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Three Pillars of Pensions?
A Proposal to End Mandatory Contributions

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Abstract

The three pillars of a pension system are defined in varied ways. The author focuses on a definition provided by the World Bank in its 1994 Report. He argues that with a universal Pillar 1 (a flat, subsistence pension), there is no need for Pillar 2 (earnings-related pensions). Pillar 3 (voluntary retirement savings) should not receive tax subsidies, which are regressive and also have not been shown to have any significant effect on private saving. Such a pension scheme may appear utopian, but it is in effect in New Zealand.

Keywords: public pensions, tax incentives.

Three Pillars of Pensions?
A Proposal to End Mandatory Contributions

In this paper I focus on the overall design of a pension system, including tax incentives and subsidies that governments might provide for contributions to such a system. In examining these issues, it is important to keep in mind the purpose of pensions. Pensions do not exist to increase national savings or to provide jobs for actuaries, tax lawyers, accountants, fund managers and regulators. Their purpose is to allow the elderly and disabled to retire from work in dignity.

Three Pillars, Three Views

To avoid misunderstanding, it is useful at the onset to define terms. Traditionally, specialists have divided pensions into three pillars:

1. Public pensions
2. Occupational pensions
3. Personal pensions

Within each pillar there are many types of pensions, sometimes referred to as 'tiers', but the three categories exhaust all possibilities with respect to providers of pensions. There are only three sources of pensions: government schemes, schemes set up by a trade union or employers, and individual annuities. At this Meeting of the OECD Forum, numerous speakers have referred to these traditional three pillars, or to some variant of them. For some purposes, this is a useful way to look at pension systems, especially if the aim is to compare pension systems in different countries.

I prefer to use an alternative framework developed six years ago by the World Bank in a now famous Report titled Averting the Old Age Crisis. The authors of the Report analyse the problem of income maintenance in old age not from the perspective of pension providers but rather from the perspective of those who participate in retirement income schemes. Somewhat confusingly, the Report retains the terminology of 'three pillars', and refers often to Pillar 1 as synonymous with 'public pillar', even though the second pillar in this scheme typically is, and the third pillar could conceivably be, publicly managed. The Report defines its three pillars in this unique and useful way:

1. Non-contributory (basic pension)
2. Contributory (forced savings)
3. Contributory (voluntary savings)

The first pillar is an anti-poverty pillar that is non-contributory and guarantees a minimum income in old age. The second is a forced savings pillar that provides benefits only to contributors, and, in general, provides the most benefits to those who contribute most. The two mandatory pillars differ only in whether benefits are flat, or related in some way to contributions. The Report (p. 238) is prescriptive rather than descriptive when it "recommends separating the saving function from the redistribution function and placing them under different financing and managerial arrangements in two different mandatory pillars—one publicly managed and tax-financed, the other privately managed and fully funded." Pillar 3 is a voluntary savings pillar, available to anyone who cares to supplement the retirement income provided by the first two pillars. The first pillar protects the elderly from absolute poverty (consumption below a minimum subsistence level), whereas the second two pillars protect them from relative poverty (a fall in consumption following retirement).

The first pillar is invariably public, financed by government on a pay-as-you-go basis. It is possible to imagine private employers or trade unions providing each covered worker with a pension unrelated to earnings or contributions, but in practice this never happens. Pillar 2 almost everywhere has traditionally been public and pay-as-you-go as well; increasingly it is private and prefunded, in part or in whole. Governments have a choice, which is precisely why the World Bank encourages them to prefund Pillar 2 and to shift management from the public to the private sector.

When Pillar 2 is financed on a pay-as-you-go basis and is publicly managed, the contributions of workers and their employers are classified as 'payroll taxes'. This is misleading. When pension schemes, whether prefunded or not, promise greater benefits to those who contribute more, they are best described as forced saving rather than taxation. The third pillar is identical to the second, except that it is always prefunded and is typically private because participation is voluntary. It is important to note that contributions to pillars two and three need not result in pensions. Benefits can be (and often are) drawn as a lump sum or as a series of withdrawals beginning at a specified age.

