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ESAU Briefing Paper

Ageing in a low-income country: is an old age pension necessary and affordable? case study of Sri Lanka

Economics and Statistics Analysis Unit (ESAU)

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Ageing and pensions in poor countries

Asian countries are ageing fast, faster than the rate experienced by OECD countries. The percentage of old people in the population has been doubling in the space of 25–30 years in Korea, Thailand and China, whereas this has taken 50–120 years in OECD countries. Sri Lanka expects that its population over 60 years old will double in less than 20 years: the share of the over-60s in its population will rise from 10% in 2000 to 18% in 2020 and 27% in 2040.

Low- and lower-middle-income countries in Asia are fast approaching, or have already reached, the point of demographic transition. Life expectancy has already increased considerably. Fertility rates have dropped dramatically, falling in some cases to the replacement rate or below (Sri Lanka). In the first instance, lower mortality among working age adults, combined with lower fertility, reduces the ratio of persons not of working age to those of working age (15–64) – the dependency ratio. In due course, however, as the relative number of the elderly rises, the dependency ratio increases again. The question of how to provide for old people is a growing social and political preoccupation.

Some middle-income countries have introduced systems of universal state-provided old age pensions. In Asia, pension arrangements with widespread coverage exist in Korea, Taiwan, and Thailand. South Africa has long had a state pension with widespread and now universal entitlement. State pensions are financed by general taxation and/or by payroll taxes, the burden of which rises through time as pension entitlements per retiree increase, and with the increasing ratio of the retired to the working-age population. In Brazil and South Africa, however, state pensions are found to have brought an appreciable reduction in the poverty headcount rate among households with older people, and to be fiscally affordable (Barrientos, 2003).

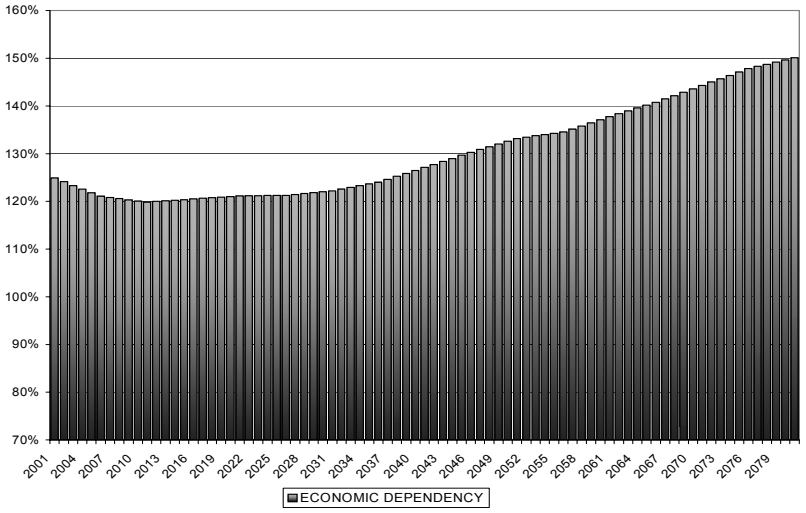
In low-income countries, most elderly people rely for their subsistence on what they are able to earn or produce, or on family support. Only a fortunate minority who have been employees in the formal sector, and in particular in the public sector, and who have contributed to pension plans, are entitled to the regular payment of a pension on reaching the retirement age. However, a recent estimate puts the cost of giving all residents of least developed countries over 65 a pension equal to 30% of per capita GDP (less than $/1 per day in international prices in most LDCs) at no higher than 1% of GDP (HelpAge International, 2002).

What will happen in future to the rising numbers of old people in poor countries? With longer life expectancy their working lives will be longer, and to an extent they will be able to support themselves. But there will also be more who are unemployed and infirm. There is a danger that traditional family support for them will be less reliable than in the past, because of urbanisation and changing employment patterns. Is a universal state pension needed and affordable in low- and lower-middle-income countries? This is a question under active consideration in Sri Lanka where the population is ageing fast.

In the 1990s, the ILO and the World Bank promoted two somewhat differing versions of a policy for pension provision in developing countries, in which there would be a basic, tax-financed, universal pension as a safety-net for the poor which would be complemented by contributory plans – compulsory or voluntary, private or public – for employees and the self-employed.

A recent ESAU/ODI research project undertaken by Nirosha Gaminiratne reaches the conclusion that Sri Lanka's current formal and informal arrangements for income support for the elderly, which primarily benefit former employees and the better-off, are unsuited to tackling

Figure 1: Projected economic dependency 2001–81 with unchanged female participation



Source: Gaminiratne (2004)

pensioner poverty, whose scale is likely to grow with ageing (Gaminiratne, 2004). There should be a means-tested benefit to assist the elderly poor.

