ASSOCIATION OF COLLECTIVE INVESTMENTS

South African Retirement Savings

A Response to the National Treasury

Retirement Fund Reform Discussion Paper

March 2005

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Background Information

A brief account of the Association of Collective Investments' interaction with National Treasury on the subject of retirement saving.

The Association of Collective Investments (ACI) would like to express its appreciation for an opportunity to respond to National Treasury's Discussion Paper issued in December 2004.

For ease of reference, we preface our response with a brief recap of our interaction with Treasury to date on the subject.

1. New Options for Saving in South Africa was a proposal we submitted to National Treasury in 2001. Its primary aim was to recommend ways of addressing what we had identified as deficiencies in the provision of saving opportunities in South Africa. We examined the evidence for a link between tax incentives and new household saving. International literature was conflicting on the subject. At the very least, we concluded, governments could use incentives to promote a saving culture. We favoured a consumption approach to taxation, recommending that South Africa should have both tax deferred saving vehicles (current retirement funds) and tax pre-paid vehicles (such as the current National Savings Fund proposal). The latter "tax format" was not mutually exclusive with the former and provided a good platform for promoting household saving in South Africa. We also focused our attention on the basis on which certain un-catered for sectors of the market could be drawn into the savings net. Domestic workers, farm workers, casual

RECOMMENDATIONS

- Tax pre-paid long-term saving
- Tax deductions for employers contributions on behalf of domestic workers
- Unit trusts as retirement products

workers, those with irregular income and interrupted income motivated us to recommend:

- An income tax deduction for employers of domestic workers who contribute to recognised retirement savings vehicles.

- The recognition of Prudential Unit Trusts as low cost, portable vehicles for this target market and those who are not able to participate in occupation based pension schemes.

2. New Option for Retirement Saving in South Africa was a proposal we submitted in October 2004, expanding our previous recommendation to recognise collective investments as retirement saving products. In particular, we analysed the legislative impact of including collective investments as retirement products. The congruency of the provisions of the Collective Investment Schemes Control Act No 45 of 2002 (CISCA), the Pension Funds Act No 24 of 1956 (PFA) and the Income Tax Act No 58 of 1962 (ITA) was assessed. We concluded that there is a high degree of compatibility between the objectives of the PFA and CISCA. However, the PFA does not envisage the inclusion of collective investments and therefore excludes these funds, not because they are not suitable, but because they were never envisioned as a solution in the 1950's. When the PFA was promulgated, collective investments did not exist in South Africa and furthermore, occupational retirement provision seemed sufficient in an economy that tended to only concern itself with formal

RECOMMENDATIONS

- Collective investments suitable as retirement products i.t.o. existing legislative objectives
- Restrictive scope of the Pension Funds Act should be expanded.
- Restrictive "product" definitions in Income Tax Act should be re-structured

employment. The ITA on the other hand, had defined "tax" products (pension, provident fund and retirement annuities) which by definition excluded collective investments. The latter clearly requires a "life licence" to constitute and the former two do not include the definition and use of a collective investment scheme in the PFA..

COMMENTARY

- Support general policy approach in Retirement Fund Reform document
- Support National Savings Fund with certain reservations
- Welcome emergence of Individual Retirement Funds

3. Our submission to the Parliamentary Portfolio Committee on Finance on 15 February 2005 emphasised our broad support for the Retirement Fund Reform proposals. We supported National Treasury's general policy approach to retirement saving and affirmed the central transformation themes identified in the paper. We furthermore welcomed the recommendation to harmonise the legislative treatment of existing retirement vehicles, a consequence of which would be the emergence of Individual Retirement Funds (IRF's). This would de-link retirement saving from the employer relationship, allowing portability and accessibility for all, especially lower income earners, the self-employed and those with interrupted or irregular income. We supported the concept of a National Savings Fund (NSF), whilst cautioning against too much optimism. We offered our co-operation to explore how this might be achieved at minimum expense. The ACI recommended that thorough modelling be done before any final decisions are made. A non-compulsory policy has its benefits, but we questioned whether there was sufficient incentive to induce a savings habit amongst a target group who often experienced income deficiency. Retention incentives are difficult to administer and 'who would fund them?', we asked. No restrictions on withdrawals would further weaken the attainment of "critical mass", necessary to produce economies of scale. Numerous transactions would also drive up costs. In

conclusion, we recommended that the launch of a NSF should not be the sole prerogative of Government and that financial institutions should at least be allowed to launch such products under like tax dispensation. Failure to include all existing providers would result in portfolio shifts in the economy. Lastly, we suggested that tax deferred and tax pre-paid formats are not mutually exclusive policy options, but contribute to a consumption tax methodology for smoothing lifetime consumption choices. We included a paper by Kesselman, Jonathan and Poschmann (2001), "*A New Option for Retirement Savings: Tax-Prepaid Savings Plans*", C.D. Howe Institute, Canada.