All retirement income falls by definition into one of these three World Bank pillars. Wherever the state (or, conceivably, an employer, a trade union, a charity or an extended family) provides benefits to the elderly that are not related to earnings or contributions, this is Pillar 1. Pillar 2 consists of entitlements derived from mandatory contributions to a pension or retirement savings scheme. Pillar 3, we have seen, is voluntary, thus it encompasses all other retirement income. What if an employer pays the entire cost of a pension? This is Pillar 2 if the scheme is mandatory, for the employer could offer higher cash wages in lieu of a pension plan. What if participation is mandated not by the state, but by an employer or by a trade union? This also falls under Pillar 22, for an employee can withdraw from the scheme only by changing employment. In a state-mandated Pillar 2, workers can similarly escape the scheme only by moving to the informal sector or to self-employment where pension contributions can be avoided.

A number of World Bank staff subsequently altered the definitions of two of the three pillars by reserving the term 'Pillar 2' for fully funded, privately managed schemes, and by placing all public schemes, contributory or not, in Pillar 1.[1] Holzmann et al. (1999, p. 2) thus describe the ideal system as "(i) a publicly managed, unfunded, and defined benefit pillar, which is tax or contribution financed and should take care of poverty and redistributive concerns; (ii) a privately managed, fully funded, and defined contribution pillar, which takes care of income replacement and is financed by earnings-related contributions -- both (i) and (ii) are mandatory – and (iii) voluntary saving for old-age in the form of assets, insurance contracts, housing, etc." The public pillar includes earnings-related as well as flat pensions, but this is by default rather than by design. The World Bank would prefer to prefund all earnings-related pensions, and leave to Pillar 11 the task of reducing poverty with flat, universal pensions financed on a pay-as-you-go basis.[2] If all public pensions were universal and flat, today's three pillars would coincide with the three pillars of 1994. This is not the case, so I ignore this evolution in World Bank thought, and retain instead the three pillars of their 1994 Report.

Pillar 1

Averting the Old Age Crisis (pp. 239-244) emphasizes the need for first pillar protection against absolute poverty in old age.[3] Staff of the World Bank have since paid scant attention to the universality of Pillar 1, so it is useful to recall that the 1994 Report describes how governments ought to provide a flat pension for "everyone of pensionable age, regardless of income, wealth, or employment history". With an eye on the budget, governments seldom accomplish this task. They frequently offer the benefits of Pillar 1 only to those who contribute to Pillar 2, thus excluding workers with low lifetime earnings, such as domestic servants, caregivers, agricultural labourers and workers in the informal sector.

[1] Using this revised definition of the two World Bank pillars, Fox and Palmer (1999) are able to report "in 1994 most of the world had Pillar 1 systems" and "only Chile and Australia had a second pillar system." Not all World Bank staff have adopted the revised definition, however; James (1999) clearly refers to the pillars of the 1994 Report in a recent paper.

[2] Holzmann (2000, p. 20), who is Director of Social Protection at the World Bank, recommends that governments assign to Pillar 1 responsibility for flat pensions and to Pillar 2 responsibility for earnings-related pensions. He complains that "most of the reforming countries so far have chosen to target relatively high replacement rates, which has given the PAYG [pay-as-you-go or public] pillar the dual duty of poverty reduction and contributing to income replacement."

[3] See also box 4.2 of the Report (World Bank 1994, pp. 117-118).

Old-age pensions almost everywhere are a privilege of urban workers in the formal sector of the economy. Covered workers amount to perhaps 45 per cent of the labour force in developing countries with a relatively high income, such as Chile and Mexico, 25 per cent of the labour force in middle-income Colombia and Peru, and 11 per cent of workers in low-income India. Governments in addition use means tests and employment tests to deny Pillar 1 pensions even to those who have contributed to Pillar 2. The 1994 Report supports removal of all these restrictions in order to give every elderly person access to a basic pension:

> "Administratively, this is the simplest structure, with the lowest transaction costs, for the public pillar—an important advantage in developing countries with limited institutional capacities and incomplete record-keeping systems. It avoids the disincentive to work and save inherent in means-tested plans. Its universal coverage helps ensure that the poverty reduction objectives are met, provides a basic income for all old people (coinsuring against low investment returns or high longevity), and might receive broad political support" (World Bank 1994, p. 240).

