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FUNDED PENSION SCHEMES FOR GOVERNMENT WORKERS: PROPOSAL FOR STUDY

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Objective and scope

1. This document proposes a worldwide survey on pension funds for government employees. This category includes pension schemes designed to cover workers employed by central, provincial or local governments, state-owned companies, uniformed public services (e.g. militaries, police and fire fighters). The aim is to develop an international comparative analysis focusing on the governance structure, investments, funding rules, disclosure and specific regulations applied to these funds. The analysis will consider both the regulatory environment governing these funds and their operational experience.

2. Generally, these pension funds are organised as occupational or provident schemes for civil servants. They can be established either as private or public institution, with internal or private asset management. Many of these funds have been established as defined benefit plans, but there is a trend towards moving to defined contribution or hybrid arrangements.

3. The key analytical difference between these funds and the corporate private pension funds is the presence of the government (and thus of the taxpayers) as plan sponsor, which has important implications for the governance structure, investments practices, funding rules and disclosure policies to stakeholders. Specific government-related agency risks and problems that could arise with respect to these funds differ from those frequently analysed in the private sector.

4. The proposed study will look at ways in which government workers pension funds are structured and governed. Of particular interest is the institutional relationship between the funds and government in this context. How is the investment management process designed? How are the fund assets invested and what has been the typical investment performance? What risks do participants and plan sponsors (and hence taxpayers) bear? What role do these funds play in corporate governance? Are these funds subject to an external regulatory framework and supervision? How do they disclose information? The study will seek to address these questions by analysing the main features of these schemes, with a view toward identifying good practices in this field.

5. The proposed survey will examine selected national, state and local experiences from OECD and non-OECD countries, including Australia, Canada, Costa Rica, Hong Kong, India, Japan, Korea, Philippines, Malaysia, the Netherlands, Norway, Singapore, Sweden, Switzerland, South Africa, Thailand, Taiwan, the United Kingdom and the United States. Several different types of funds will be examined, including occupational privately managed and public funds, and provident funds, that support defined benefit, defined contribution or hybrid regimes. The sample will not include either the public centralised pension funds created to pre-fund general basic schemes (e.g. the Canadian Pension Investment Board and the Korean National Pension Fund), or non-specific personal savings arrangements (e.g. Hungary and Poland). Initially, some few selected and volunteered countries and pension funds will be analysed and afterwards the study will be extended to a broader group, pending on resources availability.

6. The project represents the continuation of the work developed by the OECD Secretariat in the document entitled "Issues concerning occupational schemes for civil servants and other public sector workers". That paper discussed issues regarding the integration and/or coordination of the civil service pension system with the general schemes, the transition from pay-as-you-go (PAYG) to funded schemes and issues related to the regulation of defined contribution and defined benefit plans for government workers. It was noted that these types of schemes operate in what amounts to a "standard-setting limbo", as private sector standards, regulatory framework and supervision are not necessarily applied to them and there is a lack of research and discussion at the national and international level regarding this issue.

7. The afore-mentioned document highlighted that the Working Party on Private Pension (WPPP) may wish to better understand the particularities of government employees' schemes and possibly develop further work in this area, which could include specific recommendations for regulation and supervision on these schemes, based on variations of the principles and standards for private pension funds.

8. The current proposal is also related to the activities carried out by the WPPP on governance, funding, investment regulations and financial education. The study will draw on this previous work to apply the specific elements that are relevant for government workers pension funds. The survey results will be useful as a complement and extension of the research already undertaken in these areas, providing a more comprehensive approach to the overall activities developed within the working party.

9. The survey will be conducted based on quantitative and qualitative information collected by questionnaire, analyses of the regulations and of the pension funds' organisational structure and analysis of the pension funds' annual reports and other disclosed information. It will also collect relevant statistics of government workers pension funds in co-ordination with the OECD Task Force on Pension Statistics (TFPS), supporting the development of a comprehensive system of international pension statistics, gathered from primary sources, under consistent statistical concepts, definitions and methodologies.

