Sri Lanka’s Experience with Informal Sector Contributory Pension Schemes

World Bank-Hitotsubashi University-MOF

Workshop on Closing the Coverage Gap:

The Role of Social Pensions

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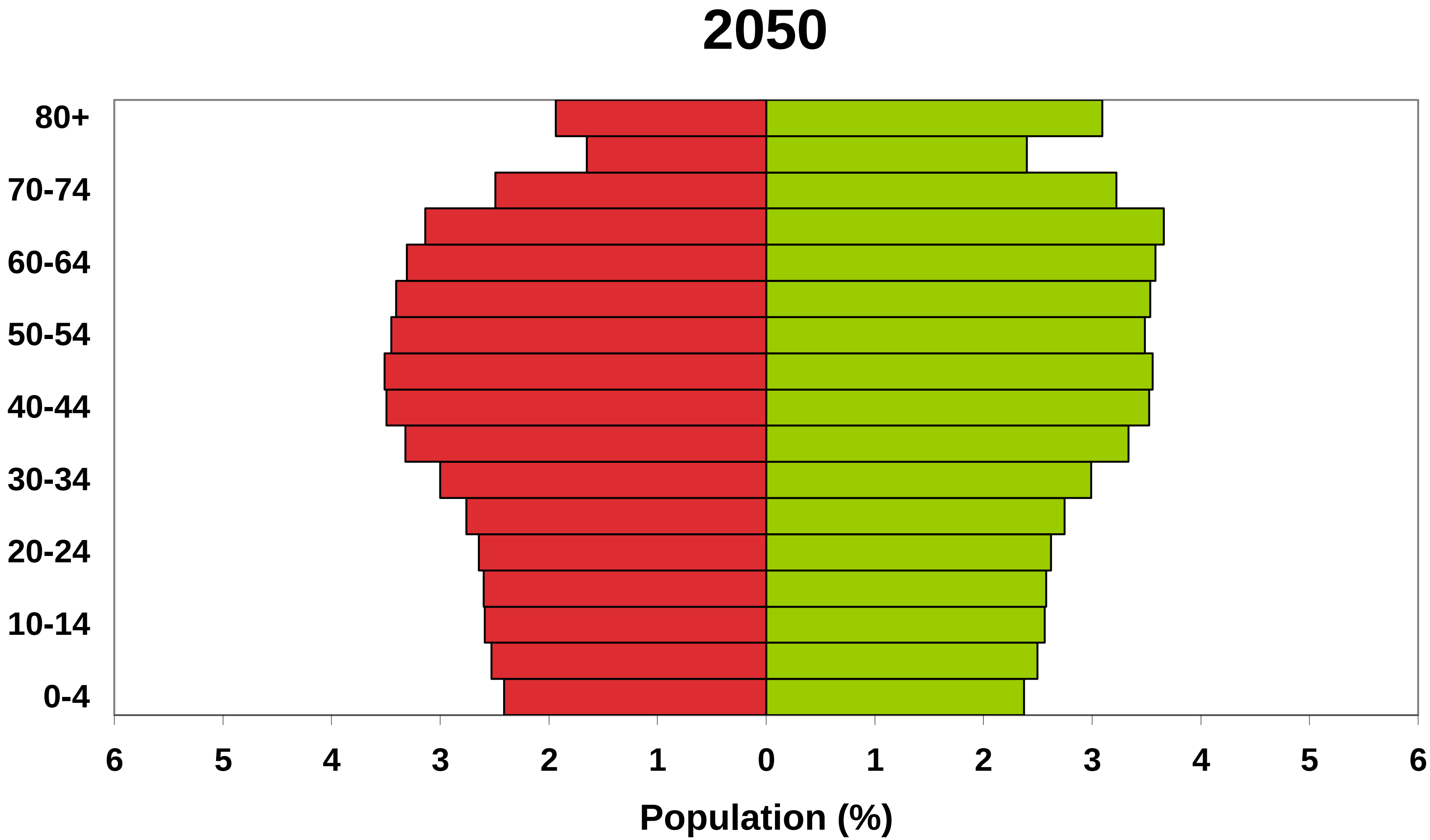
Agenda

- Sri Lanka Context
- Informal Sector Schemes
- Problems
- Potential Solutions
- Lessons

