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Mongolia: Policy Options for Pension Reform

The World Bank recently completed an evaluation of the pension insurance scheme and social pension provisions and needs for reform in the light of rapid demographic and socio-economic changes. The report, ***Mongolia: Policy Options for Pension Reform (2012),*** was prepared to assist the authorities to make informed policy reform decisions by evaluating the benefits and financial costs of current pension provisions and of different reform options. Key motivations for pension reform include:

i) Reforms are needed to prevent a severe reduction in the levels of income replacement for new retirees in 2015 (women) and 2020 (men).

ii) The state subsidy for pensions and social insurance (about 2.5% of GDP) is projected to increase substantially over time under current policies as the proportion of elderly increase amongst other factors including relatively low retirement ages and contribution rates relative to benefits provided.

iii) Coverage of the elderly by pension insurance will decrease and benefits for most herders and the informal sector are likely to be low because of limited participation in the pension insurance scheme and gaps in provision of pension benefits. This may contribute to income inequality among the elderly.

International best practice suggests that in reforming pension systems, policy makers need to focus on key design parameters including:

- The targeted level of income replacement in retirement;
- The contribution rate of employers and employees to achieve such income replacement;
- The expected and fiscally affordable level of subsidy by the Government; and
- The length of the work-life and the average period of retirement as a result of the retirement age for benefit eligibility.

The report outlines a possible three tier approach to old age income protection in Mongolia which has been consistent with the Government's approach. This approach could ensure basic income protection for all elderly, provide a strengthened contributory pension insurance benefits to smooth consumption from worklife into retirement and elaborate a framework to provide additional opportunities for pension savings for those willing and able to save more during their working lives.

The analysis suggests that it would be useful to consider the following policy options:

(i) Establishing a non-contributory *targeted social pension* that would use public resources to provide minimum subsistence income supplements to retirees in the bottom half of the income distribution;

(ii) Reforming key parameters of the pension insurance scheme (such as the retirement age, contribution rate and annuity factor) while replacing the minimum pension with the *targeted social pension* above;

(iii) Establishing a stronger legal framework and oversight for private voluntary individual and occupational savings arrangements;

(iv) Strengthening the incentives for herders and the informal sector to save for pensions either through mandatory or subsidized voluntary arrangements; and

(v) Establishing a financing plan and potentially pre-financing some of the costs of transition to put in place the above reforms and avoid dramatic changes in benefits between cohorts.

The report evaluated four different design options (currently under consideration by the authorities) for post-1960 cohorts in the pension insurance scheme concluding that parameters such as the contribution rate, accrual rate, and retirement age had much more substantial impact on pension system costs and benefits than the scheme designs themselves. The report suggested that the option of modifying the current Notional Defined Contribution (NDC) scheme offers some advantages when compared with reinstating a defined-benefit scheme for post-1960 cohorts. An option considered by some officials to establish a Funded Defined-Contribution (FDC) scheme was found to present financial risks and institutional challenges which appear to outweigh the potential returns. Sufficient depth, regulatory infrastructure, contestability and other enabling conditions to support such an arrangement do not exist in the domestic financial markets in Mongolia at this point and may not for some time. Utilization of international markets for investment of reserve accumulations still presents substantial challenges and risks given Mongolia's legal, regulatory and supervisory structure.

The report also evaluated options for improving future retirement incomes of herders and those in the informal sector and suggested several measures, including replacement of existing minimum pension and social welfare pension provisions with a Targeted Social Pension. Other measures suggested include: (a) establishing regulated voluntary individual retirement savings arrangements in accordance with the development of supplementary voluntary pensions savings; (b) elaborating a plan for matching defined contributions for post-1960 cohorts participating in regulated voluntary savings arrangements; and (c) elaborating a plan for introduction of mandatory contributions to the largest herders, self-employed and informal sector workers. All of these measures will require additional consideration and analysis to operationalize the concepts into operable programs, rules and supporting institutions.

Earmarking a portion of mining royalties to finance a Pension Reserve Fund can provide one instrument to manage natural resource revenues as part of a more consistent policy and governance framework. At the same time, such a Fund can earmark resources to address the short- and medium-term challenges identified by financing a well-considered pension reform policy transition process.