

# THE ROLE OF SOCIAL PENSIONS IN KOREA

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## [ABSTRACT]

Currently, Korea has the highest elderly poverty rate among OECD member countries mainly due to the limited role of immature public pensions. In 2007, the Korean government expanded the pension coverage by introducing the Basic Old Age Pension, a new non-contributory social pension. This short paper examines the issues and limitations attending to the recent pension reform in Korea.

## Introduction

Until 2007, Korea's major old age income security system for the general public was largely composed of the National Pension Scheme (NPS), a contributory social insurance scheme, and the National Basic Livelihood Security program, a public assistance program. The NPS, first introduced in 1988, is a partially-funded defined benefit plan that provides a survivors' pension and disability pension as well as a relatively generous old age pension with a 60% average replacement rate (based on an assumption of 40-year participation). However, this scheme is still in its infancy and has yet to come to fruition. Currently only about 20% of senior citizens aged 65 and above receive pension benefits. In actual fact, benefits are rather low due to the short participation period of current beneficiaries.

The National Basic Livelihood Security program, introduced in 2000, is a means-tested public assistance program targeted at poor households. Since more than one fourth of its recipients are senior households, however, it actually functions as zero-pillar old age income security.<sup>1</sup> This program's objective is to guarantee basic income by compensating for the gap between actual household income and the poverty threshold officially announced every year. The minimum livelihood costs are set at about 40% of average household income. However, a recipient needs to meet criteria based on his/her income and asset level as well as a set of strict rules regarding family support. When the income of a child's household exceeds 120% of the combined minimum living costs of both child's and parents' households combined, the right of the elderly household to receive NBLSS support is restricted. The actual number of recipients is therefore less than 10% of senior households aged 65 and above.

In sum, only about 30% of those aged 65 or over are actually drawing benefits from Korea's public old age income security system. Moreover, a majority of low-income elderly receive no public support, resulting in widespread elderly poverty. In addition, many low-income participants such as informal-sector workers, the self-employed, and small business owners evade mandatory NPS

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<sup>1</sup> In 2006, 25.8% of the total recipients of the NBLSS program were 65 years old or more, which accounted for 8.1% of the total population aged 65 and above (Ministry of Health and Welfare [2007]).

contributions. The Korean government reformed the NPS in 2007, reducing overly generous pension benefits and adding the Basic Old Age Pension Scheme, a new non-contributory social pension. This short paper examines the limitations and issues attending to the coverage of Korea's old age income security system and discusses future policy directions for the system based on an assessment of the recent pension reform.

## 1. Problems in the Coverage of the Korean National Pension

### **1.1 Low coverage of the elderly population**

Despite continuous economic growth, poverty among the elderly remains a very critical problem. As demonstrated in Figure 1, poverty can be expected to afflict about one fourth of all households where the head of household is over 60 and around half of those where the head of household is over 70. These figures are, respectively, two and four times higher than the overall poverty rate . Likewise, Korea has both the highest elderly household poverty rate and the widest relative income gap between working families and elderly households among OECD member countries (Whitehouse [2008]).

The reason behind the elevated elderly poverty rate can be easily understood by looking at the sources of income for elderly households, as seen in Table 1. As the table shows, private transfers, accounting for 25.8% of total income for elderly Korean households, are the largest of all income sources. Public pensions amount to a mere 12.8%. This stands in stark contradiction to and contrast with the fact that public pensions are the most important income source for the elderly in other developed countries. Thus, a majority of elderly Korean households are financially dependent on offspring, continuing a tradition of informal safety nets. Given the limited role of public pensions, elderly household without savings or offspring are at high risk of poverty.

**[FIGURE 1 HERE]**

## [TABLE 1 HERE]

The narrow coverage of the NPS will gradually increase as the scheme matures. The National Pension Service predicts that over 70% of the population aged 65 or over will receive old age pension by 2070, and 90% of the elderly will be NPS beneficiaries when survivors' and disability pensions are included (Committee on the National Pension's Financial Evaluation [2008]). Since more than half of the elderly population is not expected to enjoy pension benefits until 2030, however, the narrow NPS coverage will remain a social issue for the next 20 to 30 years. This implies that more measures need to be taken to fill the gap between the NPS and the last resort social safety net NBL program, that supports only 8.4% of the elderly population.

### 1.2 Low contribution payment rate

Another problem in applying the NPS is that many working-age members of the scheme do not actually pay contributions. As seen in Table 2, 5.1 million participants, or 28% of the total, are classified as exempt payers, meaning they are given a grace period for the time being because they can not afford to pay contributions. Even more grave is the recent rise in the number of such participants. Since many of them are classified as poor or nearly so, a substantial number will continue to have difficulty accumulating a contribution history sufficient to draw benefits in the future.<sup>2</sup> Exempt payers are at high risk of eventual elderly poverty.

