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Pension Systems for the Informal Sector in Asia

Edited by Landis MacKellar

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ABSTRACT

This paper looks at the experiences of various Asian countries in expanding the coverage of the pension system to informal sector workers. The paper argues that given aging and growing informality, a rapid forward-looking response from governments in the region is necessary to provide protection against the risk of poverty in old age. This risk is particularly acute in the case of informal sector workers, as is the difficulty of reaching them through traditional formal-sector pension approaches. From the analysis of various case studies the paper concludes that expanding coverage to informal sector workers through mandatory systems is unlikely to work. Alternative, voluntary arrangements are need. However, because informal sector workers tend to have lower savings capacity and high discount rates, targeted subsidies might be required to encourage enrollment. The paper discusses some of the issues related to the design of these programs -- including those related to administration and the collection of contributions. In all cases, the paper emphasizes the need to resolve difficult tradeoffs between these transfers to prevent poverty during old-age and expenditures in other social programs.

JEL Classification: J14 and J26

Key words: Pensions, Coverage, Asia, Informal Sector, Matching Contributions, Social Pensions.

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Foreword

New responses to providing social protection to the informal sector are being developed and tested in such countries as Vietnam, China, Thailand, Indonesia, the Philippines, Korea, Sri Lanka, India and Bangladesh. In November-December 2006 the World Bank organized a workshop, “Extending Pension Coverage to Informal Sector Workers: The Asian Challenge,” in Bangkok, Thailand, that brought together government representatives from these countries to share their recent experiences. Building on the presentations made and discussions held in the workshop, this report provides a summary of the key issues and challenges involved in expanding pension coverage to the informal sector. It furnishes an outline of innovative experiences across Asia and highlights the lessons learned as well as the policy implications to be considered in moving forward.

1. The Asian context

The irreversible process of population aging has rapidly unfolded in Asia in recent years. The region, which currently holds over half of the world's elderly, will house two thirds of the total world's population over 60 by 2020. However, economic growth in the region and thus income per-capita levels are not at par with the pace of the Asian demographic transition. The Western world developed first, then aged; many Asian countries will age while they are still developing. This, coupled with the progressive weakening of informal safety nets that result from growing urbanization and higher labor mobility, is putting a high share of the Asian elderly population at risk of poverty. The region is currently trying to address the challenges created by this phenomenon through the establishment of pension or retirement income systems that help the population cope with the risk of poverty in old age. One of the key issues in the ongoing debate is how to reach the large and often growing percentage of the Asian population that works in the informal sector, a population not only harder to reach with traditional social security approaches but at higher risk of poverty than formal-sector workers.

2. Expanding pension systems' coverage in Asia: Issues and Approaches

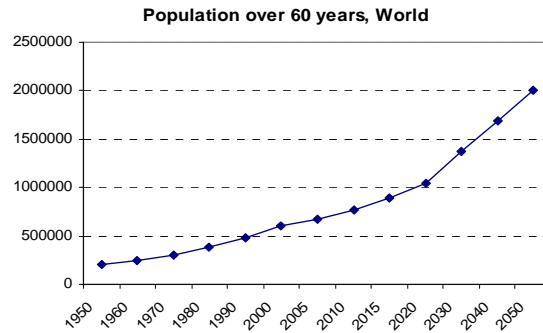
In Asia, almost all governments have the mandate to provide pension coverage for formal sector workers. However, in developing Asia it is estimated that eight out of ten workers are still not covered by a pension scheme. Although this figure should rise along with growing income levels, it is very likely that without special efforts, aging will outpace the spread of pension provision.

While this coverage gap in pension programs is a challenge for countries across the world, it is particularly pressing in Asia, mainly due to the rapidity of the demographic change underway in the region. Just over half of the world's population over 60 lived in Asia in 2005. This figure is expected to increase to more than two thirds by 2050 (see figure below). It has been projected that the number of older persons in Asia will rise from 410 million in 2007 to 733 million in 2025 and 1.3 billion in 2050¹. To picture the magnitude of this aging process, estimates suggest that by 2030 the percentage of population aged 60 and above in a number of Asian countries will be greater than the OECD average in 2000². The speed at which the region's population is aging is thus without historic precedent. The explanation lies in the rapidity and magnitude of the fertility decline which has taken place in the region.

¹ UN News Center, August 2007, *Asian nations confer on impact of population ageing at UN-backed forum*

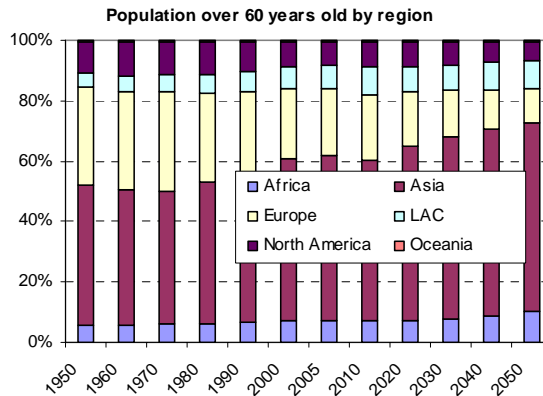
² UN World Population Prospects: The 2006 Revision

Figure 1. Population aging trends 1950-2050



Source: <http://esa.un.org/unpp>

Figure 2. Population aging trends 1950-2050 by region



Source: <http://esa.un.org/unpp>

The severity of this demographic situation will be more acute for some countries and less so for others. Countries like Hong Kong and Singapore are expected to have more than 30% of their populations above the age of 60 by 2030 while Thailand and China, where the demographic transition is less rapid, will have slightly smaller age-60-and-above cohorts (20%-22%). In developing Sri Lanka the proportion of the population over 60 will double from 10% to 20% over the next two decades.

This same process occurred in the rich OECD countries during the last century. However, it took place over a much longer period of time at much higher income levels. The challenge to address the coverage gap in Asia is thus also compounded by countries' fiscal constraints, i.e. the fact that they are still too poor to afford an adequate level of public expenditure. Most of the Asian region has experienced strong economic growth, underpinned by high savings rates; for the last decade. Demographers and economists have talked of a "demographic window of opportunity" or "demographic dividend" when fertility decline leads to a temporary situation in which a relatively large cohort of dating from the era of

high fertility is supporting a small cohort of children, freeing up resources for investment. Many, including the authors of the World Bank's influential 1992 study *The Asian Economic Miracle*, attribute a substantial portion of the region's growth to this favorable demographic environment. But the demographic window of opportunity ineluctably must close, when the small cohort of today's children; born during the era of low fertility, find themselves supporting a large cohort of elderly parents (today's workers) born during the era of high fertility.

Not only population ageing, but also equity and fairness are also major concerns in Asia's dynamic economies. In many Asian countries, that lucky portion of the population protected against the risk of old age, especially public sector workers, enjoys fairly generous benefits. If coverage is not extended to the rest of the aging population, this could result in pension "haves" and "have nots." Consider the example of China, where the urban middle class enjoys reasonable coverage while the rural population has, for all intents and purposes, no pension coverage at all.

It is inevitable that all human beings, for at least some period prior to death, will be incapable of working to produce income. Retirement-income or pension systems are programs instituted by the state so as to provide people with means to cope with the lack of income in old age, and thus to deal with the risk of impoverishment. Throughout the world, there exists a wide range of retirement-income systems aimed at addressing the risks associated with old age. The demand for these mechanisms becomes more acute and obvious with economic development, which normally leads to the dismantling or weakening of the traditional informal safety nets, leaving the elderly unprotected. The experience of Japan, where the traditional three-generation household crumbled with breathtaking speed and few of today's workers expect to receive any old-age support at all from their children, is a sobering example.

3. Pension policy: goals and approaches

Overall, the two major objectives of pension systems are providing for consumption smoothing (i.e., protecting against the risk that there will be an abrupt drop in consumption when income ceases or savings are depleted) and protecting against the risk of old age poverty. The characteristics that define a good pension system are that it is *adequate*, providing sufficient benefits to prevent old-age poverty; *affordable*, meaning that it is within the financial capacity of individuals and the state; *sustainable* over time and under different scenarios; and *robust*, meaning that it is resistant to major shocks. These characteristics provide the main criteria for evaluating the effectiveness of pension systems. A characteristic that cuts across all of these criteria is *coverage*, i.e. the proportion of people that enjoy the protection of the system.

There are various types of pension systems. A fundamental distinction may be made between redistributive (non-contributory) and insurance (contributory) pension schemes. Redistributive systems include: (1) basic pension programs, where benefits are flat (or, less commonly, determined by the number of years worked); (2) targeted programs that pay

higher benefits to poorer retirees; and (3) minimum programs, which link the benefits with earnings and contributions during the working life, but prevent pensions from falling below a certain level. The main objective of all these approaches is to prevent old-age poverty. Insurance systems have a common characteristic – how much the beneficiary gets out depends on how much he or she puts in. The main types of insurance systems are: (1) *defined benefit* or earnings related systems, which link the benefit received with years of contribution and some measure of the individual earnings during the working life (which effectively guarantees at least some link between how much went in and how much will come out); and (2) *defined contribution* systems, where each worker has an individual account for contributions and the capital accumulated is converted into a pension stream at retirement.