Why investigate government workers pension funds?

10. The top 5 world pension funds in terms of assets are dedicated to government workers. Among the 20 world's largest pension funds, 13 cover public sector employees accounting for 76.5 per cent of the accumulated assets (see Table 1). Three of these are centralised public funds that are not covered by this study (in Singapore, Malaysia, and Norway). In most of the countries where civil servants are covered by funded schemes, their pension funds are the largest in terms of assets and number of participants. Generally, these funds are not subjected to national pension regulation and are supervised under a distinct institutional framework.

Table 1: 20 World's Largest Pension Funds – 2002

Ranking	Pension Fund	Country	Assets (€ billion)
1	California Public Employee's Retirement Systems	USA	152.2
2	ABP	Netherlands	135.6
3	California Teachers' Retirement System	USA	115.4
4	Federal Thrift Savings Plan	USA	113.6
5	Florida State Board of Administration	USA	109.7
6	General Motors	USA	101.4
7	New York City Retirement Systems	USA	96.8
8	Norwegian Government Petroleum Fund	Norway	85
9	New Jersey Division of Investments	USA	84
10	Verizon Investment Management Corporation	USA	83.6
11	National Public Service Mutual Association	Japan	79.3
12	General Electric	USA	77.7
13	Boeing	USA	72.6
14	IBM	USA	67.7
15	Central Provident Fund	Singapore	63.5
16	Employees Provident Fund	Malaysia	61.4
17	Wisconsin Investment Board	USA	58.2
18	Michigan Department of Treasure	USA	58.1
19	Georgia Division of Investment Services	USA	57.8
20	Lucent Technologies	USA	56.1

TOTAL		**1729.7**

Source: Investment and Pensions (2003). "*International Pension Funds and their Advisors 2003.*" ASPIRE Publications LTD, London.

11. The significance of the government workers pension funds is explained, in part, by the fact that governments are often the largest single employer at national or local level and thus preside over larger funds. Indeed, in 2000, the average share of the public employment over the labour force was 13.8% among OECD countries, and in countries such as Denmark and Finland the proportion reached 20%.[1] Nonetheless, recent trends show that public sector employees in OECD countries are ageing. In the Netherlands, for instance, the ratio of civil servants older than 50 years old increased from 15.2 in 1993 to 27.7 in 2000.[2] Additionally, since 1990, most OECD countries have either had stagnation or decrease in the number of civil servants. For example, between 1991 and 2000, Germany and Spain reduced the number of federal public employees in 2.9 and 2.3 per cent, respectively, per year. These facts are stressing the public sector pension system, specially the PAYG and defined benefit schemes.

12. A second factor favouring the large size of public workers' funds is the fact that governments have more instruments at their disposal to address potential solvency problems and ensure the financial stability of a pension fund. Frequently, taxpayers and the population as a whole are invited to share the sponsor's responsibilities through increases in taxes, issuance of public debt or reduction in public expenditures in other areas, from which resources are reallocated to finance eventual unfunded liabilities. For example, during the privatisation of state-owned companies in Brazil throughout the 1990s, a significant part of the revenues collected from the sales were channelled to finance the liabilities of the occupational pension schemes sponsored by these firms.

13. Finally, a third factor explaining the relatively larger size of these funds is the fact that, in many cases, the government workers' pension funds were among the earliest ones to be established. For example, in the Netherlands, the Pension Fund for Government and Education Authorities – ABP was created in 1922, and the California Public Employee's Retirement Systems (CALPERS) was established in 1939 and is currently covering several jurisdictions as service provider and investment manager.

14. Generally, government workers pension funds are locally regulated and supervised, but often are global players. International and national financial markets are sometimes strongly influenced by their institutional investment decisions, taken according to their specific, although not always very well understood, governance structures. Moreover, their relatively large sizes imply substantial and broader interactions with banks, insurance companies and mortgage and credit markets. In some cases (e.g. the Netherlands), government pension funds control subsidiaries and affiliated companies operating as financial conglomerates.

