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I Z A
World of Labor
Evidence-based policy making

The incentive effects of minimum pensions

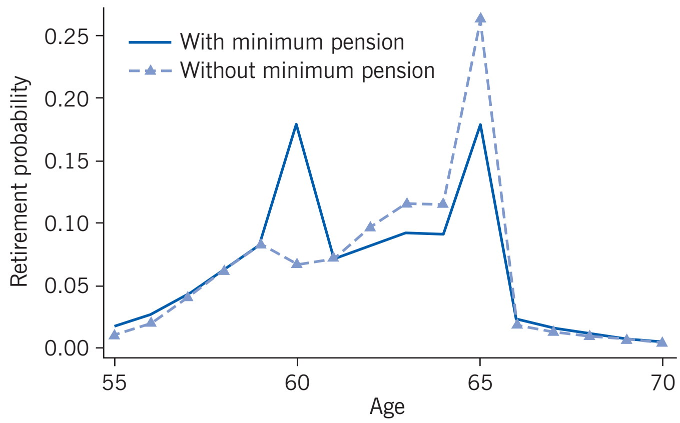
Minimum pension programs reduce poverty in old age but they can also reduce the labor supply of low-income workers

Keywords: retirement, incentives to retire, life-cycle model, minimum pension

ELEVATOR PITCH

The main purpose of minimum pension benefit programs and old-age social assistance programs is to guarantee a minimum standard of living after retirement and thus to alleviate poverty in old age. In many developing and developed countries, the minimum pension program is a key welfare program and a major influence on the retirement decisions of low-income workers and workers with erratic work histories. The design of many minimum pension programs tends to create strong incentives for low-income workers to retire as soon as they become eligible for the program, which is often earlier than the normal retirement age.

Shift to early retirement under the Spanish minimum pension



Source: [1], Figure 7.

KEY FINDINGS

Pros

- Minimum pensions help low-income workers achieve a minimum standard of living in old age and thus reduce poverty.
- Minimum pensions transfer income from people with high incomes to those with low incomes.
- The incentive effect of minimum pension programs at the normal retirement age is in general moderate.

Cons

- Minimum pensions fundamentally alter the work incentives of low-wage earners.
- The influence of minimum pension programs on labor supply peaks at the early retirement age, thus reducing the labor supply of eligible workers.
- Noncontributory social assistance benefits in old age also lower the work incentives of older workers.
- Minimum pensions lead to peaks in early retirement as well as in normal-age retirements.

AUTHOR’S MAIN MESSAGE

Minimum pensions are useful for reducing poverty in old age, but they can cause substantial distortions in the incentives to work (and to contribute to the system) as individuals age. When benefits are available at the early retirement age, the incentive effects can be substantial. By encouraging early retirement, such programs reduce the labor supply of workers approaching retirement age. The size of the effect depends on both eligibility conditions and the generosity of the minimum pension compared with the average wage. However, when minimum pension benefits are not available until after normal retirement age, they tend to have little incentive effect on retirement decisions.

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