Universal Age Pensions

Larry Willmore
Strategies for the Extension of Social Protection
International Training Centre of the ILO
Turin, Italy, 29 November 2007
Traditional three pillars

1. Public pensions
2. Occupational pensions
3. Personal pensions
World Bank’s three pillars (1994)

1. Basic pension
2. Mandatory earnings-related pension
3. Voluntary saving
World Bank’s five pillars (2005)

0. Non-contributory basic pension
1. Public earnings-related pension
2. Private earnings-related pension
3. Occupational or personal pension
4. Other retirement savings, government services, informal support from family and community
“Extending coverage by requiring low income informal sector workers to contribute to social security would not be in the best interests of these workers …, even if the government had the capacity to enforce the mandate.”

Pillar 2 pension coverage in Chile

Year

% of labor force
0 10 20 30 40 50 60 70

Old System (collective PAYG)
New System (pre-funded individual accounts)
"The ability to retire in a degree of personal comfort, without worry and with dignity, is the least that citizens can expect in a modern, developed economy.... [I]t is also most they can expect. They cannot expect the state to maintain in retirement the incomes people became accustomed to during their working lives”

Dr. Michael Cullen, New Zealand’s Finance Minister, 13 June 2003.
Six types of Pillar 1 pensions

Contributory (2)

- Flat pension
- Minimum pension guarantee (or flat top-up) for Pillar 2 pensions

NB: These are excluded from the World Bank’s five-pillar system.
Six types of Pillar 1 pensions

Non-contributory (4)

- Universal NMT pension
- Residence-based pension
- Recovery-conditioned pension (*ex post* means test)
- Social assistance pension (*ex ante* means test)
Advantages of universal pensions

- Simple and easy to administer
- Automatic, 100% coverage
- Reach women and rural areas
- Do not stigmatize recipients
- Broad political support
- Avoid disincentive to save for old age
- Avoid disincentive to work in old age
The cost of universal pensions

\[ r = \text{ratio of eligible to total population} \]
\[ p = \text{ratio of pension to per capita GDP} \]
\[ y = \text{per capita GDP} \]
\[ t = \text{ratio of pension taxes to GDP} \]

\[ ty = \text{tax revenue per capita} \]
\[ rpy = \text{pension expenditure per capita} \]
The cost of universal pensions

Taxes = Expenditures

\[ ty = rpy \] \hspace{1cm} (1)

Solve for rate of tax:

\[ t = rp \] \hspace{1cm} (2)

Example: \( t = (0.1)(0.3) = 0.03 \) (3% of GDP)
Universal NMT pensions

1. New Zealand - 1940
2. Mauritius - 1958
3. Brunei - 1984
4. Namibia - 1990
5. Samoa - 1990
8. Bolivia - 1996
9. Mexico City - 2001
10. Kosovo - 2002
### Universal pensions: actual values for $p$ and $t$

<table>
<thead>
<tr>
<th>Country</th>
<th>$p = \text{pension/ y}$</th>
<th>$t = \text{taxes/ GDP}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Zealand (65)</td>
<td>35% – 46%</td>
<td>4.3% (gross) 3.6% (net)</td>
</tr>
<tr>
<td>Mauritius (60-100)</td>
<td>16% – 68%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Brunei (60)</td>
<td>10%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Namibia (60)</td>
<td>16%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Samoa (65)</td>
<td>9%</td>
<td>0.4%</td>
</tr>
</tbody>
</table>
Universal pensions: actual values for $p$ and $t$

<table>
<thead>
<tr>
<th>Location</th>
<th>$p$ (pension/y)</th>
<th>$t$ (taxes/GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nepal (75)</td>
<td>10%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Botswana (65)</td>
<td>10%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Bolivia (65)</td>
<td>26%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Mexico City (70)</td>
<td>5.5%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Kosovo (65)</td>
<td>50%</td>
<td>2.7%</td>
</tr>
</tbody>
</table>
Residence-based pensions
(age, basic pension as % of per capita GDP)

- Denmark (65, 21%) *
- Finland (65, 22%)
- Iceland (65, 9%) *
- Norway (67, 17%) *
- Sweden (65, 30%)
- Canada (65, 14%) *
- Netherlands (65, 39%)

* plus means-tested supplement
Recovery-conditioned pensions
(ex post means test)

- Denmark (65)
- Finland (65)
- Iceland (65)
- Norway (67-69)
- Sweden (65)
- Canada (65)
- United Kingdom (80)
- Chile (65)
Recovery-conditioned pensions *(ex post means test)*

<table>
<thead>
<tr>
<th>Country</th>
<th>Pension/y %</th>
<th>Recovery Rate %</th>
<th>Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>21%</td>
<td>31%</td>
<td>earnings</td>
</tr>
<tr>
<td>Finland</td>
<td>22%</td>
<td>50%</td>
<td>pension</td>
</tr>
<tr>
<td>Iceland</td>
<td>9%</td>
<td>30%</td>
<td>income</td>
</tr>
<tr>
<td>Norway</td>
<td>17%</td>
<td>40%</td>
<td>earnings</td>
</tr>
<tr>
<td>Sweden</td>
<td>30%</td>
<td>100%</td>
<td>pension</td>
</tr>
<tr>
<td>Canada</td>
<td>14%</td>
<td>15%</td>
<td>income</td>
</tr>
<tr>
<td>UK</td>
<td>13%</td>
<td>100%</td>
<td>state pension</td>
</tr>
<tr>
<td>Chile (2008)</td>
<td>21%</td>
<td>100%</td>
<td>pension</td>
</tr>
</tbody>
</table>
Examples of social assistance pensions, 2003 (*ex ante* means test)