Sri Lankans are growing older and more dependent

Sri Lanka's per capita income ($930 in 2003) has been increasing at a commendable 3% p.a. This economic performance has benefited from having a working age population which has been growing appreciably faster than the population as a whole. Nevertheless, the economy's size and productivity is restrained by the still fairly low rate of female participation in the labour force (32%), and by a rate of domestic saving (16% of GDP) which is low by South-East Asian standards.

Life expectancy in Sri Lanka – 73 years for men and 76 years for women – is already close to that in OECD countries, and is projected to continue rising. The ageing process is now sufficiently advanced for the dependency ratio to start rising in the near future. Unless there is an increase in the current level of female participation, the economic dependency ratio (non-labour force participants/labour force participants) will rise, after a pause, from little over 120% currently to 133% in 2050, and 140% in 2065 (Fig. 1). On the other hand, if female labour force participation rises steadily, the dependency ratio will fall, and its subsequent rise will be postponed until the second third of the century.

The prospect of increasing dependency poses a threat to the livelihoods of the elderly, unless there are countervailing factors.

The elderly are not so poor

An important discovery of Gaminiratne's research is that the incidence of poverty among the elderly in Sri Lanka is lower than the average for the population as a whole (Fig. 2). The headcount poverty rate for the population as a whole is estimated at 22%. In the population cohort aged 60–70 the headcount rate is only 16%. Only among the over 75s does the share of people with incomes below the poverty line exceed 20%.

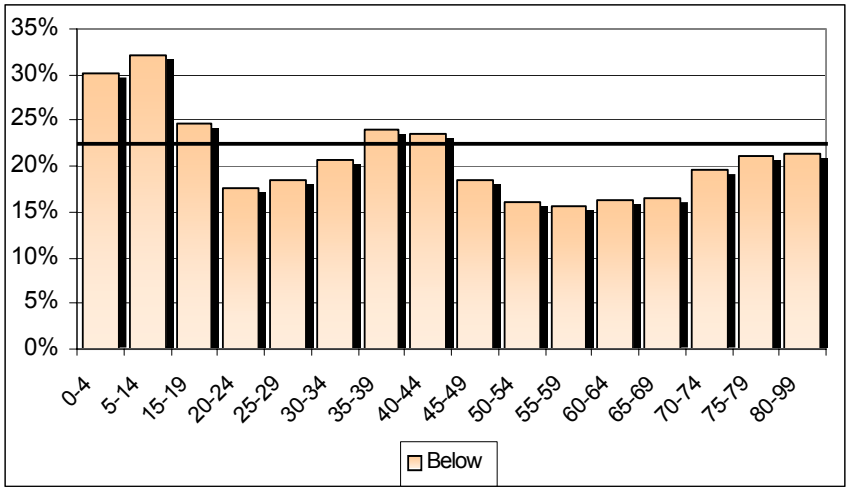
An important reason for the relatively low incidence of poverty among the elderly is that many older people continue working. Almost 50% of men aged 65–70 are still active labour force participants, and in the 75–80 age group 30% are still working (Fig. 3). They draw a correspondingly high share of their income from employment or self-employment (Fig. 4). In formal public sector employment, the average retirement age is 60, but in the private sector it is estimated from Labour Force Survey data to be 67.

Older people who are not working have, on aggregate, a multiplicity of other sources of income (Fig. 4). For the 60–64 cohort, this includes just over 20% of income from property (rent, imputed rent, interest, dividends etc.). Family transfers make up a larger share of the (lower) income of women than of men – 16% and 10% respectively in the 60–64 age group. Men, on average, draw 12% of their income from pensions and other government transfers, and women 32%, though the great majority of women receive no pension.

The rate of self-employment at present increases with age: 70–80% of active men over 60 are self-employed, compared with 50% or less of those under 60 (Fig. 5).

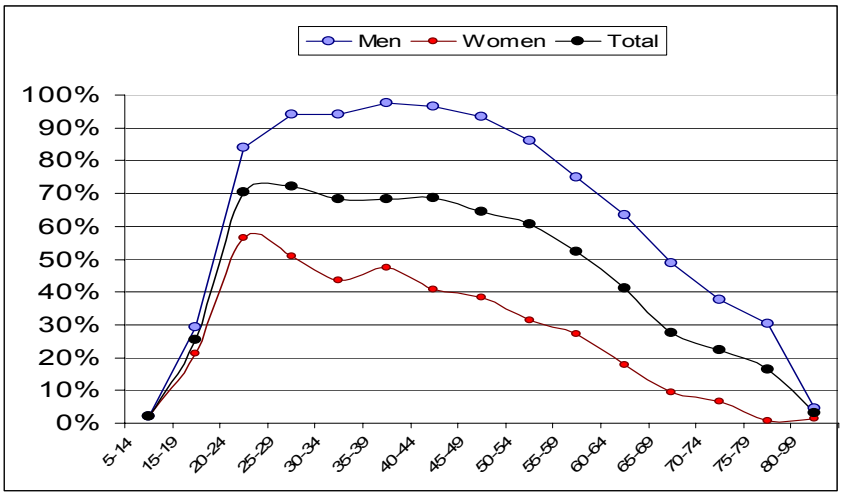
In sum, older people in Sri Lanka are less than averagely poor, and tend to continue working into old age, much more on a self-employed basis than as employees. They have income from accumulated property and, for men at

