SOCIAL DEVELOPMENT POLICY GUIDES

How to Design Inclusive Old Age Pension Systems in Asia and the Pacific

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The role of inclusive old age pension systems in an ageing Asia and the Pacific

Pension schemes protect older persons and their families facing barriers to earning an income in old age, as well as potential increases in health and other expenditures. While many people in the Asian and Pacific region continue to work into old age, labour force participation and earnings decrease at older ages. This is strongly linked to higher levels of disability and decreasing health in old age. It is related to factors such as age and gender discrimination in the workplace, legal restrictions, mandatory retirement age and cultural norms. Women are also more likely than men to be without income in old age. Disability and ill health not only create challenges for accessing paid work, but contribute to higher costs for older persons, including costs of accessing health care and personal assistance. While cultural traditions of family support to older persons have been historically strong in the region, the support provided is often insufficient, and providing this support puts pressure on household finances and employment prospects, particularly for women.

Effective pension systems have a range of important impacts on older persons, their families and the wider society. These include:

- **Reducing poverty and inequality**: Pension income can have significant impacts on a household's socioeconomic situation. Georgia's universal pension substantially reduces income inequality and poverty of both older persons and other household members, including children.[1]

- **Increasing the wellbeing and dignity of older persons**: Having an independent pension income, and less need to rely on families for financial support, increases the autonomy and dignity of older persons, which improves health and wellbeing.[2] A pension can also increase the ability of older persons to access health care.

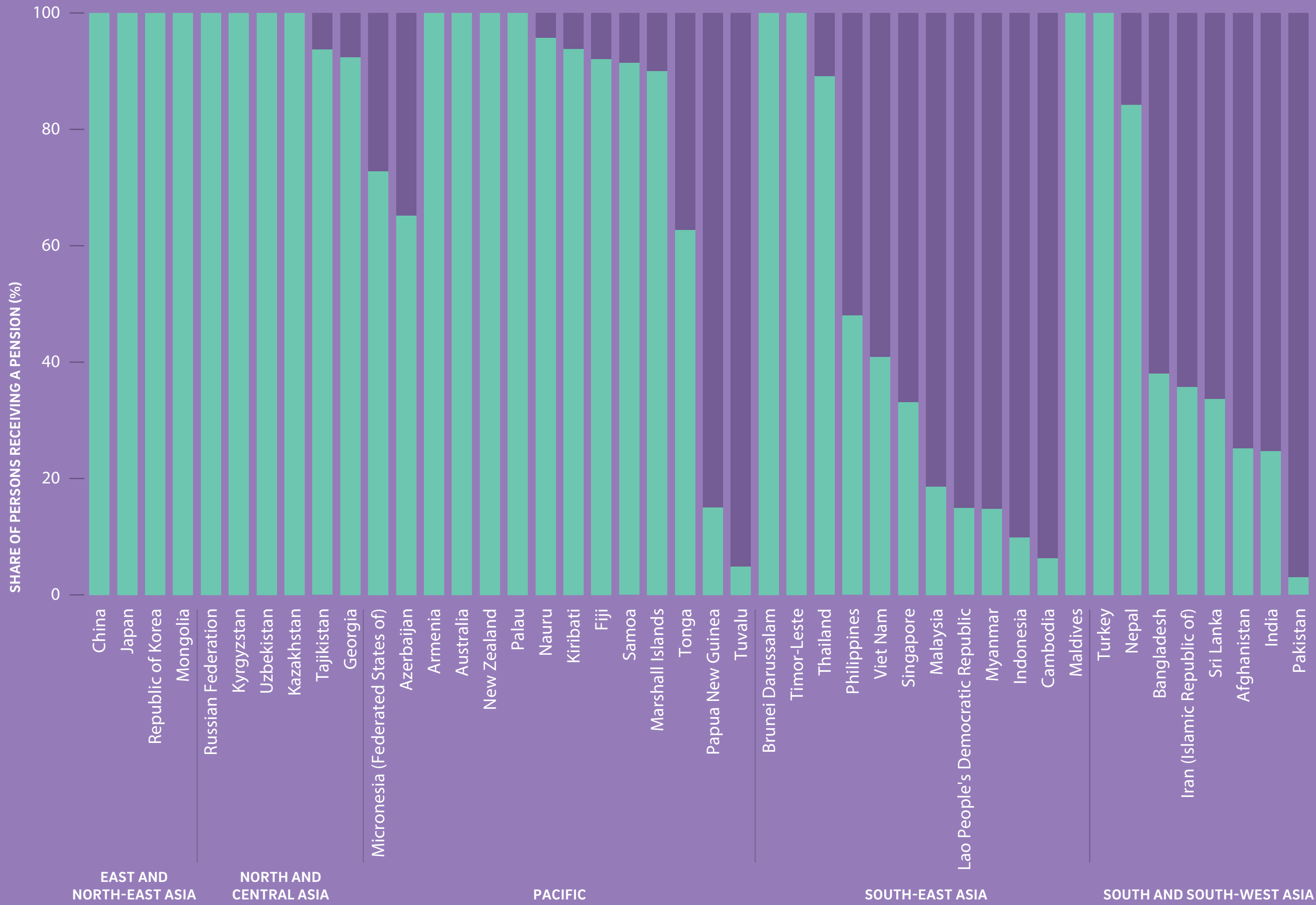
- **Supporting investments in livelihoods and human capital**: Increased household income reduces the need to provide financial support to older persons, which enables households to invest in areas such as schooling and improving livelihoods.[3]

- **Catalysing economic development**: Pensions — as with other cash benefits — generate economic multipliers at local and national levels and are a key tool to boost aggregate demand. They also tend to be key enablers of the emergence of a "grey economy" in Asia and the Pacific as the population ages, with a stronger orientation towards goods and services for older persons.