Governments often appropriate contributions to a public Pillar 2 for the purpose of redistributing income and alleviating poverty. This collapse of the first two pillars into a single public pillar has the effect of converting forced savings into payroll taxes, with all the inequities that regressive taxation can imply (World Bank 1994, box 4.3, p. 119; Willmore 1999). The 1994 Report recommends wisely that governments shift to broader, more progressive taxes to finance the first pillar:

> "Heavy reliance on a broad tax base, such as an income or consumption tax instead of a payroll tax, is the most efficient in the long run, since it reduces the tax rate needed to finance benefits. It is also most consistent with the redistributive function of the public pillar, particularly when coverage is broad" (p. 243).

Should the basic pension of the first pillar be means tested? The World Bank in its 1994 Report pointed out the negative consequences of such a policy. First, the administrative simplicity of the programme would be lost; administrative costs would rise, as would opportunities for corrupt behaviour on the part of government officials. Second, means tests act as a tax on retirement income, discouraging saving for retirement as well as continued work in old age. Third, means-tested benefits become characterized as 'welfare', which reduces their political appeal and discourages applications from the eligible poor.

Nonetheless, many countries, especially developing countries, meet taxpayer resistance in collecting tax revenue, so finance of the first pillar can present major problems. There are two possible solutions, which can be used in combination, if desired. First, the coverage of the first pillar might be limited not by a means test, but rather by making disability, not chronological age, the criterion for eligibility. If age is also used as a criterion, this could be set rather high, say at 70 years. It is important to retain disability as a sufficient test for a basic pension, for the very poor are more likely to become disabled at an early age, and are less likely to live long enough to collect a pension based on age. A second way to limit coverage is with a means test, but one that does not stigmatize the recipient as a pauper and does not discourage saving or work. This can be accomplished with an 'ex post' means test, by granting a universal pension based on age or disability, then 'clawing back' some or all of the pensions of wealthier citizens by imposing an appropriate surtax on their income. Suppose, for example, that a country has a graduated income tax that begins with a marginal rate of ten per cent, then increases in increments of ten to reach a top rate of 50 per cent. Recipients of a basic pension from the state could be subjected to a surtax of, say, 20 per cent until the full amount of the pension was recovered. For these elderly contributors, then, the first income tax bracket would then be 30 per cent, the second 40 per cent and the third (if necessary) 50 per cent. Alternatively, the marginal rates for all taxpayers could be increased by a smaller amount, but we are assuming that this solution would meet with resistance in the form of a taxpayer revolt.

Pillar 2

There is a large literature that addresses whether Pillar 2 should be public or private, prefunded or pay-as-you-go, defined benefit or defined contribution.[4] In this paper I address a more fundamental question: Is there need for Pillar 2 in any form?

The case for a first pillar is compelling: no one wants to see workers forced to toil until they die or retire with less than a subsistence level of income. If the state does not guarantee some minimum standard of living, families and private charities will step in, and most likely provide a social safety net that is much less even, one that misses many of the elderly. But why have a second, earnings-related pillar? Why should society care whether a worker has the means to consume well above a subsistence level during retirement? Governments of course would like workers to enjoy a comfortable retirement. But they also would like them to own a home, eat plenty of vegetables and exercise regularly, yet they do not mandate home ownership, purchase of vegetables, or an exercise regime. They might provide tax incentives, but for the most part they leave this to individual choice. Why don't they leave pensions to individual choice as well? Pensions are different, it is said, first because governments want to protect taxpayers from the demands of penniless retirees, and second because they want to protect workers from their own shortsightedness.

Some economists argue that it is a duty of governments to protect taxpayers from the consequences of 'moral hazard'. The moral hazard they stress is that the guarantee of a minimum income in old age discourages people from saving for their own retirement. In essence, the existence of a first pillar makes the second pillar necessary. But their argument assumes the existence of a rather poorly designed means test for basic pensions. Martin Feldstein (1998, p. 105), for example, defends mandatory contributions to Pillar 2 on grounds that pensions of the first pillar

> "encourage some lower-income individuals to make no provision for their old age deliberately, knowing that they would receive the means-tested amount. For individuals with low enough income, that combination might be preferred to saving during their working years to have a higher level of retirement consumption. A mandatory system of individual saving would prevent poverty in old age while avoiding the temptation to 'game' the system in that way. The options that I have studied therefore always assume that individuals would be required to save some fraction of their wage and salary income."

