Social Security and Retirement Reform

Questions & Answers

National Treasury
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Introduction

President Mbeki announced in the State of the Nation Address on 9 February 2007 that proposals would be tabled as part of the 2007 Budget for a contributory earnings-related social security arrangement, informed by the principle of social solidarity. These proposals will form the basis for consultation with the organized business sector, trade unions and other stakeholders this year.

Chapter 6 of the *Budget Review* provides an overview of the present social assistance grant programmes and social security funds, and an outline of the proposed social security reforms. The main proposals include:

- A mandatory, earnings-related social security tax to finance basic retirement fund contributions, improved unemployment insurance, death and disability benefits and administration costs
- A wage subsidy to offset the costs of social security contributions for low-wage employees and to encourage employment creation
- Administrative reforms to enable the SA Revenue Service to maintain individual contributor records and to ensure efficient and reliable benefits administration
- Complementary reforms of the governance and regulation of the retirement fund industry, which will continue to provide occupational and individual retirement funding arrangements to supplement the basic social security scheme.

Key features of the proposed reforms are explained below. Further details on these and associated reforms of the retirement fund industry will be the subject of a discussion paper to be released on 23 February 2007.

Why do we need a social security system?

Social security is partly about redistribution – that a society should share jointly in the basic safety net that protects everyone against poverty. It is also about contributory insurance – ensuring that everybody participates in an agreed basic social insurance arrangement to protect household incomes in the event of death, disability or unemployment. All contributors will be entitled to benefits from the fund, which will be governed through standard rules and implemented through a common administrative platform.

A national social security fund would be large in terms of the number of contributors. A key test of its success will clearly be the quality and efficiency of administration. Standardisation of contributions and benefits and consolidated information systems provide some scope for economies of scale and low operating costs per member. Cost-efficient administration contributes in turn to the value and security of benefits for contributors.

South Africa has a well-established retirement industry. What is wrong with the present arrangements?

Most people in formal sector jobs contribute to pension, provident or retirement annuity funds, and some people save enough in this way to be able to live adequately in retirement. However, many South Africans do not save, or leave it too late in their careers to save enough for retirement. This is partly because many working people cash in their pension savings when they change jobs, or have informal or irregular employment which makes it difficult to save.

So although South Africa has a well-established retirement industry, it does not adequately meet everyone's needs.

The problem of retirement saving is closely related to other aspects of social insurance. Some people cash in their savings when they lose their jobs because their unemployment benefits are insufficient. Some people find it necessary to draw on their savings to meet medical costs in the event of an injury or ill-health. If the benefits available for dependent children are inadequate when someone dies or becomes disabled, then other family members carry an increased burden.

These are vulnerabilities that can be addressed in an integrated way in a social security system. By combining savings for retirement with unemployment insurance and protection of dependants when someone dies or becomes disabled, a social security system can provide affordable basic benefits for everyone.

But we already have social assistance grants. Why do we need social security?

The social old age grant pays up to R820 a month, to be increased to R870 a month in April 2007, to elderly people (men over the age of 65 and women over the age of 60) who do not have a sufficient income from other sources. Nearly three-quarters of all elderly people rely on the old age grant.

This grant is therefore an important part of South Africa's social assistance system. Studies show that social grants contribute significantly to reducing poverty. The social assistance grants (including the child support grant and disability grants) will remain in place, as they provide a basic "safety net" protecting the poor.

These grants are paid for out of general revenue, and they are targeted at those who would otherwise not have an adequate income. The social assistance safety net is a *redistributive* arrangement.

Maintaining and extending this safety net for the poor is an important expression of social solidarity, in the context of South Africa's legacy of poverty and inequality. But as a society we also need to encourage saving and basic social *insurance*, which are the goals of an earnings-related *contributory* arrangement.

It is not enough just to provide a grant when people reach retirement age and don't have enough to live on. It is also important that people who can afford to do so should save during their working years and provide for their children in the event of death or disability. Society as a whole is better off if everybody contributes to saving and social insurance arrangements. For these arrangements to be fair and equitable, the basic minimum standards of social insurance need to be compulsory.