There are major gaps in pension coverage and benefit adequacy across the region. In total, 73 per cent of the population above statutory retirement age receive some form of pension in the Asian and Pacific region, but this coverage is unevenly distributed. When excluding China, the figure falls to 52 per cent. In many countries, coverage is far below this level, particularly in South and South-East Asia (Figure 1). For women, coverage is often lower than for men. Even where older persons are receiving a pension, benefit levels are often far from adequate, an issue which is discussed in further detail below.

These issues are becoming even more pressing in the context of rapid population ageing and other economic and social changes. Falling fertility rates and increasing life expectancy across the region mean that old persons will have fewer adult children to look to for support than previous generations. Trends such as urbanisation, migration and changing family structures mean that older persons are also less likely to be living close to other family members. Cultural norms around financial support as well as the role of younger people to provide financial support to older family members are changing, with growing expectations of the role of government.[4] Population ageing also raises questions about the financial sustainability of existing pension schemes when supporting a growing number of older persons with shrinking share of workers.

FIGURE 1 SHARE OF PERSONS ABOVE STATUTORY RETIREMENT AGE RECEIVING A CONTRIBUTORY AND NON-CONTRIBUTORY PENSION, LATEST YEAR



Source: International Labour Organization, World Social Protection Database. Available at https://www.social-protection.org/gimi/ShowTheme.action?id=10.

Building an effective pension system

SYSTEM OBJECTIVES

Before exploring the variety of old age pension schemes, it is important to identify the core objectives of pension systems. These can be summarized as follows, drawing on key international standards (see ESCAP Primer "Why We Need Social Protection"):

- **Coverage**: Pension systems should be universal, that is, they should ensure that all older persons above a stipulated age receive at least a basic level of income security. This is critical to ensure that no one is left behind by the pension system, but also for the system to act as a mechanism that supports redistribution and risk-sharing, and thus address poverty and inequality. The principle of universality is emphasized in a range of human rights instruments and international labour standards.[5]

- **Adequacy**: Adequacy has two main dimensions. Old age pension systems should guarantee a minimum floor of protection in old age for all people (the *horizontal dimension*) but also provide a mechanism by which workers can achieve a level of protection proportional to their working lives (the *vertical dimension* provided via earnings-related benefits). Systems also need to be built in a way that addresses disability-related extra costs that older persons may face, for example, with complementary benefits and services for older persons with disabilities and those requiring care and support (See ESCAP Primer "How to Design Disability-Inclusive Social Protection").

- **Predictability:** It is critical that younger generations understand what level of pension they can expect to receive in old age and that older persons know how their benefit level might change. Provision of regular pension benefits, rather than lump-sum payments such as in the case of provident funds, is critical to ensure predictability, as are decisions around the benefit formula and indexation.

- **Fairness:** Pensions are an important mechanism to redistribute between men and women, between generations, and between higher and lower income earners. However, this needs to be done in a way that is perceived as fair. These dynamics also need to be reconciled with other principles of fairness, such that those who paid into contributory schemes should receive higher benefits than those who did not.

- **Sustainability**: This can be defined as the current and future capacity of the economy to bear the costs of the pension system which implies that pension systems need to be able to adapt to economic and demographic changes over time. However, there is no simple formula for what level or configuration of expenditure is sustainable. This will eventually depend on the balancing objectives of pension systems — and the economic, social and political costs of investing too little — against other national priorities.

- **Gender-sensitive**: Effective pension systems should extend coverage and adequacy to ensure women's income security in old age. To this end, it is important to undertake gender analysis to identify shortcomings in pension system design, and to guide appropriate reforms. (See ESCAP Primer "How to Design Gender-Sensitive Social Protection Systems").

To achieve the above objectives, pension systems require effective governance and administration. This includes governance arrangements that support system coherence, sound administration and communication to support coverage and accessibility, and social and national dialogue to support policy formulation, scheme design and implementation.

Achieving these objectives requires a mix of contributory and non-contributory schemes. Non-contributory schemes are essential to reach those who have had low lifetime earnings and/or substantial periods of time outside the labour force or in forms of employment not reached by contributory schemes. Meanwhile, contributory schemes are a key mechanism to provide earnings-related benefits which achieve the vertical dimension of coverage and adequacy. Most countries in the region already have a mix of these two schemes.

BOX 1

CONTRIBUTORY OLD AGE PENSION SCHEMES: BENEFITS AND FUNDING OPTIONS[14]

HOW ARE BENEFITS DETERMINED?

A **defined-benefit** scheme is one where the pension benefit is calculated using a formula established by law. The benefit usually depends on the number of years of contributions and the insurable earnings over the same period. Such schemes provide regular pension benefits for those with a minimum number of years of contribution.

- Countries with defined benefit schemes include the China, Iran (Islamic Republic of), Mongolia, the Philippines, Republic of Korea, Thailand, Turkey and Viet Nam.