15. They also have huge investments in corporations and, in some cases, they hold the management control or participate in the management boards of these companies. Given the State's responsibilities as plan sponsor, fiscal accounts are also quite vulnerable to their performance and results. Eventual funding or investment problems in some of the largest pension funds might provoke worldwide financial, fiscal and economic turmoils. Despite this relevance, there are relatively few analytical and descriptive studies addressing the particularities of the public workers pension schemes at an international level. This proposed study is intended to fill part of the knowledge gap in the area.

[1] See OECD (2002). *"OECD Labour Force Statistics, 2002".* Paris; and

OECD (2002). *"OECD Public Management Service*, 2002". Paris.

[2] See document PUMA/HRM (2002)7 *"Highlights of the Public Sector Pay and Employment Trends: 2002 Update",* Paris.

Characterising specific regimes for civil servants throughout the world

16. In most countries, government workers were the first category covered by social security schemes. Some European pre-Bismarck pension schemes for civil servants, which were mostly based on earnings-related arrangements, date back to the beginning of the 19th century and were created as a reward for the length of service dedicated to the State.

17. Throughout the 20th century, despite the gradual broadening of social insurance policies and the development of national pension schemes, separate and comparatively more generous subsystems were maintained for civil servants in several countries. The degree of separation and generosity is currently explained by the special labour conditions prevailing in the public sector employment. Traditionally, the human resources management policies governing civil servants have been designed to stimulate longer careers and loyalty. Salaries have rarely been fully linked to productivity, as is the case (in theory at least) in the private sector. Generally, compensation has tended to increase gradually on a scale basis according to years of service, merit-related mechanisms and budget constraints. In this context, the relatively more generous retirement scheme has been expected to function as an incentive to employment in the public sector.

18. Nevertheless, in the past few years, there has been a trend towards unification and coordination of rules for both private and public sector workers schemes, with the introduction of some pre-funding or fully funded complementary pension schemes. This process has been driven mainly by the necessity to alleviate the fiscal burden imposed by relatively generous public employees' pension schemes and to build more equitable and financially sustainable social protection networks.

19. Table 2 provides a preliminary classification of selected countries in four groups, according to the degree of institutional integration of the civil servants pension schemes into the general social security and complementary pension systems.

Table 2: Civil Servants Pension Schemes in the Selected Countries

GROUP 1 Separated unfunded scheme	GROUP 2 Separated funded or partially funded scheme	GROUP 3 General national basic scheme + specific complementary occupational pension fund	GROUP 4 General national basic scheme + general complementary pension fund
Argentina (some provinces) Austria China Colombia Brazil Belgium France Germany Greece Ireland Kenya Luxemburg Mexico Portugal	Korea Italy India Hong Kong Indonesia Jordan Malaysia Namibia Philippines Spain Singapore Thailand Taiwan United States (some states' schemes)	Australia Canada Costa Rica Denmark Finland Iceland Japan Netherlands Norway Sweden Switzerland United States (Federal Workers and some states' schemes) United Kingdom	Argentina (federal and some provinces) Chile Czech Republic Hungary Poland Uruguay

Peru Turkey	Uganda		

20. The OECD countries belonging to the first group include Austria, Belgium, France, Germany, Greece, Ireland, Luxemburg, Mexico, Portugal and Turkey. These countries have a completely separate earnings-based PAYG scheme for civil servants. Generally, the systems are comparatively generous for those servants, but initiatives are being undertaken to homogenise rules and provide incentives for private retirement savings. For example, France approved in July 2003 a reform intended to change the retirement age and benefit calculations in order to introduce more flexibility, discourage early retirement and coordinate public and private sector rules. Simultaneously, this reform established a new private pension savings plan based either on individual or collective affiliation to personal or occupational pension funds with tax exempt contributions mechanisms.