In response to the National Treasury discussion paper, the ACI has thus far taken the following steps towards providing an informed response:

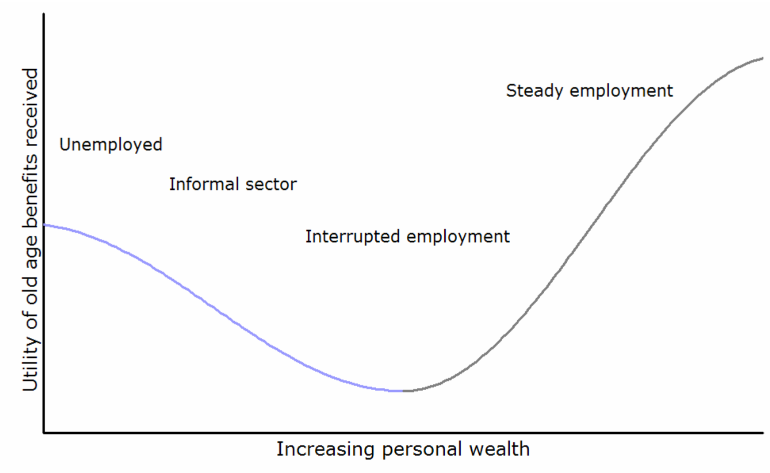
1. The discussion paper was circulated via the ACI website to all industry members;
2. A synopsis of the key recommendations was presented to delegates from all member companies at the ACI annual conference in February 2005.
3. On 7 March we conducted a workshop for members from across S.A.

Introduction

ACI views on saving which inform our response to the discussion document.

As we have previously explained, the Association of Collective Investments has been actively involved for some years now in trying to promote simple, practical solutions to cater for the under-provided for segments of the long-term savings market. The danger as Rusconi has stated is, "…*not that the "lifetime employed" retire with inadequate retirement savings, but that the "occasionally employed" arrive at old age having saved nothing.*"[1]

Figure 1



Source: Rob Rusconi – An Intuitive Representation of the Problem

We endorse the stance of the Acting Deputy Director General of National Treasury, Mr Elias Masilela, who prefaced his presentation to Parliament on 15 February 2005, by stating that Government was in revising the Pension Funds Act not seeking short-term enhancements, but measures that would

[1] See Rusconi, R, 2004, "*Costs of Saving for Retirement - Options for South Africa*". Presented at the 2004 Convention of the Actuarial Society of South Africa, October 2004, Cape Town, S.A. at page 45.

ensure the long-term success of the nation's retirement funding provision. In our opinion, this may necessitate several iterations in the revision process, involving all aspects of policy. Treasury also stated that the taxation of retirement savings is not yet up for discussion. However, tax forms an integral part of the design specifications for the National Savings Fund, where inducement to save (rather than tax per se), is vital to its success. We have therefore included commentary on this subject.

If income disparity in South Africa is high, then asset disparity data would surely reveal an even more shocking profile for our country. Anderson, 1999, Wolff, 2001, Carney and Gale, 2001 found that the distribution of assets in the USA is highly unequal, and far more unequal than the distribution of income.

> In fact, while the top 10% of Americans command 40% of national income, the top 1% controls 90% of assets. These data confirm that asset poverty is not confined to a small minority of US households.
>
> There are many reasons for this wealth gap[2], but both a lack of institutional mechanisms to encourage saving and government policies in place seem to have played an important role in its creation…Today, current asset national policies are funded through the federal income tax system. $300 billion/year is devoted to asset-building policies for individuals through the tax system, but these policies exclude the poor and those on low incomes who lack assets and have little or no tax liability. In fact, the tax system - where the bulk of savings benefits come from in the U.S. – highly subsidises wealth creation in the higher-income households. Two-thirds of pension tax expenditures go to families in the top 20 percent distribution. (Barr, 2001).
>
> Economically, accumulation of assets is the key to the development of poor households. For the vast majority of them, the way out of poverty is not through consumption, but through savings and accumulation…Work and income alone are not likely to allow most working families to escape poverty.[3]

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[2] Carney and Gale (2001) summarise the following explanations : lack of sufficient income for consumption ; lower levels of education, single parenthood, and a lack of a good financial education, which tend to depress savings ; lack of "institutional mechanisms" to save, such as through employer-based pensions and 401(k)s -a 401(k) is a form of retirement plan that allows employees to save and invest for their own retirement - which are less available to lower-income employees, are marketed to higher-income households, and depend on a tax liability for incentives; government policies, which provide a consumption loop that may not make saving necessary, and which disallow asset accumulation for recipients of means-tested programmes; "psychological models" which mean that low-income households may see an accumulation of large amounts of assets as unattainable and thus do not bother; and "sociological models" which emphasise social, peer and community pressures in taking the decision to save, noting that such pressures are usually lacking in low-income communities.

[3] OECD (2001), Local Economic and Employment Development, Conference on Individual Development Accounts, OECD, Paris.

It is because of the above concern, that we believe that the recommendation by National Treasury to launch a National Savings Fund is so important. It is a direct attempt to seek to address the same structural flaws referred to above in the USA. Furthermore, the proposed tax format for the NSF has significance as a complimentary (to existing tax-deferred retirement funds) means of incrementally shifting the tax system towards a consumption base.

Secondly, the emergence of Individual Retirement Funds, which will follow a harmonisation of legislation, should considerably broaden coverage in South Africa. We expect this to result in the opening up of the retirement market to new vehicles such as collective investment schemes.

The above proposals by National Treasury are the kernel of structural enhancement intended to deliver the long-term objectives of government for retirement provision. It is therefore essential that these two proposals are:

1. Contextualised in the broader policy framework they represent and;
2. Thoroughly debated, as broadly as possible, to ensure that their design features are as effective as possible to ensure success when implemented.