In other words, working poor are asked to reduce their consumption in order to protect the lifestyle of relatively wealthy taxpayers. As Dimitri Vittas pointed out in this Meeting, it is difficult to take this argument seriously when one observes how shabbily governments treat their homeless citizens. In any event, to protect taxpayers, governments need not force all workers "to save some fraction of their wage and salary income". They need only require workers to save enough to finance a minimum pension, enough to ensure that they will not become eligible for a Pillar 1 pension. High-income workers would contribute no more than low-income workers to Pillar 2, and they would receive the same basic pension. Those who prefer additional retirement income always have the option of Pillar 3.

We do not observe in any country the flat, low pensions that the 'taxpayer protection' rationale would predict for Pillar 2. Nowhere are mandatory pensions capped at a subsistence level.

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[4] See Orszag and Stiglitz (1999), Willmore (1999), and the references cited in those papers.

Instead, mandatory contributions and benefits increase with earnings to a point far beyond the basic pension of Pillar 1. The usual explanation for this pattern of pensions is that governments are paternalistic and seek to protect not the taxpayers but rather workers themselves. The belief is that at least some workers are so shortsighted that they would consume too much of their salary and save too little for retirement if they were allowed to choose their own pattern of lifetime consumption. The implicit assumption is that government knows best: without compulsion, individuals make mistakes that they later come to regret. So government forces each worker to save enough to avoid any drastic fall in his or her standard of living in retirement.

These same arguments for mandatory saving apply to withdrawals during retirement. Workers do not escape from moral hazard or myopia simply because of age. In a traditional second pillar, which is defined benefit and pay-as-you-go, retirees receive a pension, which is a series of payments paid on a regular basis until the death of both the participant and any dependent spouse. These payments are often indexed, explicitly or by custom, to prices or to average wages. In a defined contribution, prefunded Pillar 2, an individual account exists in the name of each worker. There is no automatic pension. Instead, the accumulated savings must be converted into some sort of an annuity, that is, into a stream of payments extending perhaps until the death of the participant or the participant and any designated dependent. The possibility exists, then, that workers might receive all or a part of their savings as a lump sum on retirement. But, if moral hazard justifies mandated saving in the first instance, the same logic dictates that no lump sum payments be allowed. A myopic retiree, or one intent on 'gaming' the system, would quickly spend the proceeds of a lump sum, or appear to spend them, in order to become eligible for a means-tested pension.

This would seem to be the logic, yet the World Bank in its 1994 Report (p. 331) left open the possibility of lump sum payments by declaring "In a mandatory saving scheme workers should not be required to purchase annuities with their entire retirement saving." More recently, the World Bank (2000, p. 8) has elaborated on this position, recommending that participants in a mandatory Pillar 2 be required only to purchase "a minimum, indexed annuity with adequate survivor's provision, with flexibility for any remaining retirement savings." The minimum is set at the level of Pillar 1 ("the social safety net") for both the participant and any dependent spouse, and begs the question as to why saving in excess of that needed to purchase a minimum pension or annuity is mandated in the first instance.

For individuals, the purchase of an annuity—other than a small one that provides survival insurance in the event of unexpected longevity—makes little sense; and it makes even less sense if the person happens to be poor. The decision to purchase an annuity is an irreversible decision everywhere, for good reason. If insurance companies were to allow annuitants to reverse their decision at any time, then a person whose health turns for the worse would naturally want to cash in her annuity. Everyone, but especially the poor, can benefit by keeping options open, by forgoing the purchase of an annuity. An individual might want access to cash in the future for a medical emergency, or to draw on during a bout of unemployment or a crop failure. The poor have short expected-lifetimes in any event, so annuities are less appealing to them, especially if they are pooled with wealthier people, who live much longer on average. And the poor face very high rates of interest if, indeed, they have any access to credit at all. This diminishes even more the value of annuities, which, in any case, are poor value for money. (See World Bank 1994, pp. 329-331.)

With this reasoning, on 4 April 2000, the second day of this Meeting, Mr. Dimitri Vittas and Ms. Estelle James of the World Bank reached the following conclusion: once a subsistence pension is assured, it is not advisable for anyone to annuitise additional wealth at the time of retirement. They recommend that retirees keep the remainder of their savings invested, and that they draw down these savings in a phased fashion adjusted each year for changes in each individual's life expectancy. The minimum pension is sufficient insurance for longevity, for the risk of outliving one's savings.