21. Mexico, back in 1997, introduced a radical reform of its general regime, replacing the PAYG system with a fully funded scheme managed by the private pension funds administrators called *Administradoras de Fondos de Retiros* (AFORES). However, civil servants were not included in the reform, and they retain a quite generous regime without a retirement age limit, with high replacement rates and health care provision, carried out at the federal level, by the *Instituto de Seguridad Social y Salud de los Trabajadores del Estado - ISSSTE*. At the state level, there are several other pension schemes for state workers and universities, most of which are facing financial problems. The overall system presents two serious drawbacks: first, the existing rules tend to reduce transparency and produce cross-subsidies among workers; and second, the operation of numerous institutions reduces economies of scale and scope, thereby increasing administrative costs and inefficiency. Moreover, there is no portability or vesting between the different public schemes or between public and private sector schemes.

22. Mexican authorities are studying the homogenisation of rules and the replacement of the public PAYG with a fully funded personal mandatory scheme. The main discussion is related to the financing of the transition costs and whether the civil servants will join the new AFORES or maintain a separated occupation scheme operated by ISSSTE, which could reduce administrative costs and political resistance.

23. The Irish government approved, in 1999, a pre-funding strategy for civil servants, creating the Public Service Pension Fund. According to the new arrangement, a portion of the national public accounts surplus (almost 1% of the GDP) is to be deposited annually in this fund for a period of 55 years.

24. Pension reform for civil servants schemes is also currently being discussed in Brazil. There, the government's proposal combines a comprehensive adjustment in the current PAYG system (retirees' contribution, retirement age increase, replacement rates reduction and benefits cap) with the introduction of complementary funded pension schemes. For future workers, the civil servants pension scheme will be quite similar to the private workers' system.

25. In the second group, Korea, Italy, Spain and some US states maintain fully funded or partially funded separated schemes for civil servants. In the United States, the employees' pension funds of the states of California, Florida, New Jersey, Georgia, Wisconsin and the New York City are among the largest in the world. Most of them are defined benefit plans and are not subjected to federal regulations regarding governance, investments and funding. A recent survey indicates that 25 per cent of all US public employees are not covered by the national scheme and, thus, their specific regimes provide basic and complementary benefits.[3] In Spain, there is a traditional complementary scheme called "*mutualidades*". The schemes are treated as life insurance companies and are subject to local regulation and are supervised

[3] See Mitchell, O (2002). *"Redesigning Public Sector Pensions in Developing Countries*". Pension Research Council Working Paper 2002-9. University of Pennsylvania, Pennsylvania.

by regional bodies. In the Basque Country and Catalonia most public sector workers are affiliated with one of these schemes.

26. In India, the Employees' Provident Fund is the world's largest pension fund in terms of number of participants, covering over 20 million civil servants. Recent reforms introduced a portable DC scheme for new entrants, with government contribution matching the employees' contribution. The new system is expected to start operations in the beginning of 2004.

27. In the third group, civil servants participate in a general basic scheme and have specific complementary pension plans. In Canada, most government workers contribute to the basic retirement fund (Canadian Pension Plan or Quebec Pension Plan) and have complementary specific funded regimes. Actually, in Canada, 8 of the top 10 largest pension funds are for government workers and 95 per cent of the total membership is in defined benefit plans.[4]

28. Similarly, in the mid-80's, the US government introduced a new pension system for federal government workers that entered into public service after the reform. Post-1984 entrants are covered by the general scheme (Old-Age, Survivor and Disability Insurance – OASDI) and, in addition, by a defined benefit scheme and a defined contribution plan. This reform was adopted by some states that also integrated the basic component of their schemes into the OASDI and develop complementary regimes.

29. In Japan, civil servants are also integrated in the basic partially funded PAYG scheme (step-up contribution system) and, complementarily, contribute to the National Public Service Mutual Association. In Australia and the UK, workers receive the basic pension from the general system, but there are different rules for the complementary scheme. While Australian private workers are covered exclusively by defined contribution plans, the Australian Commonwealth Government Retirement Scheme and some State's schemes (e.g. New South Wales) adopt hybrid arrangements.