Figure 2: Poverty incidence (poverty line = Rs. 871 per capita per month)



Source: Derived from CFS data, Central Bank, 1996/97

Figure 3: Labour force participation disaggregate by age and gender



Source: Derived from Labour Force Survey data, 2000, DCS

least, have quite low dependence on pensions and cash transfers. About half of older women's income, however, comes from transfers and family support.

Current pension coverage is partial, contributory, and with low returns on savings

54% of working age people in Sri Lanka are entitled to enrol in at least one formal pension scheme, but only half of these, 3.5–3.7 million, are actually enrolled. The coverage rate is low compared with other middle-income countries in Asia.

The pension schemes are all statutory and run by the state. They are the:

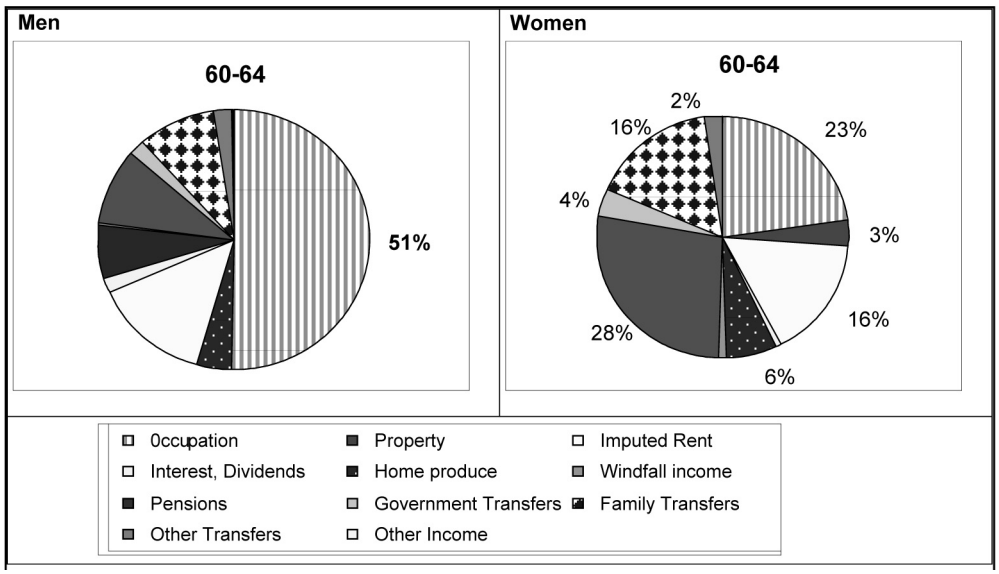
- Public Service Pension Scheme, formerly compulsory for civil servants but closed to new entrants since 2002; it provides a pension of 90% of final salary after 30 years of service, but this not formally index-linked and loses its purchasing power with inflation, unless discretionarily adjusted;
- Public Service Provident Fund, now mandatory for public sector employees;
- Employees' Provident Fund, invested mostly in government stock, to which two-thirds of private sector employees contribute; its defined contribution accounts have earned an average return of only 0.2% p.a. since 1960 – though performance has improved in the last five years;
- Approved Private Provident Funds, available to employees who opt out of the Employees' Provident Fund; however, these have suffered from weak management and inadequate regulation and supervision.
- Farmers', Fishermen's and Self-Employed Person's Pension Schemes, to which a minority of eligible workers make voluntary (and often episodic) contributions; these earn returns lower even than the Employees' Provident Fund, and provide benefits which are so low as to be worthless, because savers' capital is not indexed on inflation.

Sri Lanka needs, and can afford, a means-tested old age pension for the poor

Pension schemes have, for some time, only covered just over a quarter of the working age population. The over-60 population will triple over the next 50 years, threatening to increase the (at present relatively low) rate of pensioner poverty. Given the occupational structure of the labour force, the still high rate of male self-employment and the low rate of female participation, employment-based pension plans are unlikely to provide adequate future coverage. Alternatives have to be considered.