Among earning related systems there are three main types. (1a) the classic defined-benefit system prevalent in most countries where the pension is calculated as the product of an accrual rate, times the number of years of contribution, times an average of past salaries; (1b) *points* systems, where calculation of benefits is based on the points that workers earn depending on their individual earnings for each year of contribution; and (1c) the more recent *notional defined contribution* systems that record each worker's contributions as if he had an individual account and apply a rate of return (i.e., benefit calculation mimics a defined contribution system but pensions are financed out of current contributions, as in pay-as-you-go systems defined below).

Another important distinction is between funded- and pay-as-you-go pension systems. In *funded* systems there is an asset allocated today against the future benefits to be paid, whereas in *pay-as-you-go* systems the pensions of today's beneficiaries are paid by today's workers contributions. Provident funds, funded systems for the employees of Government or public enterprises that typically paid a lump-sum on retirement, are a type of funded system historically popular in Asia. The pros and cons of this approach are summarized in Case Study 1.

Over half of OECD pension systems are of the defined-benefit variety, as are most systems in North Africa and the Middle East, and half of Eastern European and Central Asian systems. The defined benefit approach is the most common worldwide. A number of Latin American countries and about half of Eastern European and Central Asian countries have defined contribution systems. In Europe, France, Croatia, Estonia, Germany, Norway and Slovakia have points systems, while Italy, Latvia, Poland and Sweden have notional accounts and Switzerland a notional defined contribution systems.

Case Study 1: Southeast Asian Provident Funds

In Asia, the mandatory provident fund has been the most common, approach. The advantages of national provident funds are:

- simplicity, both from the participants' and administrators' point of view (although record-keeping requirements are stringent),
- a substantial capital reserve is generated, both promoting economic growth and stimulating development of capital markets,
- no government subsidy is required,
- the portability of pensions is assured through job transitions,
- transparency is encouraged in the form of a strong contribution-benefit link, and
- since there is no risk pooling, the potential for "crowding out" traditional old-age support mechanisms is minimal. In effect, provident funds provide a supplemental savings vehicle.

The typical provident fund as it has developed is aimed at private-sector employees (only Singapore has succeeded in moving a substantial portion of its public workforce and armed forces to the national provident fund) financed by a joint employer-employee contribution out of wages. In general, public-sector employees enjoy more attractive (typically defined benefit) pension arrangements. Participation on a voluntary basis by the self-employed is typically allowed but take-up has been low because of mediocre rates of return. Originally most funds paid out a lump sum on retirement, but with the development of insurance and annuity markets, a range of options is now permitted in most countries.

The general disadvantages of provident fund approaches are:

- The resulting pensions are low because contributions are low and pre-retirement withdrawals are common.
- There is need to protect benefits against inflation both during the contribution period and when a pension is being paid out.
- Lack of risk pooling means that there is no "safety net" feature.

The main conclusion to emerge from a survey of the literature is that pre-retirement withdrawals for health, education, and housing expenses have been large. Thus, the amount actually available on retirement is much lower than would be indicated by the contribution rates. In effect, provident funds have become multi-purpose saving instruments, not retirement accounts. This tendency has exacerbated the already-serious problem of the inadequacy of retirement accumulation due to low contributions. With life expectancy rising rapidly, provident funds offer insufficient protection against longevity risk. Thin annuity markets and continuing reliance on lump-sum payouts worsen the problem.

Case Study 1 (continued)

Despite the development of capital markets in the region, Southeast Asian provident funds essentially invest in government securities or loans to government-sponsored projects (or private-sector projects favoured by government). Thus, they have contributed little to the capital market development that has been achieved. In effect, governments have used provident funds as a means of raising development capital, much of which has been inefficiently invested, or of pursuing other social goals, such as house ownership. Until very recently (in Malaysia, Singapore, and Hong Kong), all countries have prohibited foreign investment of funds, making it impossible to diversify country risk. Low rates of return and inadequate protection against inflation (as well as longevity risk) have, in turn, encouraged withdrawals to finance house purchases or education of children, exacerbating already insufficient replacement rates. There has been insufficient transparency and fundamental flaws in provident fund governance have been identified across the region. Characteristic problems have been:

- low return on investment,
- restricted investment choice,
- lack of contribution to financial market development,
- inadequate benefits, and
- inadequate benefit provision (lack of annuity markets).

All of these are related in one way or another to the centralised nature of the funds.

While voluntary “Third Pillar” retirement saving schemes have been a major component of reform in the formerly socialist countries of Europe, there is little experience with them in Asia. In part, this is because of the strong role played by mandatory national provident funds, whose sometimes substantial contribution rates leave little room for further retirement saving. However, there has been some development of the third pillar in Southeast Asia. In Singapore, households may contribute up to 15 percent of their income to the Supplemental Retirement Scheme (SRS) introduced in 2001. This option has attracted few takers because of the already-high contribution rate to the national provident fund and the fact that tax advantages from further retirement saving benefit only workers at the very top end of the income distribution. The SRS contribution to social security in Singapore has been marginal. In Malaysia, there has been spectacular growth in the Unit Trusts industry, and provision has been made for those who have substantial assets in national provident funds to transfer small portions of their balances to unit trusts. Saving in unit trusts has become widespread, but there is no evidence that this is retirement saving *per se*.

4. The challenge of covering the informal sector

Most pension systems provide at least basic protection against the risks associated with old age for formal-sector workers. However, most workers engaged in the informal sector, particularly in developing countries, are left out of the traditional pension systems. It has been estimated that between half and three fourths of non-agricultural employment in developing countries is informal, although the degree of informality varies across countries and regions. In Africa, informal work was estimated to account for around 80% of non-agriculture employment and 90% of the new jobs in the past decade³. In Latin America 55% of the labor force is in the informal sector and this share has been increasing in most countries.⁴ In Asia, between 45% and 85% of non-agricultural employment, depending on the country, is estimated to be informal⁵. Once it was assumed that the share of the informal sector would invariably decline with economic development, but in many countries – including some of the most dynamic Asian economies – it has in fact increased. If action is not taken in Africa, Latin America, and Asia, it is not unlikely that global pension system coverage may actually decline, thus threatening one of the great economic achievements of the twentieth century.

The informal sector in Asia is heterogeneous, ranging from casual individual workers (street hawkers, for example) to workers in sectors that may be characterized by a high degree of organization (bidi-rollers and rickshaw pullers, for example) to workers in sizeable establishments (restaurants, shops, etc.). Some attempt to capture this heterogeneity is given in Table 1.

Probably the only definition broad enough to cover the entire sector is that informal sector workers are:

- employees who work without a labor contract, and
- entrepreneurs whose businesses are not registered with the authorities.

³ J. Charmes, cited at Women in Informal Employment: Globalizing and Organizing (WIEGO), Second Annual Meeting, Cambridge, Massachusetts, 22–24 May 2002; cited in SIDA, 2004, *The Informal Economy*

⁴ Verdera F. Informality in Latin America, Recent trends, policies and prospects, 2004; cited in SIDA, 2004, *The Informal Economy*

⁵ Refers to the legalistic-definition of informality. See Chapter 1 (p. 29) in Perry Guillermo, William F. Maloney, Omar S. Arias, Pablo Fajnzylber, Andrew D. Mason, Jaime Saavedra-Chanduvi (2007). “Informality: Exit and Exclusion.” World Bank Latin American and Caribbean Studies. Washington DC.

Table 1: Who's who in the Asian "informal sector"?	
Employment category	Comments
Owners and employees of micro-enterprise	<ul style="list-style-type: none"> - Typically enjoy reasonable income - Main customers in urban areas are non-state enterprises; main customers in rural areas are households.
Own-account workers <ul style="list-style-type: none"> - Self-employed <ul style="list-style-type: none"> • Independent contractors • Sub-contracted home workers • Out-workers • Owner-drivers • Casual employees • Free lancers - Independent contractors - Street vendors - Transport providers 	<ul style="list-style-type: none"> - Self-employed workers are not associated with an employer and work at their own financial risk - Many are affiliated with a small enterprise or middleman organizing their activity. - A large percentage of self-employed work at least two jobs. - Disproportionately female.
Employees <ul style="list-style-type: none"> - Wage laborers in micro-enterprises - Unpaid workers - Home-based workers - Paid domestic workers 	<ul style="list-style-type: none"> - Home workers disproportionately female - Firm provides raw materials; home worker then transforms into finished product on piecework basis.

By this definition, the informal sector includes seasonal workers and workers on short-term contracts who do not, as a result, qualify for formal pension coverage. Not surprising in view of the heterogeneity of the informal sector and the dynamic nature of Asian societies, gray areas abound and there is considerable mobility between formal and informal employment. It is important not to fall into the error of assuming that all informal sector employment is unattractive and poorly paid. Whatever approach is implemented to extend pension coverage to informal sector workers, it should take portability of benefits into account and ensure that the incentive structure does not encourage informal sector labor at the expense of formal sector development. What is sought is an even playing field.

