Social pensions and public finances

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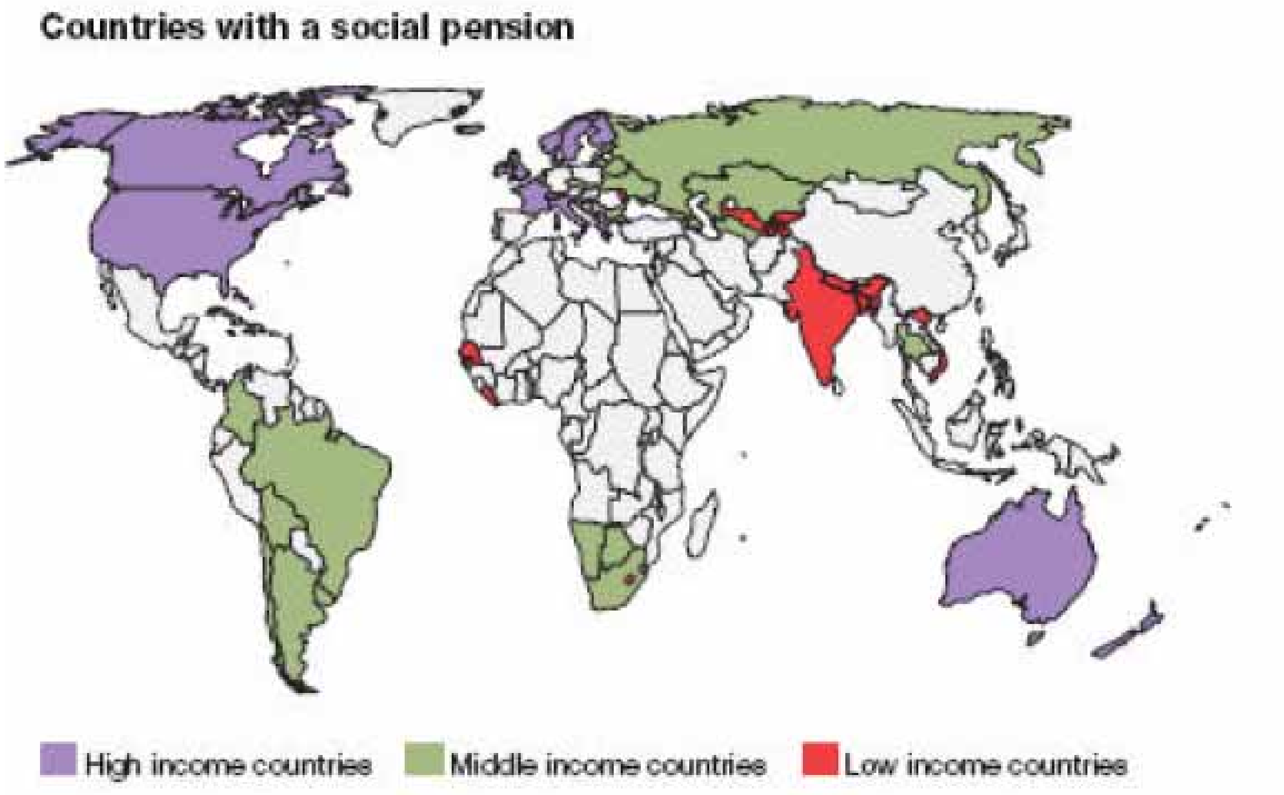
Social Pensions

- Definition

  non-contributory cash income given to older persons

- They can be very heterogeneous, with widely different effects
  - On individuals and other economic agents
  - On macroeconomic outcomes, such as aggregate savings and growth
  - On social outcome indicators, poverty and inequality
  - **On public finances**

Illustration of diversity…



Source: C. van Dullemen (2007)

Outline

1. Key dimensions of social pensions
2. What is the role of financing?
3. Contributory pensions?
4. How does this all add up in the face of individual decision-making?
5. Summary

1. Social pensions: key dimensions

- Why intervene?
  - Survival, growth, education, “decent” living?
  - Reduce poverty, inequality?
- Coverage
  - Universal (thus, tax-financed Beveridgean system)
  - Targeted (on need, resources, etc.)
  - But, even pure age targeting raises questions!
    - Why elderly are more worthy of intervention?
    - Problem of rigid age-cutoffs: see many developed countries’ pension systems!

