PENSION NOTES

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Non-contributory pension programs in Latin America

Executive Summary

Most Latin American countries are under pressure to introduce non-contributory pension programs or expand existing programs. This is mainly due to the low coverage of contributory systems. More than half of the population of the region, on average, is not covered by the contributory systems. Hence, non-contributory pensions provide a solution to this problem by offering protection against poverty to this segment of the population. Non-contributory pensions, as their name implies, are those that do not require prior social security contributions. These pensions are usually financed by general State revenues.

However, non-contributory pension programs must be carefully designed so as not to discourage contribution to contributory programs. The choice of the key parameters of the programs (eligible age, benefit amounts and target population) must consider their impact on individual incentives and the fiscal budget. It is also important to consider the interaction between contributory and non-contributory programs, in order to promote synergies between them.

Finally, it is essential for non-contributory programs to adapt to the conditions of contributory programs. As contributory programs mature, covering a greater portion of the population, non-contributory pensions should gradually lose relevance.

This Pensions Note is organized as follows. The first section defines non-contributory pensions and their purpose. Section 2 examines how non-contributory pensions could be used as a strategy for improving social security, given the low coverage of the contributory systems. Section 3 provides a brief summary of design recommendations for non-contributory pension programs. Section 4 explores the situation in Latin America. Finally, section 5 briefly explains how the solidarity pillar of the Chilean pension system works.

1. Non-contributory pensions: definition and purpose

The minimum income mechanisms in the pension systems seek to provide sufficient amounts of resources to avoid people being unprotected and at risk of poverty. These mechanisms basically include non-contributory and guaranteed minimum pensions.

Guaranteed minimum pensions are granted to those individuals whose accumulated resources in contributory systems are below the minimum considered necessary for averting poverty in old age, but who meet the age and years-of-contribution requirements. However, in countries with low coverage in their contributory systems, minimum pensions are insufficient for averting poverty among the elderly, since a high proportion of the population does not meet the years-of-contribution requirements for accessing a minimum pension. Hence, minimum pensions do not protect the most vulnerable workers.

Noncontributory pensions (also called social pensions), as their name implies, are those that do not require prior social security contributions. These pensions are usually financed by general State revenue. Noncontributory pensions can be universal, i.e., granted to the entire population, or means-tested. The latter are assigned subject to an assessment of the income of the individual or family.[1] whereby the need for such pension is verified. There may also be means-tested noncontributory programs, by geographical area, gender, or ethnic origin.

The main purpose of noncontributory pensions is to help reduce poverty in old age, by increasing the income of the poor in order to guarantee a minimum standard of living. They also provide a safety net for the most vulnerable, who are usually not covered by the contributory programs.

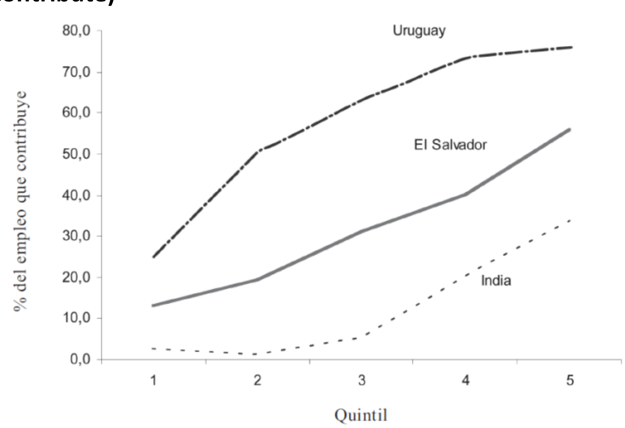
[1] In some countries, such as China (Hong Kong), the benefit depends on the amount of accumulated assets.

2. Non-contributory pensions as a solution to the coverage gap

There is a significant coverage gap in the contributory pension systems in developing countries (whether individually funded or PAYGO). In general, contributory systems only require mandatory contributions from dependent workers, leaving out the self-employed and all those who work informally. This is why the coverage of contributory systems depends not so much on their specific characteristics, but rather on the composition of the workforce (Palacios, 2007).

The coverage of contributory systems is also related to income distribution: lower-income workers contribute less than higher-income workers. Graph No. 1 provides evidence from three countries with very different levels of overall coverage. In all of them, the coverage for the lowest income quintile is considerably lower than for the higher quintiles. Thus, the contributory systems may not be sufficient for resolving the poverty-in-old-age issue among lower-income workers (Palacios, 2007).