Why the poor record to date in providing pension coverage to the informal sector? There are a number of challenges to be surmounted:

- Informal-sector workers, sometimes thinly scattered across the countryside, are difficult to reach (“affiliate,” in social insurance jargon) and administratively expensive to cover. The latter reflects high collection costs and the small size of contributions, described below. Informal sector workers are very mobile. Either tax collectors cannot contact them or they fail to claim the social security benefits they are entitled to, even when they have made some contribution to the scheme.
- If the scheme is contributory, poor workers will have little to contribute, meaning that
 - o transaction costs and administrative costs will be relatively high, while economies of scale will be elusive; and
 - o retirement annuities will be low, perhaps to the point of failing to provide even a poverty-level income. This problem will especially acute for workers who are well into middle age when the scheme is initiated. Substituting some defined benefit for an annuity raises the problem that it is difficult to define a “reference wage” on which to base the annuity, plus the problem of unfunded liability if the benefit is set at a reasonable level. Another response to inadequate accumulation is for public authorities to subsidize, top up, or match contributions, but this carries with it the same fiscal costs of non-contributory approaches.

Exacerbating the problem of inadequate accumulation is the fact that saving in low-income settings is precautionary, not long-term in nature. Poor households accumulate a bit in good times so as to have a cushion against bad times; that is why they often prefer highly liquid assets such as gold. The volatility of income in many informal sector occupations strengthens this liquidity preference. Convincing informal sector workers to tie up their money in a long-term saving instrument is likely to be difficult. Yet, if early withdrawal (to cover family emergency) is made easy, older workers will find themselves with only a pittance upon retirement. Alternative investments – in land improvement, say, or in educating a child – may offer an expected rate of return well above the financial rate of return. The nearly irresistible urge of the public sector authorities to claim pension assets by limiting investment options exacerbates the problem of the low rate of return. Financial literacy is likely to be low, and distrust of formal saving institutions high, in informal settings.

Almost all schemes to extend pension coverage beyond the formal sector will need to involve implicit or explicit subsidies. In some cases, the subsidy will come at the stage of contribution, in others, it will come in the calculation of benefit, in yet others, it will come from support for the scheme’s operating costs. But, subsidies are ineluctably linked to liabilities. Even fully-funded defined contribution approaches may turn out, on careful analysis, to involve significant unfunded liabilities.

Policy makers will be naturally reluctant to grant subsidies to those who do not need them. Means testing is an option attractive to many governments, but means tests are expensive to implement and may carry with them perverse incentives. A literature has developed on “proxy means testing” which indirect indicators are used to identify families eligible for a subsidy.

Roberts et al. (2002), based on a survey of 15 countries ranging from very poor to very rich, gave a comprehensive list of reasons for low coverage of agricultural and urban informal sector workers:

- Low level of economic development / low level of fiscal resources
- Incapacity of low-income groups to contribute
- Unwillingness of some individuals and firms to contribute
- Incapacity to detect, affiliate, and collect contributions among micro-enterprises and informal workers
- Lack of institutional infrastructure
- Intrinsic difficulties in extending coverage to rural areas.

In Table 2, these factors are arranged in order to illustrate that, in order for effective social protection to come into being, all three groups – Government, employers, and workers – must be ready, willing, and able to enter into an insurance contract. How do these factors combine to explain low social security coverage in many Asian countries? Governments may be ready and willing to extend social protection to urban informal sector workers and farmers, but far from having the capacity to put these wishes into action.

Table 2: What stands in the way of broad social security coverage – a Ready, Willing, and Able approach

All actors must be ...	Government / institutions	Employers	Workers	Self-employed	Farmers	What is to be done?
Ready, ...	Low level of development	Wish to perpetuate exploitative labor relations	Lack of awareness; myopia	Lack of awareness; myopia	Lack of awareness; myopia; preference for traditional sources of old-age support	Economic development promotes awareness, reduces myopia, and modernizes labor relations But it also erodes traditional old-age support systems, so take care to encourage these.
Willing, ...	Political will	Distrust of regulations; wish to avoid government scrutiny	Distrust of system's benefits, dissatisfaction based on bad experiences.	Distrust of regulations, distrust of system's benefits, dissatisfaction based on bad experiences	Distrust of the system's benefits	Improve "user-friendliness" for both employers and workers. Offer reasonable rate of return on contributions. Keep contribution rates low. Tighten link between contributions and benefits But some persons' benefits will be ipso facto small, so targeted social assistance is needed. Relieve credit constraints on small businesses, self-employed, and farmers.
And able.	Institutional capacity to detect, affiliate, and collect.	Costs of compliance. Inadequate and unstable cash flow.	Incapacity of low-income groups to contribute	Incapacity of low-income groups to contribute	Incapacity of low-income groups to contribute; geographical isolation.	Choose a modest replacement rate that keeps contribution rates low. Charge reduced contribution rates below a given threshold. Avoid covering groups for whom costs of enforcement will be prohibitive.

Many employers, as evidenced by broad avoidance and cheating, still desire to keep their workers attached to them to them under conditions that are more or less exploitative. Note that what is identified as exploitation, however, is not infrequently characterized by collusion between employer and employee. In this case, the problem is at the level of willingness, not readiness.

In addition to the problems cited above, the rural population poses special challenges (Holzmann 2004). Many rural risks, such as harvest failure and natural catastrophe, are highly correlated. Practical issues abound: how to cover regions characterized by poor transport and communications infrastructure, thinly-spread and sometimes remote populations; how to determine revenue for purposes of collecting contributions? Incomes are low, poverty is widespread, and there is an abundance of alternative insurance instruments, in the form of community and extended family support.

It is relevant to recall that the September, 2004 General Assembly of the International Social Security Association (ISSA) in Beijing was devoted to extending social protection to rural populations. Both the ILO and World Bank noted, in their keynote interventions, that pensions are uncertain and far away from the perspective of the rural poor, whereas other risks are in the here-and-now. The ILO suggested that extending rural social protection should first take the form of improved insurance against work-related injury and illness, which disrupt the ability to earn a living. The World Bank prioritized health insurance and protection against natural catastrophes and harvest failure.

Some of the challenges experienced in trying to extend pension coverage to the countryside are summarized in Case Study 2, which described a celebrated pilot scheme from Nghe An province in Viet Nam. While this scheme was targeted at farmers, much of the Nghe An experience is relevant to attempts to extend social security to the urban informal sector, as well.

Case Study 2: The Nghe An experiment in Viet Nam

An important source of information on the viability of voluntary saving schemes in Viet Nam, and especially on their potential to provide retirement saving vehicles for the informal sector, is the experience with the pilot farmers' scheme organized in Nghe An province since 1998. The minimum monthly contribution, previously set at VND 10,000 (US\$=VND 15,000) is now VND 20,000 payable quarterly. The contribution amount is flexible; it can be changed month by month and can be paid either quarterly or semi-annually. However, members who drop out after less than three years or who miss twelve months' contributions without offering a reason such as illness, are considered to have dropped out and receive no compensation.

The contributory period to qualify for a pension is 20 years; participants can "buy in" by paying back contributions, but there are a minimum number of payments that must be made and, if necessary to meet this minimum, the onset of pension benefits will be delayed after the normal pensionable age (55 for women, 60 for men). Only a handful of pensions are actually being paid out by the scheme so far. As of December 2003, 77,339 persons participated, and the accumulated reserve in mid-2004 to be about VND 50,000 billion. Poor households are not participating in the scheme because they cannot afford even the minimum contribution.

Contributions are collected in communities. Contributors receive a receipt for their contribution and an entry is made in their individual contribution book. Funds collected are paid into an account at the district agricultural bank, whence they are transferred to the provincial level. While loans to banks are possible, to date virtually all of the funds collected have been invested in the Provincial development fund; the rate of return is now estimated to be approximately 8 percent per annum. Administrative charges, set at 6 percent of accumulated capital, are collected at the time of annuitization.

Monthly pension benefits are calculated as the total contribution plus interest earned minus administrative costs, all divided by 120. Actuarially, then, the assumption is made that the average beneficiary will live 10 years following retirement at 55 for women and 60 for men. When accumulated consumer price inflation is estimated to have reached 10 percent, pension payments are adjusted upward accordingly. When a pensioner dies, survivors receive a lump-sum payment calculated as a percentage of the amount paid in, the percentage varying according to the number of years that a pension has been paid. If the beneficiary has received pension payments for more than ten years, there is no payment, but rather a death benefit of VND 200,000. If a member dies before pensionable age, a payment between 100 and 145 percent of the total paid in (depending on contribution period) is paid out to survivors. A similar procedure is followed in case the member is certified to have become disabled. The Nghe An scheme receives two major subsidies from the Provincial government. First, operation of the fund (staff, building maintenance, equipment, transport, etc.) is being financed by the provincial authorities. Second, it is envisaged that the cost of living adjustment to pensions will be financed not by the Fund, but by the provincial government.