30. Denmark, the Netherlands and Finland have segmented funds for civil servants, but the rules are the same as for private sector funds. In the 1950s the Danish civil servants moved from a non-contributory employer sponsored defined benefit arrangement to a defined contribution schemes based on collective agreements. By contrast, the Dutch government workers scheme is managed by a unified pension fund that covers central provincial and municipal employees, police and the judiciary, defence, water, school, cultural and other public agency workers.

31. The fourth group includes countries that undertook structural pension reforms during the 80's and 90's, introducing mandatory private personal funded arrangements for the entire working population. In Latin America, the Chilean pension reform unified 32 different social security institutions and over 100 pension programmes with distinct contribution rates, benefit formulas, eligibility conditions and pension readjustment criteria. Colombia, Mexico and Peru introduced mandatory fully funded pension, but only for private sector workers. Public servants are still covered by a more generous regime. Argentina's pension reform has not affected some provinces that were not integrated into the new system. In Eastern European Countries, such as the Czech Republic, Hungary and Poland, the pension systems for civil servants and for private workers were completely merged with both the basic PAYG component and the second mandatory funded pillar.

32. The proposed survey will initially cover some selected countries classified in groups 2 and 3, where there are specific pension funds for government workers operating in a distinct regulatory and supervisory environment. Afterwards, the study will be extended to all countries listed in these groups.

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[4] See Pozzebon, S (2000). *"Canadian Public Sector Employees Pension Fund*". In Olivia Mitchell and Edwin Hustead (2000). "*Pension in the Public Sector"*. University of Pennsylvania Press, Pennsylvania.

Regulatory and operational issues

33. In most of the countries in these two above-mentioned categories, government workers' pension funds are predominantly defined benefit schemes, with eligibility and funding conditions defined in laws rather than in contracts, operated by public entities or a similar governing body and ruled by specific local regulations. In a few countries, such as the Netherlands and Denmark, the same rules are applied both to private and public workers.

34. The state and local governments' pension funds in the US are established and modified by law and do not need to comply with national provisions, except for tax qualification rules. US federal prudent person regulations are only used as a guide. For example, CALPERS developed its own governance philosophy based on US national regulations and on a broader international experience, including the OECD principles on corporate governance. The fund is playing an important role in the dissemination of these principles by its active monitoring of the over 1800 private corporations in which CALPERS holds its investments. The Dutch ABP is also applying OECD principles to provide guidance for its governance efforts. In the Ontario Municipal Employees' Retirement System (OMERS), employees are subject to a strict code of ethics, standards of professional conduct and conflict of interest policies.

35. The governance structure in these types of pension funds must be adapted to the participation of the government (and hence tax payers) as employer and plan sponsor. The government is a complex employer financed by tax payers, who eventually bear the burden of the any potential unfunded liabilities. Moreover, with public employees' pension funds, besides the traditional principal-agent problems related to self-interest, self-dealing and corruption, there are additional risks associated with the political manipulation of the investments.[5] In this context, the governance structure should be designed both to avoid future transfers of liabilities to tax payers and to prevent the use of the fund resources to politically-targeted objectives that could reduce long-run returns.

36. In order to address these issues and identify good practices regarding the design of appropriated governance structures, the study will analyse the composition of the boards, the criteria used to nominate (and terminate) trustees, incentives for the performance of investment managers and other officials, and conflicts of interest provisions. The survey will also analyse how the governance of pension funds managed by public entities may be influenced by operational constraints imposed on public administration related to the management flexibility, capacity to pay competitive salaries and attract good professionals.

37. Governmental workers pension funds are also often required to, directly or indirectly, finance the government. In India, a minimum of 80 per cent of the Employees' Provident Fund assets must be invested in public bonds, which are, in some cases, non tradable. In other cases, they have more restricted assets allocation regulations. Some investment boards are subjected to maximum limits or can only buy equities above certain rating classification, what constraints their investment strategies and reduces their capacity to optimise the portfolio allocation, maximizing the returns and minimising risks.