We cannot attempt a full response to the discussion document. The subject of old age financial provision is an extremely broad subject and even the detail within the discussion document spans a broad front. In framing our response, we have therefore limited ourselves to commenting on the above two structural recommendations and secondly, including annexures with tabulated responses to National Treasury's recommendations, where relevant to our Industry. For ease of reference, our annexures are numbered identically to those in National Treasury's document.

Chapter

1

A National Savings Fund

Broad policy implications and design challenges

The proposed National Savings Fund (NSF), according to our reading of National Treasury's discussion document, is intended to have the following features:

- Exemption from the means test for the Social Old Age Pension to avert the "poverty trap" often induced by such mechanisms.
- Affordability through economies of scale and cost minimisation.
- Irregular contributions permitted.
- Competitive returns.
- Participation encouraged rather than compulsory, with retention incentivised.
- Withdrawals permitted at the discretion of the investor.
- Exemption from Retirement Fund Tax.
- Taxed on a TTE basis (EEE effectively for those below the tax threshold).
- Affluent discouraged from participation through anti-abuse mechanisms.

1. Inducement to Save

The "inducement to save" is central to the success of the policy objective to raise new long-term saving for retirement amongst lower income earners. The above features could be re-categorised as "inducements" as follows:

1. Affordability (low cost product)
2. Accessibility (many are currently excluded from existing retirement products which are employer dependent)
3. Flexibility (irregular contributions and withdrawals permitted)
4. Competitive (market related capital and income growth)
5. Incentivised (for long-term saving through retention bonus and tax exemption on withdrawal)

Financial incentive is central to the NSF's success.

Savings products currently in the market exhibit many of the above features, but do not currently participate as retirement savings vehicles. When considered individually or collectively, features one to four above do not offer the necessary attraction to future retirees to successfully fill the gap in the existing retirement market. For example, collective investments are *affordable*[4]. They are *accessible* over the counter, through brokers and even retailers. They are *flexible*, in that they permit irregular contributions and no limitations on withdrawals. A full range of *competitive* capital and income growth options are available to the investor, yet collective investments have attracted only a small percentage of the overall savings market to-date in South Africa.

The definitive inducements for the NSF must therefore be *financial incentives.*

The ACI has reservations about the proposed retention bonus. The proposal to penalise early withdrawals and incentivise those who remain invested through to retirement constitutes a potential moral dilemma when a contributor in desperate circumstances has to make a forced withdrawal and forego investment return to other contributors in more fortunate circumstances. It also makes for extremely complicated accounting. We therefore recommend that this route not be followed.

[4] Rusconi, R, 2004, Costs of Saving for Retirement, Options for South Africa, at page 104. "This analysis suggests that, as claimed, the unit trust industry offers fair value for money to retirement savers…Charging levels appear to compare reasonably well to those in the United States and very well to those in other developing countries."

The primary inducement mechanism is therefore the tax incentives. This begs the following questions:

1. Are tax incentives effective in raising new savings, rather than diverting flows away from other less attractive repositories?
2. Do they successfully target lower income individuals?
3. What policy options are there to increase participation at low and middle income levels.
4. What is the significance of introducing a new tax format (TTE) into the South African economy?
5. What will it cost the fisc?

In seeking to cast some light on the above questions, we turn to international literature.

1.1. Do Tax Incentives Raise New Savings?

This is a controversial subject, with literature indicating wide ranging empirical results. In our 2001 submission, we quoted Besley and Meghir (1998) in their summation as follows:

> Thus, the value of tax incentives for saving may not after all be in the carefully calculated changes in marginal returns to assets, but in the excuse that it gives governments and the private sector to expound the virtues of thrift and in encouraging individuals to save in long-term assets.[5]

Antolin, de Serres and Maisonneuve (2004)[6] update the view on empirical studies as follows:

> The extent to which tax incentives create rather than divert saving is ambiguous in theory and still **unresolved empirically**, despite the large amount of studies addressing the question, in particular in the United States. As reported…the range of

[5] See AUT, 2001, New Options for Saving in South Africa at page 13.

[6] See Antolin, Serres and Maisonneuve, 2004, Long-Term Budgetary Implications of Tax-Favoured Retirement Plans, OECD, at page 17, paragraph 47 and footnote 27.

> estimates found, even in the most recent papers, still goes from almost one extreme to the other. **Nevertheless, the weight of evidence would suggest a proportion of new saving in total contributions of between 25 to 40 per cent at most.**[7]

In Table 1[8] we have included the above authors' tabulation of empirical research and the findings on which the estimates are based.

Research from the OECD indicates that on balance, new saving from tax incentives could be in the range of 25% to 40%.

In the most extreme view, we could therefore state that incentivising saving through the tax system at least provides government with a good marketing platform to promote saving, as it is in its long-term interest to reduce the dependency of its citizens on the State. According to this view, savings are diverted through portfolio shifts because of the incentive, and one cannot exclude the possibility that national savings could decline as a result of tax incentives.[9] This would be the case if contributors to these plans were to consume part of the tax subsidy.

The above view cannot be the whole truth and the authors move from this base position to include empirical results that justify a weighted **estimate of new saving in total contributions of between 25 to 40 per cent.**

1.2. Do Tax Incentives Successfully Target Lower Income Groups?

Recent studies[10] have found positive links between incentives and new saving among low and middle income earners, which show a stronger *impact* than on high income earners. However, weaker participation and contribution rates from these groups may be due to several factors. The reason for the difference between good impact, yet weak participation, is not thoroughly understood by

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[7] Emphasis our own.