Graph No. 1: Coverage of contributory pension systems by income quintile (% of employees that contribute)



Source: Palacios (2007).

Thus, non-contributory pension systems are seen as an alternative for resolving the low-coverage issue of contributory systems, since expanding the coverage of contributory systems is linked to the process of economic growth of countries, as well as the maturation of the systems, which can take a long time.

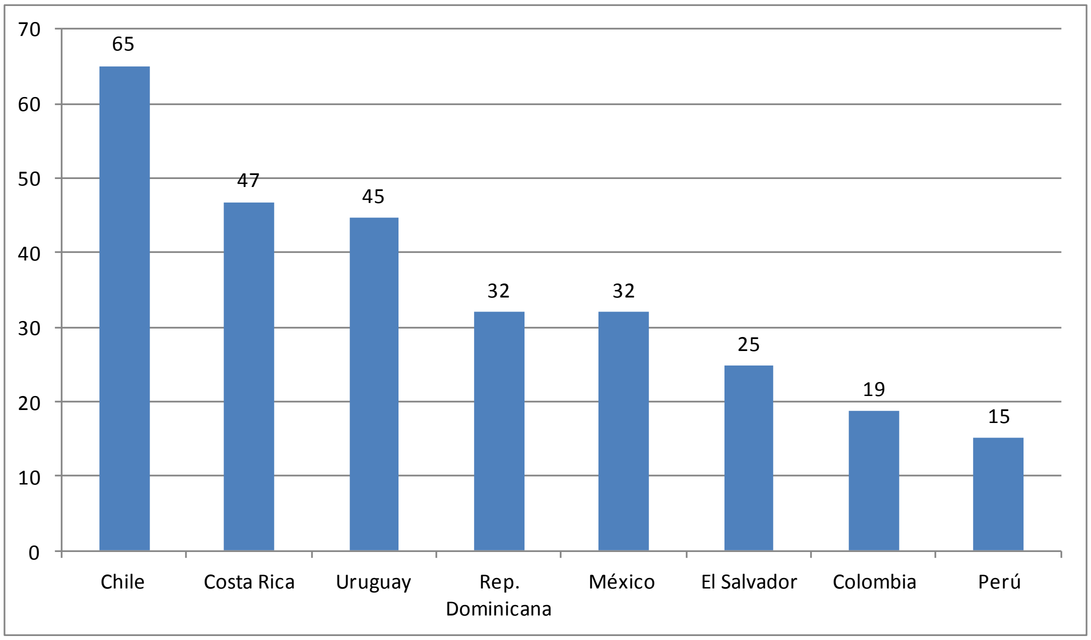
According to the OECD, the expansion of the non-contributory pension programs is a global phenomenon, but nowhere has it been as significant as in Latin America (OECD, 2014). In fact, according to ECLAC figures, between 2002 and 2015 the proportion of Latin Americans over the age of 65 with access to some kind of pension rose from 53.6% to 70.8%, and this increase was due primarily to the expansion of the non-contributory pension systems. In fact, between 1990 and 2016, the number of countries with non-contributory pension systems in Latin America and the Caribbean went from 8 to 26 (ECLAC, 2018).

The lack of access to contributory pensions by a large part of the population could be one of the main reasons for the considerable expansion of noncontributory pensions in recent years. Among FIAP member countries (see Graph No. 2), we can see that the coverage of the contributory pension systems in 2016, measured as the ratio of contributors to the economically active population (EAP), is more than 40% in Chile, Costa Rica and Uruguay, whereas in Colombia and Peru, coverage is below 20% of the economically active population.

Another important conclusion that emerges from the ECLAC (2018) report, is that old age noncontributory pensions cover women, the elderly belonging to the lowest income quintile and the inhabitants of rural areas to a greater extent (see Graph No. 3). This would be in line with the criteria of allocation of non-contributory pensions, which specifically seek to provide protection for the most vulnerable elderly population.