1. Social pensions: key dimensions

- Magnitude
  - Sizable element of the system
  - “Marginal”
- How they integrate with other programs applicable to the old, <u>public and private</u>
  - Cumulative
  - Exclusive

→ **both cost and effects depend heavily on specifics!**

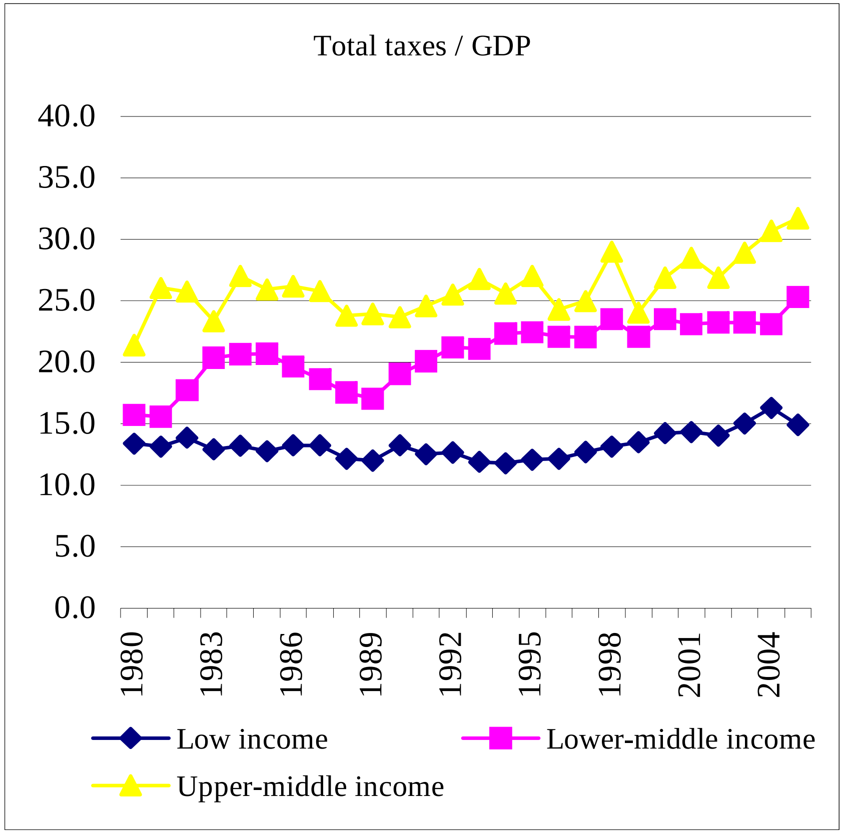
2. What is the role of financing?

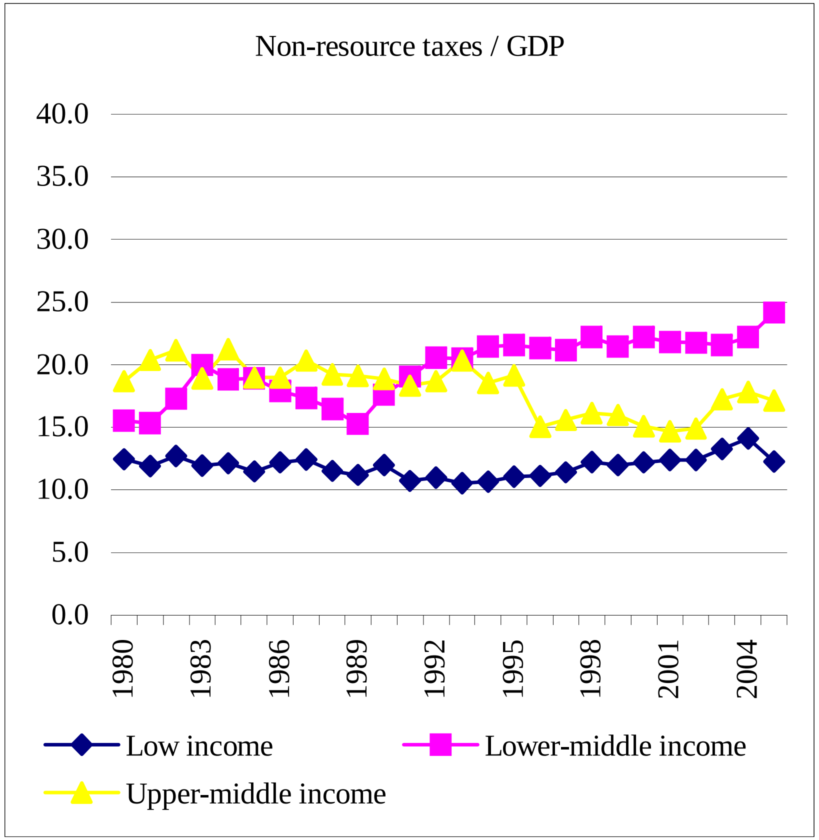
- Generally, social pensions are tax-financed
- Perspective: current revenues…
  - e.g., x percent of GDP can be a hard-to-achieve goal
- … and future revenue challenges
  - Trade tax revenue declining
  - Tax competition on corporate taxes
  - Increasing role of indirect taxes

