

# **The Role of MDC Approach in Improving Pension Coverage**

Workshop on the Potential for  
Matching Defined Contribution (MDC) Schemes  
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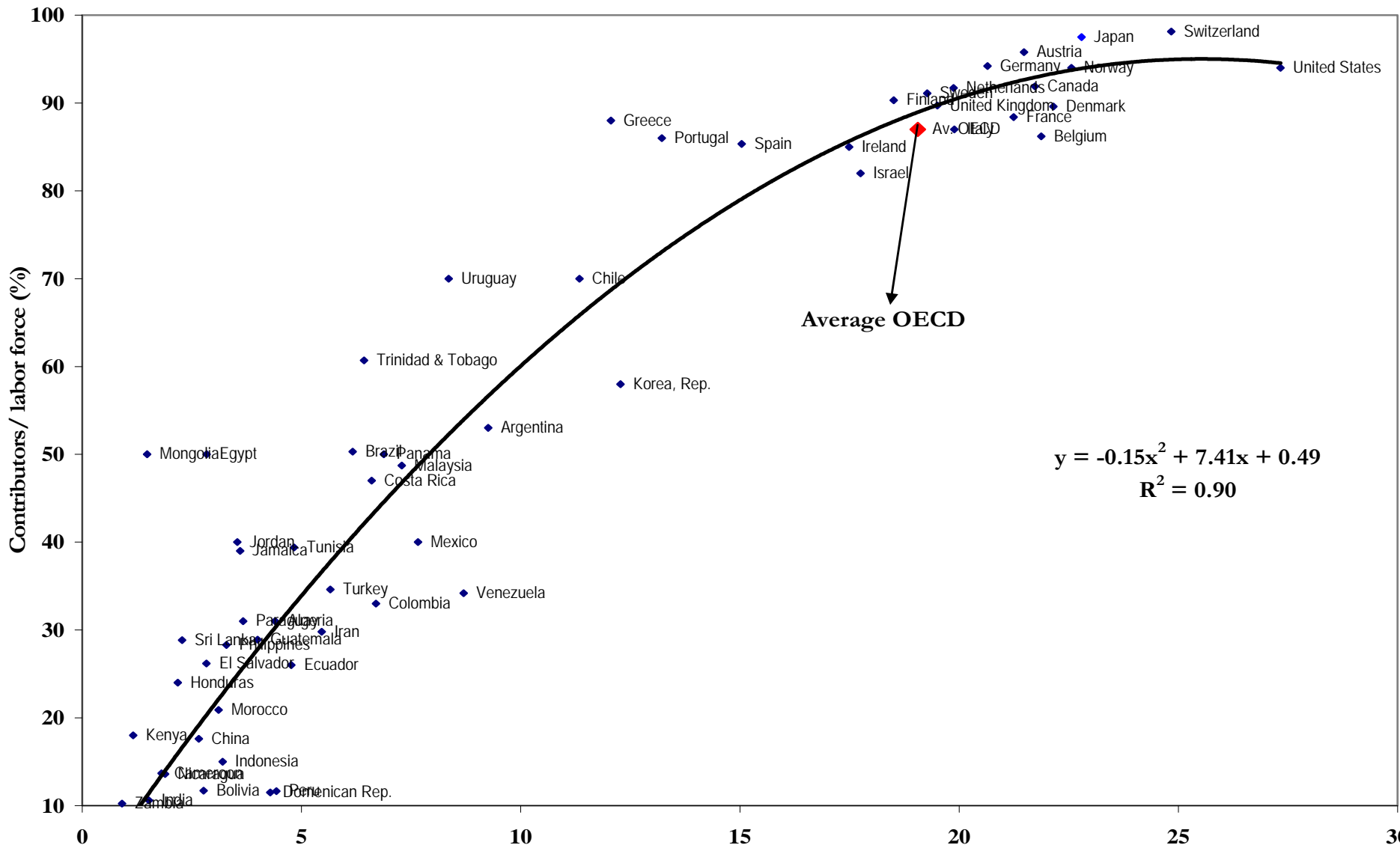