## [TABLE 2 HERE]

As can be seen in Table 3, 90% of exempt participants have difficulty keeping their livelihood and 75% are unemployed. However, what is most noteworthy in Table 3 is that the number of exempt payers who are unemployed is far higher than the figure publicly announced by the government.<sup>3</sup> Because exempt payers include not only the currently unemployed but also a certain portion of the

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<sup>2</sup> Among the 5,107 exempt payers, 79.9% (4,079) have been in the category for one year or more and 53.2% (2,716) for three years or more as of Dec. 2007. (National Pension Service).

<sup>3</sup> The number of the unemployed officially announced by the Korean National Statistical Office as the end of 2007 is 736 thousands (unemployment rate of 3.1%). (Korea National Statistical Office, 「Current Status on Employment」, 2007).

economically inactive who previously contributed, it would be hard to draw a comparison. Many exempt participants may be temporary or daily workers, the self-employed, or small business owners, who underreport income and are not discovered by the National Pension Service..

**[TABLE 3 HERE]**

Such exempt payers are not the only problem. Delinquency on the part of those who actually do report income is another problem. As of January 2008, about 2.7 million participants are delinquent in their payment, half of which are long-term delinquents who have failed to pay for more than two years (National Pension Service). While many of these long-term delinquents have reasons for their inability to pay, including insufficient income, the government's administrative deficiencies in the NPS bear a portion of the blame.<sup>4</sup>

2. Evaluation of the 2007 Korean National Pension Reform

Government has identified the narrow coverage of the NPS, its low participation rate, and fragile long-run financial security, as priority issues. Having recognized the problem, the government implemented a reform of the NPS, focused on enhancing sustainability and expanding coverage, in 2007. The reform intended to extend coverage by introducing the non-contributory Basic Old Age pension. Long-run financial stability of the NPS was addressed by maintaining a 9% contribution rate while immediately lowering benefit levels from the current income replacement rate of 60% (for an average income earner with a 40-year participation history) to 50%. The benefit reduction is planned to continue by 0.5% per year until the replacement rate reaches 40% by 2028. Military service pension credits for compulsory military service and childbirth pension credits for female participants were newly introduced, and the elderly were provided with greater incentives to continue to work in the form of enhanced delayed pensions.

The Basic Old Age Pension Law, introduced to help the low-income elderly, stipulates that an amount equivalent to 5% of the average monthly income of NPS participants be paid to those aged

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<sup>4</sup> Among the delinquents, only 587,000 or 21.8%, have taxable income (National Pension Service).

65 or over whose income level is lower than a threshold. In 2008, that threshold for a single-member household was monthly income of 400,000 won or less and for a couple, 640,000 won or less. The benefit rate is to be incrementally raised from 5% in 2008 to 10% in 2028. As of July 2008, 60% of the population 65 and over qualify; it is planned to adjust eligibility so as to reach 70% of those aged 65 or over in January 2009.

Government believes that the 2007 pension reform will substantially contribute to old age security for all, as well as increase long-run NPS financial sustainability. In particular, the Basic Old Age pension's introduction as a new zero pillar means that the government has officially recognized the coverage gap of the nascent NPS and the issue of elderly poverty. Nonetheless, the recently introduced basic old age pension scheme is cause for a number of concerns in terms of structure and benefit level.

First, classification poses a problem. The number of recipients of the basic old age pension is restricted to 60% to 70% of the population aged 65 or over. Thus, it is hard to classify this system either as a demogrant-type universal basic pension or as a public assistance pension aimed at poor seniors. In fact, the basic old age pension is subject to means-testing, making it look more like public assistance rather than an entitlement. However, even in this case, the 70% coverage target seems too high a figure for a policy aimed specifically at the poor elderly. The problem of classification is the byproduct of political compromise: when the introduction of the Basic Old Age Pension was first discussed, the government proposed the adoption of a public assistance pension geared toward about 40% of the elderly population in poverty while the opposition party (Grand National Party) insisted on the introduction of a demogrant-type universal basic pension. During the course of political deliberation, the coverage of the Basic Old age pension was haggled over, and eventually a compromise between the two was reached (Moon [2007]). The compromise has left, however, a system which is neither fish nor fowl.

Second, the basic old age pension's benefit level is too low to relieve poverty among the elderly population. The 2008 benefit level is set at 84,000 won for a single-member household, or 134,000 won for a couple, which is 5% of NPS participants' average monthly income (1,677,000 won).

However, this is less than even one fifth of the government's official poverty threshold. Even though it is to be increased gradually by 2028, it will account only for 35% of minimum livelihood costs. Therefore, it is dubious whether the basic old age pension would effectively resolve the issue of elderly poverty with such a poor benefit level.

In summary, political considerations have led to wide basic pension coverage, but not wide enough for the scheme to be called universal. Wide coverage has required a very low benefit level in order to make the scheme affordable.