Case Study 2 (continued)

The naïve mathematics of this scheme indicates that the resulting pensions will be extremely low. Assuming the VND 20,000 minimum monthly contribution maintained at the same level in real terms over 20 years, the real rate of return would need to be 8-9 percent per year in order to achieve a VND 100,000 poverty-level monthly annuity. A reasonable assumption for the long-run inflation rate is 3 percent per year, which would mean that recent real rates of return have been only about 5 percent per annum. Assuming that the provincial subsidy for administration will eventually be phased out, account must also be taken of the 6 percent administration fee foreseen – a fee that may eventually have to be raised. All in all, an 8-9 percent real rate of return, especially if investment decisions continue to be made by the provincial authority, is highly unlikely to be attained.

These calculations are moreover, optimistic because the scheme as currently defined is unsustainable. Even now, life expectancy at 55/60 is well above 10 years for females/males in Viet Nam – over twice as high, about 23 years, in the case of women aged 55. As the scheme moves forward in time, benefit cuts will be necessary to address this imbalance. According to an actuarial analysis of the scheme, in the long term, the divisor used to calculate the monthly pension would need to be 127 and 145 for males and females, respectively, assuming that inflation adjustments continue to be financed outside the Fund and that pensioners do not continue to accumulate pension rights after they retire (i.e., that they do not benefit from continued appreciation of their accumulation). If inflation adjustments must be financed by the Fund, the necessary divisors would be 162 and 192; if pensions are adjusted to reflect continued appreciation of the Fund (i.e., every year the pension increases to include interest earned in the Fund reserve), the divisors would have to be 204 and 250. All of these calculations assume that the pension age for women is raised to 60; if it is maintained at 55, the divisors for females are increased substantially. Assuming indexation to inflation, a 4 percent real rate of return, and 1 percent per annum improvement in life expectancy, a divider of 192 might be sustainable.

Given monthly contributions at an initial rate of VND 50,000 per quarter and upward adjustment of contributions in line with inflation, initial pension entitlements would vary between VND 23,508 and VND 77,779 for males and VND 15,913 and VND 62,381 for females. These figures depend on (i) whether the contribution period was 20 or 35 years, (ii) whether pension payments are increase to reflect the rate of return on the accumulated fund, and (iii) whether pensions are adjusted upward in line with inflation (or, more accurately, whether these cost of living adjustments must be financed by the Fund). With the new, increased monthly minimum contribution of VND 20,000, these pensions would be slightly higher, but still far from sufficient to exceed the poverty level.

Non-contributory approaches, in the form of targeted (means tested) social pensions or universal basic pensions are also possible. The problems here boil down to fiscal cost, equity, and moral hazard:

- While advocates often point to the fact that the cost of providing a basic income to all persons over a certain age (sometimes called a “demo-grant”) is low as a share of GDP, tax revenues as a share of GDP are also low in many Asian countries. The fiscal commitment required of governments to finance such programmes is not trivial. Targeting can reduce costs, but is itself costly to implement and works against the administrative simplicity that is the greatest charm of universal pensions.
- There is a fierce debate over which group is more affected by poverty, children or the elderly. Regardless of the merits of the argument in various settings, the debate reminds us that the claims of the elderly population must compete with the claims of the rest of the population.
- Social programs for the elderly are strikingly modest in a range of Asian countries. Few qualify, the application process gives rise to stigma, and successful applicants receive little money. It seems as though, across the region, policy makers fear that provision of universal or broadly available basic income programs for the elderly will encourage the breakdown of traditional support systems and more generally give rise to moral hazard. Asian governments as disparate as Viet Nam, Indonesia, Thailand, Malaysia, and Singapore all appear to resolutely reject universal approaches.

In addition to these problems particular to the informal sector, there are the general problems that all types of pension systems in poor countries have to face. These include inadequate regulatory frameworks for pension funds, lack of management capacity, poor business processes, the absence of management information systems, and often, the lack of a universal personal identifier. Many existing social security systems are simply “bad brands,” characterized by excessive bureaucracy, tedious procedures, and unfriendly service to members. Extending them to cover broader segments of the population would be a bad policy decision.

New responses are thus required to ensure that these workers are covered against the risks associated with old age.

In recent years, a growing number of initiatives across Asia have been launched to set up special contributory pension arrangements for informal workers. We look at some of these, and a number of relevant schemes from other parts of the world, as well, in the following pages.

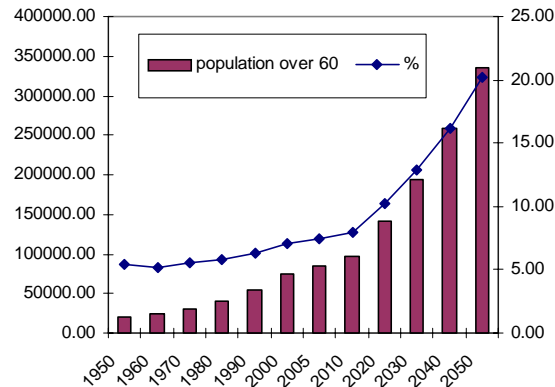
5. Country experiences

A wide range of approaches to expanding social security coverage are being experimented with in Asia. In this section, we will review some major reform efforts

5.1 India

India contains one of the largest, if not the largest, informal sectors in the world.⁶ Following national statistical conventions, organized sector workers represent only about 7-10 percent of the aggregate workforce, while, the remainder, amounting to 369 million in total, is in the unorganized sector.⁷ This includes 107 million landless agricultural workers (29%), 130 million other agricultural workers (35%) and 132 non-agricultural workers (64%) represent around 90% of the total workforce. These unorganized sector workers are often impoverished, have low literacy levels, are frequently migrants, and tend to be dispersed all over the country. Virtually none of them are covered by the formal pension system.

Figure 3. Population over 60, India 1950-2050



Although the present share of the population aged 60 or above in India is lower than the Asian average, it is projected to increase from 7.5% to 9.8% by 2021 and to around 20% by 2050. Over one eighth of the world's elderly live in India and a large majority are not covered by a formal pension system.⁸ Traditional community and family care-giving systems are under stress, in particular because of rural-urban migration.

In 2003, the Indian government embarked upon an ambitious pension system reform that aimed to replace the traditional public sector unfunded defined benefit scheme with a mandatory individual accounts system for government workers that would also provide voluntary coverage to informal sector workers above the poverty line. One of the main features of the proposed New Pension System (NPS) is that it intends to outsource

⁶ 2003, ADB

⁷ The unorganized sector is defined as a collection of those operating units whose activity is not regulated by any statutory act or legal provision and/or do not maintain any regular accounts.

⁸ Palacios, *The Challenge of Pension Reform in India*

administrative duties (e.g. fund management and the tracking of individual contributions and accumulation) to the private sector through a system of licensing and registration supervised by a new regulator, the PFRDA (Pension Fund Regulatory and Development Authority), officially established in 2005.⁹ Another feature of the system is the individual defined contribution account, the first of that kind in South Asia.¹⁰ Contributions from government workers were set at 10% of the salary, to be matched by a 10% made by the government and additional voluntary contributions by the employees above the 10%. The contributions are tax-exempt.

To supplement the NPS, additionally, a non-contributory government-funded system is to cover the 13.5 million people aged 60 and above who live below the poverty line and provide them with a pension of US\$4.4 per month. It is estimated that US\$760 million per annum would be required to achieve that goal. Welfare-fund schemes have been already working in different States for different categories of workers before.¹¹

There is some experience with voluntary retirement saving schemes covering groups such as self-employed women, but these have reached only around 3% of all informal workers.

Broad coverage requires a different approach to the one previously adopted.

The government envisages a comprehensive social security scheme entailing life insurance, health insurance, and old age pension coverage for the

“There is still a long way to go [in providing informal sector workers in India with old-age income security]”

Mr. Anil Swarup, Joint Secretary, Ministry of Labor, Government of India

unorganized sector workers. Beneficiaries will have an option either to take the phased withdrawal or purchase an annuity; the amount that can be withdrawn as a lump sum will be regulated to guard against immoderate spending. The current position of government is that early withdrawal of assets will not be permitted. The system planned for informal sector workers is unique in the world and its success will mainly depend on the degree to which the PFRDA manages to develop a market for the voluntary scheme.¹² While practicalities remain to be worked out, current planning is that PFRDA will market the scheme by using Post Offices, insurance company offices, bank branch offices, and other Points of Service in rural areas. A key challenge, however, will be to make offering the service profitable to these institutions, especially insurance company offices, who will be able to make a far higher profit marketing their product as opposed to the public pension plan.

Many challenges remain to be resolved regarding how collections are aggregated and transmitted to the central repository, portfolio choice, design of the default portfolio, and the management of information flows, including, most crucially, contributor queries regarding the status of accounts. However, market research surveys indicate that the demand for a retirement saving vehicle suitable for low-income Indians is enormous, and there is reasonable penetration of financial service institutions, especially insurance companies, into rural areas.