Graph No. 2: Latin America (8 countries): Coverage of the contributory pension systems (contributors/EAP), 2016

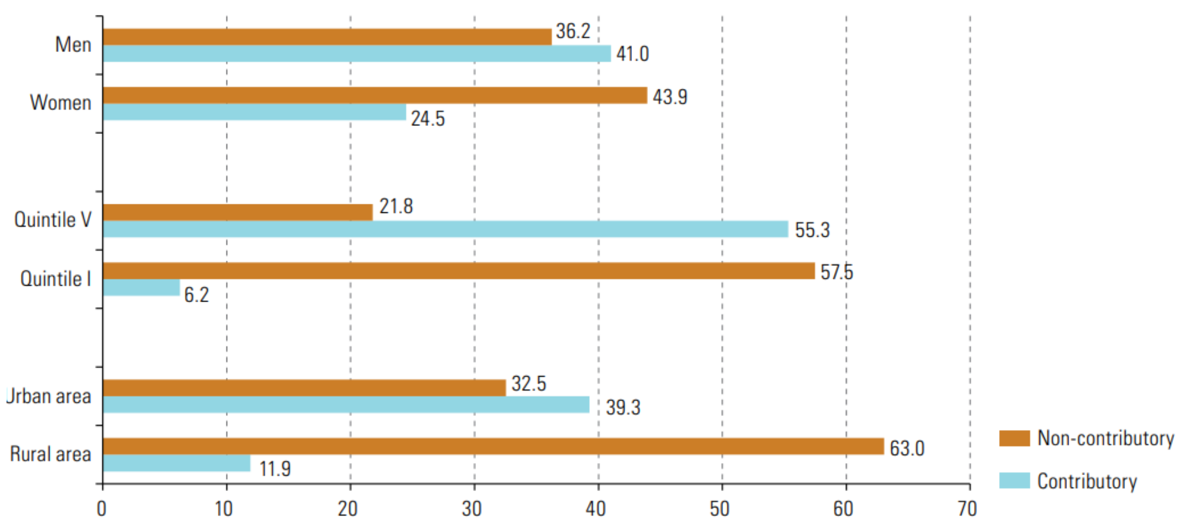
(In percentages)



Source: FIAP.

Graph No. 3: Latin America (8 countries): Beneficiaries of contributory and non-contributory pensions among individuals over 65, according to gender, area of residence, and income quintile, around 2015.

(In percentages)



Source: ECLAC (2018).

3. Design of a non-contributory pension system

It is not yet clear what an optional design should be (World Bank, 2012). The big challenge is for non-contributory pensions not to discourage the pension culture in society, i.e. that they do not generate incentives for workers to stop contributing to contributory systems. Overly-generous benefits of the non-contributory programs entail the risk of workers choosing not to contribute to the formal system, because they have a guaranteed pension when they reach retirement age. Hence, the general recommendations of the World Bank (2012) are that non-contributory pensions should focus on the poorest and that benefit amounts should be defined in order to prevent people from falling into poverty. To this end, the gap between average poverty and the relative level of salaries or income must be taken into account, also considering the long-term fiscal sustainability of the program.

According to Palacios (2007) there are three key parameters that must be taken into account when designing a non-contributory pension program.

i. **Eligible age.** Non-contributory pensions should be paid once there has been a substantial drop in the worker's productivity. This age may vary depending on the health conditions and labor productivity of each country, and therefore the non-contributory programs in each country can have different ages of eligibility. Another factor to consider when defining the eligible age for the non-contributory programs, is the retirement age of the contributory programs. The ages of both types of programs must be coordinated and aligned with the life expectancies of the countries. Finally, the eligible age of both programs can be flexible, provided that the benefits are adjusted in an actuarially fair manner. For example: If the eligible age for a non-contributory pension is 65, but a worker requests access to it at age 60, the amount of the benefits will be reduced in an actuarially fair manner. If, on the other hand, the worker postpones applying for benefits until he is 70, the amount of the benefit should increase in an actuarially fair proportion.

ii. **Amount of the benefits.** This point is the most difficult to determine, because on the one hand the amounts of benefits should be sufficient to prevent the worker from falling into poverty once his working life is over, but on the other hand, the amounts should not be so high that they generate incentives to stop contributing to contributory programs. Moreover, for noncontributory programs to be financially sustainable, the amounts of their benefits must be commensurate with the real situation of the country's resources. According to Palacios (2007), benefit amounts must be determined by comparing them with the amounts of the expected benefits of the contributory pension plan. The design of the solidarity pillar of the Chilean pension system has been put forward as a suitable example. Further information on this pillar will be provided in the following section.