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# Background and Motivation

- Social policy concerns about low and stagnating coverage of pensions (and other key social) programs in LICs and MICs
- Economic concerns about high and at times rising level of informality and perceived negative effects of other options.
- Fiscal concerns about the costs of coverage expansion and sustained informality
- Expectations about better outcomes from MDC approach fostered by theoretical and empirical insights, and country pilots
- Yet there is little consolidated knowledge to provide substantiated policy guidance

# Variation in Coverage and Correlation with Per-Capita Income



# Structure

- I. Objectives, Definitions, and Modalities
- II. Role of MDC Approach Under Main Reform Scenarios
- III. Conceptual Issues for Investigation

# I. Objectives, Definition, Modalities

## ■ Key objectives:

- Increase basic and/or supplemental coverage of population against key risks (in particular old age and health)
- Do not contribute to, better reduce incentives for informal sector participation (i.e. not participating in mandated social insurance schemes)
- Fiscal efficiency: Ex-ante transfers hoped to be fiscally more efficient compared to universal and means-tested (ex-post) transfers

# MDC Definition Elements

- Contribution based scheme
- Direct financial contributions by employer and/or government to encourage individuals' scheme participation (in contrast to indirect expenditure/tax incentives)
- Encouragement for system participation may include major elements of "nudging" et al
- Schemes be funded or unfunded (typically funded and DC type for pensions and unfunded and basic package type for health)

# Envisaged Mechanism

- External contribution to overcome non-participation decision due to, e.g.
  - High discount rate
  - Liquidity constraints, etc
- Nudging elements to overcome bounded rationality through, e.g.
  - Default options
  - Peer pressure
- Nonparticipation decisions in mandated scheme due to high tax element, lacking credibility, etc should be directly addressed?

# Modalities (examples pension)

- Pure matching contribution, say 1:1
- Means tested matching contribution with taper
- Matching contribution (ex-ante transfer) plus conditional minimum pension guarantee (ex-post transfer)
- Yearly pension capital transfer and withdrawal conditional on non-contribution by individual



## II. Role of MDC Approach Under Key Reform Scenarios

1. Supplementing universal (basic or means-tested) benefits
2. Supplementing (reduced) earnings-related mandated benefits
3. Coverage expansion within the mandated SI scheme
4. Coverage expansion outside mandated SI schemes – universal approach
5. Coverage expansion outside mandated SI schemes – sector/group specific approach

# 1. Supplementing Universal Benefits

- Done in countries like
  - New Zealand (demogrant): KiwiSaver
  - [Australia (means tested): mandated]
  - [South Africa (means-tested): voluntary and tax privileged]
- Could become more important if SL convinces LAC (et al) to get universal:
  - As supplement to basic provisions
  - As means to address the transition problem

## 2. Supplementing (Reduced) Public Earnings-related Benefits

- Done in many countries, e.g.
  - USA (401k): employer matched
  - Italy & Korea: reformed severance pay
  - Germany (Rister pensions): budget
  - Czech Republic: budget
- Likely to gain importance as public generosity is being reduced and tax incentive questioned for reasons of effectiveness and equity

### 3. Coverage expansion within mandated SI schemes

- Done in a few countries, e.g.
  - Mexico (quota social, 1 peso inflation adjusted): budget financed
  - Columbia (2pp of CR distributed flat rate): contribution financed
- Key aspect is to make mandated scheme more interesting to lower income groups in countries with moderate contribution density

## 4. Coverage expansion outside mandated SI schemes – universal approach

- Done in few countries, e.g.
  - India (informal sector workers joining national New Pension Scheme mandated for civil servants): annual budget contribution of 1,000 RS (US\$ 25)
- Relevant for low coverage countries with matching toward future unified system
- Key question: Vision of future joint system and transition toward, and exit strategy

## 5. Coverage expansion outside mandated SI schemes – group-specific approach

- Done in few countries, e.g.
  - China (rural, soon urban area pension pilots)
  - Tunisia, Capo Verde (plans for fisherman, etc)
- Key questions:
  - Vision of future joint system and transition toward
  - Impact on mandated system/level of formality

# III. Conceptual Issues for Investigation

- Understanding the trade-offs between coverage expansion, informality impact and fiscal costs
- MDC design and parameter selection
- Using lessons from behavior economics to support MDC design
- What is the enabling environment needed for (unfunded and unfunded) MDC
- How to implement targeting in MDC schemes