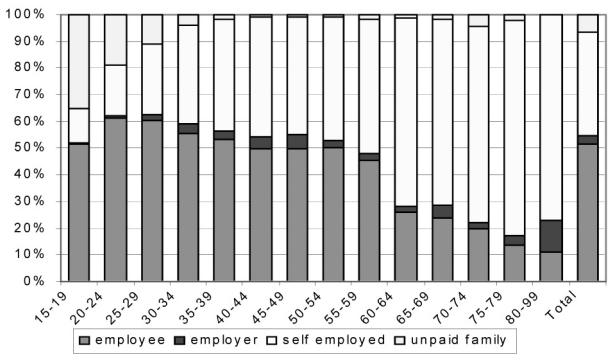
One option in Sri Lanka is to implement a universal basic, tax-financed, average earnings-linked state pension, along the lines advocated by ILO and the World Bank. This would be affordable at the outset, but would become increasingly burdensome with the passage of time. If the pension were set, and maintained, at a modest 15% of per capita GDP, and all persons aged 65 or more were eligible, the cost of provision would rise from 1.7% of GDP (10% of fiscal revenues) in 2001 to 4.4% of GDP (26% of revenues) in 2030. Even if the tax effort is increased within feasible limits, the burden would eventually become unsustainable without measures to curb entitlement.

Figure 4: Income sources of the 60–64 age cohort, by gender



Source: Derived from Consumer Finance Survey data, 1996/97, Central Bank

Figure 5: Male employment status by age: 2000



Source: Derived from LFS data, 2000, CSD

This could be done by reducing the value of the state pension relative to average incomes through indexation on prices rather than earnings, or on a less-than-full share of earnings growth. Absolute pensioner poverty would therefore be banished, though with the 'deadweight' fiscal cost of paying pensions to the non-poor. However, any such course of action would bring significant and growing political risk from widening income disparities, and the discontent of a growing number of pensioners reliant on the state pension for the majority of their income.

A safer alternative would be to provide a means-tested state pension, indexed on average earnings, to the 20% or so of elderly people whose income from other sources falls below the national poverty line. Projections of the fiscal burden of means-tested pensions to the over 65s of a value of close to 15% of GDP show that the cost would rise, without increase in tax buoyancy, from just below 2% of revenues in 2001 to nearly 5% in 2030. This would be sustainable in the longer run, particularly if the economy achieves consistent economic growth and strengthens its revenue buoyancy.

There would be practical implementation difficulties in a country where personal incomes and wealth are hard to assess. To be sure that all poor pensioners are covered it would be necessary, initially at least, to tolerate significant leakage to the non-poor. Sri Lanka would also have to overcome the clientelism which prevents some of its current means-tested poverty transfers from reaching eligible beneficiaries.

Implications for other countries

Sri Lanka is in the enviable position of being able to plan for ageing and to develop its pensions policy without having to immediately confront a financial crisis of fiscal entitlements, or a social crisis of deepening poverty among the elderly. It can afford to take a relatively long view, anticipating future changes in patterns of earning and informal social protection, and can choose and implement sustainable policy instruments for ensuring the livelihood of growing numbers of old people. A lesson of universal validity is that:

- strategy on ageing and pensions can be, and should be, devised in good time, and should not through procrastination be precipitated by the imminence of social or financial crises.

Sri Lanka's contributory pension arrangements have not been as successful in achieving general coverage in either the formal or informal sectors as their architects intended. Over the years, they have served their scheme members rather badly by (a) effectively taxing their savings – by providing rates of return below those which might have been attained if balances had been more wisely and imaginatively invested, and (b) failing to protect pensioners against the effects of inflation. In poor countries, contributory schemes are never likely to provide full pension cover to more than a minority of the working age population. However, they deserve every encouragement in order to (a) relieve the growing burden on the state of pension payments, and (b) foster private financial savings mobilisation and responsible financial intermediation. In policy terms Sri Lanka, and other similarly placed countries, should consider:

- de-regulating contributory pension and provident fund schemes, allowing a much wider role for private sector providers – to be properly regulated, run on sound actuarial lines and subject to prudential supervision – which should be free to seek high returns on behalf of their members.

The mapping of demographic projections onto fiscal scenarios makes it clear that, at least for the next half century, any state pension entitlements created in Sri Lanka which maintain a politically acceptable ratio of pensions to average earnings will create a rising fiscal burden. This burden is likely to become unsustainable unless the entitlement is circumscribed and targeted in some way, e.g. by means-testing. Two general implications flow from this:

- Poor countries should be cautious about creating universal pension entitlements which may initially impose only a minor budgetary cost but which, with ageing, will eventually become unsustainable.
- In order to contain the fiscal cost of pension benefits, systems of targeting have to be devised which are equitable, politically acceptable, transparent and workable. The design of such systems is a major challenge, and should be the subject of extensive debate and consultation before implementation.

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