[8] See after annexures.

[9] See Antolin, Serres and Maisonneuve, 2004, Long-Term Budgetary Implications of Tax-Favoured Retirement Plans, OECD, at page 17, footnote 25.

[10] Poterba, 2003; Engen and Gale, 2000; Benjamin, 2003.

researchers, but various possibilities have been suggested by authors. These include empirical observations that:

Even though impact may be significant, lower income groups still do not participate as desired.

1. High-income earners have higher saving rates and therefore the impact is greater on those who would have saved less. (Dynan et al. 2004).

2. Tax-favoured schemes such as 401(k) plans lower transaction and information costs of investing on the stock market, allowing for an easier access to shareholding for low-income households. Initial access does not, however, imply strong participation.

3. Another possibility is that the higher degree of economic sophistication allows upper-income individuals to better maximize the advantages of tax sheltering without having to cut consumption.

4. Low-income earners are less likely to hold the types of assets which are close substitutes to retirement savings, raising the likelihood that contribution would be funded by reduced consumption (Samwick, 1995).[11]

5. Saving may not be considered optimal (despite tax incentives) given that many lower income earners, (which may especially be the case in an economy in transformation such as South Africa), believe that their income earning capacity will improve considerably in years to come. They therefore delay the saving decision and prefer consumption.

6. Most importantly, in the context of the NSF proposal, tax deferred formats may be of little value to those in lower tax brackets and below the tax threshold. If there is no liability for tax, or no significant liability, even the promise of eventual tax exemption

[11] See Antolin, Serres and Maisonneuve, 2004, Long-Term Budgetary Implications of Tax-Favoured Retirement Plans, OECD, at page 18, footnote 31.

The ACI is concerned that proposed incentives for the NSF are not sufficient to overcome consumption pressures.

(TTE) when personal marginal tax rates may be much higher at retirement age, may be of limited appeal in the present context.

Tables 4 and 5[12] show participation rates by workers in private pension plans across income ranges in the United Kingdom (2001) and the USA (1997). The percentage differences in participation, even across all age groupings, between the upper and lower income ranges is stark.[13]

As we mentioned in our presentation to Parliament, the ACI is concerned that the proposed incentives are not sufficient to achieve participation rates that are significant for the target groups.

1.3. Policy Options to Increase Participation at Low and Middle Income Levels

There are no easy answers to this challenge. The ACI understands National Treasury's concern about the payroll-tax-like effect of compulsion on workers and the fact that it may discourage businesses from joining the formal economy. There is, however, a difference between benefit-linked and general payroll taxes. Furthermore, we would argue that there are already significant, far greater disincentives for businesses, such as VAT and income tax. In South Africa we have good coverage and participation in existing occupational schemes, not only because there are tax deductions for contributions, but because employers, rather than the State, have compelled employees to join as a condition of employment. Unions have played a powerful role in achieving this aim. South Africa's success is therefore in large measure due to informal compulsion. Australia, Hungary, Iceland, Mexico, Poland and Switzerland

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[12] See after annexures.

[13] See Antolin, Serres and Maisonneuve, 2004, Long-Term Budgetary Implications of Tax-Favoured Retirement Plans, OECD, at page 41, 42.

have achieved high and uniformly distributed participation rates in tax-favoured private pension plans by means of compulsion.[14]

Some form of compulsion may be unavoidable.

Compulsory or quasi-compulsory schemes tend to offer less generous incentives, but the incentives do have value in encouraging participation beyond the compulsory threshold and do provide a moral means of defending, an admittedly, paternalistic policy. The World Bank model for Pillar 2 does include compulsion.[15]

The feasibility of a subsidy for low income earners should be evaluated.

Compulsion aside, we are of the opinion that consideration should be given to strengthening the incentives for low and middle-income workers. In a TTE context, which is effectively EEE for the target group, this could be achieved by a flat rate subsidy[16] up to a desired minimum contribution amount. In order to avoid subsidising the wealthy or the higher income earners, this would need to be less attractive than the deductions for deferred schemes. Furthermore, the E_pTT and TTE formats would need to be integrated so that after participating in the former, higher income individuals do not "top-up" their benefits by migrating to the latter. For the NSF target group, the State subsidy would represent a like incentive to a matching contribution by an employer.[17] However, this will have disruptive effects on low income workers currently in occupational funds.

[14] Employers are legally compelled to enroll employees into pension plans. In Australia and Switzerland self-employed and very low income workers are not covered by the mandatory rule. See Antolin, Serres and Maisonneuve, 2004, Long-Term Budgetary Implications of Tax-Favoured Retirement Plans, OECD, at page 21..

[15] "The second pillar is typically privately managed, fully or partially funded, with **mandatory** participation, within which individuals save to provide themselves with an income during retirement." ACI emphasis. See National Treasury, RSA, 2004, Retirement Fund Reform, A Discussion Paper at page 11.

[16] Czech Republic, Germany and Mexico use subsidies. 401(k) plans in the USA have experienced lower rates of participation at lower income levels. In the last decade, there have been proposals in the United States to augment private pension contributions with government contributions on behalf of low-income workers. Such proposals have been promoted as a mechanism for encouraging retirement income security for low-income households. See Poterba, 2003, Government Policy and Private Retirement Saving at page 9.