→ **Tax revenue could be costly to obtain!**

Tax Trends in SSA Countries by Income Level, 1980-2005

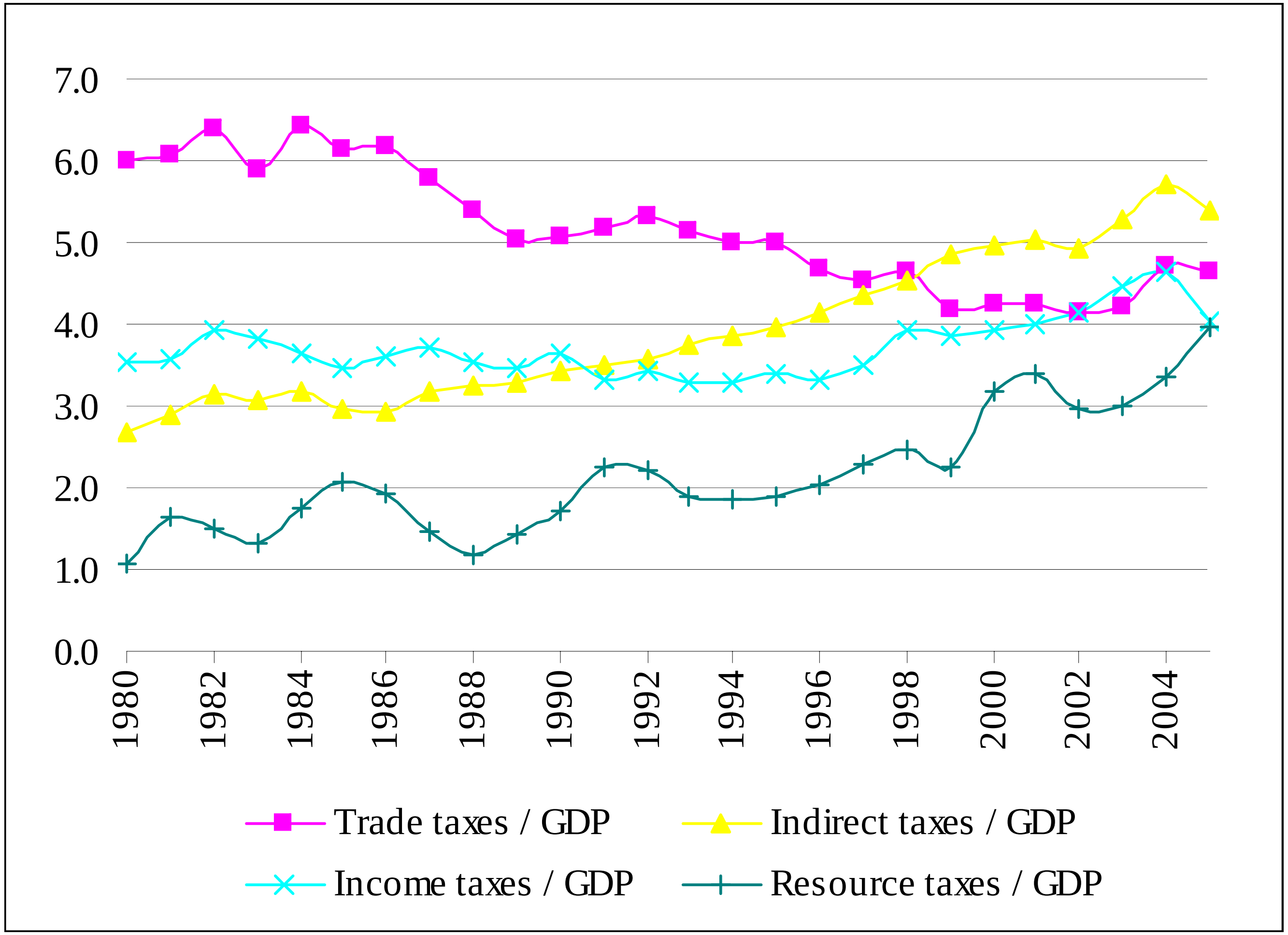
(source: IMF staff compilation)