With a generous and universal Pillar 1 in place, the implications of this reasoning are even more profound: there is no need for pensions at all! Moreover, there is no need for the forced savings of Pillar 2. After all, governments force workers to save for retirement on the assumption that they are myopic. Any myopia they have is not apt to suddenly disappear the day they retire. If workers are to be given access to a lump sum of savings upon retirement, why not give them access to their savings before retirement? Better yet, why not allow each person to make his or her own decision as to how much to save and in what way to save for retirement?

Tax incentives

Almost everywhere, retirement savings are taxed more lightly than savings for other purposes. It is not clear why this is done. Perhaps governments believe that subsidization of savings (granting a higher return to saving) might have a positive effect on private or national saving. Theoretically, the effect might be positive or negative. After all, if a person earns a greater return, she might well save less, since less saving is required to reach a specific target savings. Empirically, the best evidence is that subsidies and tax incentives affect the form but not the amount of saving (Engen, Gale and Scholz, 1996). In other words, saving that flows into subsidized retirement plans is, on average, at the expense of other, non-subsidized, forms of saving. This point is so important that it merits emphasis and repetition: subsidies, including tax incentives, have no discernible effect on private saving.

Following Dilnot and Johnson (1993) and Dilnot (1996), we identify three points of taxation of savings: contributions to the schemes, income and capital gains generated, and benefits paid. At each of these three points, the cash flows can be taxed (T) or exempted (E). Of the eight resulting permutations of T and E, the following five are of interest. Each has an appropriate name:

- TTE Comprehensive income tax
- ETT Deferred income tax
- EET Classical expenditure tax
- TEE Pre-paid expenditure tax
- EEE Tax haven

The simplest way to illustrate the differences in these taxation regimes is with the aid of an example. Assume that there is a proportional (flat) income tax at the rate of 20%. Savings in the amount of 100 units are invested 10 years before retirement. The rate of interest is 10 per cent per annum and we assume there is no price inflation.

	TTE	ETT	EET	TEE	EEE
Contribution	100	100	100	100	100
Tax	-20	--	--	-20	--
Fund	80	100	100	80	100
Return	93	116	159	127	159
Final Fund	173	216	259	207	259
Tax	--	-43	-52	--	--
Net Pension Fund	173	173	207	207	259

In the first column (TTE), which corresponds to the comprehensive income tax, saving is with after-tax income, so only 80 of the 100 units reaches the fund. The returns are also taxed, but not the benefits, so after ten years the fund grows to 173. The second column (ETT) is a deferred income tax, because contributions are exempt, whereas both the earnings and the benefits are taxed. In this example, the rate of taxation does not vary, so the first two regimes produce identical results. If a person expects to be subject to a lower rate of tax in retirement, then deferred income tax has an advantage over the comprehensive income tax. The third and fourth columns (EET and TEE) for the same reason produce the same result, a net fund of 207. These refer to expenditure taxes, which are more favourable to saving. Finally, when contributions, earnings and benefits are all exempt from tax, the fund grows to 259 at retirement.

It is sometimes said that an EET (or TEE) regime for retirement savings ‘mimics’ a consumption or expenditure tax. This is not true. An expenditure tax exempts all saving from taxation, not saving for a particular purpose. The case for an expenditure tax is that consumption today is taxed the same as consumption tomorrow. This requires all saving be exempt from taxation, as well as the earnings on saving and investment (unless, of course, they are consumed); and there would be no corporate income tax since, by definition, corporations do not consume. On the other hand, a comprehensive income tax treats citizens according to their ability to pay, and this, in effect, is the system chosen by governments everywhere. Only two countries –India and Ceylon (now Sri Lanka)—have experimented with an expenditure tax, and it proved to be extremely unpopular in each country. Another argument in favour of an expenditure tax is the fact that with inflation, income taxes fall on nominal rather than real returns from investment. The expenditure tax promises to solve this by exempting all investment returns and all capital gains from the tax base. But the income tax could be reformed, and has been reformed in a number of countries with a history of high inflation, to tax only real investment earnings and real capital gains. (See Kaldor 1955 and Pechman 1980).