Sri Lanka Context

- LMIC
  - GDP per capita ~ $1,500, AGR ~ 5-6%
  - Low tax base ~ 17% GDP
  - Fiscal deficits ~ 8% GDP
  - Inflation ~ 8-20%
  - <35% of working age population in formal sector
- Social protection
  - History of early and high levels of coverage for health, education, poverty transfers driven by early experiences of democratic politics and global recession in 1930s
  - Dominance of general revenue financing - no history of social insurance
  - ~45% of workforce covered by formal old age income schemes

Rapidly Ageing Population

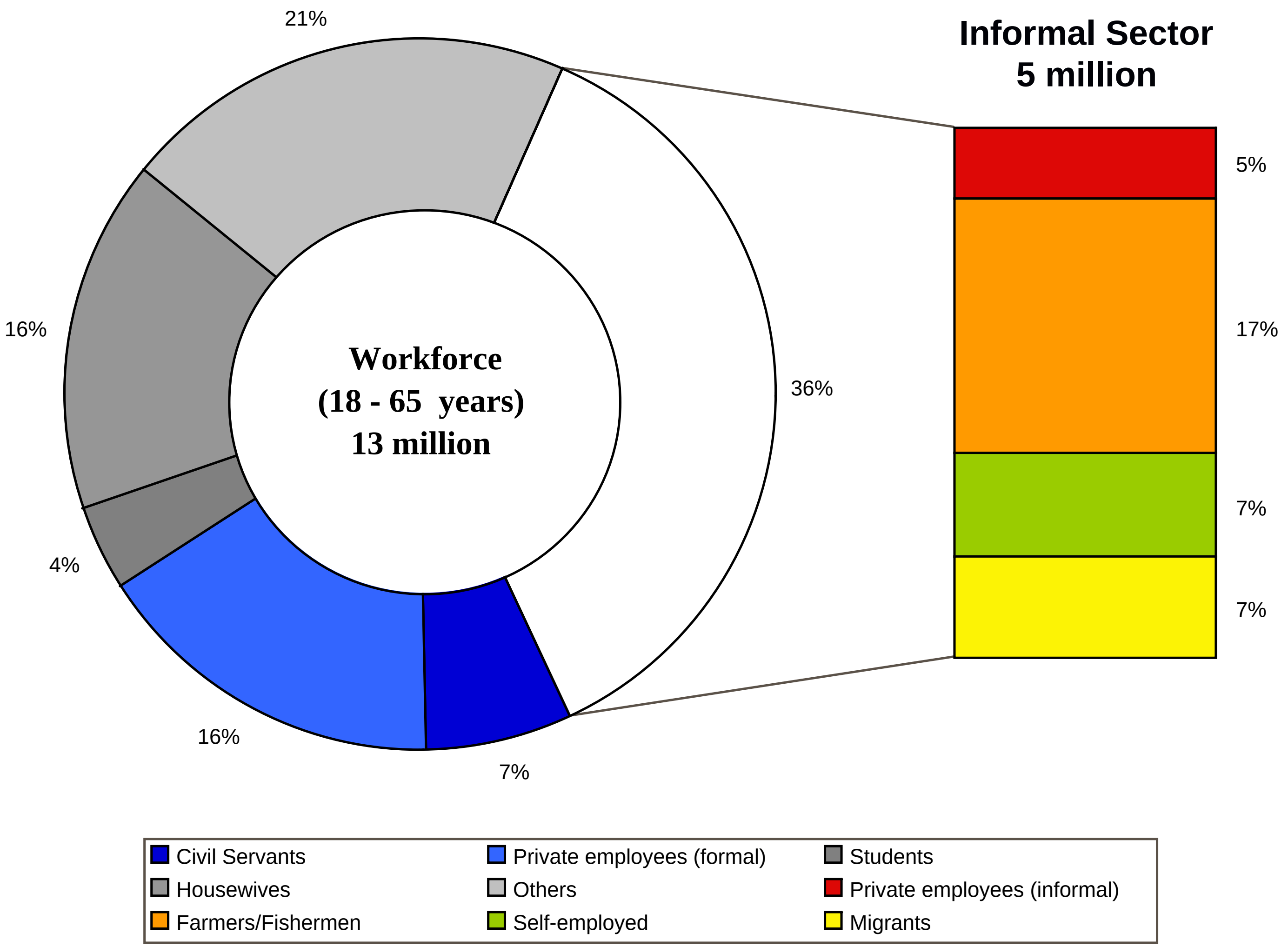


Social pensions vs. Social assistance transfers

Country	Type	Beneficiaries/65+ population (%)	Social pension impact index (%)
Sri Lanka	Means-tested SA	23	1.2
India	Means-tested SP	14	1.4
Bangladesh	Means-tested SP	22	1.6
Nepal	Universal, flat SP	21	4.7
South Africa	Means-tested SP	86	27.3
Mauritius	Universal flat SP	100	27.1