A **defined-contribution** scheme is one where contributions are saved or invested and an individual's final benefit depends on the contributions plus the returns in their individual account. The accumulated funds can either be paid in the form of a lump-sum or converted into an annuity (a regular payment).

- The most common type of defined contribution schemes in the region are **provident funds** which in most cases pay out lump-sum benefits on retirement. These exist, among others, in Bhutan, Brunei Darussalam, Fiji, India, Kiribati, Malaysia, Nepal, Samoa, Singapore, Solomon Islands, and Sri Lanka.

A **notional defined-contribution** scheme operates on a similar principle to defined-contribution plans, with individuals having an individual account, however, such schemes are not funded (see section below "How are schemes funded?"). Account balances are increased each year in line with a virtual annual rate of return and converted into a pension at retirement age. Virtual interest rates and factors used to calculate pensions are normally stipulated by law but may be linked to factors such as GDP or wage growth and demographic changes.

- Countries with notional defined contribution schemes include Azerbaijan, Kyrgyzstan, Tajikistan and Turkmenistan.

In countries in North and Central Asia, defined-benefit schemes historically formed the main contributory scheme, but in recent years these have been supplemented or replaced by forms of individual accounts, either via defined-contribution or notional defined contribution schemes.

The above schemes are all publicly managed, however, some countries or areas — such as Australia and Hong Kong, China — have significant systems of mandatory **occupational pensions**. Many countries also supplement public schemes with voluntary occupational schemes and other voluntary saving arrangements.

HOW ARE SCHEMES FUNDED?

A key feature of defined-benefit schemes is that they rely on contributions of current workers to pay the benefits of current pensioners. Schemes may be **partially funded,** where a scheme has a minimum level of reserves and this is used to pay current pensions. Alternatively, they may be **pay-as-you-go (PAYG)** where all — or the vast majority — of benefits for current pensioners are paid from contributions from current workers.

Defined-contribution schemes are usually **fully funded**, meaning the level of assets or reserves in a scheme at a point in time aim to cover the value of pension liabilities determined at that same point.

CONTRIBUTORY SCHEMES

In many countries of the Asia-Pacific region, contributory schemes have limited coverage and provide inadequate benefits. Most countries in the region have some form of mandatory contributory schemes in place, although these vary by design (Box 1). Regardless of design, these schemes usually cover only a minority of workers, often only those in the public sector jobs. Just over half of the labour force in the region is contributing to a pension (55 per cent), which falls to 37 per cent when excluding China.[6] Women are generally less likely to be covered by contributory schemes than men. This is linked to lower labour force participation rates, fewer years of employment, often with lower income. They are also overrepresented in part-time employment and more often found in different forms of vulnerable jobs, including unpaid domestic work.

Contributory schemes also commonly have shortfalls in terms of adequacy and predictability of benefits. This is particularly the case for provident funds, which usually only provide lump-sum benefits, with evidence from Fiji, Malaysia and Sri Lanka showing they are commonly exhausted relatively shortly after retirement.[7] Issues of adequacy also exist in defined benefit schemes, for example, where accrual rates are low or where workers do not meet the minimum years of contribution to receive regular pension benefits. There are also concerns about the financial sustainability of defined benefit schemes in the context of population ageing.

There are a number of ways in which governments can seek to enhance contributory schemes:

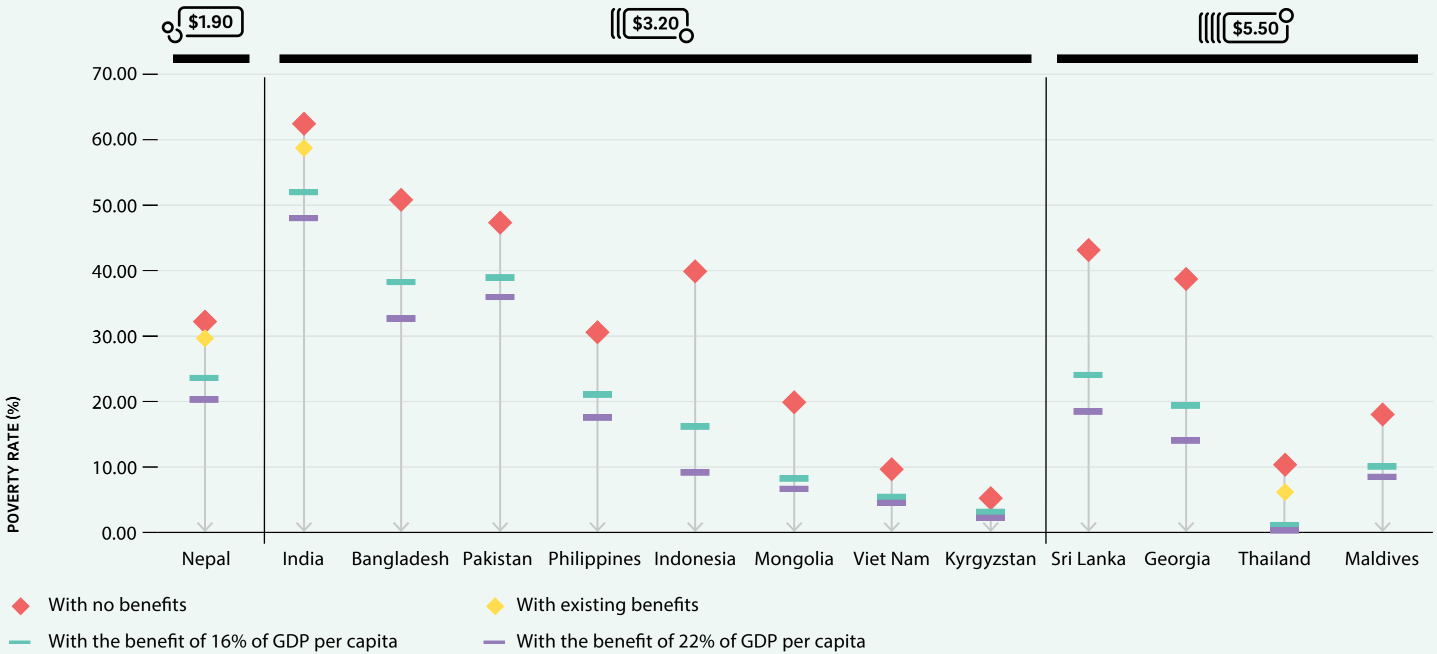
- **Make proactive efforts to extend coverage, linked to the development of the labour market.** The low coverage of contributory schemes, especially among women, is strongly linked to the nature of the labour market, including high levels of informal, vulnerable[8] and unstable forms of employment that either fall outside the mandate of such schemes, or are difficult to incorporate in practice. For example, women are often excluded from contributory schemes due to their shorter and more interrupted careers to tend to unpaid care work, meaning they often do not meet eligibility criteria. When they do, the pensions received are often too low. Contributory schemes can do more than simply wait for the labour market to change. There are various ways in which the legal framework, administration, communications, and financial incentives of such schemes can be adjusted to extend coverage, especially of women. Several countries provide schemes with financial incentives to increase voluntary participation of women in contributory pension schemes.[9] There are also opportunities for contributory schemes to link to other parts of government — including business registration and the tax system — as part of broader efforts towards formalization of the labour market.[10]