Main Components of the Tax/GDP Ratio in SSA Countries, 1980-2005

(source: IMF staff compilation)



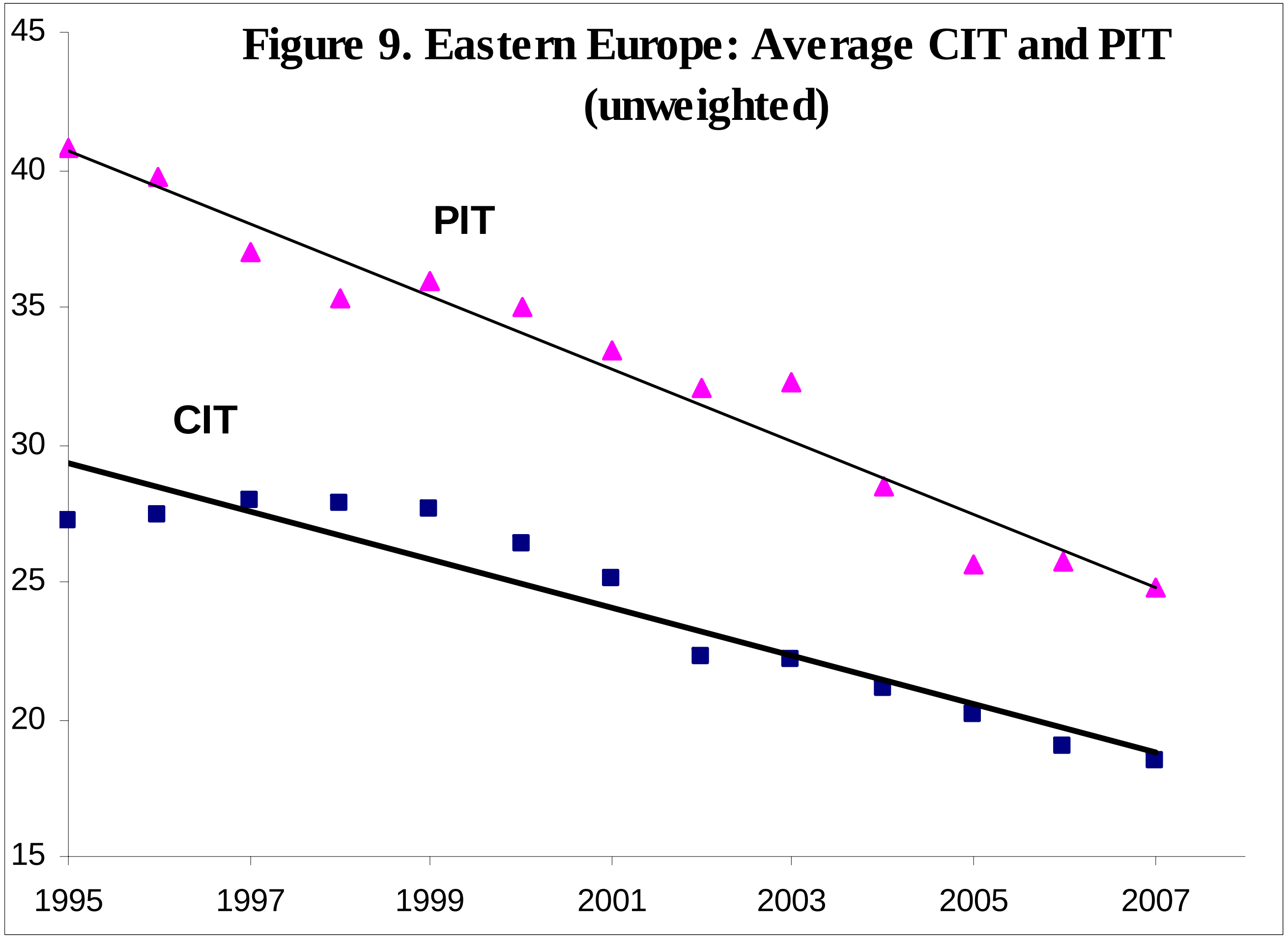
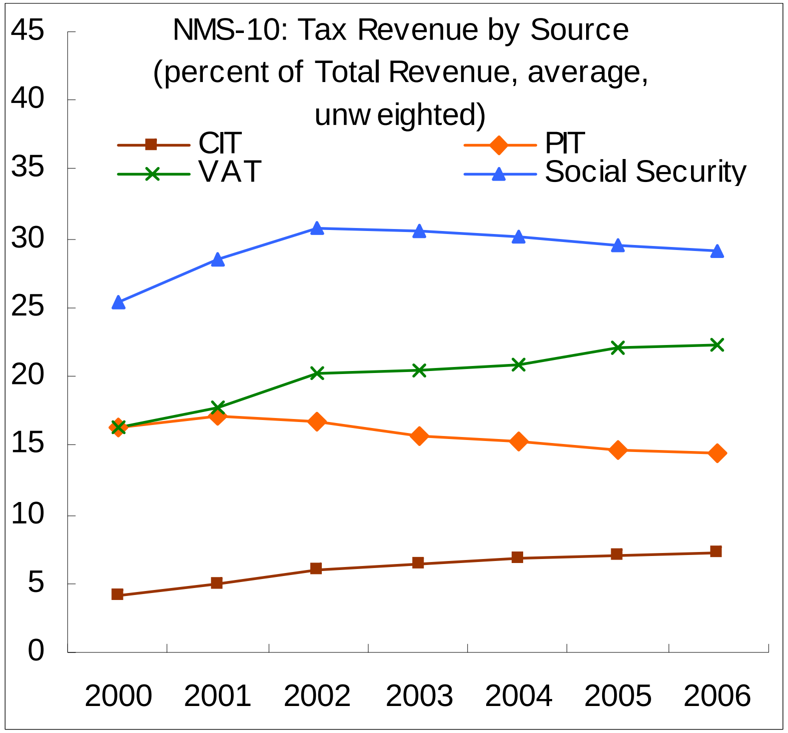
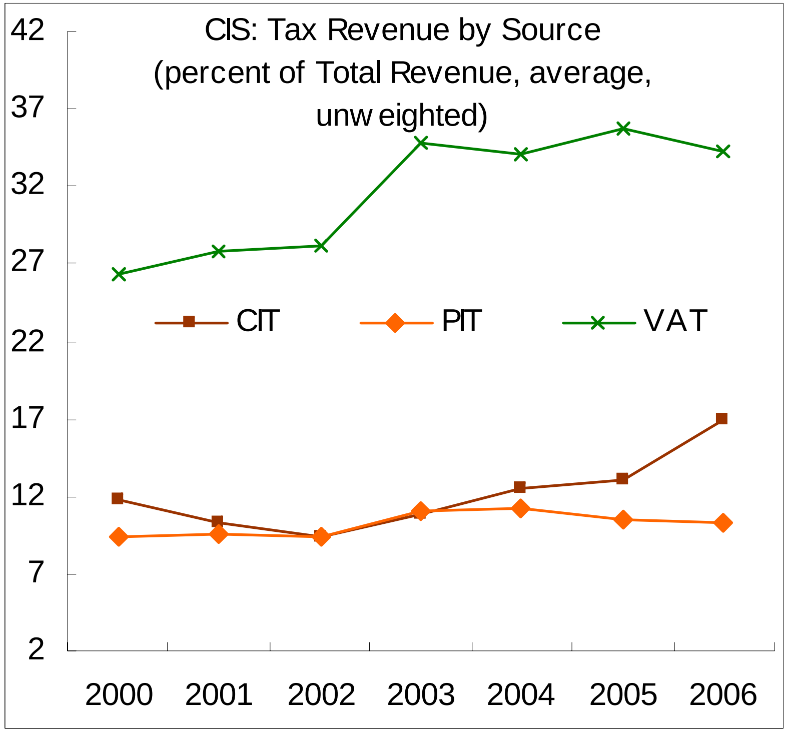


Figure 9. Eastern Europe: Average CIT and PIT (unweighted)
PIT
CIT
45
40
35
30
25
20
15
1995
1997
1999
2001
2003
2005
2007

Composition of Tax Revenues in NMS-10 and CIS, average





Application : Is there room for a "social" VAT?

