# Tackling Poverty in Old Age:
# A Universal Pension for Sri Lanka

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# Acknowledgements

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# Executive summary

Sri Lanka's population is ageing rapidly. Residents over 60 years of age comprise 9% of the population and will reach 25% by 2041. The existing pension system in Sri Lanka is unable to guarantee a minimum income for older people to prevent them from living in poverty. Coverage of pensions is small - probably no more than 10% to 15% of the population have access to any form of pension scheme - and, most pension schemes provide benefits that are well below the poverty line. Even if existing pension schemes were to be improved, they would still be unable to provide income security for the vast proportion of the older population.

If Sri Lanka is to be successful in tackling old age poverty, there needs to be a fundamental shift in pension policy. Internationally, there is clear evidence that, in countries with high levels of poverty and informal employment, the simplest and most effective form of pension is a universal non-contributory pension paid out of government revenues. In such pension schemes, every older person - upon reaching a specific age - receives the same minimum benefit to keep them out of poverty.

A number of countries - both developed and developing - have put in place universal pension schemes. The first country to do so was New Zealand in 1940 but, since then, a range of countries as diverse as Mauritius, Nepal, Namibia, Bolivia and Kosovo have established similar schemes. Evidence indicates that these pension schemes have been very successful in tackling old age poverty. They are very simple to administer and are politically popular.

Universal pensions can play an important role as the foundation pillar of a broader pension system, upon which other pension pillars can be built, whether they be mandatory or voluntary contributory schemes. Universal pensions have significant advantages over means-tested pension schemes which are much less effective in reaching the poor and create a series of perverse incentives, including discouraging people from working in old age. Means-tested pensions can also undermine contributory pension schemes by discouraging people from saving for old age. Universal pensions create no perverse incentives and provide a solid basis upon which to establish a system of contributory pensions.

This study provides estimates of the fiscal cost of a universal pension in Sri Lanka. It challenges those opponents of universal pensions who claim that such schemes are unaffordable, despite the fact that many developing countries have already successfully put in place such schemes. The study demonstrates that a universal pension in Sri Lanka can be affordable.

The study proposes a level of cash benefit for a universal pension in Sri Lanka at the national poverty line, currently around 2,950 rupees (US$27) per month. This would provide older people with a benefit that is approximately three times as large as those offered by the most generous informal sector contributory schemes. The study estimates the cost of a pension for four qualifying ages: 60, 65, 70 and 75 years. Calculations also include the costs of administering the schemes and providing a funeral benefit equivalent to three months of pension benefits.

Estimates indicate that the cost of providing a pension to everyone in Sri Lanka above the age of 70 would be **0.8% of GDP**. When compared to the cost of universal pensions in other developing countries - estimated as a proportion of GDP - such a scheme would be one of the least expensive schemes internationally. The study also

indicates that a pension for everyone over 60 would cost 1.8% of GDP, for those over 65 it would be 1.2% of GDP and for over 75s it would be 0.4% of GDP.

Costs of a universal pension up to 2041, adjusted for inflation, are also provided, to take into account the growing number of older people. Assuming a continuation of the trend per capita growth rate over the past 20 years of 3.6% per year, the study indicates that a universal pension for those over-70s would become increasingly affordable, dropping to 0.6% of GDP by 2041. If however, growth of per capita GDP were to fall to 1.8% per year, the fiscal burden of a universal pension would increase, but only modestly, rising to 1.1% of GDP for everyone over 70.

The financing of a universal pension is, ultimately, a question of political will. But, even with political commitment behind a pension, governments still need to find the necessary funds. Taxpayers may be more willing to finance age pensions if the additional taxes required are collected exclusively for the purpose of universal pensions and they are assured that the pension benefits will be protected. Since everyone benefits from universal pensions, it is important that everyone contribute to their finance. The tax, therefore, ought to have a broad base.

Consumption taxes are one option in Sri Lanka. The study indicates that a small increase in VAT and excise duties could provide sufficient funding to finance a universal pension. For example, an increase in VAT of 5% to 5.5% (along with similar small increases at higher levels of VAT) would pay for a pension for everyone over 70 years. For lower ages of eligibility the surcharge would, of course, be higher.

A universal pension would be relatively simple to set up and administer in Sri Lanka. Registration of beneficiaries would be unproblematic because the only information required from applicants is proof of age and residence. Most will already have a national identity card and, for those lacking a card, the more than 10,000 village elders' societies across the country can help in verifying their age. One of the main challenges in any pension system is ensuring that beneficiaries are de-registered on their death. A simple way of encouraging the reporting of deaths is to provide a funeral benefit equivalent to, perhaps, three months of pension benefits if a pensioner's death is reported within 20 days.

A universal pension set at the poverty line is likely to transform the lives of older people and their families across Sri Lanka. It will almost certainly be politically very popular with citizens and could play an important role in building social cohesion and strengthening the social contract between the state and people from all ethnic backgrounds.

informal sector are more apt to work for wages or - in the case of farm wives - to contribute to household production of cash crops.