- **Addressing adequacy:** The predominance of lump-sum benefits in schemes across the region presents a major barrier to pension adequacy. This can be addressed through adjustments such as introducing annuity benefits to provident funds (as in Singapore) and reducing the minimum years of contribution to receive pension benefits within defined benefit schemes. There are various ways in which the pension formula can be adjusted to comply with international minimum standards, and to provide proportionally higher benefits for those with shorter-contribution histories and lower wages, a situation which disproportionately affects women (see ESCAP Primer "How to Design Gender-Sensitive Social Protection Systems").

BOX 2 IMPACT OF BROADENING NON-CONTRIBUTORY PENSIONS

As part of a broader microsimulation exercise, the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) simulated the impact of introducing a universal non-contributory pension in a selection of countries across the region. Two benefit levels were selected: 16 per cent of GDP per capita (which aligns with the global average benefit level of a non-contributory pension) and 22 per cent of GDP per capita (which reflects the corresponding average in OECD countries). The impact was measured against the reduction in the poverty rate, using international poverty lines relevant to the level of economic development of each country. As shown in Figure 2, universal pensions would result in a substantial fall in poverty amongst recipient households. The scale of poverty reduction is particularly notable in Bangladesh, Indonesia and Sri Lanka.

FIGURE 2 SIMULATED REDUCTION OF POVERTY RATES AMONG RECIPIENT HOUSEHOLDS OF AN OLD AGE PENSION, SELECTED COUNTRIES



Source: ESCAP's elaboration using the Social Protection Simulator https://www.socialprotection-toolbox.org/simulator.
Note: Recipient households are all households in which at least one household member receives the benefit.

NON-CONTRIBUTORY SCHEMES

Non-contributory old age pension schemes have enabled a significant increase in pension coverage in many countries. Various countries across the region, such as Nepal, Samoa, Thailand and Timor-Leste have rapidly expanded pension coverage within a matter of years through the introduction and expansion of tax-financed non-contributory pensions. Still, many non-contributory schemes are targeted to the poorest older persons (such as those in Bangladesh, India, the Philippines and Sri Lanka) and leave a substantial portion of the population with no pension at all. When compared to other regions, non-contributory pension benefit levels in the Asian and Pacific region are also relatively lower. Microsimulation analysis by ESCAP has found that extending universal non-contributory pensions would have a substantial impact on reducing poverty of older persons and their families, at a modest cost (Box 2). The largest fall in poverty can be observed for Sri Lanka with a poverty reduction of up to 24 per cent at the $5.5 a day international poverty line.

There are several ways to enhance non-contributory pensions:

- **Moving away from narrowly poverty-targeted schemes:** By design, targeting non-contributory schemes to the poorest older persons excludes a large share of older persons who spend their working lives in insecure employment and may therefore not meet the poverty eligibility criteria for the benefit.