Isn't this just going to be another tax?

The proposal is that everyone in formal employment will pay a social security contribution of between 13 and 18 per cent of their earnings, up to an agreed threshold. This will include the present unemployment insurance contribution, and in addition will finance an individual savings account for retirement, and death and disability benefits. It is, in effect, a standardized insurance contribution, collected by the SA Revenue Service, as part of the Standard Income Tax on Employees, but it will pay for benefits that belong to each individual contributor.

The social security tax will be capped, in the same way that the present UIF scheme is capped – everyone contributes and is entitled to claim benefits, but up to an agreed threshold. Above the threshold, employees will be able to choose between further contributions to the social security scheme, or participation in an occupational or individual retirement fund.

What will the contribution threshold be?

The threshold has still to be decided. One option would be for the present standard income tax on employees (SITE) threshold of R60 000 a year to apply. That means that everyone would contribute an agreed percentage of their earnings – say 15 per cent, up to R750 a month.

Does SARS have the capacity to manage a social security tax?

A key feature of successful social security systems is that both contributions and benefits should be simple and straightforward – no exceptions, no complicating deductions, no special allowances. SARS will develop the required systems and capacity, based on the present SITE system, but including individual contributor records. This is an opportunity to update and modernize the interface between SARS and employers, and rationalize the present UIF, skills levy and SITE collection systems. It's a big project, and the work has already begun.

Does social security replace the social old age pension and other social grants?

No. The social assistance grants programmes will remain in place as a redistributive safety net, paid for out of general government revenue. Options will be explored for merging the administration of the old age grant and the new social security pension amount.

Will the means test be abolished?

Social security reform will make it possible for the means test thresholds to be lifted significantly, although not necessarily abolished. Government's intention is that ordinary working people should be able to receive a pension financed through their social security savings in addition to the old age grant.

Does this replace existing pension or provident funds?

Once the social security system is in place, then everybody will be a member of the social security scheme and many employees will also be members of occupational pension schemes or individual retirement funds (such as retirement annuities).

There will be transition arrangements to allow existing pension and provident funds to adapt to the new dispensation. Many will continue as supplementary occupational schemes, but an option to transfer accumulated funds and benefits into the social security scheme on behalf of members will also be provided.

Who will manage the social security fund and administer benefits?

This has still to be decided.

Social security funds and benefits administration are usually managed by government and governed by law. But there are examples of countries that have opted for competitive provision of services by the private sector, subject to agreed product standards and a regulatory framework.

Doesn't the present tax system already provide enough encouragement to save?

For higher income people, there are considerable tax benefits from contributing to an approved retirement fund. But for many working people, the tax benefit does not help. If your wage is less than the tax threshold of R43 000 a year, then there is no tax advantage in contributing to a pension fund.

The present fiscal arrangements are unfair to low-wage employees. If they do not save, then the old age grant provides a basic retirement income. If they contribute enough to a fund to receive a pension, then as a result of the means test they will get a smaller grant or no old age grant at all. This is a "poverty trap" – in effect, working people are penalized for saving. On the other hand, higher income earners can take advantage of the tax benefits of saving, and these benefits rise in proportion to their taxable earnings.

So is the government planning to take away the tax deductibility of pension contributions?

No, the tax system will continue to reward retirement saving.

However, the present limits to the deductibility of pension and other contributions are under review. It is unsatisfactory that the tax system continues to provide an effective 40 per cent marginal subsidy for this particular form of saving, without a cap. This is both disproportionate from a retirement policy point of view, and it has distorting effects on saving and investment decisions. The tax benefit can be capped in various ways, and the Treasury is currently looking at international practice with a view to identifying options for reform.

There are also unsatisfactory features of the tax treatment of lump-sum benefits at present, including complex formulas and thresholds that have not been adjusted for a long time. Proposals will be tabled this year for changes to these formulas and thresholds.

If this is a new tax, either wages and salaries will have to go up, or employees will be worse off. Surely that's not good for the economy?