Source: Palacios in World Bank, *“Sri Lanka Addressing the Needs of an Aging Population” (2008)*

Employment Structure



Informal Sector Schemes

“Contributory” Pension Schemes

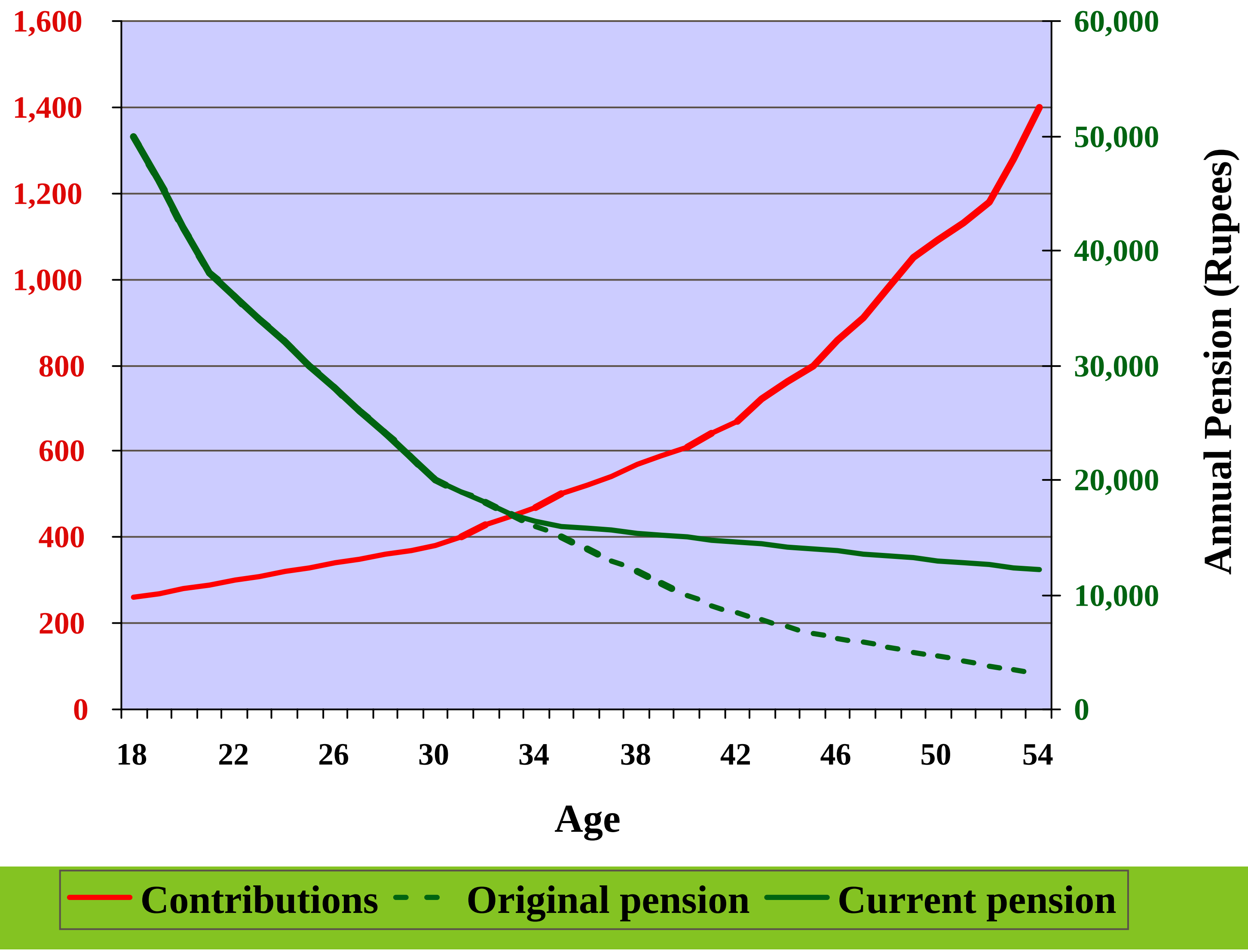
- Farmers’ Pension Scheme 1987
  - ~650,000 coverage
  - ~50-60% coverage
- Fishermens’ Pension Scheme 1990
  - ~45,000 coverage
  - ~40-50% coverage
- Self-employed Pension Scheme 1996
  - ~70,000
  - <5% coverage