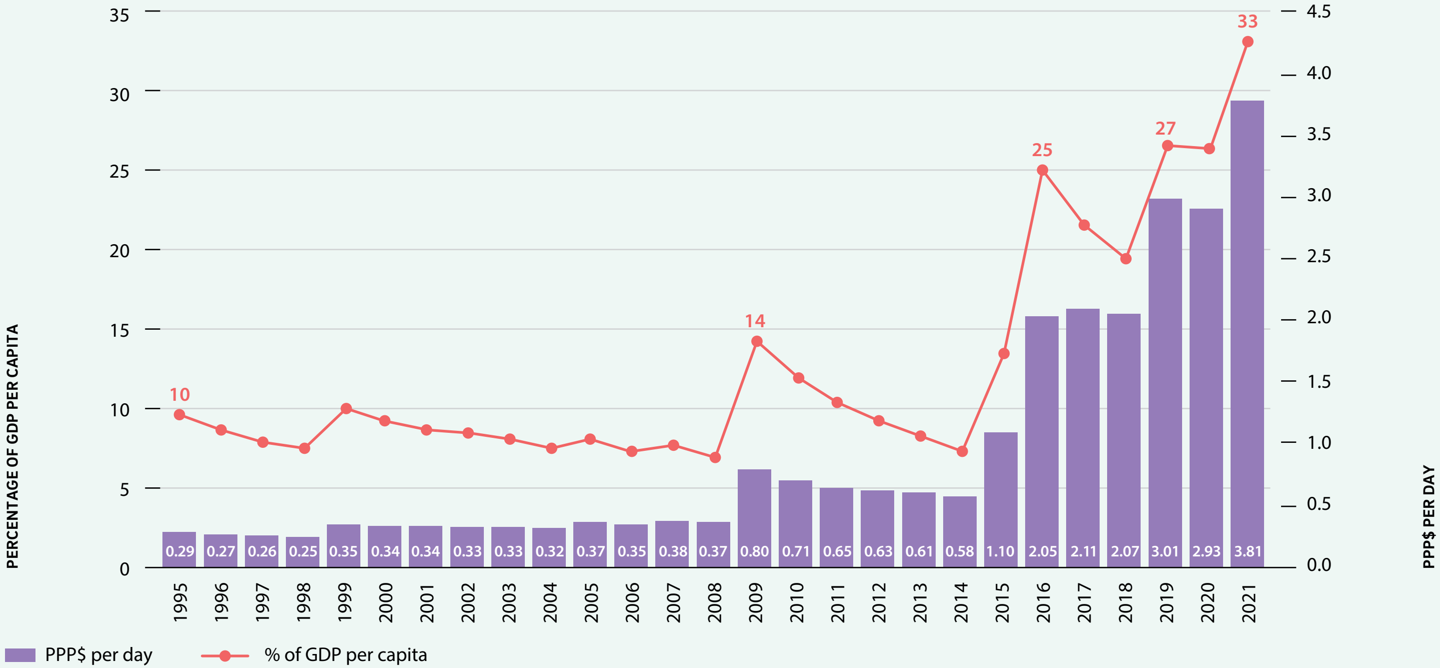
- **Avoiding proxy means-testing:** Throughout the region, inadequate means-testing practices, tend to exclude large shares of people that the schemes were intended to cover. In India, only around 20 per cent of households with a person aged 65 and over in the poorest decile receive a pension. By contrast, universal schemes in Georgia and Thailand have shown to be highly effective at reaching the poorest households, with over 90 per cent covered in both cases.[11]

- **Increasing benefit levels:** As shown in the microsimulation in Box 2, increasing benefit levels can significantly reduce poverty. This means a move beyond the very low benefit levels in many countries across the region. While this requires investment and political will, it is notable that one of the poorest countries in the region — Nepal — has been able to provide comparatively adequate benefits for its non-contributory pension (Box 3). As countries seek to enhance benefit adequacy, it is also important that they consider how these can be supplemented with additional benefits where older persons are living with disability (See Primer "How to Design Disability-Inclusive Social Protection").

BOX 3 BENEFIT ADEQUACY IN NEPAL

Nepal's non-contributory pension covers all older persons aged 70 or older. The age requirement is set at 60 for Dalits and those living in the poorest region of the country (the Karnali Zone). The pension is part of a broader package of non-contributory benefits including for single women, widows, persons with disabilities and children. While the scheme dates back to the mid-1990s, initially the benefit was relatively low at about 10 per cent of GDP per capita, or between PPP$ 0.3 and 0.4 per day. Since 2015, the benefit level has increased several times. It is now one of the highest benefits in the world relative to GDP per capita (33 per cent) and above the international poverty line for a lower-middle income country (PPP$ 3.8). The total cost of the scheme is estimated to around 1.7 per cent of GDP,[15] which is higher than other countries in the region, but in a similar range to non-contributory pension expenditure in other countries such as Brazil, Mauritius and South Africa.

FIGURE 3 DEVELOPMENT OF BENEFIT LEVEL OF SENIOR CITIZENS' GRANT IN NEPAL, 1995–2021 (% OF GDP PER CAPITA AND PPP$ PER DAY)



Sources: Budgetary documents 1995–2021 and International Monetary Fund, World Economic Outlook Database, October 2021. Available at https://www.imf.org/en/Publications/WEO/weo-database/2021/October.

BUILDING MULTI-PILLAR SYSTEMS

While many countries have both contributory and non-contributory pension schemes, few conceptualize them as part of a coherent system. Typically, these schemes are divided between different institutions, with separate mandates and distinct conceptualizations of social protection. It is common for non-contributory pensions to be managed by the social welfare ministries, focusing on programmes for the poor, while contributory schemes are often overseen by Ministries of Labour or Finance, with a focus on protection of those in more stable forms of employment. This leaves a blind spot in terms of how to extend coverage to the missing middle of the social protection system. It also creates risks of inconsistencies between non-contributory and contributory benefits, which can create perverse incentives to contributing to a social protection scheme.