### 3. Future Policy Directions in Korea

A public old-age income security scheme should, at a minimum, prevent elderly poverty. With this in mind, it is necessary to reevaluate the validity of the recently introduced Basic Old Age Pension System, and to investigate whether its combination of wide coverage with low benefit levels will be effective in achieving its stated goal. President Lee Myoung-Bak, inaugurated in February 2008, stated that he would again reform the current National Pension and Basic Old Age Pension by reorganizing them as a first tier non-contributory universal basic pension and a second-tier contributory earnings-related pension. Under his plan, with the adjusted benefits of the National Pension maintained, the Basic Old Age Pension System would be integrated into the NPS and transformed into a tax-financed basic pension that guarantees minimum income for elderly citizens while the pre-funded National Pension maintains its actuarial balance. (Transition Committee White Paper [2008]). Although the details - such as the scope of coverage and the level of benefits - are not yet determined, the new administration is clearly making a priority of extending the scope of pension coverage by introducing a universal pension scheme. Yet the fiscal cost needs to be considered. According to one estimate (Moon [2007]), if we pay 15% (20%) of the average income of national pension participants to 80% of those aged 65 years and over, the total payment will account for 5.8% (7.7%) of GDP in 2050. If the value-added tax revenue is to be appropriated for these expenses, the tax needs to be raised to the 21% (25%) level in 2050, which is more than double the current level of 10%.

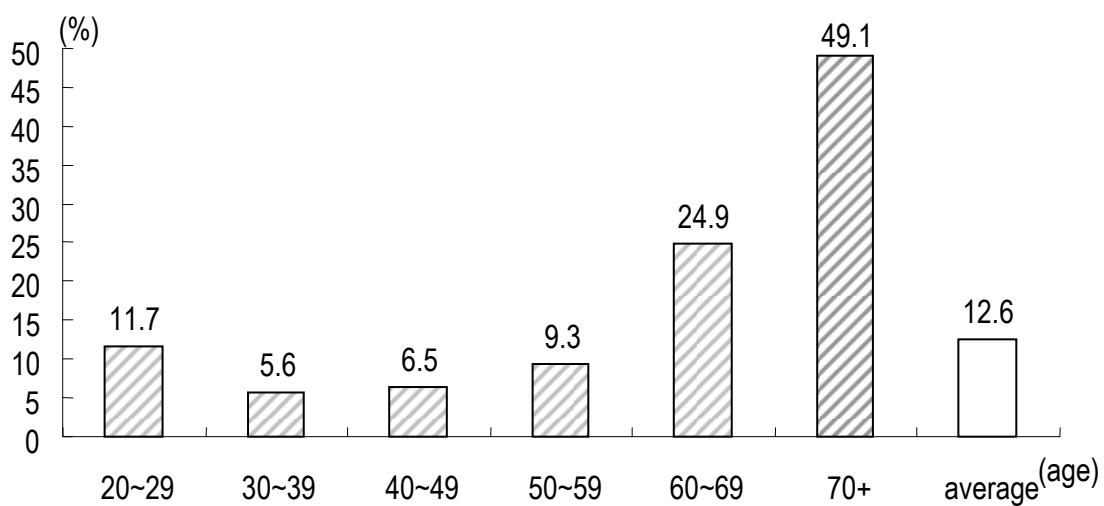
In conclusion, coverage continues to be inadequate and old-age poverty continues to be a problem in Korea, despite pension reform. The current reform priority appears to be the extension of coverage, in part through the provision of a universal basic pension. This is laudable, but the fiscal costs are not inconsiderable.



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[Figure 14.1] Poverty Rates by Ages of Household Heads in Korea



Note: 1) Poverty line is set at 40% of the median income and the number of households is converted by applying equivalence scale.

Source: Korea National Statistical Office, *National Household Survey*, 2006.

**Table 14.1:** Composition of Income, Elderly Households

(Unit: %)

Income source	Payroll income	Business income	Asset income	Private transfers	Public transfers		Non-ordinary income	Total
					Public pension	Others		
	22.8	9.7	10.9	25.8	12.8	7.8	10.1	100.0

Note: 1) Based on the households with a 65-year-old or over household head.

Source: Korea National Statistical Office, *National Household Survey*, 2006.

**Table 14.2:** Current Status of National Pension Exempt Payers

(Unit: thousand, %)

	Total participants	Workplace participants	Regional participants	Exempt payers
2005	17,074 (100.0)	7,951 (46.6)	4,489 (26.3)	4,634 (27.1)
2006	17,691 (100.0)	8,605 (48.6)	4,150 (23.5)	4,936 (27.9)
2007	18,212 (100.0)	9,149 (50.2)	3,956 (21.7)	5,107 (28.0)

Source: National Pension Service.

**Table 14.3:** Exempt Payers (2007)

(Unit: thousand, %)

Reasons	Unemployed	On leave	Business closed	Hardship in livelihood	In school / military service	Unknown address	Others	Total
Headcount	3,799	137	428	218	120	396	9	5,107
(%)	(74.4)	(2.7)	(8.4)	(4.3)	(2.3)	(7.8)	(0.2)	(100.0)

Source: National Pension Service.