

The ILO Multi-Pillar pension model: Building equitable and sustainable pension systems

Social Protection for All Issue Brief



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This policy brief aims to provide a set of principles, concepts, tools and orientations for designing and reforming pension systems, in accordance with ILO principles and international best practice.

Introduction

Since its foundation in 1919, the ILO has played a key role in the global development of social security systems, including pension systems. The ILO's contribution in the field covers three main areas.

First, over almost 100 years, the ILO has developed a set of normative instruments related to social security systems, embodied in International Conventions and Recommendations covering all areas of social security, including pension systems. These standards are agreed collectively by governments, employers and workers, and constitute a guide in terms of principles both for policy design and implementation of social security systems. At the global level, the majority of countries with the most advanced social security systems as well as countries with developing systems have ratified and adopted ILO conventions and recommendations on social security. This reflects the critical importance of the standards in designing and reforming pension systems.

Second, the ILO has played a leading role in the development of quantitative, actuarial, financial and economic instruments for the assessment of pension systems. The ILO methodological framework is accepted as a best practice virtually everywhere.

The third area of ILO contribution to the development of pension systems relates to the continued provision of technical advisory services. A majority of pension systems around the world have been designed with the technical assistance provided by the ILO. A

fundamental characteristic of the ILO is its commitment to support countries in their efforts to build systems through social dialogue. This is a differentiating element of the ILO's work in comparison with other international organizations.

Today, public pension systems exist virtually in all countries. Their main objective is to ensure income security for older persons, preventing poverty and reducing inequality in old-age. In many countries, the right to social security is enshrined in national legislation and in the Constitution – it is a right for all citizens. Countries aim to provide universal pension coverage at adequate benefit levels. This is normally achieved by a public system that comprises contributory and non-contributory pensions, as recognised in the Social Protection Floors Recommendation No. 202, adopted unanimously in 2012 by governments, and workers' and employers' organizations. Universal social protection for older persons is part of the Sustainable Development Goals (SDG) and the UN 2030 Agenda, in particular SDG 1.3 which calls for the implementation of national social protection systems for all, including floors, with special attention to the poor and the vulnerable.

ILO principles as a starting point for designing and reforming pension systems

An international consensus has been forged by governments, and employers' and workers' organizations on the objectives, functions and appropriate design principles of pension systems. These are embodied in the International social security standards.

Principle 1. Universality. Social security is a human right, which in practical terms is understood as the

need to guarantee universal protection without leaving anyone behind. The principle of universality is enshrined in the ILO's Constitution and its body of standards, as well as in several UN instruments, including the Universal Declaration of Human Rights, which states in its article 22 that *"everyone, as a member of society, has the right to social security."*

Principle 2. Social solidarity and collective financing.

Social solidarity and solidarity in financing are at the heart of social security and, hence, of ILO's standards and action. Contrary to privately operated pension schemes based on individual savings accounts, collectively financed protection mechanisms generate positive redistribution effects and do not transfer the financial and labour market risks onto individuals

Principle 3. Adequacy and predictability of benefits.

This principle refers to the entitlement to defined pension benefits prescribed by law. The Social Security (Minimum Standards) Convention, 1952 (No.102) and the Invalidity, Old-Age and Survivors' Benefits Convention, 1967 (No. 128) envisage the provision of income security to people who have reached pensionable age through: (i) earnings-related contributory pensions (guaranteeing minimum benefit levels, or replacement rates corresponding to a prescribed proportion of an individual's past earnings – in particular for those with lower earnings); and/or (ii) flat-rate pensions (mostly residency-based and financed by the general budget) and/or means-tested pensions. These standards prescribe that earnings-related schemes, for example, need to provide periodic payments of at least 40 per cent (Convention No. 102) or 45 per cent (Convention No. 128) of the reference wage after 30 years of contribution or employment. These standards also require that pensions need to be periodically adjusted following substantial changes in the cost of living and/or the general level of earnings.

Principle 4: Overall and primary responsibility of the State. It refers to the obligation of the State, as the overall guarantor for social protection, to ensure the "financial, fiscal and economic sustainability" of the

national social protection system "with due regard to social justice and equity" by collecting and allocating the needed resources with a view to effectively delivering the protection guaranteed by national law (Recommendation No. 202).

Principle 5: Non-discrimination, gender equality and responsiveness to special needs.

With a view to secure gender equality, pension designs should duly take into account solidarity between men and women, by adopting financing mechanisms, eligibility conditions and benefit conditions that offset gender inequalities originating in the labour market or due to interruption in the careers of women arising from their reproductive roles and/or care responsibilities (Recommendation No. 202).

Principle 6: Financial, fiscal and economic sustainability.

Sustainability refers to the current and future capacity of the economy to bear the costs of social security. Ensuring the sustainability is a permanent challenge for the State in exercising its overall and primary responsibility to guarantee a functional and comprehensive social protection system. This requires taking all necessary measures, including realizing periodically the necessary actuarial studies and introducing as required minor parametric reforms to ensure the sustainability of the pension system. According to Recommendation No. 202, the State is also accountable to ensure the sustainability of national social security systems in view of, among other factors, demographic change.

Principle 7: Transparent and sound financial management and administration.

The principle refers to the need for good governance of the system, particularly with respect to financing, management and administration, to ensure compliance with the legal and regulatory frameworks (Convention No. 102 and Recommendation No. 202).

Principle 8. Involvement of social partners and consultations with other stakeholders.