[17] "…contribution rates are higher, and participation rates are higher, in 401(k) plans that offer employer matching for employee contributions…Interestingly, it seems to be the presence of the match, rather than the level of the match, that has the most important effect on contributor behaviour." See Poterba, 2003, Government Policy and Private Retirement Saving at page 10.

1.4. What is the Significance of Introducing a New Tax Format (TTE) in South Africa?

Income can be thought of as either the sum of its uses or the sum of its sources.

An individual’s total income may be conceptualised in one of two ways: as the sum of the uses of that income or as the sum of its sources. In the former, the portion not consumed in a given period, is by definition saved. Those who consume more than they save are dissaving, that is, they are either borrowing or running down savings. The second, is to view income in terms of its sources. The distinction is between labour and capital. Capital income results from lifetime savings of labour income. Taxing both labour and capital income therefore represents a double tax (a taxation on saving). In the former model, to tax consumption assumes that saving is encouraged (and vice versa). Another way to implement a personal tax on consumption is to use only labour income as the base in the source model.

In South Africa we have a hybrid system, with a consumption methodology for retirement saving ($E/_{p}T/T$)[18], a consumption tax in the form of VAT, an income tax on labour earnings and a Capital Gains Tax. A TEE tax format for retirement savings is an example of a methodology that would shift taxation patterns incrementally towards a consumption base.

Figure 2.
Alternative Views on Taxation:

Individual income = sum of **uses**

consumption *or* saving

OR

Individual income = sum of its **sources**

labour income *or* capital income

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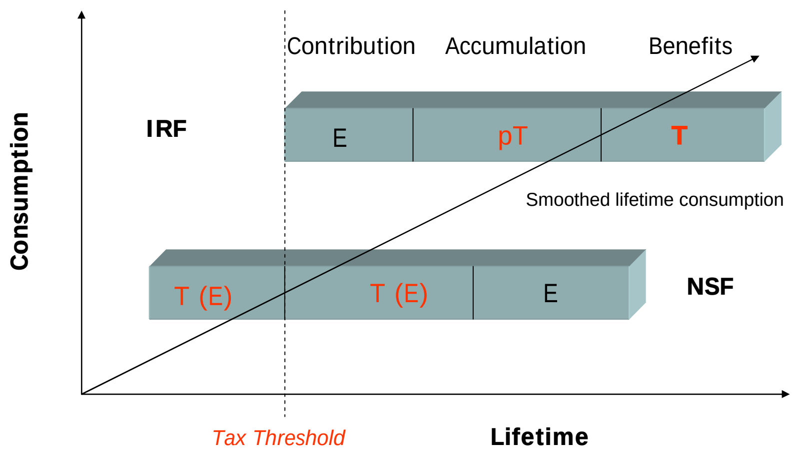
[18] Accumulation phase subject to Retirement Funds Tax.

Therefore, a consumption base using tax-deferred savings plans, exempts both the initial amount saved and the accruing returns, but it later taxes the full amount withdrawn for consumption (hence E/E/T). A consumption base using tax-prepaid savings plans fully taxes the initial savings (along with the rest of labour earnings), but then exempts investment returns as well as future withdrawals (hence T/E/E).[19]

Figure 3 is a non-empirical representation of how National Treasury's proposal to introduce a tax-prepaid format retirement vehicle (the NSF), would incrementally shift the tax system towards a consumption base, by offering taxpayers the choice whether to pay their taxes up-front or later in life (which is currently the case). In the existing tax-deferred format and the format proposed for the NSF, the accumulation phase will be taxed (Retirement Funds Tax (RFT) for the former and personal income tax for the NSF). Taxing the accumulation phase mutes the consumption methodology, but reduces the cost to the fisc.

The addition of the NSF tax format complements existing schemes.

Figure 3.
Lifetime Consumption



[19] See Kesselman and Poschmann, 2001, A New Option for Retirement Savings: Tax-Prepaid Savings Plans at page 4.

Table 2 simplistically illustrates the effect of the various taxing formats.

Table 2.
Alternative Pension Tax Regimes
Source: OECD

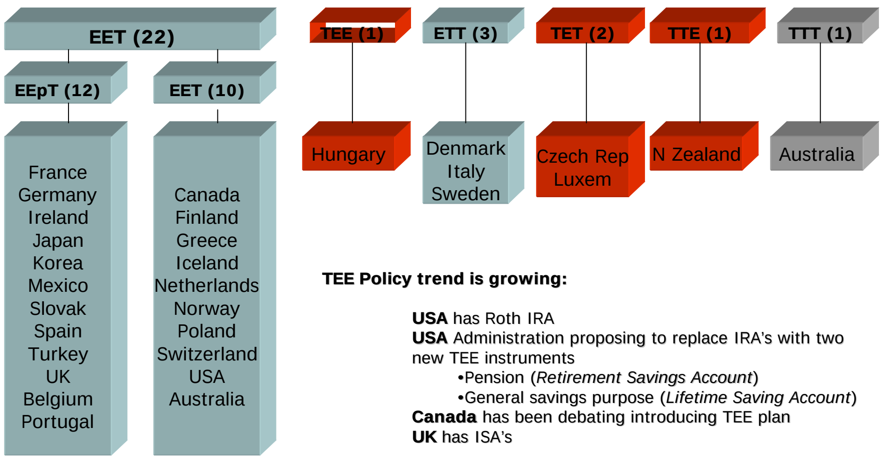
Table. Alternative pension tax regimes, current dollars[1]