38. There have been a number of cases in which pension funds have been mandated to make economically-targeted investments according to the government's political priorities. In Korea and Japan, government workers' funds have been oriented to finance hospitals, housing and infrastructure and welfare projects. Throughout the 1960s and 1970s, the Swedish government used pension fund reserves to expand housing

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[5] See Hess, D and Impavido, G (2003). *"Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence*". World Bank Policy Research Working Paper 3113, World Bank, Washington.

opportunities.[6] During the same period, in Brazil, the public pension funds' reserves were consumed in development-oriented investments. Some empirical evidence for the US shows that public pension funds that had been required to make a certain portion of in-state investments generated lower investment returns compared with otherwise funds.[7] Popular measures such as extending personal loans for housing, education, health provision, subsidies to mortgage markets can bring short-term relief to participants, but may generate future liabilities to taxpayers. In order to address these concerns, this study the will investigate the process of deciding, implementing and managing the investments of the public employees pension funds.

39. Regarding the funding issues, in contrast to arrangements in the private workers funds where the main funding parameters are contracted between the parties concerned, in the case of government workers schemes, they are generally established and modified by law or, in extreme situations, by constitutional amendments. As an example, the current Brazilian pension reform proposal includes a legal provision prohibiting schemes other than defined contribution for civil servants. When the pension plan's entitlements benefit formula, contributions, actuarial and accounting standards are set by law, the ability of the policy-makers (or trustees) to adjust the plans according to the funding requirements may be constrained by political forces.

40. Additionally, the legislative process can generate mismanagement or unfunded liabilities, as some groups may promote changes that are not necessarily financially and actuarially sustainable. In the political arena, the collective action might benefits well-organised minorities at the expenses of the non-organised majority of tax payers. This process is reinforced by the lack of transparency and limited financial education.

41. In the private sector, any unfunded liabilities are part of the sponsor's balance sheet, whereas in the case of governments' pension funds in some countries, they are rarely measured because the available records are not sufficiently reliable. And, when measured, they do not appear in the public sector accounts as a contingent liability. Regarding these issues, the proposed survey will collect information to characterise the funding and accounting parameters relevant to government pension funds and compare with those used by the private sector.

42. Disclosure and financial education are extremely important to these types of plans in order to avoid political misuse of the reserves and creation of unfunded liabilities that may be borne by tax-payers. This argument is reflected in potential controversies and problems that usually arise when public agencies are supervised by another public entity. Some authors report that this is the major problem with government workers' provident funds in Southeast Asia (e.g. Indonesia, Malaysia and Singapore).[8]

43. Specific financial literacy strategies need to be designed to convince and orient tax payers who are not directly involved in pension fund management to take steps to ensure that the fund managers do not act in a way that is contrary to the best interests of the plan members and beneficiaries. Public awareness and understanding may induce better discipline and good communication mechanisms shall improve organisational performance. Good public accountability, transparency and financial literacy should promote stakeholders' participation filling eventual supervisory gaps that may arise in the government

[6] See Iglesias, A and Palacios, R (2000). *"Managing Public Pension Reserves Part I: Evidences from International Experience".* Primer Pension Reform. World Bank, Washington.

[7] See Mitchell, O and Hsin PL (1994). *"Public Pension Fund Governance and Performance".* NBER Working Paper 4632, Cambridge.

[8] See Asher, M (2003). *"Governance and Investment of Provident and Pension Funds: The Case of Singapore and India".* Presentation prepared for the Second Public Pension Fund Management Conference, World Bank, Washington, May 5-7, 2003.

workers' pension funds. In some cases, audit and annual reports are not enough to pursue participation and a broader communication policy is necessary. In this sense, the proposed survey will analyse what and how information is disclosed, what are the accountability avenues and how the communication process operates.