- Unclear if intention to make imports and all factors of production support part of the social programs...
- Complicated GE dynamics
- Analysis often focused on developed countries
  - Redistribution from consumers (young/old) to beneficiaries
- Developing countries?
  - Further analysis needed as VAT systems often work differently, and some key sectors not taxed
  - Needs thorough redistributive analysis including effect on consumption, taxes and income!

3. Contributory public pensions

- Two extreme situations
  - Contributory Beveridgean
  - Contributory Bismarckian

3. Contributory public pensions

- “Social insurance” can be synonymous of large degree of coverage…
  - In developed countries, often a large to universal coverage of workers…
  - …and many inactive individuals too.
- …but also of largely selected coverage limited to some narrow groups, particularly in LIC
  - Public sector employees
  - Formal private sector employment
  - “Informal” sector is excluded! (>40% in SSA)
- Degree of crowd-out will depend on these!

3. Contributory public pensions

- Many advanced contributory pension schemes have features of social pensions!
  - Quasi-universal benefits such as the AOW pension in the Netherlands
  - Minimum benefits irrespective of currency value of contributions
  - Imputed coverage for missing or reduced years: studies, unemployment, disability, maternity, child-raising, etc
- and not infrequently, budgetary transfers!

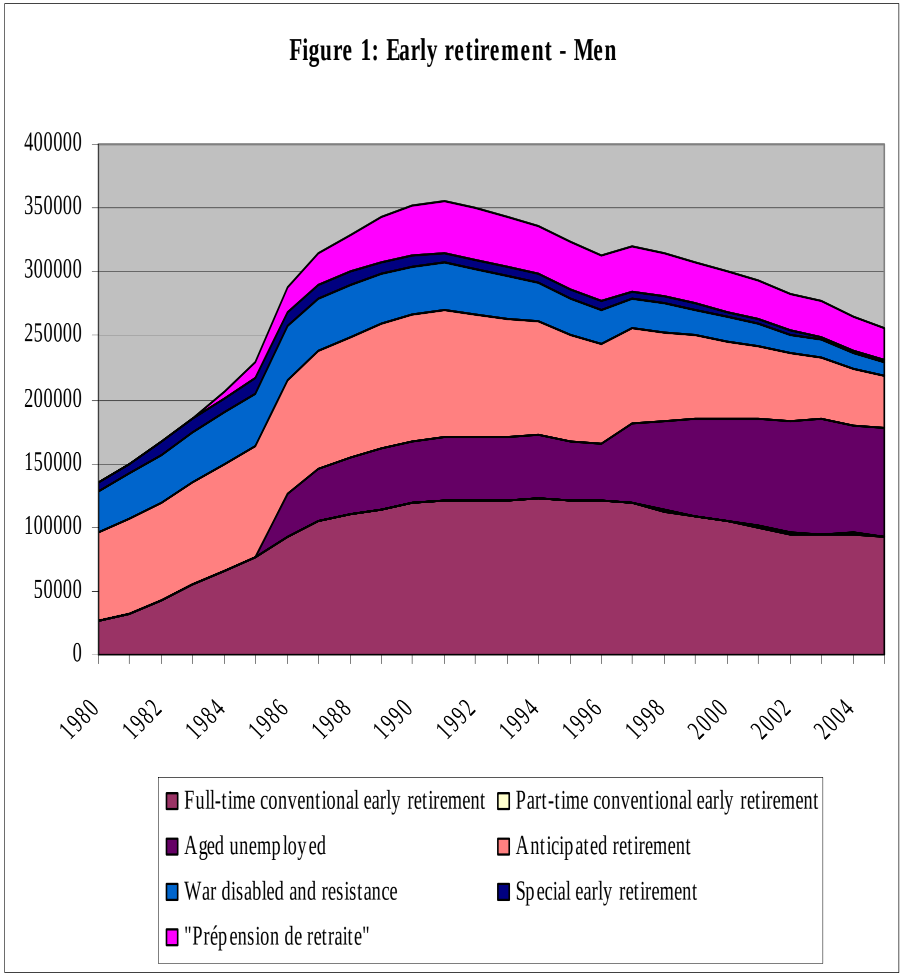
3. Contributory private pensions

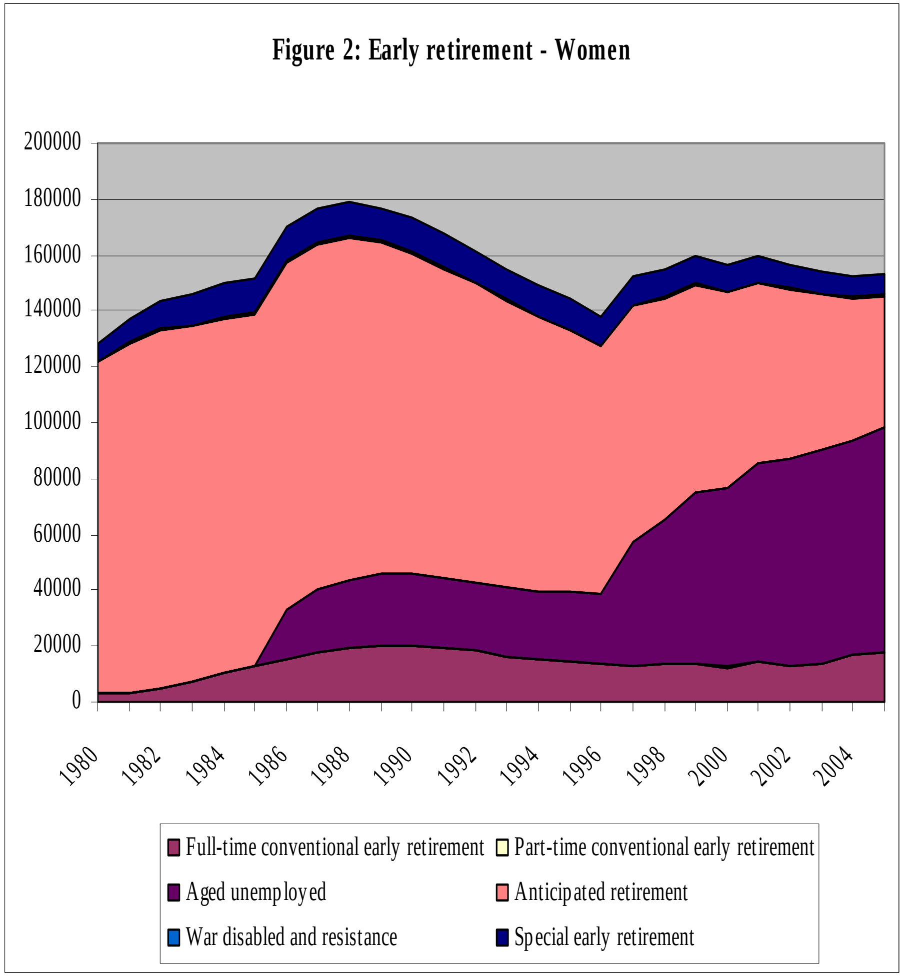
- Similar…
  - Contributions link: often under the form of earnings linkage
  - Preferential tax treatment of contributions AND/OR benefits