## 2.1 Existing pension schemes

The pension system in Sri Lanka is built, essentially, around a number of non-contributory and contributory schemes covering both those working in the formal sector and a small proportion of the informal sector labour force. The main pension and pseudo-pension schemes are described below.

### 2.1.1 The Public Service Pension Scheme (PSPS)

The PSPS is a non-contributory benefit financed from general government revenues, currently at a fiscal cost of 2% of GDP. It is provided to former civil servants. A full pension is payable from age 55 (men) or age 50 (women) and must be taken at latest by age 60. The pension is based on final salary (85-90% replacement after 30 years of service), is not taxable, but is not indexed for inflation. There is no explicit spousal allowance, but widows (widowers) receive a survivor's pension following the death of their husband (wife). There is a separate, contributory Widows, Widowers and Orphans Pension Scheme that provides benefits to survivors of public sector workers who die in service.

### 2.1.2 The Employees' Provident Fund (EPF)

The EPF is much larger than the PSPS but it provides only lump sum payments, not a retirement pension. Government requires contributions equal to 20% of wages (8% from workers and 12% from employers), which are credited to a notional account of the worker and invested almost solely in government securities and loans. The accumulated funds can be withdrawn on retirement, which can be as early as age 55 for men and age 50 for women. The scheme covers most workers in the formal sector who do not participate in the PSPS. At the end of 2006, the EPF had 11.3 million member accounts, of which 2.0 million were active (Central Bank of Sri Lanka, 2006). There are also several small Approved Private Provident Funds (APPFs) and Private Contributory Pension Schemes created by enterprises that opted out of the EPF.

### 2.1.3 Informal sector contributory pension schemes

The 4.7 million workers in Sri Lanka's informal sector are potentially covered by a large number of contributory pension schemes, but they do not perform particularly well. All the schemes are voluntary, and neither benefits nor contributions are indexed.

The oldest and largest scheme is the Farmers' Pension Scheme, begun in 1987 and administered by the Agricultural and Agrarian Insurance Board (AAIB). The scheme has over 680,000 accounts but, due to poor record-keeping, it is not known how many are active. Eriyagama & Rannan-Eliya (2003, p. 18) report that: "it is believed that at least half the enrolees have defaulted and are no longer active contributors". Contributions are collected in half-yearly instalments and the size of the pension at age 60 depends on the age when membership begins. The required contributions are small, ranging from 84 instalments of 130 rupees for someone joining at age 18 to ten instalments of 690 rupees for someone joining at age 55.

likely that a means-tested pension in Sri Lanka would merely replicate the unfortunate experience of both India and Bangladesh.

In contrast, international experience demonstrates that universal pensions, given that they reach almost all older people, provide excellent coverage of the poor and those who are in danger of falling into poverty. In Sri Lanka, there is no reason to assume that a universal pension would not be able to reach almost 100% of poor older people.

There are also additional factors militating against the adoption of means-tested pensions in developing countries:

**High administrative costs** Means-tested pensions have very high administrative costs when compared to universal pensions. This is the result of having to invest a lot of time and effort into identifying the poor. And, the more effective a means-tested pension is in reaching the poor, the higher the costs. In Sri Lanka, the administrative costs of a well-targeted means-tested pension would be very high. In contrast, it is very easy to identify those eligible for a universal pension, thereby keeping down administrative costs significantly.

**Rewarding cheating and penalising honesty** Means-tested pensions reward cheating and penalise honesty. They encourage people to hide their true income and wealth. Those who are honest in declaring their wealth find that they lose out in accessing means-tested pensions. Those who lie and cheat are often rewarded. This is one of the main reasons why Mauritius moved from a means-tested to a universal pension (see Annex A).

**Creating perverse incentives** Means-tested pensions create perverse incentives and encourage people to act in ways that can harm their best-interests and those of the country. People are discouraged from saving for old age thereby undermining contributory pension schemes (receiving a contributory pension in old age would disqualify someone from the means-tested pension). And, of course, means-tested pensions discourage older people from continuing to work. Universal pensions do not put in place any disincentives. In contrast, people are more likely to save for old age - thereby strengthening the contributory pension system - and to continue to work once in receipt of a pension.

**Disempowering older people** Means-tested pensions disempower older people by placing decisions on their income in the hands of bureaucrats and politicians. Government officials decide who receives the pension and this can place them in a significant position of power over older people. As a result, older people often find that they have to pay government officials if they are to receive a pension or promise to support local politicians in elections. In contrast, a universal pension is often regarded as an entitlement and, given that age is the only qualification, decision-making power is taken out of the hands of bureaucrats.

**Politically unpopular** Means-tested pensions are not popular politically with the wider population. Removing a majority of the electorate from benefits reduces the appeal of a pension scheme and makes it difficult to collect the taxes needed to finance it. And, as has been seen in many countries, continuous denunciations in the media of the corruption associated with means-testing can undermine the popularity of schemes and cause difficulties for governments. In contrast, universal pensions - because they are paid to everyone - are very popular politically, particularly among those who have paid their taxes.