Achieving the key objectives of pension systems means building multi-tier pension systems, where there is a coherent interaction between benefits. Multi-tier systems have two core characteristics:

- They ensure that everybody receives a minimum level of protection.
- They ensure that those who pay into a contributory scheme receive higher pensions, which seeks to address issues of fairness and incentives.

A key feature of a multi-tier system is the overlap between contributory and non-contributory arrangements, recognizing some people will have some contributory capacity, but also require support from non-contributory schemes to secure an adequate pension. Different ways to configure multi-tier systems are shown in Box 4.

BOX 4

CONFIGURATION OF MULTI-TIER PENSION SYSTEM

There are a variety of different models for multi-tier pension systems. Figure 4 presents three simplified models in comparison to the "status quo", namely a poverty-targeted non-contributory scheme combined with a low-coverage contributory scheme.

- **A universal foundation tier:** In this case, all older persons receive a non-contributory benefit, with any contributory benefits from the second tier being paid in addition. A strong feature of this model is its simplicity and that it allays concerns around disincentives to pay into the contributory scheme. This approach broadly reflects the non-contributory Old Age Allowance and Social Security Fund in the Thai pension system.

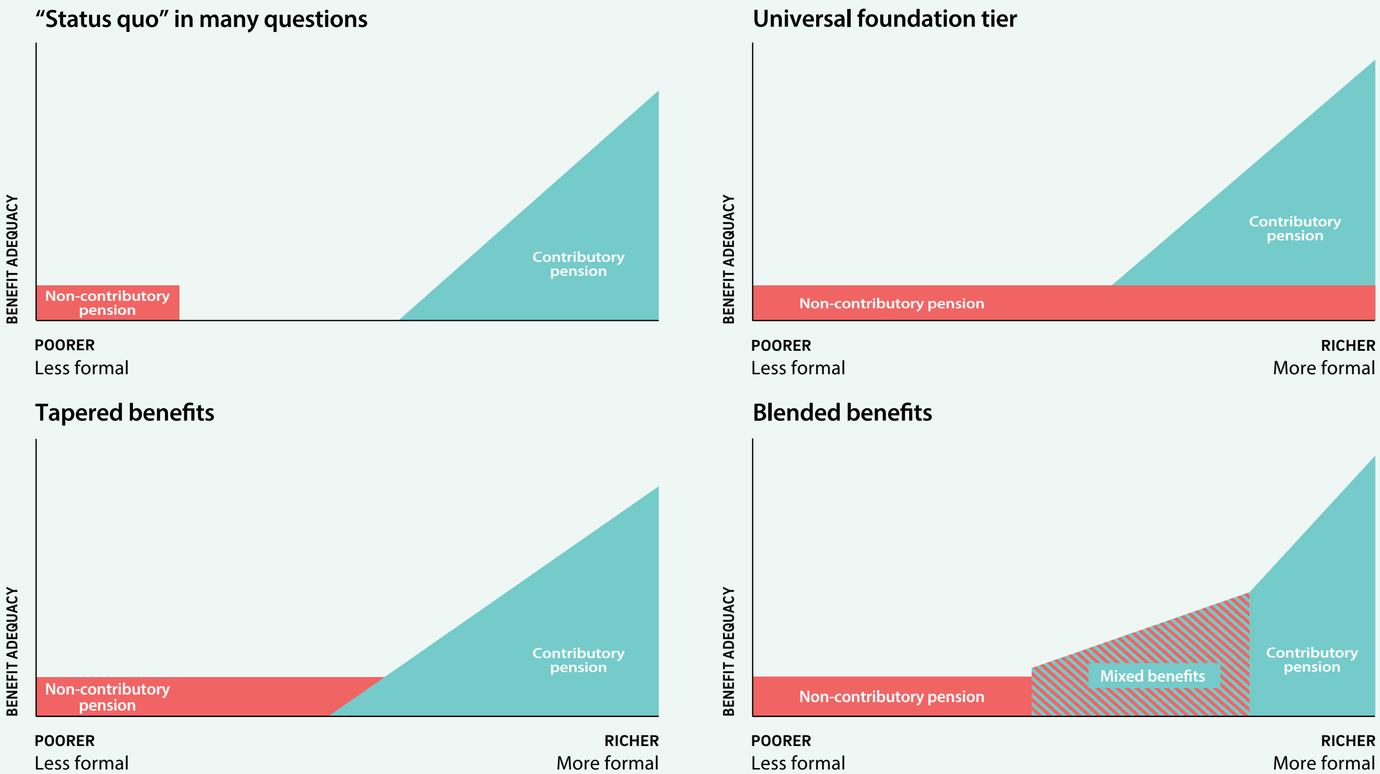
- **Tapered benefits:** This approach is similar to that of the universal foundation tier, but non-contributory benefits are gradually reduced according to the level of contributory benefits. For example, for every \$2 of pension income from a contributory scheme, the non-contributory benefit might be reduced by \$1. This seeks to avoid perverse incentives while reducing costs. The Maldives is one country in the region using this approach, which also exists in Chile and various Scandinavian countries.

- **Blended benefits:** This approach involves mixing the concept of contributory and non-contributory schemes. This means that — at least for some workers — the benefit can be considered partially contributory, but also partly financed by general revenues. At the same time, higher income earners might still participate on a fully contributory basis, while those outside the system might still receive non-contributory benefits. Mongolia is one country that displays some features of a blended model, with exemptions, buyback arrangements and reduced contribution rates for certain groups of workers within the contributory social insurance scheme, and a significant subsidy to the scheme from the state budget.