	EET	TEE	TTE	ETT
Pre-tax contribution (A)	100	100	100	100
Tax (B)	-	25	25	-
Post-tax initial asset (C=A-B)	100	75	75	100
Net accrued income (D)	33.1	24.8	18.2	24.2
Asset at retirement (E=C+D)	133.1	99.8	93.2	124.2
Tax on withdrawal (F)	33.3	-	-	31.1
Net pension income (G=E-F)	99.8	99.8	93.2	93.2
memorandum:				
Net present value of total tax[2]	25	25	30	30

1) Assumes a 10% pre-tax rate of return, 25% marginal tax rate, and 3 years of investment
2) Assumes the discount rate is equal to the rate of return

Figure 4 illustrates private pension fund tax formats in OECD countries. The text insert notes those countries with or considering tax pre-paid formats for long-term saving.

Figure 4.
Taxation - Private Pensions in OECD Countries
Source: OECD (2003)



1.4.1. TEE Policy Trend is Growing

Tax-prepaid schemes in Britain have proved to be very popular since their launch in 1999 (ISA's). In particular, they have appealed to many lower and moderate income households who had little formal savings previously. Treasury reports that over 14 million people (one in four adults) now have an ISA. Over 105 billion pounds have been subscribed to ISA's since launch. Ready acceptance was aided by their forerunners, PEP's and TESSA's which had become familiar concepts to many households.

Similarly, the tax-prepaid savings schemes that the US introduced in 1998 (Roth IRA's) have also been very popular. The US allowed people to convert from deferred schemes (and pay the tax). Beginning in 2006, Roth IRA's will be incorporated into 401(k) plans as an integrated option. This will allow employees to save after-tax dollars in a separate account under their traditional 401 (k) plan. Distributions from the account are generally tax free, once the participant reaches the age of 59,5 years. An employee's annual elective deferrals and designated Roth 401(k) contributions combined may not exceed $15 000 in 2006. Roth IRA's are only available to individuals below a certain income level and contributions must be maintained in a separate account within the employee's 401(k) plan.

TEE policy trend is growing as a long-term savings methodology.

Canada has been debating the introduction of tax-prepaid vehicles, rather than raise the expensive tax-deferred limits. The proposal is aimed at broadening the coverage of retirement saving policy to lower paid earners. Jon Kesselman[20] and Finn Poschmann[21] have led much of the debate and informed our submission by sharing with us their correspondence with the Canadian Department of Finance.

[20] Jon Kesselman holds the Canada Research Chair in Public Finance, Public Policy Program, Simon Fraser University.

[21] Finn Poschmann is Associate Director of Research and Senior Policy Analyst, C.D. Howe Institute.

1.4.2. Potential Benefits of a "Tax-Prepaid" Format[22]

1. For many low and moderate earners, the existing tax-deferred retirement vehicles are not suitable because the advantage of the tax deductibility on contributions is worth little, and the funds have Retirement Fund Tax imposed on them. At retirement, these individuals face much higher effective tax rates that will be imposed on their withdrawal of savings during retirement, and are penalised by the means testing for the Social Old Age Pension. The tax-prepaid format gives them the advantage of being able to sacrifice to save in earlier years of low income and then have that decision rewarded by not having to pay taxes on withdrawal at much higher marginal tax rates later in life, when their financial position has improved.
2. For higher income earners, the existing tax-deferred savings vehicles have the disadvantage (from a policy perspective) that the contributions are deducted at a marginal tax rate typically higher than the effective marginal tax rate they will face on withdrawals after they have retired. This can exert an economically inefficient bias toward excessive saving by these earners.
3. For earners at all levels, the complexity of having to forecast one's effective marginal tax rate in future periods may inhibit savings for precautionary purposes in tax-deferred savings vehicles. The tax-prepaid format has the advantage to the fisc that taxes are paid up-front and the advantage to the contributor, that having paid his or her dues to the State, the savings are liberated from unforeseen tax consequences in the future (the introduction of the RFT in existing vehicles would be an example).
4. Adding a tax-prepaid format to the existing tax-deferred format would move the personal tax system toward an economically appealing consumption base and add the economic efficiency attributes of the

[22] See Kesselman and Poschmann, 2004, The Tax Treatment of Personal Savings in Canada: The Potential Role for TPSPs – A Consultation Document generally.

new format to the income-averaging attributes of the tax-deferred schemes.

5. Contribution limits to a tax pre-paid format like the NSF could be integrated with existing deferred-tax retirement funds. An overall contribution limit for retirement saving could be set by government, within which would be a lesser limit for the more expensive tax-deferred vehicles. Lower income earners would utilise the EEE benefits of the NSF in earlier years and higher earners would migrate to the NSF once their contribution ceiling limits have been reached on the deferred plans. This integration strategy not only smoothes consumption choices for individuals, but also allows government to moderate the revenue cost and smooth its receipts over time.[23]

TTE format should be integrated within revised contribution limits for retirement saving.

1.5. Cost to the Fisc

When considering the implementation of two tax formats, the first question is how do they compare over time, from a taxpayer perspective and cost to the fisc? We refer the reader to our 2001 submission, "*New Options for Saving in South Africa*", pages 22 to 26 where we illustrated the various scenarios[24].