However, one possible solution to the challenges raised by the existing informal sector contributory pensions is for them to focus on ‘gap coverage’. In other words, they could provide a retirement income not for a lifetime but, rather, for the five or ten years prior to the age at which a member of the scheme qualifies for a universal pension. So, if a universal pension were introduced at 70 years of age, the contributory pension could cover the period from 60-70 years. This could also lead to a higher level of benefit being paid from these schemes than the current very low pensions of 500 or 1,000 rupees a month (or, indeed, it may make these pensions more affordable).

Private initiatives such as the National Savings Bank’s ‘Pension+’ scheme could offer similar coverage for ‘gap years’ of workers in the informal sector (Anonymous 2008).

contribute to social cohesion as their distribution can be more easily manipulated to favour one group over another.

Finally, however, and of greatest significance, a universal pension can restore dignity to many older people who now live in deep poverty and are often treated as a burden by their families. In north-east Brazil, the provision of pensions has restored older people - who had been increasingly regarded as outcasts - to their position as the most respected people in their community. With a minimum pension, older people no longer have to beg from others to survive and have a greater chance of living out the final years of their lives in peace.

Consumption - and, therefore, taxes on consumption - tends to track GDP. If real economic growth continues its long-run per capita trend, revenue from any of the surcharges reported in table 3 will be adequate to finance the desired pension. In fact, with trend growth, revenue will be more than adequate, providing allowance for a future reduction in the surcharge or increase in benefits. If growth is lower than expected, the additional finance required to fund the pension would be minimal since the main body of funding would be guaranteed.

Funds collected from this additional taxation could be placed directly into a **Universal Pension Fund**. The existence of this fund - with suitable guarantees built in - should convince the general population that it is worthwhile paying into this fund as it will provide them with a guaranteed pension in old age. As the fund increases in size, the surcharge could be reduced, the size of benefits could be increased, or the age of eligibility for the pension could be reduced.

One way of easing pressure on administration when the registration begins is to allow applicants to receive up to twelve months benefits in arrears, without interest but also without penalty. This will ensure that an older person does not suffer unduly if the registration process is slow, or even if an applicant was late in learning about the new benefit.

### 7.1.3 De-registration of beneficiaries

In a universal pension system, it is only necessary to de-register beneficiaries on their death. Relatives continuing to receive benefits following the death of a beneficiary is one of the biggest fraud risks in any pension system. It should, of course, be made illegal for relatives of beneficiaries not to report the death of a beneficiary. However, the state can also put in place positive incentives to encourage relatives to notify the pension administrators of the death of a beneficiary.

Rather than hire an army of inspectors to police beneficiaries, it is preferable to give a **funeral benefit** of, perhaps, three months of pension benefits as a lump sum, on condition that a pensioner's death is reported within 20 days. The benefit could be paid to a designated beneficiary or, in the absence of a designated beneficiary, to the person who arranges and pays for the funeral of the deceased. The process could be supported by village elders committees who could assist relatives of the recently deceased in reporting the death.

### 7.1.4 Creation of a registry for pension recipients

The government will need to create a 'registry system' to hold information on beneficiaries and to pass the data to relevant payment providers to enable cash to reach older people on the scheme. A computerised system using advanced software will be the most efficient means of holding information on beneficiaries and it should be directly interfaced with the payment mechanism. The registry should be able to accommodate new registrations for the pension and the removal from the registry of those who have died.

Although the registry will be co-ordinated centrally, it will be most effectively managed if local government offices are able to administer data locally, inputting into the central database.

There will be a number of design options for a registry depending on the payment mechanism chosen and the process which is established for on-going registrations to the scheme. The decision on the form a registry will take would need to be made during the design phase of a pension scheme.

However, rather than developing its own software for a beneficiary data-base, Sri Lanka should, first of all, investigate data-bases used elsewhere. The South African Ministry of Social Development has expressed interest in sharing its technology with other countries and may be willing to export its data-base software to Sri Lanka at little or no cost and, potentially, provide technical advice to adapt it to the Sri Lankan context. Brazil is another country that may be interested in exporting its registration data-base technology.

# 8. Conclusion

A universal pension is both affordable and feasible in Sri Lanka with no need for targeting. It is clear that the existing pension system in Sri Lanka is severely flawed. Even if existing pension schemes were improved, they would still not be able to provide a guaranteed minimum income for all older people, in particular those living in poverty. International experience indicates that a universal pension scheme is relatively simple to put in place and, once established, is very simple to administer. The impacts of such pensions on the lives of older people are significant.

Sri Lanka's population is ageing rapidly. Older people are likely to become a more powerful force politically in the next few years. It is essential that an effective pension system - based on the foundation pillar of a universal pension - is put in place as soon as possible. Fortunately, international experience demonstrates that a universal pension is very popular politically and so it is highly likely that a decision to move ahead will be received positively by the vast majority of citizens.