At each tier, conscious and specific efforts need to be made to ensure pensions reach everyone, including women and informal workers. This can be done by, for example, adjustments in pension formulas, provisions of pension credits that compensate for the years spent in unpaid care work, or by providing financial incentives to contribute to voluntary pensions schemes. Though pensions cannot redress the inequalities leading to their exclusion, such measures can help to mitigate the impact of these inequalities by providing a secure income in old age. For the system to be truly gender-responsive, these measures will need to be joined up with wider gender equality policies.

FIGURE 4 MODELS FOR MULTI-TIER SYSTEMS

The charts show a simplified illustration of the interaction between contributory and non-contributory benefits. The horizontal axis represents pension coverage of older persons, from poorer to richer, while the vertical axis represents the adequacy of benefits received in old age.



FINANCING SYSTEMS INTO THE FUTURE

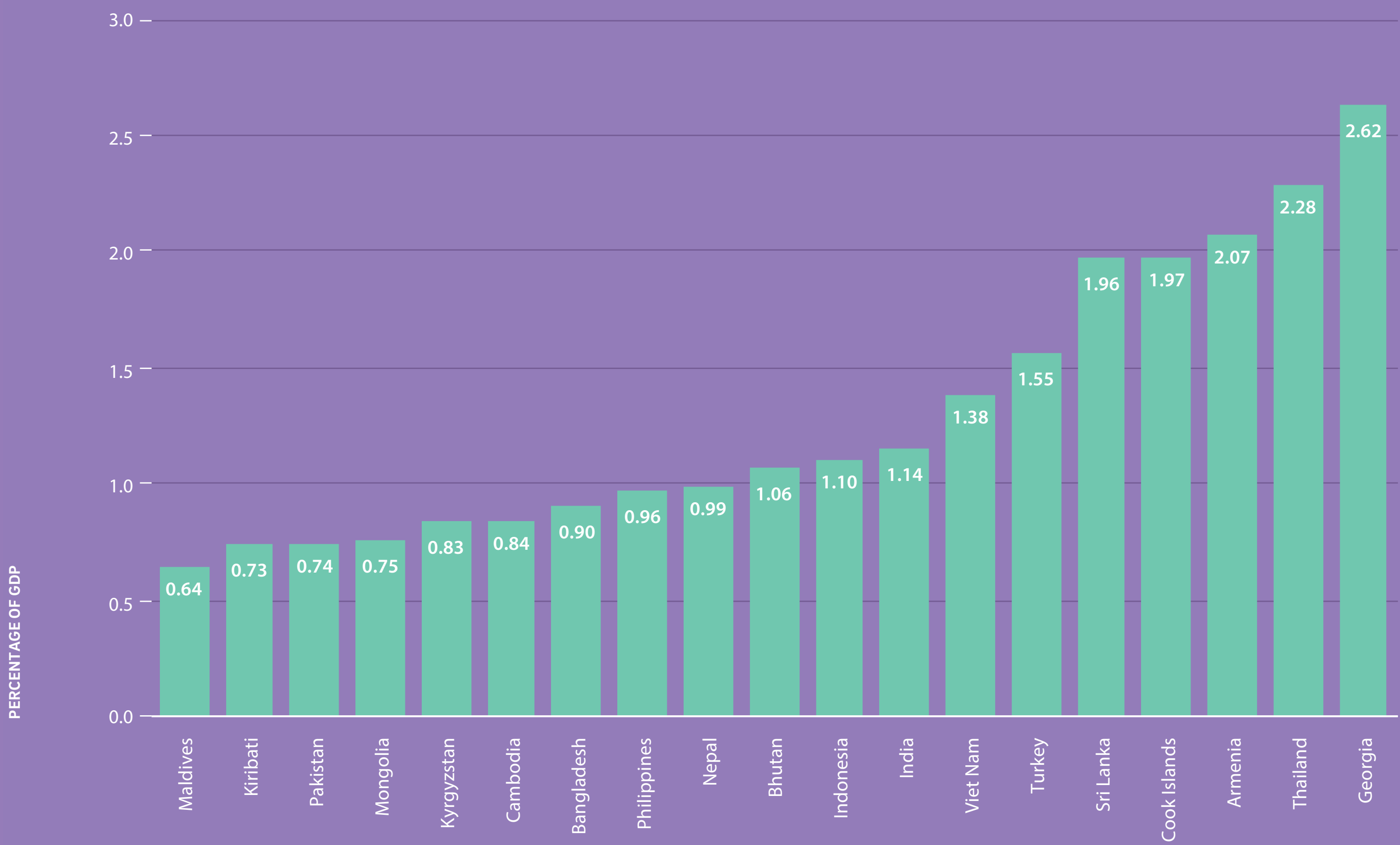
In most countries in the region, pension systems will require more — not less — investment in the future to provide effective old age income security. In general, old age social protection expenditure is low by international standards and addressing gaps in coverage and adequacy would require substantial extension of both non-contributory and contributory schemes. Figure 5 outlines the cost of providing a minimum floor of social protection (equal to 16 per cent of GDP per capita[12]) to all older persons aged 65 and over in 2021. The costs in 2021 for a minimum floor achieved through non-contributory schemes ranges between 0.6 per cent and 2.6 per cent of GDP. Given the expected pace of ageing in the region over the coming decades, the demand for and costs for old-age pensions will increase. Population ageing would result in a gradual rise in expenditures in most countries, however, the scale and speed of this increase will also depend on system factors including approaches to benefit indexation. There are various mechanisms to control costs incurred from general revenue, including adjustments to retirement ages and a greater role for contributory schemes. Moreover, as highlighted in Box 4, a minimum floor can be reached through a mix of non-contributory and contributory benefits.