In any event, the typical taxation of savings around the world is as follows:

- TEE For home ownership
- EET For approved retirement savings
- TTE For all other savings

Home ownership and retirement savings are almost everywhere favoured over saving for other purposes. In the case of owner-occupied housing, tax authorities ought to impute the rental value of the home and add it to the income of the homeowner for the purposes of calculating taxable income. This is rarely done, presumably because voters dislike paying taxes in cash on imputed income that they have never seen. Norway is one of the few countries to tax imputed rent in this way, but the imputed rent is rather low (2.5% per year of the taxable value of the house), capital gains are not taxed, and young people saving to buy a home receive a special tax deduction (EIU 1999).

In the case of retirement savings, the typical treatment is EET, but treatment is sometimes even more generous. A number of countries, for example, tax benefits at a reduced rate when they are taken as a lump sum rather than as an annuity (Dilnot and Johnson, p. 7). What accounts for this generous provision of tax shelters for retirement savings? In the case of mandatory pension schemes (Pillar 2), they are said to encourage compliance. In the case of voluntary savings (Pillar 3), the motive seems to be paternalism: tax subsidies allow governments to require that savings be 'locked in' until retirement. Governments are aware that these tax incentives are costly, and for that reason always limit the amount of income that can be sheltered in this way. Since retirement savings are not available (or available only upon payment of a large penalty) for any purpose other than retirement, this type of subsidy is more valuable to the wealthy than to the poor, who have greater need to retain access to their savings in the event of an emergency such as illness or unemployment. In the United States, according to analysis prepared by the Department of Treasury (cited in Orszag and Orszag, 2000), two-thirds of all tax subsidies for retirement saving go to the wealthiest 20 per cent of the population while only one-eighth go to the bottom 60 per cent of the income distribution.

In sum, tax subsidies for retirement saving are common, but they are costly and they have regressive effects on income distribution. They are harmful to the poor and affect only the form, not the amount, of private saving in an economy.

Coverage of pension systems

An estimated 85 per cent of the world's households (Holzmann et al., 1999) and 90 per cent of its working-age population (Gillion et al., 2000) lack any form of income security in old age. With the exception of a few high-income countries in the OECD, guaranteed minimum pensions of the first pillar apply only to those who contribute to the second pillar, and coverage is very low in developing countries. The privatization promoted by the World Bank, which favours defined contribution schemes and individual accounts, does nothing to expand coverage. On the contrary, it typically results in decreased coverage because benefits are linked more tightly to contributions, so there is less redistribution and less reason for the poor to participate.

Estelle James (1999), lead economist for the 1994 World Bank Report, addresses this important issue in a thoughtful and honest paper. She acknowledges the limited pension coverage in developing countries and concludes, correctly in my opinion, that "contributory insurance for many of these workers, particularly for low income workers, is neither feasible nor desirable" (p. 1). Expansion of the first pillar seems a logical way to extend coverage to these workers. To my surprise, James rejects this solution on grounds that incomes are distributed very unequally in developing countries. Her reasoning is as follows:

> "When income is unequal, a uniform benefit that is reasonable from the point of a poor worker would be negligible for a rich worker who would therefore be uninterested in supporting it. But a benefit that is high enough for the rich worker would exceed the wage level of a poor worker, and would be very expensive for the economy as a whole. Relatedly, when incomes are very unequal, typically only a minority of people pay general taxes, and these people would oppose financing a universal benefit…. Note that the OECD countries with universal benefits all have a high degree of income equality" (p. 3).

Ms. James concludes on a rather pessimistic note. Pensions, at least in developing countries, will have to be financed with earmarked taxes, and pension benefits will have to be linked to taxes paid. She allows for the possibility of means-tested assistance for the elderly, but cautions that "to avoid negative effects on the contributory program, redistribution via social assistance to the uninsured should not be 'too' generous" (p. 18).

