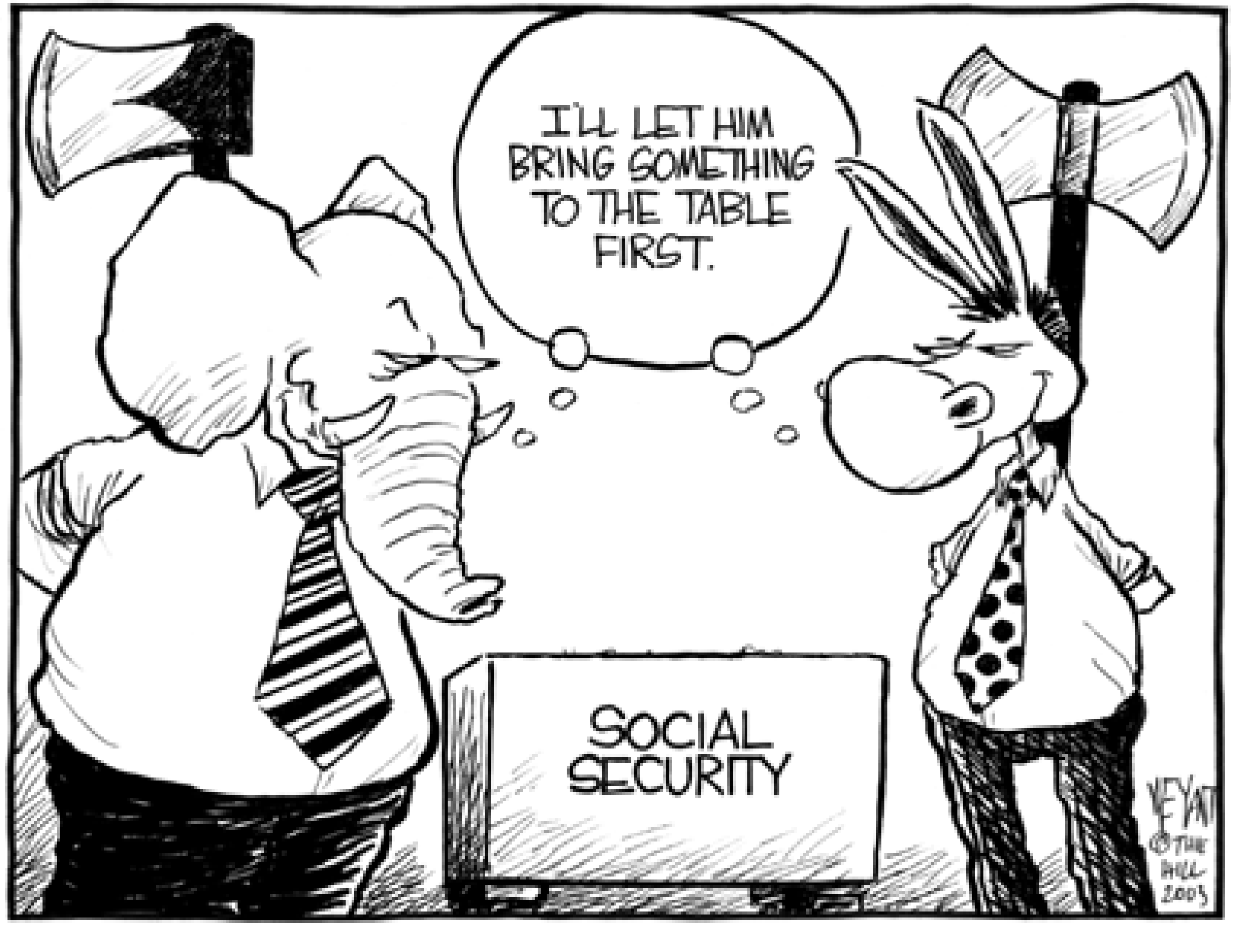
When is the best time for you to retire? At www.pensionsmyndigheten.se/B3, you can obtain forecasts that also include your occupational pension and possible private pension. The forecasts make it easier for you to plan and make the right decisions about your future. The forecasts are generated by Minpension.se, a collaboration between the Swedish Pensions Agency and the private pension companies.



The bottom line:

- Consensus on difficult pension reforms is unlikely, but acquiescence is more feasible
- Each country must tailor pension reform processes and mechanisms to their own political system—there is no single template for successful reform processes or content
- Blame-diffusing mechanisms usually break down over time as opposition politicians face strong electoral pressures to criticize “difficult” reforms

Questions?


I'LL LET HIM BRING SOMETHING TO THE TABLE FIRST.
SOCIAL SECURITY
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