Increasing investment in old age social protection can happen progressively. Extension of contributory coverage is inherently a gradual process, linked to the evolution of the labour market and concerted efforts to include more workers. In the meantime, while non-contributory schemes can be rapidly expanded, there are also ways to do this incrementally, by gradually lowering ages of eligibility and increasing benefit levels over time. Countries such as Fiji, Myanmar, Nepal, the Philippines and Viet Nam have all sought to increase coverage of non-contributory pensions by starting at a higher age of eligibility, then gradually reducing it over a number of years.

Despite new challenges created by population ageing, it is important to avoid alarmism relating to pension financing. It is common for specific pension schemes to be labelled "unsustainable" within public discourse and narratives, and calls made for radical reforms — often with a greater focus on private saving. However, more often than not this unsustainable outlook relates to a scenario where no scheme adjustments are made. In fact, changes to parameters such as retirement ages, contribution rates and benefit formula can radically change this projection. For example, even in a rapidly ageing country like Thailand, simulations have shown that pragmatic and gradual parametric changes could put the country's defined-benefit pension scheme on a solid financial footing for the next 100 years.[13] These are not easy decisions, but they are best served by national dialogue underpinned by effective governance, rather than hastily implementing new pension arrangements which may only repackage the same decisions in a different format. Effective dialogue and governance is strongly linked to the existence of a single and coherent multi-tier pension system that serves all national residents in their diversity.

To leverage the socioeconomic opportunities of population ageing, forward looking policies need to be put in place. The 2002 Madrid International Plan of Action on Ageing provides a blueprint for policy options and highlights the critical role of social protection to ensure the dignity and autonomy of older persons.

FIGURE 5 SPENDING REQUIRED FOR PROVIDING A MINIMUM FLOOR OF NON-CONTRIBUTORY PENSIONS FOR OLDER PERSONS AT 16 PER CENT OF GDP PER CAPITA, 2021



Source: ESCAP Simulator, https://www.socialprotection-toolbox.org/simulator

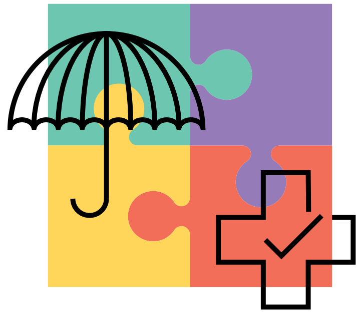
Did you get that?

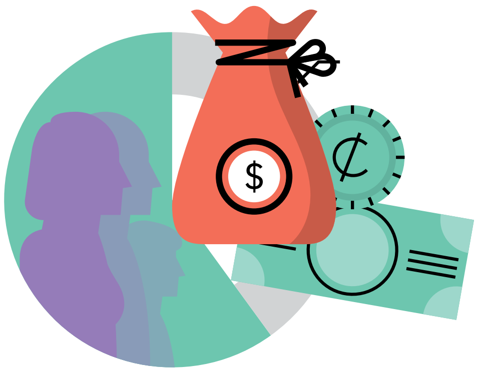
KEY TAKEAWAYS FROM THE POLICY GUIDE: "HOW TO DESIGN INCLUSIVE OLD AGE PENSION SYSTEMS IN ASIA AND THE PACIFIC"

Effective pension systems are key to supporting older persons, their families and wider societies to adjust to changes in the Asian and Pacific region over the coming decades…

…but pension systems have significant shortfalls in terms coverage and adequacy, and generally receive limited investment.

Addressing the multiple objectives of pensions requires a multi-tiered system that combines contributory and non-contributory benefits. Even where coverage remains low, it is not too early to set out a vision of how pension components should interact in the future.





Expanding universal or high-coverage non-contributory pensions provides a rapid means to establishing a minimum floor of protection to all older persons.

Meanwhile, proactive efforts should be made to extend coverage of contributory schemes, ideally in strong coordination with initiatives related to formalization of the labour market.

Addressing financial sustainability requires good governance and planning, but also efforts to build understanding of and trust in the pension system, and national dialogue to identify how systems should evolve.

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How to Design Inclusive Old Age Pension Systems in Asia and the Pacific

This is the seventh in a series of primers developed to support policymakers and practitioners in Asia and the Pacific in their efforts to strengthen social protection. This primer highlights key design elements in developing an inclusive and comprehensive old age pension system. It illustrates the importance of establishing an effective and financially sustainable pension system to support older persons, their families and society at large, especially in preparing for a rapidly ageing population over the coming decades.

The first primer in this series explores why social protection is needed; the second explains how to design inclusive and robust social protection systems and focuses on tax-financed income security; the third focuses on its effective implementation; the fourth discusses options for financing; the fifth highlights key concepts and schemes required for disability-inclusive social protection; and the sixth illustrates how the design of social protection systems can either exacerbate or mitigate the disadvantage women.

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