Ms. James' reasoning is not convincing. Consider provision of other government services such as schooling. There is widespread illiteracy in developing countries, and the level of primary education that is adequate for a poor worker is not likely to interest a wealthy taxpayer. Moreover, the cost of primary education adequate for the wealthy exceeds the wage of a poor worker, and would not be affordable for the economy as a whole. Governments nonetheless seek to provide all citizens with schooling at the primary level, even though they are not always successful. Primary education is not means-tested, and it is financed from general revenue, not earmarked taxes. Some taxpayers, in countries at all levels of development, pay for private schooling because they want a higher or at least a different standard from that offered by the government. Many of these taxpayers are relatively wealthy; others are of modest means. Governments do not provide tax rebates to childless taxpayers or to those who pay for private education, although some governments have begun to experiment with vouchers.

If universal provision of primary schooling is politically feasible, universal provision of basic pensions is even more feasible. Unlike public schooling, public pensions are of value to everyone, regardless of income, religion or family structure. There is no need for taxpayers to replace public pensions with private provision, for they can supplement public pensions with income from their own savings. From the perspective of how citizens value benefits, universal provision of public pensions should be more popular than universal schooling.

Conclusion: an ideal pension system

My vision of an ideal pension system is one where a universal first pillar covers every resident. This would not be some sort of minimal "safety net for the poor" pension, but neither would it be one that would cover the needs of the wealthy for retirement income. Some recipients would receive a larger income in their old age than the average pay they received during their working years. This would certainly be true, for example, of many women who have a history of little or no attachment to the paid labour force. I see no harm in this, and much potential for good. If society cannot guarantee workers a minimum income by means of unemployment benefits, wage subsidies or a negative income tax, it can at least give those who have nothing something to look forward to at the end of their lives. Those who are more fortunate would have the option to purchase an additional annuity to supplement the basic pension provided by the state. In other words, there would be a second pillar, but a voluntary second pillar. Everyone would have the option to save for retirement, but these savings should not be taxed any differently than savings for any other purpose. If governments tax income rather than expenditure, which is true for all countries in the world today, this means that all saving for retirement would be done with after-tax income. The saving from eliminating costly tax incentives could finance at least a portion of the generous universal pension.

This ideal system appears to be utopian, but it is functioning today in New Zealand (St. John 1999). In that country, any resident who reaches the age of 64 (rising to 65 by 2001), regardless of work history, receives a basic taxable pension sufficient to meet the usual living needs of a homeowner. The net pension is indexed to prices, but it is also tied to a band of net average wages, and currently is at the floor of 65% of the net average wage for a couple. A single person receives 39% of the net average wage, with a supplement for those who live alone. The system is simple, unique, and enjoys widespread popularity and political support. Since 1998, after 15 years of a surcharge that excluded the wealthiest 10 per cent of the population, these pensions have been universal. There is no retirement test, but the age of eligibility has increased gradually from 60 to 65 years over the period 1991-2001.

Public pensions in New Zealand are taxable as regular income, so the net budgetary cost of pensions is less than the gross cost. Projections done by the Periodic Report Group in 1997 show the net cost rising from a low of 4% of GDP in the year 2000 to around 9% in 50 years' time as a result of population ageing. Pensions are financed on a pay-as-you-go basis from general revenue, largely from a graduated income tax with marginal rates that go from 15% to 39% and from a broad sales tax (Goods and Services Tax or GST) set at 12.5%. Apart from a scheme in the 1970s, which was quickly abandoned, New Zealand has never had a second pillar. Since 1990 no incentives of any kind have been given for retirement savings or private pension plans. Owner-occupied housing is the only savings favoured by the tax system, for homeowners are not obliged to declare imputed rents as income, nor are capital gains taxable for most personal real estate transactions. Home ownership is thus common, with the result that 83% of New Zealand's pensioners own their own homes. Pensioners who rent homes are eligible for a means-tested housing allowance to supplement the basic pension.

New Zealand could provide a model for developing countries. Instead, we look to Chile, which has a pension system that excludes a majority of its population. In low-income countries, the basic pension should be set in relation to per capita income rather than average wage, for wage data refer to the formal sector of the economy, whereas much of the population toils in the informal sector. Very poor countries most likely cannot afford to encourage able-bodied workers to retire, regardless of their age. So the criterion for a pension should perhaps be disability—inability to work at a steady job—rather than age. Or, the age of eligibility could be set rather high, say 70 years, without a retirement test. But disability alone should always be sufficient grounds to receive a pension. Otherwise, benefits will go disproportionately to the wealthy, who are more apt to reach the age of eligibility, rather than to the poor, who are prone to become disabled or die early in life.

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