Yoo and Serres (2004)[25] analysed the net tax cost per unit (e.g. one rand) of contribution to tax-favoured retirement savings plans in OECD countries. It is a measure, in present value terms, of the net fiscal revenue foregone associated with one unit invested over a given time horizon. Their analysis measures on a

[23] Stakeholder pension legislation allows partial concurrency. Those who earn under £30,000 a year, will also be able to contribute to a defined-contribution scheme up to the £3,600 annual subscription limit for these funds (which is not linked to earnings). This concurrency covers 90% of savers in occupational schemes. See Jarvis, 2001, Stakeholder Pensions, Business and Transport Section, House of Commons Library at page 12.

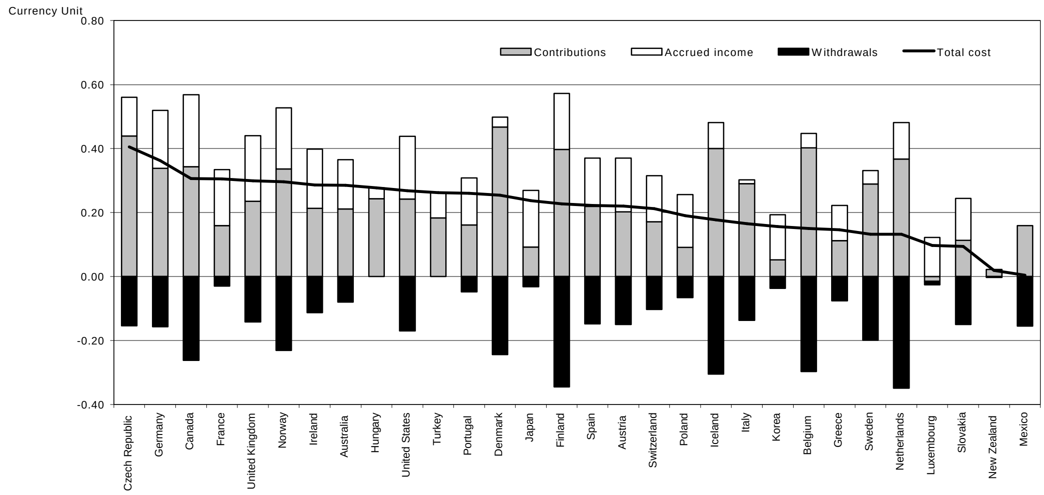
[24] This empirical example was cited from Kesselman and Poschmann's (2001) paper (but changed to local currency) and the explanation simplified.

[25] Yoo and Serres, 2004, Tax Treatment of Private Pension Savings in OECD Countries and the Net Tax Cost per Unit of Contribution to Tax-Favoured Schemes, OECD.

net basis the revenue foregone at contribution stage (tax deferred), the non-taxation of accrued income (or taxed where relevant), and also takes account of the revenues collected when assets are withdrawn.

A similar exercise is recommended in the South African context, which will enable a better understanding of the existing deferred schemes and the potential integration of an alternative TTE (or EEE) scheme. Figure 5 below illustrates the perspective such analysis can add to the pricing of South African retirement incentives, both from an internationally competitive and a reasonability perspective.

Figure 5.
Net tax cost associated per unit of contribution, age-group average [1,2]



1. Based on the employer-sponsored schemes (except Italy and Korea) and annuity pension income. However, for countries in which tax treatment between the employer's and employee's contributions is the same, the distinction between employer-sponsored and individual pension schemes is meaningless.
2. The outcomes in New Zealand and Mexico are driven by following factors. In New Zealand, employers' contributions are subject to a flat rate of 21 per cent, the rate lower than the marginal income tax rate. Mexico exempt income accruing to regular investment from taxation.
Source : OECD

1.6. Concluding Remarks on Inducement to Save[26]

Tax relief is not everything. Wise (2001) has shown that the great success of individual retirement accounts (IRA's) and employer-sponsored retirement saving plans (401(k) plans) is also due to information and advertising, and a consistent capital market regulation that reduced uncertainty for investors.

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[26] See Borsch-Supan, 2004, Mind the Gap: The Effectiveness of Incentives to Boost Retirement Saving in Europe at page 16,17.

In the UK, there were bad experiences summarised by Disney (1996), where lack of regulation and information led to the miss-selling scandals that undermined investment in private accounts. In this scandal, inappropriate financial products were sold to households, often by door-to-door salespersons, resulting in huge financial losses to many families. On the other hand, the reforms in Germany post 2001, with the introduction of "Riester pensions" (which resemble IRA's in the U.S.) show that take-up can be slow due to overregulation – which appears to have destroyed all positive incentives created by tax relief.

Research indicates that most workers prefer reform that protects them from their own failure to save.

Furthermore, research by Börsch-Supan and Tabellini (2001 and 2002a), which may be pertinent to take-up concerns for the NSF, actually find that most workers in France, Germany, Italy and Spain prefer a pension reform with mandatory savings over a reform with voluntary savings. This is in keeping with the remarks we made to Parliament in February in our submission. The reasons are several. As long as there is a SOAP, providing a pension income of last resort, voluntary savings may be considered a waste. People therefore show a preference for a mandatory system that reduces the moral hazard of not bothering to secure a fuller pension. On these grounds, we therefore support exemption from the means test.

Other factors include self awareness of lack of self-control and the fear of procrastination. Börsch-Supan (2004) therefore makes the point,

> All of these arguments underscore a need for government intervention – most strongly, in the imposition of a mandatory saving plan; less strongly, by giving tax relief.[27]

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[27] See Börsch-Supan, 2004, Mind the Gap: The Effectiveness of Incentives to Boost Retirement Saving in Europe at page 17.