⁹ 2006, ADB, TA 4226-India: Pension Reforms for the Unorganized Sector

¹⁰ Bhardwaj, Dave, Palacios; *Rethinking Pension Provision for India*

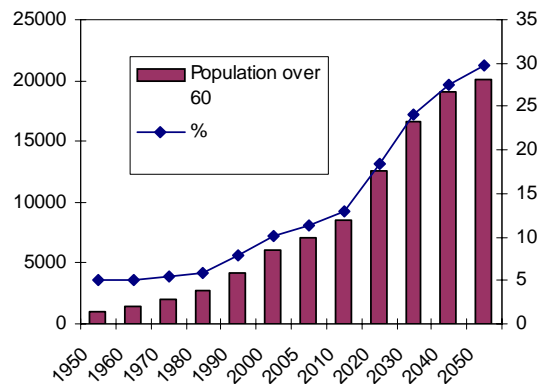
¹¹ 2000, Indian Ministry of Labor,, *Informal Sector in India, Approaches for Social Security*

¹² 2006, ADB, TA 4226-India: Pension Reforms for the Unorganized Sector

5.2 Thailand

Despite the fact that the demographic transition in Thailand has been markedly smoother than in other Asian countries, it has been estimated that the population over 60 years old will increase from just over 7 million people or 11% of the total population in 2005 to 20 million or around 30% of the total population in 2050 (see figure below). Thailand has in recent years strived to provide a response to this challenge, and has accordingly built a multi-pillar system to address the issue of old-age income. Today the majority of the formal sector workers—mainly government employees and private employees in the non-agriculture sector—are covered by some old-age income security scheme.

Figure 4. Population over 60, Thailand, 1950-2050



The current system in Thailand includes different components or pillars, a Pillar 0 which provides a non-contributory benefit of 300 Thai Baht (8.5 USD) a month to poor elderly who live on their own¹³; a Pillar 1 covering government employees through the original pay-as-you-go system and private employees in the non-agriculture sector through the Old-age Pension System (OAP); a Pillar 2 including the Government Pension Fund (GPF), a mandatory defined contribution system, supplementary to the Pillar 1 for government employees; and a Pillar 3 consisting of voluntary provident funds. The private sector's provident funds to which employers and employees voluntarily agree to contribute fall into this category. These funds were contributed by 7,800 employers and 1.7 million employees in 2006, and had an asset value of 382 billion Baht. There are also Retirement Mutual Funds (RMFs) which consist of 66 funds worth about 20 billion Baht.

However, taken together, the Thai pension system described above covers only about 10.5 million people or around 30% of the labor force, leaving out the two-thirds of Thailand's 36 million labor force that are estimated to be in the informal sector.¹⁴

¹³ Thailand Development Research Institute (2006), *Risk and Vulnerability in Thailand: A Quantitative and Qualitative Assessment*

¹⁴ Deolalikar, A. (2005) *Social Risk and Responses in Thailand: Analysis of Household and Individual Survey Information*, work commissioned under World Bank/Thailand Country Development Partnership on Social Protection

The Thai government is currently considering two different policy options for extending pension coverage to informal sector workers: the transformation of community savings funds into community old-age pension funds; and extending the coverage of the Old-age Pension System, now limited to private employees in the non-agricultural sector, to informal sector workers.

Collective saving funds available to community members for various purposes have been established in many communities throughout Thailand. One approach to covering informal sector workers might be to separate these funds into two components, one designed to finance activities to which the funds are now applied, and the second being explicitly targeted at retirement saving for the informal sector. While it is recognized that the funds should continue to be self-administered at the level of local communities, there have been proposals made to establish an institution to provide the technical assistance that would be needed to run retirement saving funds. The problems, in terms of capacity building, the need for legal reform, modalities for integrating funds with the rest of the capital market, and the potential for abuse are daunting, but the goal of providing old-age security at the community level is deeply appealing in the Thai context.

The second option being considered would extend the OAP to cover informal sector workers on a voluntary basis, possibly with matching contributions from the government. Different benefit packages have been proposed, but concerns over the long-term viability of the scheme due to potential adverse selection effects prompted the Social Security Office to revise the plan and technical details.

5.3 Sri Lanka

Sri Lanka provides the most extensive formal social security coverage in South Asia.¹⁵ However, as is the case in the rest of Asia, a large segment of the population working in the informal sector goes uncovered. Regrettably, Sri Lanka is an example not so much of a country coming to grips with its informal sector coverage problem by innovative means as it is an example of a country where failed policies are not being replaced by new ones.

Yet, Sri Lanka was a leader in making an effort to involve the informal sector and farmers in a voluntary retirement saving scheme in Sri Lanka. Formal sector workers in Sri Lanka are covered by the Employees' Provident Fund (EPF), a traditional fully-funded defined contribution provident fund, while public-sector employees are covered by the Public Service Pension Scheme (PSPS), a defined-benefit, PAYG scheme. In this, Sri Lanka resembles the Southeast Asian countries described above. What is unique about Sri Lanka is that three voluntary schemes – the Farmers' Scheme, the Fishermen's Scheme, and the Self-employed Scheme, were founded in 1987, 1990 and 1996 respectively to provide retirement insurance for those outside formal-sector wage employment. In addition to pensions, these provide survivors benefits, a death benefit, and disability insurance. The first two schemes are administered by the Agricultural and Agrarian Insurance Board (AAIB), with overall supervision provided by the Minister in charge of Agriculture and the Department of

¹⁵ World Bank (2006), *Sri Lanka: Strengthening Social Protection*

Fisheries. The third one is administered by the Social Security Board and is supervised by the Ministry of Social Services.

They cover around 600,000 farmers and 43,000 fishermen, accounting for 28% and 78% of the total respectively. Experience with coverage has not been encouraging. It is estimated that 36 percent, 79 percent, and 8 percent of those eligible for Farmers', Fishermen's, and Self-employed schemes, respectively, are enrolled. This makes for an average of under 30 percent. Since many persons contribute for a few years but then stop contributing, forfeiting what they have put in, effective coverage rates are estimated to be about half these nominal coverage rates. Among the reasons given for non-participation are low incomes, instability or seasonality of earnings and, in the case of the self-employed, the high price of paying both employer's and employee's contribution. There is no systematic protection against inflation, but in practice, the government has stepped in to adjust pensions on an ad hoc basis. The real rate of return in the informal sector schemes is estimated to have been on the order of 1-2 percent per annum. This is too low to produce a survival-level income in retirement, so the schemes are effectively supplemental saving schemes.

Despite being defined contribution schemes, the schemes imply significant unfunded liability for the government. One source, ad hoc pension increases, has already been mentioned. In addition, the schemes in practice tend to "forgive" persons who default but then return to the fold. It is estimated that the Farmers' and Fishermen's Schemes, for instance, carry 20-50 million USD and 3 million USD unfunded costs respectively. Although the government made capital commitments to support the two AAIB schemes' financial sustainability at their inception, only one third of the payments promised were actually paid, and the government has advised both schemes not to expect further funding.

Contribution collection is decentralized for the three schemes, and has in part been delegated to other government agencies, including the Post Office. The three schemes mainly rely on field officers from the AAIB or from the supporting government departments to collect contributions. Collected contributions are paid into separate pension and social security funds maintained by AAIB. Most funds are invested in deposits at state banks or in treasury bills. The AAIB is required to follow the advice of the Finance Minister when investing.

Members' records are maintained mostly on a manual and decentralized basis. The Farmer's Scheme, in particular, lacks an efficient information system. In addition to making asset-liability management difficult, the lack of a computerized information systems meant that the schemes lack ready access to detailed information on the profile and payment histories of members. This means, among other things, that 30-40% of those contributing to the Farmers and Fishermen schemes and 10-20% of those contributing to the Self-Employed scheme eventually default (i.e., stop contributing according to the fixed schedule). In practice, ad hoc forgiveness of contribution defaults is granted.

The total combined fund assets of the Farmers' and Fishermen's Schemes are 30 million USD and annual expenses are 2.5 million USD, an extremely high ratio of costs to assets. While the Self-Employed scheme is regarded as better managed, it is also seen as understaffed.

Finally, these schemes are not suitable for an economy undergoing dynamic economic change, because they lack portability and do not make allowance for farmers who move into non-agricultural occupations, the self-employed who eventually obtain formal-sector employment, etc.

The challenge in Sri Lanka is thus to design a scheme that meets poverty objectives while being fiscally sensible. A better approach would involve a contribution design that allows for flexibility in payments, and a benefit design that is actuarially linked to contributions, but at the same time recognizing social preference to ensure a minimum pension floor and political willingness to use tax money to pay for the lowest wage workers. Finally, the primary goal of such a scheme should be the fund's security and gaining workers' trust, not capital market development.

“... preoccupation with fiscal sustainability [has] tended to obscure the broader goal of pension policy, that is, to reduce poverty and improve retirement income adequacy within a fiscal constraint.” World Bank OED 2006, cited in Dr Ravi P. Rannan-Eliya, Director Institute for Health Policy, Sri Lanka

5.4 China

Population aging is most acute in China's rural areas since, due to the transfer of young rural workers to cities, the rural old-age dependency ratio significantly exceeds the urban one. In addition, Chinese policymakers long avoided extending pension and health arrangements to rural areas. In 1986, however, the Chinese government recognized the need for a rural pension system. At this point, it started studying the possibility of using community pension schemes for farmers initiated by local people to build a formal national system. Subsequently, the Chinese government launched several rural pension scheme pilot projects in several relatively well off districts and provinces. None of these has been rolled out to the national level, however, and the great majority of China's rural population continues to lack any organized old-age income insurance scheme.