iii. Target population. The purpose of noncontributory pensions is not to help people with high incomes or equity, although some countries, like Bolivia, have established universal pensions that pay very low amounts. An argument in favor of universal pensions is that it is administratively easier to pay a uniform benefit to all individuals at a certain age, instead of identifying the poorest workers. However, this distorts the redistributory purpose of non-contributory pensions. As an alternative, means-tested noncontributory pensions determine compensation depending on the level of income or assets of the individual. Nonetheless, it may be difficult to measure the income of individuals, complicating its implementation. Another alternative is to perform a pension assay, in which the amount of the noncontributory pension is reduced in the same proportion as the contributory pension. Because contributory pensions are easy to observe, this mechanism is easier to implement, but it also has two problems. First of all, it ignores income other than pensions, whereby individuals who do not require it can be benefited. Secondly, it could discourage contribution to the contributory system. Regardless of the chosen mechanism, means testing and coordination between the different institutions involved in the provision of benefits are desirable characteristics of a noncontributory pension program.

4. Situation in Latin America

Table No. 1 summarizes the main characteristics of the non-contributory pension programs of 14 countries in the region. As we can see, there are considerable differences in the amounts granted by the different programs. Whereas in Brazil the benefit of the two non-contributory programs is USD 300 (equivalent to one third of the per capita income), in Peru it is barely USD 38 (8.2% of the per capita income).

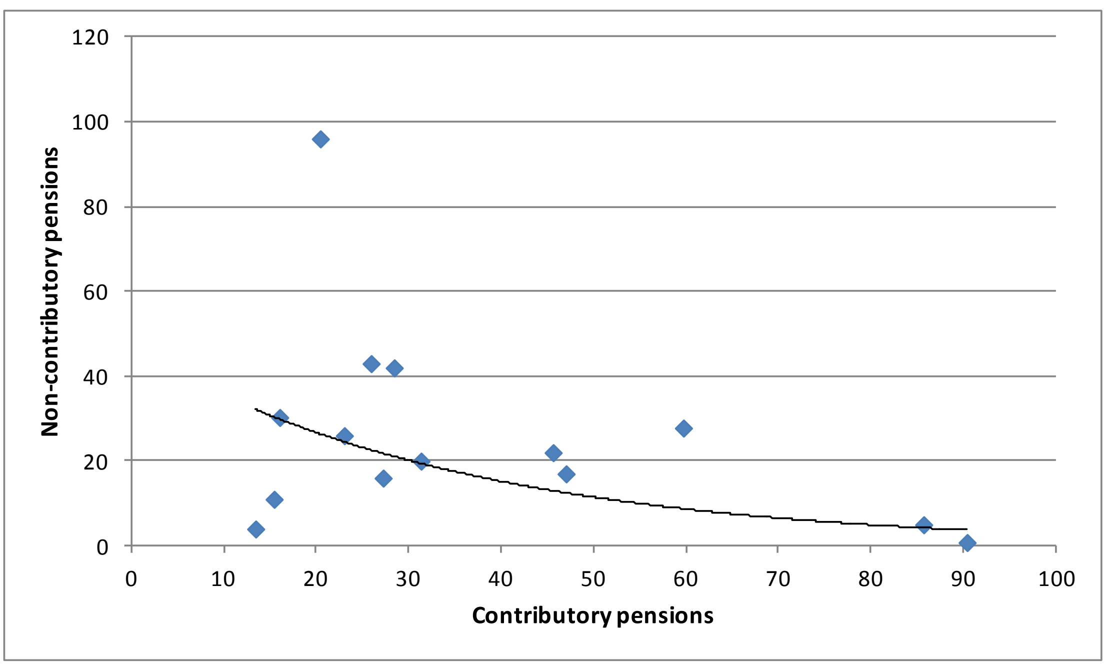
In the majority of countries non-contributory pensions are means-tested according to poverty level or geographic location, with the exception of Bolivia where the Renta Dignidad program is universal. The noncontributory programs cover almost 100% of people over 60 in Bolivia, whereas in countries like Argentina and Uruguay the noncontributory pension coverage is 0.8% and 4%, respectively. This low coverage of the noncontributory pensions in these countries is related to the high coverage of the contributory systems. And as we can see in Graph No. 4, there is a negative correlation between the proportion of beneficiaries (in the population over 65 years of age) who receive contributory and noncontributory pensions. I.e., in countries with low contributory pensions coverage, noncontributory pensions are more relevant, and vice versa.