It would be impractical and unreasonable to introduce a mandatory social security system without compensating measures. The government is proposing that a wage subsidy should be introduced, both because that is an effective way of encouraging employment and because it would offset the costs of a social security contribution for low-wage employees.

For someone earning a higher income, say R20 000 a month, transition arrangements will allow for adjustments to be made to pension or provident fund plans to ensure that the social security tax does not result in a reduction in disposable income, or a loss in retirement savings.

In developing the details of transition arrangements, particular attention will be given to the earnings range where the present tax liability is low and pension or provident fund arrangements are either non-existent or are very limited, or contribution rates are lower than the proposed social security arrangement. Taking into account the structure and costs and advantages of the benefit schemes currently available to people in this earnings range, it is clearly important to ensure that preservation is accompanied by equivalent or improved benefits, while avoiding any negative effect on take-home pay.

How will the wage subsidy work?

Partly for administrative reasons, it is proposed that the wage subsidy will be implemented as a rebate paid to employers through the SITE system. In effect it will be a subsidy, rather than a tax, for wage-earners below the tax threshold. It will be calculated at a standard subsidy rate, up to an agreed threshold, and then phased-out at or close to the tax threshold. For low-wage earners it will fully offset the social security contribution.

Will there still be lump-sum benefits?

The social security arrangement is about income security, and it is not intended to fund lump-sums at retirement.

In general, the aim of retirement policy is to encourage saving for post-retirement income ("annuities"). But it is recognized that lump-sum payments are a well-established part of the South African retirement system, and in some instances they meet needs that an annuity income cannot. Supplementary occupational and individual retirement funds will continue to allow for moderate lump-sum payments, but with the bias in tax treatment continuing to favour conversion of accumulated funds into income. (Allowance for lump-sum payments as an alternative to very low annuity amounts will not apply to social security savings, as even small annuities can be added to the social old age pension.)

Why a wage subsidy? Hasn't that been tried before and it ends up benefiting employers not workers?

There are wage subsidies of various kinds, in many different countries. The proposed approach draws on international experience, but also aims to respond to South Africa's own challenges and opportunities.

We have to confront both poverty and unemployment. Social security reform is about attacking poverty, by reducing income vulnerability. The wage subsidy makes the social security reform affordable for low-wage workers, and it will also reduce the costs of job creation. Together, this brings about a structural shift in favour of employment creation in our labour market.

So a broad-based wage subsidy is proposed, not another ad hoc selective incentive for industrial or regional development, as these have had decidedly mixed results both in South Africa and elsewhere.

It is important to understand that the wage subsidy is targeted at low income earners – it will only go to people with earnings below the tax threshold. It will be implemented in the formal sector first because the systems can more easily be put in place where employers are already part of the tax system. Because it is targeted at low-wage employees, it will play a greater role in some sectors than others, and it will tend to benefit young people or entry-level workers.

The social security system will also be available to informal workers and seasonal or household employees, and we have to look at options for extending wage support to these hard-to-reach parts of the labour market.

The learnership incentive that was introduced in 2002 serves a different purpose – it encourages firms to invest in training their new employees and it was introduced in the context of the phasing in of the skills development strategy. Whether it will be continued or not will depend on a review of its effectiveness as part of addressing the skills challenge, so it is not affected by the wage subsidy now under consideration.

How will the social security tax affect the risk benefits provided by existing retirement funds?

Occupational risk benefit arrangements, such as group life cover or disability benefits, are very varied. Many of these schemes will continue as supplementary insurance options. Some may be discontinued, where their purpose is adequately served by the new social security scheme.

What about the retirement industry reform issues covered in the 2004 Discussion Paper?

A discussion paper on retirements reform was issued by the National Treasury in December 2004, focused mainly on the private occupational pension funding environment. Wide-ranging comments have been received and these have been taken into account in framing both the wider social security proposals currently tabled, and various reform options for the occupational and individual retirement funding industry. A further document outlining joint aspects of social security and retirement reform will be released on 23 February 2007, to be followed by several discussion papers on governance, regulation and taxation issues.