Some places such as Jiang Su Province, Dong Guan city and Beijing have piloted pension insurance programs especially designed for rural settings. Additionally, 15 provincial governments have released documents exploring possibilities to put in place a suitable social security scheme for farmers whose land has been requisitioned, mostly for industrial development. By the end of 2005, around 4 million farmers who lost their land had been covered by the system of basic subsistence allowance or pension insurance, and over 40 billion Yuan (around 5.3 billion USD) were raised for this purpose. Additionally, in some places like Shang Xi province, insurance schemes for migrant workers have been introduced. The 11th Five-year Plan launched in 2006 provides specific directions on how to develop a rural pension insurance system that is in line with the

“Experience has shown that in areas where farmers are able to provide for themselves and there are grassroots' organizations needed, a rural pension system could be gradually put in place”

Mr. Zhao Dianguo, Director General, Department of Rural Social Insurance, Ministry of Labor and Social Security

development of the rural economy and other social security measures. It also enjoins governments at all levels to strengthen their leadership in founding a rural pension system as an integral part of their efforts to coordinate urban rural development, build a well-off society and a new socialist countryside. As to the old-age subsidy systems offered in some townships and villages, they will be gradually transformed into a social pension insurance system for their sustainable development.

The standard approach taken in pilot schemes is the institution of personal accounts in which contributions made by the individual and supplemented by the district are saved. Monthly pension benefits are received from age 60, both for women and men. Bank deposit and treasury bonds are the major investment vehicles used by the funds.

Innovation in rural pension systems is promoted mostly in areas undergoing rapid urbanization, with sufficient local fiscal revenue for local government and the collective economy having the capacity to subsidize farmers' participation. Note, however, that farmers themselves are responsible for the lion's share of the contributions, while the collective only pays a supplementary amount, in order to take into account the reality that rural areas are at a different stage of economic development and see that farmers' incomes are volatile. Central government is playing a major role in addressing regional inequalities. As there is a marked gap between the developed East and the poor middle and western portions of China, the government will preferentially channel fiscal resources into these poor areas to encourage development of rural pension systems. The accumulated volume of national pension insurance funds maintains sustained growth, and there has been a steady increase in the level of pensions paid.

By the end of 2005, 1900 counties in 31 provinces, municipalities and autonomous regions were experimenting with rural pension schemes. Over 54 million farmers were insured and had accumulated insurance funds of 31 billion Yuan (around 4.1 billion USD). About 3 million insured farmers received their pension in 2005. In areas where the pension scheme was implemented smoothly, farmers took an active part in the program and positive social effects were achieved. Even this progress, however, has been insufficient to keep pace with expanding demand for pension coverage in rural areas. While fund management has progressed and there has been an improvement in asset quality, problems remain. Most of the funds are managed at the county level and problems such as the lack of sophisticated management skills, political interference and difficulties in eliminating embezzlement keep the operational efficiency low.

5.5 Vietnam

Viet Nam has a fairly well-developed social security system, which provides pensions and other employment-related social insurance payments to formal sector workers. Public servants and armed forces personnel have been covered since 1947, and, in 1995, this scheme was expanded to private sector employees working in firms with 10 or more employees. However, out of the estimated 40 million people of working age in Vietnam, only 6.2 million or 16% participated in mandatory social insurance in 2005, and participants are mainly employed in the public sector.

The government has acknowledged the lack of coverage of the social protection system as one its major shortcomings and has tried to address it through the establishment of voluntary insurance schemes. Policymakers believe that social insurance for farmers and rural workers, in particular, is essential to building an equitable society. Government has pledged to achieve universal social security coverage in 20 years.

“A very large share of informal sector workers, especially farmers, is uncovered by social insurance”.

Ms. Hoa Thi Vinh Nguyen, Policy Maker, Department of Social Insurance, Ministry of Labor, Invalids and Social Affairs

A farmers’ pension fund was set up in the 1980s in some localities in Northern and Central Vietnam. We examined one of these the, Nghe An Province farmers’ scheme, in detail in Case Study 2. These operated on a voluntary basis and contributions were flexible, both in terms of the amount and the kind of payment—it was possible to contribute in-kind. However, they proved not to be competitive relative to pension benefits offered by commercial life insurance companies, which are normally purchased by higher-income individuals and households. The benefit levels offered were too low, in part because of the low levels of contributions and in part due to the low rate of return earned (funds were typically limited to placing their money in regional agricultural development banks). Administrative costs, particularly costs of collection in rural areas, were high and the funds were able to remain afloat only due to public subsidy of operating costs. The monthly pension calculation formula was actuarially unsustainable. The frequency of flooding in Viet Nam meant that farmers often demanded to withdraw their money, with the result that many individuals effectively accumulated no retirement assets.

A new Social Security Law that provides the legal background for a reform of the social security system was ratified in 2006. The law envisages a national voluntary pension scheme targeting workers without a labor contract, farmers and small traders. The prerequisites for receiving the pension are as follows: 1) having reached the age of 60 for men and 55 for women and 2) having paid social insurance premiums for at least 20 years. The benefits will be 45 percent of the average monthly salary when the worker has contributed for fewer than 15 years, and that amount will increase by 2 percent for men and 3 percent for women for each additional year of contribution, the maximum being 75 percent of the average monthly salary and the minimum being the official minimum wage. Participants are to pay a premium of 16 percent—to be increased by 1 percent every two years until it reaches 22 percent in 2010—of their monthly income. The Vietnam Social Security (VSS) agency is responsible for implementing and administering the voluntary social insurance fund.

The new scheme will have to overcome a number of challenges. The minimum level of contribution to the voluntary social insurance is high, which will exclude many low-income workers unless their participation is subsidized. Another shortcoming of the system is that it requires at least 20 years of voluntary participation, and thus older workers who, according to survey evidence, would agree to pay higher premiums, will not be able to participate. Finally, there is no optimal formula to calculate the average wage of those who contribute to compulsory social insurance for a certain period of time and then move to the voluntary social insurance scheme, which acts as a disincentive to mobility.

Given the small number of staff and the lack of competent managers, the fund's management will also be challenging. There is no clear regulatory framework for VSS and no clarity on the range of investments to be permitted. Another shortcoming is that the social security recording system is not yet based on social security numbers and cards, which would help simplify management, restrict losses, ensure the contributors' entitlements, and facilitate mobility.

5.6 Philippines

The Philippines' informal sector workers—comprising own-account workers, the self-employed and unpaid family workers—averaged over 16 million people in 2006, accounting for almost fifty percent of the total employment¹⁶. A 1997 study showed that the income levels of a great number of these workers fell below the poverty threshold and that about 65 percent of the working members of poor families were in the informal sector.

The Philippines' social security system has not covered even half of the country's informal sector workers. In addition, despite the fact that social security is mandatory for virtually all workers, compliance and evasion are serious problems. The number of contributing workers in 2006 was only about a third of the total workers registered, or roughly 8 million people. Among the self-employed members the problem is worse, with less than one-fifth actually contributing to the system.

While Viet Nam is putting in place a new national voluntary scheme, the Philippines is seeking to expand existing compulsory schemes. The new social security law enacted in 1997 mandated compulsory social security coverage of self-employed persons, regardless of their trade, business or occupation, with an income of at least 20.1 USD a month and not over 60 years old. As a result, the coverage of informal sector workers has tripled over the last 10 years, from 1.7 million in 1997 to 5.6 million as of September 2006. As of June 2006, out of the 26.5 million individuals that were registered with the social security system in the Philippines, around 21% were informal sector workers, up from 8.8 % in 1997.

“Many have not shared in the benefits of the progressive world”.

Corazon S de la Paz, President and CEO, Social Security System, Philippines

The Filipino social security system has launched several initiatives geared towards improving the coverage and collection of contributions. Efforts are underway to improve member convenience and cost effective service. To meet the growing demand, the social security organization opened additional reception centers in the capital region, which accounts for nearly 65 percent of total collections, in 2005. Additionally, it implemented the covenant of service (COS) program in 2001 to significantly reduce the processing time for benefit claims and loan applications.

¹⁶ Estimations from the Philippines' labor force surveys conducted by the National Statistics Office

To overcome the difficulties of reaching informal sector workers, government is working through cooperatives and people's organizations. These may play the same role that employers do in the formal sector, and serve as a conduit between the social security organization and the informal sector workers. The social security organization has already prepared guidelines for accrediting cooperatives and people's organizations to perform this task. The approach used is to provide monetary incentives to these organizations to encourage their members to pay social security contributions, rather than to accredit these organizations as collecting agents.

Informal sector workers are usually poorly served by the private banking system, which concentrates on more profitable clients. However, in collaboration with social security policy makers, the Philippines' Saving Bank and the Development Bank of the Philippines launched in 2002 a voluntary daily deposit program for informal economy workers. Through this scheme, workers are encouraged to make daily deposits to both banks in order to accumulate an amount equal to a monthly social security contribution, which is then remitted to the social security agency as a contribution on behalf of the worker. The uptake of the program is still slow and the social security agency is continuing its information campaign for it. In addition, the government is considering alternatives such as self-service facilities for payment including Bancnet Automated Teller Machines and Bancnet Online, and through short message services (SMS) or texting. Thought is also being given to using third party agents such as the Philippines' Post, especially in remote settings.