→ **Flat pension + disability, death and survivor benefits**

Design of Informal Sector Schemes

- Government administered
  - Eligibility assessment and administration by public sector
  - Payments collected through decentralized, public sector offices
- Nominal design
  - Voluntary/Defined benefit/Contributory with small tax subsidy
  - Flat contribution schedules, based on age of entry
  - Flat rate benefit at age 60, based on age of entry
  - No inflation adjustment mechanism
  - Pension fund intended to be actuarially sound

Contribution Schedules



Scheme Problems

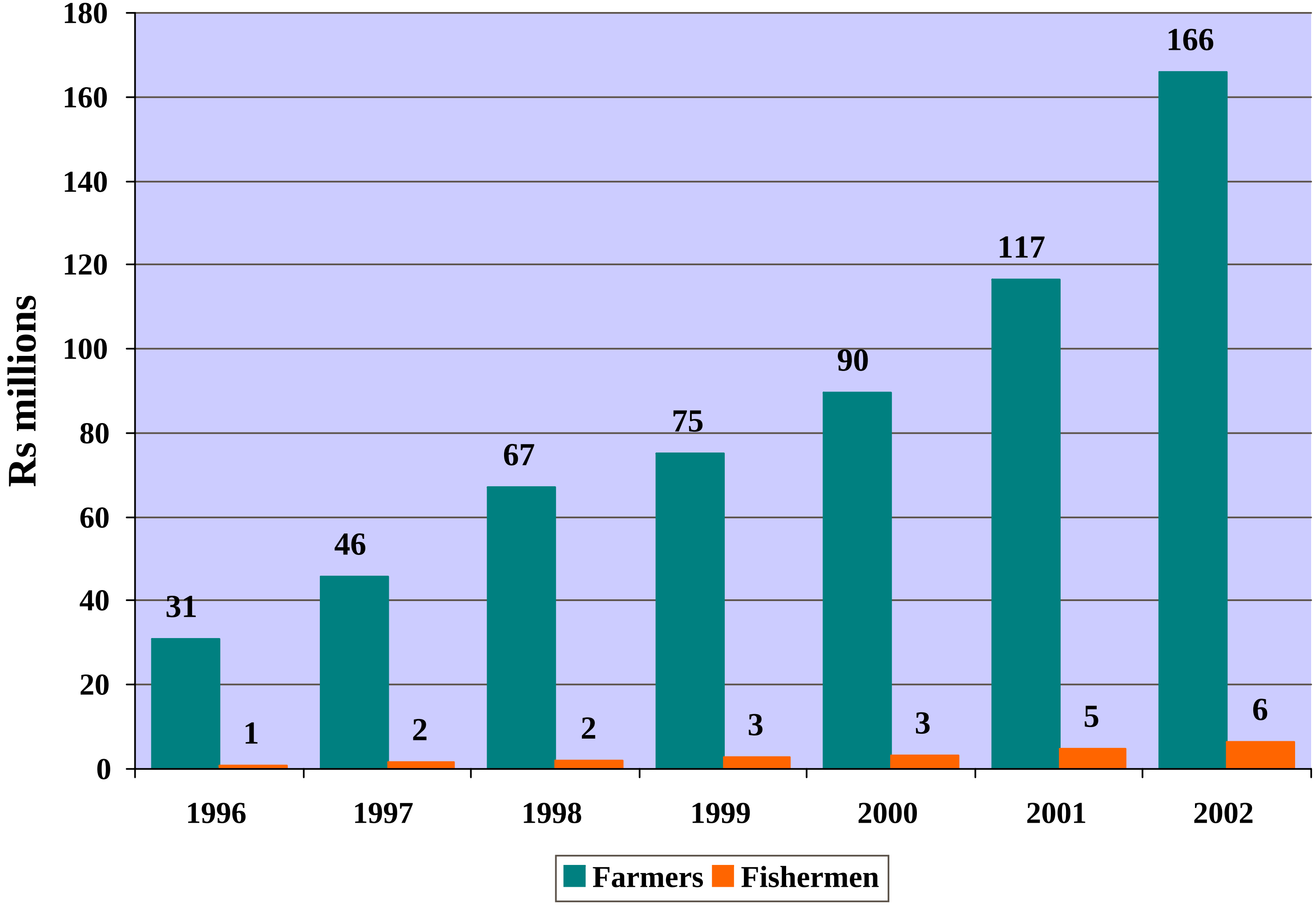
Financing/Benefit design

- Flat, nominal DB/DC schedules with no recognition of inflation/wage/life expectancy increases
  - Benefits become worthless in real terms, fail to provide adequate or any income protection
  - Political mechanism forces ad hoc upward adjustments to benefits, but not in contributions
- Not appropriate to demographic realities
  - Life expectancy at age 60: 17-21 years (2001) & increasing
- Government contribution
  - Assumed in design, but never fully paid - Not clear whether government has fully accepted need for major subsidy
- Separation of schemes
  - High administrative costs/inefficiencies
  - Weak technical capacity

Relevance to informal sector

- Fixed contribution schedule (1 mos/3 mos) not appropriate
  - Not appropriate given income flow/career paths
  - High rate of default due to non-payment >40%
  - Political mechanism intervenes to forgive defaults
- Inflexible to demands of dynamic economy
  - Lifetime membership in occupation not option for many
  - Lack of portability not suited for industrializing economy, with significant rural-urban migration
  - No option to increase contributions with income growth
- Doesn't reach poorest
  - Evidence that enrollees are wealthier than average

Current cash flows



Financial outlook

- Current cash flows positive, as schemes still not mature
  - But will change as outflows rapidly increasing
- Not actuarially balanced
  - Largely due to initial design errors, and later benefit adjustments
- Large, implicit fiscal debts
  - 5-15% of GDP

Potential Solutions

Income adequacy

- Common characteristics of informal workers
  - Lack of steady income
  - Frequent employment transitions
  - Higher rates of hard, manual work
    - Higher rates of disability
    - Less likely to be able to work to 65+ years
- Income constraints
  - Below average incomes
    - Subsistence level implying inability to forego consumption