The principle recognises the need to ensure social dialogue and representation of protected persons in social

security governance bodies. The principle of participatory management of social security systems has been since long established in international social security standards, namely in Article 72(1) of Convention No. 102, which stipulates that “where the administration is not entrusted to an institution regulated by the public authorities or to a government department responsible to a legislature, representatives of the persons protected shall participate in the management, or be associated therewith in a consultative capacity, under prescribed conditions; national laws or regulations may likewise decide as to the participation of representatives of employers and of the public authorities”.

Main functions of pension systems

Throughout the history of social security, public pension schemes have proved to be the most effective instrument to ensure income security for older persons, preventing poverty and reducing inequality. Indeed, social insurance pension schemes supplemented by tax-financed provisions if necessary, are best to ensure adequate benefit levels and to

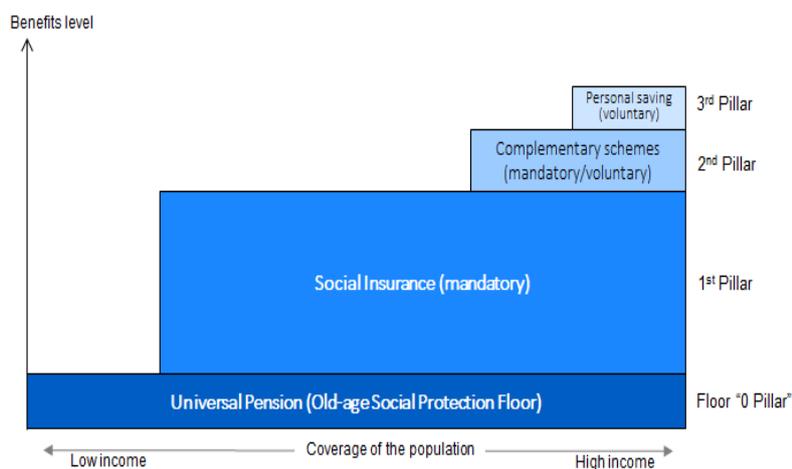
smooth consumption across a person’s life, generally through employers’ and workers’ contributions and social and inter-generational solidarity.

Through pension systems, individuals are provided with an income (a regular periodical payment) when they have reached retirement age and are no longer earning a steady income. Pension systems differ around the world, but usually they are comprised of schemes for different categories of people, from basic social pensions for those with low income, to supplementary voluntary savings for those with higher incomes.

The ILO Multi-Pillar Pension Model

The main idea behind the concept of a Multi-Pillar Pension System is the possibility of combining a set of social protection instruments, each of which plays one or more functions, to guarantee the whole range of objectives of a national pension system.

The following diagram illustrates the main components of the multi-pillar model based on the ILO principles described in the previous section.



Pillar 0 or the Pension Floor. It is aimed at establishing a social protection floor for older persons. This pillar is usually provided through a non-contributory pension scheme. It is financed from the general budget (often tax-financed). Universality of coverage can be achieved through a universal non-contributory scheme or by a combination of social

insurance and a means-tested or pension-tested pension scheme. Regardless of the specific design of Pillar 0, it should guarantee a minimum level of income, with adequate levels of benefit, for a life in decency and dignity. The setting-up of a social protection floor for older persons represents one of the most important priorities in developing countries

with high levels of informality and poverty, and where the extension of contributory coverage is likely to take decades. Together with health protection, Pillar 0 should ensure at a minimum that all older persons in need have access to essential health care and to basic income security which together secure effective access to goods and services defined as necessary at the national level.

1st Pillar or Social Insurance Pillar. It follows the typical design of social security pension systems, defined-benefit and mandatory, financed through employer and worker contributions. Its objective is to provide higher levels of pension benefits in order to maintain the standard of living after retirement. It should provide at least a minimum pension at 40 per cent of pre-retirement insured income for 30 years of contributions, as well as a reduced/adjusted minimum benefit for those who have contributed for at least 15 years.

Sound general and financial governance, and the implementation of as necessary successive parametric reforms, are required to ensure its sustainability.

Pillars 0 and I represent the fundamental components of any social security pension system.

Countries are developing important innovations to adapt Pillar I to cover those who are not yet protected, including persons working in the informal economy, self-employed workers and workers in non-standard forms of employment.

2nd Pillar or Complementary Pillar. Not all countries need to have this pillar, it is a complementary contributory component, voluntary or mandatory,

employment-based occupational or non-occupational, defined-benefit or defined-contribution, usually financed by employer's contributions and privately managed, aimed at supplementing the pension benefits from the previous two pillars. Its operation requires a high level of commitment by the State, particularly with respect to proper regulation and supervision.

3rd Pillar or Voluntary Personal Savings Pillar. Pillar III is also complementary, comprised of a set of voluntary private pension schemes for those with the economic capacity to make additional personal savings, generally managed by private pension administrators under full market competition and government regulation.

International experience has shown that pension schemes based on individual accounts, such as those usually applied in the 2nd Pillar and 3rd Pillar, place many risks -macroeconomic, financial and demographic- on individuals and are unable to guarantee the principles of social security. Therefore, the ILO's policy is that such systems, while they may be adopted by countries to complement social security pensions set out in Pillars I and II, should in no way attempt to replace them.

To conclude, the multi-pillar pension model presented in this policy brief brings together, on the one hand, the social security principles agreed by governments, employers and workers and, on the other hand, the extensive practical experience and knowledge developed by the work of the ILO over several decades.

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