Finally, the Filipino government is considering raising the minimum salary bracket for informal sector members of the social security, with the objective of setting and maintaining salary range that is sustainable for a contributory social security scheme.¹⁷

5.7 Korea

The importance of the pension system is more pronounced in Korea than in many other Asian countries due to its fast aging population and the increasing cost of supporting the elderly, coupled with the fact that the traditional informal system of old-age support within families is on the decline, a trend that will accelerate over the next few years. The old-age dependency ratio, which currently stands at 10%, is expected to rise rapidly to 18.9% by 2020 and 29.8% by 2030. Moreover, despite the fact that Korea has developed rapidly, elderly poverty remains substantially higher than in other OECD countries.

Korea, like the Philippines, is attempting to extend existing pension schemes to informal sector workers. Although Korea has had special public pension schemes for government employees and the armed forces since the 1960s and for private school teachers since the 1970s, it only established a public system for private-sector workers in 1988. Coverage under the National Pension System (NPS) was originally limited to workers at firms with 10 or more employees, or about 25 percent of the labor force. Beginning in the early 1990s, the system was expanded in stages to include employees at smaller firms, farmers, and the self-employed. However, many poor, self-employed and low-income workers were left outside the NPS. A substantial number of the self-employed do not contribute. Just 65 percent of

¹⁷ In November 27, the minimum monthly salary bracket was 20.1 USD (Nov 2006 closing rate of P49.67/US\$)

the labor force actually contributed to NPS or one of the special government pension plans for government employees, private school teachers, and the armed forces.¹⁸ Many low-income workers who do belong to the system are far in arrears on contributions, with the result that they are at risk of receiving an inadequate pension when they retire.

Although the NPS now offers universal coverage, it is still in its nascent stage. The number of beneficiaries is small and payroll contributions exceed the benefits by a wide margin, generating large payroll tax surpluses. As of 2005, just 23% of adults over the age of 60—the NPS retirement age—were receiving a pension. When the government first set up the NPS, it promised participants a 70 percent replacement rate at an ultimate contribution rate of 6 percent. Declining fertility and increasing life expectancy have made this clearly unaffordable.

In 1998, the government raised the contribution rate to 9 percent, to be equally shared between employers and employees, and lowered the replacement rate to 60 percent, while also scheduling a phased increase in the retirement age from 60 to 65 between 2013 and 2033. With the demographic outlook continuing to deteriorate, the National Assembly is now considering raising the contribution rate and cutting the replacement rate once again.¹⁹ Projections from the National Pension Corporation indicate that if the NPS scheme remains unchanged it will move into deficit in 2036 and be bankrupt by 2070. While the system's long-term deficit needs to be reduced; benefits cuts are undermining its adequacy. The current policy proposals to address these financial problems advocate a further increase in the contribution rate to 15.9 percent.

“The optimal expansion of informal sector scheme exists!”

Wonshik Kim, Konkuk University, Korea

5.8 Indonesia

Currently, only about 10% of all Indonesians, or 15% of the workforce, have some form of pension coverage, either from publicly-funded pension schemes or private ones, mostly sponsored by large state-owned enterprises and multinational corporations. There are several public pension programs that are administered by the government. The two largest programs are the *Jamsostek* program for private sector workers in the formal sector and the *Taspen* program for current and retired civil servants as well as their families.²⁰ However these existing programs have been largely ineffective due to low compliance, inadequate benefits, and poor governance.

The Indonesian government has recently undertaken a reform of the National Social Security System or *Jamsosnas*, based on a law enacted in 2004. A new mandatory defined-benefit scheme will replace the existing ones and will cover all workers in the formal and informal sectors, including the self-employed. The contributions will be shared between employers and employees. A tripartite board of government, employers and workers will

¹⁸ *Ibid*

¹⁹ Howe, N. *et al* (2007) *The Aging of Korea – Demographic and Retirement Policy in the Land of Morning Calm*, Global Ageing Initiative, Center for Strategic and International Studies

²⁰ Arifianto, A. (2004) *Social Security Reform in Indonesia: An Analysis of Social Security Bill (RUU Jamsosnas)*, Lembaga Penelitian SMERU

govern the scheme. The day-to-day management of the fund will be the responsibility of existing institutions, and a new one will be created for the informal sector. Little or no intervention of private providers is foreseen.

An interesting feature of the Indonesian approach is that, in contrast to other countries in Asia, Indonesian policy makers propose to not only cover informal sector workers but also to subsidize their contributions through formal sector contributions. Under the proposed scheme, contributions from formal sector workers will be set at a much higher rate than those from informal sector workers and the self-employed, since it is assumed that the payroll tax paid by the former group will subsidize the social security benefits of the latter groups.

The draft bill does not clearly explain this cross-subsidization scheme, which is problematic because it provides an incentive for formal-sector workers to evade contributions, to work in the informal sector, or not to work at all. Even as a matter of accounting, it is questionable whether workers who work in the formal sector—one third of Indonesian workers—can fully subsidize those in the informal sector. Experiences in other developing countries show that similar social security programs only cover a small proportion of the workforce.²¹ There have been no actuarial calculations that serve as a sound basis for determining the contribution levels and the payouts of this scheme, nor have there been any reliable analysis on the short and long-term impacts of this scheme on the labor market, the competitiveness of Indonesian businesses, and the Indonesian economy in general. The *Jamsosnas* bill could make Indonesian businesses less competitive, since it creates substantial new labor costs for companies.

“The system has some potential adverse labor market impact, as the reduction in employment and/or take-home pay, and Indonesia already suffers from a weak investment climate”.

**P.S. Srinivas, Lead Financial Economist
Finance & Private Sector Development, The World Bank, Jakarta, Indonesia**

The program could also experience significant managerial and governance problems. There is a risk of collusion and nepotism during the selection of National Security Board representatives of the, since the government could appoint private sector and labor representatives who support its interests. Additionally, the program will continue to be administered by several state-owned enterprises, which will be established as for-profit corporations and be obliged to contribute to the government’s budget. However, the current social security schemes administered by for-profit state enterprises have failed to provide adequate benefits to beneficiaries, and it is thus doubtful that the new social security scheme will be different if it is administered by the same enterprises.

The government’s proposal disregards the role of competition in providing social security benefits since, according to the bill, the government will be the sole actor responsible for social security provision. The government alone will continue to make decisions on how the fund is managed, invested, and distributed among beneficiaries, while workers will not be allowed to participate in decision-making. In addition, evidence from other countries shows that entrusting the operation of the national social security system to the same institution

²¹ *Ibid.*

that regulates it can lead to empty promises of generous benefits that governments are not able to meet, and continued corruption and abuse of social security funds by officials.

5.9 Bangladesh

Population aging has not been a concern in Bangladesh until a nascent demographic transition was recently observed.

Although Bangladesh currently has a young population, the share of elderly is expected to increase by 50% between 1997 and 2010, reaching 9% by 2025.²²

The existing pension system in Bangladesh only covers government and parastatal organizations' employees after 25 years of service.²³ Around 10% of urban employment is estimated to be informal, and the 36 million workers engaged in agriculture also have no coverage.²⁴

“As borrowers grow older, they worry about what will happen to them when they cannot work and earn any more”.

Dipal Chandra Barua, Deputy Managing Director, Grameen Bank, Dhaka, Bangladesh

For those apart from the few covered by the existing system, families provide the bulk of old-age support. Additionally, the government has recently developed a means-tested non-contributory pension scheme—Old Age Allowance Program—which has grown rapidly in recent years to cover the majority of elderly who are not covered by the pension system. However, it only targets the bottom decile of the population and some portion of the 2nd decile.

On the other hand, an innovative approach to extend coverage to the informal sector via a scheme created by the Grameen Bank is being tested in Bangladesh. The Grameen Bank (GB) Project was initiated by Professor Muhammad Yunus in the village of Jobra, Chittagong, Bangladesh, in 1976. In October 1983, it was transformed into bank, with 94% of its equity owned by the poor borrowers themselves, mostly women. The remaining 6% is owned by the government. The main mission of the bank is to alleviate poverty through the provision of micro credits. Its achievements in the first 25 years of operation include a notable increase of ‘clients’, from one to 73,000 villages, and from 42 borrowers in 1976 to 6.74 million borrowers today. GB offers a range of savings products, including personal and special savings accounts that are open to all, as well as pension savings and loan insurance saving funds for GB members.

In response to GB's borrowers' concern at the lack of income at retirement, the GB developed and offered an old age pension fund, which immediately became very popular. This portable defined contribution scheme covers those just above the cutoff for the Old Age Allowance Scheme and partially fulfills the need for old-age income insurance at no direct cost to the government. Under this program, all borrowers with a loan above Tk 8,000 (138 USD) are required to save a small amount, such as Tk 50 (0.72 USD), each month over a period of 10 years. The depositor receives almost twice the amount of the money contributed at the end of the period. The borrowers find it very attractive, so it is expected

²² Kabir, *Demographic and Economic Consequences of Aging in Bangladesh*

²³ 2005, Miyan, *Retirement and Pension System in Bangladesh*

²⁴ 2004, Szirmai, *The Dynamics of Socio-Economic Development*

that the balance in this account will reach Tk 19.60 billion (280 million USD) by the end of 2007. Contributions can be moved to any bank and thus the program allows for mobility.