- and yet different.
  - Public pensions (fund) often PAYG
    - on a non-sustainable path (viability?)
    - static deficits, dynamic issues (in face of rapid aging)
  - Private pensions often funded (huge variety… with own set of problems)

4. How does this all add up in the face of individual decision-making?

- <u>Benefit linkage is key</u>
  - Plays in each decision maker's problem
    - E.g., insurance premia versus taxes
  - Social pensions can reduce or destroy the benefit linkage of the contributory system
  - Can reduce the incentive to formalize, at
    - Level of employee
    - Level of employer
- Impact on budget will depend on individuals' reactions! (example Belgian early retirement)

E.g.: Early retirement in Belgium





How does this all add up in the face of individual decision-making?

- Implications for public finances?
  - Likely to be far-reaching
  - Static
    - Shift costs of old-age towards taxpayer
    - Less reliance on private and contributions-based approach
    - Likely to imply worsening of short-term fiscal balance
  - Dynamic
    - Disincentives to save and/or contribute and/or pay taxes
    - Implicit government liabilities on rise while revenues might be under threat
    - Behavioral reactions of individuals will enhance purely mechanical effects
    - Other growth effects? Unclear whether pensions is the right tool, as other more direct levers might exist…

Conclusions

- Static numbers likely to underestimate cost to public finances.
- Endogenous decisions of individuals will be key drivers.
  - Parallel with literature on incentives to retire
  - Welfare/workfare literature
- Similar considerations applicable in context of population-wide social assistance programs.