    - 20%+ contribution rates insufficient to generate replacement incomes above poverty line
  - Shorter working lives

Design improvements

- Contributions
  - Should allow for flexibility in payments
    - Over the year
    - Over a lifetime
  - Should allow for employment changes & be compatible with extending working lives
- Benefit design
  - Should be actuarially linked to lifetime contributions
  - … But recognize social preference to ensure minimum pension floor
  - … And political willingness to use tax money to pay for lowest wage workers

Possible solution (1)

- Contribution-based scheme
  - Initially for self-employed groups
  - Individual lifetime accounts, facilitated by use of unique lifetime personal IDs
    - Contributions at any time
    - No maximum age for contributions
  - Account balances credited with investment returns of scheme
- Option later for formal worker groups to opt in
  - Switch existing provident fund balances in with guarantee of no benefit losses
  - Retaining requirement for employer contribution

Possible solution (2)

- Benefits
  - Pension annuity at retirement age
    - With incentives for deferral
    - Inflation indexed
    - Minimum payment based on social assistance levels
  - Government contribution to individual accounts targeted to lower-wage earners
    - How much and on what basis?
    - General revenue or ear-marked taxes?
  - Requirement for scheme to adjust benefits taking into account actuarial affordability

Lessons (1)

1. Income adequacy in old age is also a political problem
   - In a democratic context, inadequate solutions will result in political corrections
2. Informal sector/self-employed are poor
   - Real problems of collection and insufficient/discontinuous incomes
   - Will require redistributive, tax financing to achieve income adequacy

Lessons (2)

- Fluid employment paths must be accommodated, esp. in dynamic growing economy
  - Requires shift to integrated, national pension systems
- Setting optimal benefit schedules, subsidies, tax contributions is political
  - Has to be done in steps
  - Take into account social reactions
  - Contributions and taxes both politically necessary

Lessons (3)

- LMICs can do well to learn more from Japanese/US experience
  - Sri Lanka's current needs/demands not that dissimilar to Japan in 1950-60s
  - US Social Security System design in 1930s still relevant to Sri Lanka in 2000s
- GoJ and WB should do more to share Japanese/US experience with LMICs

Thank You