An installment can be deposited any day of the month. Advance payment is allowed, but no interest is paid for the advance period. A one-time Tk10 commission is charged for opening the account and a Tk 25 service charge is applied in the event of early closure. If an account is closed in less than a year, only the principal will be returned. After the first year, the interest rate paid increases from 8% if the account is closed during the first three years, to 10% when closed between the third and fifth, and 12% if closed after the first five years. If an installment is not paid within the month, the account will be closed automatically. The installments' size and term cannot be changed.

The Grameen Pension Scheme is replicable in other contexts, but some issues would need to be considered when attempting to do so. First, the scheme has been feasible in Bangladesh because the penetration of Microfinance Intermediaries (MFIs) is high, with over 25 million existing accounts, and thus transaction costs are low. Second, unlike Grameen Bank, most other MFIs are not banks and thus cannot accept savings, which would require changes in financial sector regulations. Thirdly, GB cross-subsidizes pension returns from its other earnings, which is not a problem because the same members own pensions and the other products. However, for other institutions this could be a problem and might require some publicly financed incentives. Finally, Grameen's huge network of branches reduces the transaction costs, while in other cases there may be a need for initial government support to start such an initiative.

6. Closing thoughts

The unprecedented speed at which Asian populations are aging requires a rapid forward-looking response from governments in the region to provide protection against the risk of poverty in old age. This risk is particularly acute in the case of informal sector workers, as is the difficulty of reaching them through traditional formal-sector pension approaches. Given the large and sometimes growing share of informal workers in most countries in the region and the gradual weakening of traditional family safety nets, the issue of expanding the coverage of retirement-income systems to informal sector workers requires special attention in Asia. Lately, a number of Asian countries have directed efforts to develop and implement pension schemes to cover informal sector workers. These experiences provide valuable lessons with policy implications that should be considered in moving forward:

- Identifying and reaching informal sector workers, whether to “sell” them voluntary pension schemes or to ensure their compliance with compulsory systems, has proven difficult. Scheme operating costs are high and, as in the Nghe An voluntary rural saving scheme example from Viet Nam, government subsidies are sometimes necessary. This raises issues of sustainability, in addition to which, it can work against good governance – a government that has subsidized a scheme is bound to want to have a say in how assets are invested.

- Informal sector workers' capacity to contribute is low, and default rates are high. In the case of Sri Lanka, high default rates seriously compromised voluntary pension funds' ability to meet their commitments. Government top ups or contribution subsidies are often proposed, but beg the question of why, if it is going to bear a fiscal cost anyway, government does not simply provide a non-contributory basic pension. Other innovative approaches are being experimented with, such as community-based saving schemes (Thailand) and schemes targeted at members of cooperatives and occupational associations (Philippines, India). The approach being tried in Indonesia – subsidizing poor workers' contributions using the contributions of better off workers – would appear to be a recipe for disaster once the impact on incentives is taken into account.
- The mechanics of collecting contributions and paying benefits can be daunting. However, approaches using third-party collection agents; ATM, mobile telephone, and SMS technology hold promise and are being tried out (Philippines and Sri Lanka).
- Low contributions, high default rates, and low rates of return associated with poor investment performance, taken in combination, suggest that defined contribution schemes, even mandatory ones, will not be sufficient to provide adequate income in old age for the poor. Moreover, experience from across the region suggests that if mandatory schemes are not going to give rise to widespread evasion, and if voluntary schemes are going to attract participants, there must be significant leeway for early withdrawals. Yet, early withdrawal defeats the purpose of long-term retirement saving. All of these factors suggest that, while defined contribution schemes for poor informal sector workers can be an important supplemental source of retirement income, they cannot be considered to be the only, or even primary, source of income security in old age.
- Since most approaches to extending pension coverage beyond the formal sector will involve some kind of subsidy, careful analysis of the incidence of the subsidy and its effect on incentives is important.
- Informal sector pension scheme design needs to keep in mind the issue of portability of between formal and informal sectors. The portability issue provides, assuming that record-keeping issues have been solved, a clear argument in favor of defined contribution approaches. Above all, portability and the incentive structure should work in the direction of encouraging workers to be in the formal sector.
- To means-test or not? The high fiscal cost of covering the informal sector and the need to target scarce resources so as to reduce poverty as effectively as possible make means testing attractive. But means testing is prone to exclusion errors, it is demanding in terms of administrative capacity, and can give rise to perverse incentives. The pros and cons of proposed approaches need to be carefully analyzed.

The role of the private sector and competition in the provision of pensions should not be disregarded. That is one of the problems highlighted in the Indonesian system, and identified by the Indian government, which is planning to encourage private sector participation in the provision of old age income-support. The experience of the Grammeen Bank in Bangladesh suggests that privately run schemes can be a suitable option to cover those slightly above the income level of the group targeted by non-contributory schemes.

Finally, in considering treatment of the informal sector, pension policy makers should not neglect traditional formal-sector schemes. Even though the size of the informal sector has grown in many economies in recent years, long-term structural trends – especially reductions in the share of the labor force in agriculture and urbanization – favor expansion of the formal sector. Countries with unsustainable formal-sector schemes may wish to sort out these problems first, before turning their attention to the informal sector.

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**Annex: Workshop on Extending Pension Coverage to
Informal Sector Workers: The Asian Challenge**
On November 30 – December 1, 2006 in Bangkok Thailand

The World Bank Office Bangkok, in collaboration with the Government Pension Fund (GPF), organized workshop on Extending Pension Coverage to Informal Sector Workers: The Asian Challenge. The workshop was a forum for executive officers from both public and private sectors to share their experiences with pension experts on the pension development and related issues. About 150 participants from India, Sri Lanka, China, Korea, Philippines and Thailand attended the seminar, which was presided over by Mr. Suparat Kawatkul, Permanent Secretary, Ministry of Finance. Mr. Suparat's welcomed remarks were followed by a speech on "Asia's aging challenge" by Mr. Ian Porter, World Bank Thailand Country Director.

Details, agenda, presentations, and other documents of this workshop can be found at <http://go.worldbank.org/N4G4QDH5T0>

Session 1: Recent Policy Debate on Best Approach to Informal Sector Pensions: India and Thailand.

- Mrs. Pannee Sathavarodom, Director-General of Fiscal Policy Office, *Options for Expanding Thailand's Pension Coverage to the Informal Sector Workers.*

Session 2: Experience with Rural Pensions: Sri Lanka and China.

- Dr. Ravi P. Rannan-Eliya, Director of Institute for Health Policy, *Sri Lanka's Schemes for Informal Sector Workers.*
- Mr. Zhao Dian Guo, Director General of the Rural Social Insurance Department of China, *The Experiment and Progress of Rural Pension Insurance System.*

Session 3: Challenges in Implementing Legislation to Expand Pension Coverage: Korea, Philippines and Vietnam.

- Ms. Corazon S. De La Paz, President and CEO of Social Security System, Philippines, *The Challenge of Converting the informal sector: The Philippine SSS Experience.*
- Dr. P.S. Srinivas, World Bank Lead Financial Economist in Finance and Private Sector Development, Indonesia, *The Pension System in Indonesia.*
- Ms. Nguyen Thi Vinh Hoa, Policy Maker from Department of Social Insurance, Ministry of Labor, Invalids and Social Affairs, *Voluntary Social Insurance in Vietnam.*
- Prof. Wonshik Kim, Konkuk University, *Extending the Coverage of the Formal Sector Scheme in Korea.*

Session 4: Innovative Approaches with Private Sector Participation.

- Mr. Dipal Chandra Barua, Deputy Managing Director, Grameen Bank, Microcredit, *Microfinance and Pension Scheme: The Experience of Grameen Bank.*
- Mr. Ernesto Brodersohn, Director General of National Commission for the Retirement Savings System (CONSAR), *Coverage Expansion in the Informal Sector, A Mexican approach.*

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This paper looks at the experiences of various Asian countries in expanding the coverage of the pension system to informal sector workers. The paper argues that given aging and growing informality, a rapid forward-looking response from governments in the region is necessary to provide protection against the risk of poverty in old age. This risk is particularly acute in the case of informal sector workers, as is the difficulty of reaching them through traditional formal-sector pension approaches. From the analysis of various case studies the paper concludes that expanding coverage to informal sector workers through mandatory systems is unlikely to work. Alternative, voluntary arrangements are needed. However, because informal sector workers tend to have lower savings capacity and high discount rates, targeted subsidies might be required to encourage enrollment. The paper discusses some of the issues related to the design of these programs -- including those related to administration and the collection of contributions. In all cases, the paper emphasizes the need to resolve difficult tradeoffs between these transfers to prevent poverty during old-age and expenditures in other social programs.

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