<table>
<thead>
<tr>
<th>Country</th>
<th>Coverage</th>
<th>Maximum pension/ year</th>
<th>Tax/ GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Africa</td>
<td>87% (65, 60)</td>
<td>29%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Australia</td>
<td>67% (65, 62.5)</td>
<td>29%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Chile</td>
<td>15% (65)</td>
<td>14%</td>
<td>0.15%</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>21% (65)</td>
<td>10%</td>
<td>0.12%</td>
</tr>
<tr>
<td>USA</td>
<td>6% (65)</td>
<td>17%</td>
<td>0.07%</td>
</tr>
<tr>
<td>India</td>
<td>4% (65)</td>
<td>5%</td>
<td>0.01%</td>
</tr>
</tbody>
</table>
Pillar 1 in Chile (2006)

- Non-contributory Social Assistance Pension (PASIS): Ch$37,251
  - US$70 - 13% of per capita GDP

- Guaranteed Minimum Pension (PMG) (requires 240 months of contributions): Ch$87,800
  - US$163 - 31% of per capita GDP
Future Pilar 1 en Chile: Solidarity Pension System (SPS)

- Basic Pension: Ch$60,000 in July 2008
  - US$111 – 21% of per capita GDP
  - Ch$75,000 en July 2009

- Recovery from other pension income
  - 2008 100%
  - 2009 100%
  - 2010 75%
  - 2011 50%
  - 2012 37.5%
Solidarity Pension System (SPS) eligibility requirements

- Minimum 65 years of age
- Belong to the 60% of the population with lowest income
- Minimum of 20 years residence in Chile, including 4 of the 5 years previous to start of benefits
Subsidies of the Solidarity Pension System (SPS)

- For **mothers**: for each birth child a bonus at age 65 equivalent to 12 monthly contributions at minimum wage, plus annual interest of 4% plus inflation.

- For **young people** earning less than 1.5 times the minimum wage: 100% subsidy for contributions to a pension fund during the first 24 months of formal employment.
Chile’s transition to a single, recovery-conditioned pillar 1 pension
Recall the advantages of universal pensions

- Simple and easy to administer
- Automatic, 100% coverage
- Reach women and rural areas
- Do not stigmatize recipients
- Broad political support
- Avoid disincentive to save for old age
- Avoid disincentive to work in old age
So, what is the downside of universal pensions?

1. They are inequitable, since the wealthy live longer lives than the poor
2. The young should have priority over the old in government expenditure
3. Universal pensions “crowd out” private transfers
4. They are a luxury few countries can afford
1. Universal pensions are inequitable, since the wealthy live longer lives

- The wealthy also pay more taxes
- Life expectancies are averages: some of the poor live long lives; some wealthy die young
- Pension income is known to improve health and increase life expectancy of the elderly poor
2. The young should have priority over the old

- False choice, as budgets are not fixed
- For example, much money is spent on subsidies and tax breaks for contributory Pillar 2 and 3 pensions (examples of South Africa, Australia, Bolivia)
- Pensioners in developing countries live with extended family and share income
3. Universal pensions “crowd out” private transfers

- Each dollar of pension reduces transfers from children by as much as 37 cents
- So what is the implication?
- Is it possible for government to force adult children to care for their parents? After all, household income is not distributed equally: children and productive adults have priority over the old and unproductive
4. Universal pensions are a costly luxury

- Governments spend large sums on minimum pillar 2 pensions and tax relief for contributory pillar 2 and 3 pensions.
- Costs can be reduced by increasing age of eligibility or decreasing size of benefit.
- Or means tests can be applied \textit{ex ante} or \textit{ex post} (abandoning universality).
*Ex ante* means tests
(social assistance pensions)

- Very common
- High administrative costs
- Large errors of inclusion and exclusion
- Crude targeting, so disincentives for working and saving
- Facilitate corruption
"Ex post means tests (recovery-conditioned pensions)

- Very rare – this is an anomaly
- Tax collection relies on ex post tests, so why treat cash benefits differently?
- Control of recovery of pension benefits is easier than control of tax collection, because benefits can be halted whereas tax liabilities continue to grow
Mexico City’s universal pension

- Began February 2001 for age 70+
- Monthly “food allowance” equal to $\frac{1}{2}$ of the minimum wage
- Also free health care, public transport
- Universal by October 2002
- Other states now offer similar benefits, but with *ex ante* means tests
Cost of Mexico City’s universal pension

- Pension is 11% of Mexico’s per capita GDP, but 5.5% of Mexico City’s higher per capita income
- Total transfer is 4% of the municipal budget, or 0.25% of Mexico City’s GDP
- Politically popular programme
Proposed extension of Mexico City’s universal pension to nation

- Campaign promise of Lopez Obrador
- Population older than 70: 3.4% of total
- So transfer = (0.034)(0.11) = 0.00374 or 0.4% of Mexico’s GDP
- Subsidies for reformed pillar 2 pension scheme is much more costly
Subsidies for Mexico’s reformed pillar 2 pensions

- Cuota Social (flat sum deposited to each contributor’s account) cost 0.33% of GDP in 1997, projected to fall to 0.2% by 2025
- Guaranteed minimum pension equal to July 1997 minimum wage (cost?)
- “Life switch option” guarantees no loss to those who switched from public PAYGO scheme to system of individual accounts (cost?)
Further information

www.PensionReforms.com


Contact information

Larry Willmore, Research Scholar
International Institute for Applied Systems Analysis (IIASA)
A-2361 Laxenburg, Austria
Email: willmore@iiasa.ac.at
http://www.geocities.com/larrywillmore