Table No. 1: Latin America (14 countries): Main features of the non-contributory pensions systems

Country	Program	Eligibility conditions			Coverage and amount		
		Means-tested according to poverty level	Means-tested geographically.	Age	Beneficiaries/ 60+ population	Monthly amount USD	Benefit/Per capita income
Argentina	Welfare pensions	Yes	No	70	0.8	198	24
Bolivia	Renta Dignidad	No	No	60	97	43	15.4
Brazil	Previdencia Rural	No	Yes	60/55	27	300	33.3
	Prestaca Continuada	Yes	No	65	8	300	33.3
Chile	Basic Old-Age Solidarity Pension	Yes	No	65	28	174	13.3
Colombia	Colombia Mayor	Yes	Yes	59/54	26	32	5
Costa Rica	Noncontributory System	Yes	No	65	17	132	14.5
Dominican Republic	Nonagenerios	Yes	No	60	n.a.	n.a.	n.a.
Ecuador (1)	Pensions for the Elderly	Yes	No	65	43	35	7.4
El Salvador	Universal Basic Pension	Yes	Yes	70	4	50	15.1
Guatemala	Aporte Económico Adulto Mayor	Yes	No	65	11	51	18.4
Mexico	65 and over	No	Yes	65	42	35	4.7
Panama	120 a los 65	Yes	No	65	22	120	12.2
Peru	Pension 65	Yes	Yes	65	16	38	8.2
Uruguay	Noncontributory Pension	Yes	No	70	5	262	21.1

Source: Social Pension Database HelpAge, March 2018.

Graph No. 4: Latin America: Coverage contributory vs. non-contributory pension systems (% of people 65 and older who receive a pension)



Source: FIAP, based on Social Pension Database HelpAge, ECLAC (2018) and Rofman (2007).

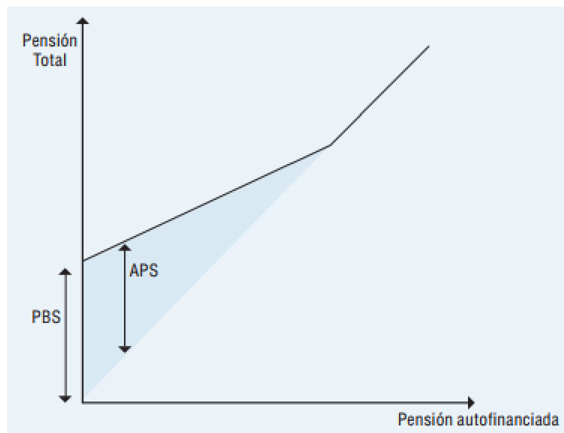
5. The integration of contributory and noncontributory pensions: The case of Chile

As previously mentioned, there is no "optimal design" for non-contributory pension programs to date since they need to be adjusted to the different realities of each country. Notwithstanding the above, the OECD (2014) and Palacios (2007), commend the design of the solidarity pillar in Chile, in which non-contributory pensions are integrated with contributory pensions, in order to reduce incentives to stop contributing or evading contribution to the contributory system. Hence, in this section we provide a brief description of how the solidarity pillar in the Chilean pension system works.

Chile implemented a new solidarity pillar in 2008 to complement the individually funded contributory system. The minimum pension guarantee existed previously, but it did not work well for the reasons explained above. According to the OECD (2014), the new solidarity pillar was designed to support the incentives for contributing to the system. Thus, the benefit was not designed as a guaranteed minimum pension, but rather as a minimum for individuals without contributions, and additionally, as an extra payment for individuals with contributions. The amount of the additional payment is inversely proportional to the amount of the contributory pension. Thus, the total amount of the pension (the sum of the contributory and non-contributory pensions) increases depending on the amount accumulated in the individual account of the worker, thus reducing incentives not to contribute.

Diagram No. 1 shows how the solidarity pillar works. At the lowest pension level, the solidarity pension contribution is the largest part of the total pension. As the contributory pension level increases, the amount of the solidarity pension contribution decreases, until the pension reaches the maximum level established in the regulations, when the total pension amount derives from the contributory program.

Diagram 1. Solidarity Pension in Chile



Source: OECD (2014)

In operational terms, the new solidarity pillar comprised two benefits: (i) the basic solidarity pension (PBS) for individuals without the right to a pension; and (ii) a solidarity pension contribution (APS), which is a subsidy for individuals who have savings in their individual accounts. The program focuses on adults over 65 years of age, belonging to the 60% of the poorest households, who have been resident in the country for a minimum of 20 years. The amount of the BSP is currently USD 171, while the maximum pension with solidarity contribution is USD 505.

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