Poterba (2003) highlights a number of lessons in plan design learned from the 401(k) plans in the USA[28] which might be helpful when designing NSF specifications:

1. Payroll deduction programs appear to attract higher contribution flows than programs that are based on voluntary individual contributions. This shows up for age and income-specific rates of participation in 401(k) plans relative to participation rates for IRA's, which are individual-based saving programs. Employer matching on 401(k) plans may account for some of this variance. Duflo and Saez (2002) found that new employees are significantly influenced by others in the workplace. Where fellow workers do not show strong participation, new workers follow suit. Because IRA decisions are made in isolation, individuals do not receive the same positive feedback that they do with occupational based 401(k) plans.

"Default options" a soft, yet successful form of compulsion.

2. Households seem to be heavily influenced by "default options"[29] such as automatic enrolment, unless the employee opts out of the saving program. The authors state that there is related evidence that individuals are not able to discipline themselves to save, but that they are prepared to accept pre-commitments that lock them in to future saving. This may partly explain the demand for pre-commitment devices that encourage household saving by removing discretion. Thaler and Bernartzi (2004) describe Vanguard's "Save More Tomorrow" (SMT) program that has been very successful.

[28] For a description of 401(k) plans refer to Annexure 6.

[29] Madrian and Shea (2001) offer powerful evidence on this point. They analysed participation in a 401(k) saving plan at a firm before and after the adoption of an "automatic enrolment" default. When the firm adopted automatic enrolment, new employees were informed that they would be enrolled in the 401(k) plan, and that several percent of their salary would be contributed to a fixed-income fund, unless they chose to opt out of the saving program. Participation in the 401(k) plan by workers who were hired after the automatic enrolment program took effect was much higher than the participation rate amongst workers who were hired earlier.

Those who sign up agree to contribute a rising fraction of their salary to the plan via the firm's 401(k) scheme.

3. National Treasury's concern about inter-employment leakage may be supported by examining the work of Bernheim and Rangel (2003). In this setting, the challenge is for the household to avoid a consumption binge that will draw down accumulated retirement resources. The model also suggests that households will value commitment strategies that make it difficult for them to draw down their accumulated resources, and it suggests that public policy should make it difficult for households to undo prior saving decisions.

4. Workplace education can effect the behaviour of participants. Bernheim and Garrett (2004) provide evidence of this link. However, studies of participant behaviour also indicate that households are myopic, procrastinate, and exhibit other pathologies in decision making. When workers are exposed to financial education, the fraction that report at the end of a seminar that they intend to increase their saving rate is much higher than the fraction that actually do. Saving thus exhibits some similarity to giving up smoking or to dieting.

1.7. Implementing the NSF Proposal

We have purposefully spent much time on some of the broader concepts that point towards thinking less about a fund (or NSF), to rather focusing on the principles. Where possible, we need to eliminate the risk of failure and potential slow take-up that could for many years to come, damage the intended success of improving coverage amongst those who find present retirement structures of little appeal, or worse still, a disincentive to save.

1.7.1. Legal Vehicle?

We make the point in the next chapter that a central NSF is not necessarily the only approach and in fact does have certain distinct disadvantages. However, the design features that National Treasury has proposed for the NSF, closely mimic the specifications for a collective investment scheme. Not only would a *national collective investment scheme* (NSF) provide all the benefits of easy and transparent daily valuation and pricing, collective investments are understood in the market. The TTE tax format will require accounting at both portfolio and contributor level and systems used for collective investments would be well suited to cope with this requirement.

1.7.2. Distribution

Distribution is vital to delivering on advertising promises. A low commission structure (rather than no commission) would make it unattractive to brokers to sell. Two potential delivery points, as a minimum, are necessary. Firstly, payroll facilities for all, which National Treasury has proposed, and secondly, an access facility suited to those who are not employer linked, such as contractors and other self-employed individuals involved in small business ventures. In order to reduce the payroll-tax like effect of mandating payroll facilities (as a minimum compulsion mechanism proposed by National Treasury) some kind of turnover threshold (or number of employees as is done with Stakeholder pensions) would probably need to be set. Those who fall into this grouping would need easy, clearly identifiable access points. The Post Office is one such choice. As an industry, we have already investigated this distribution channel as a likely candidate for low cost products. However, without government support it will be difficult to get approval for this from the Post Office. Other distribution points could include Mzanzi accounts[30], cell phones and retailers.

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[30] This would facilitate a good integration strategy between initiatives.

1.7.3. Areas of Co-operation with Industry

There are essentially six areas where industry could facilitate the establishment of a NSF:

1. Through a joint management company
2. Fund management
3. Systems
4. Administration
5. Distribution strategies
6. Public education

Each of these necessitate discussion, as time does not permit a full treatment of all these possibilities in this paper. However, industry is committed to finding low-cost solutions to fill the "gap" in the existing retirement market. We have consulted broadly with our industry members to test their willingness to involve themselves in assisting National Treasury with a solution and have had a very positive response.

1.8. Conclusion

Industry is prepared to involve itself in seeking solutions for the NSF.

As we have tried to demonstrate, there are many nuances which need to be considered in such a complex and yet vital policy initiative. The ACI accordingly recommends the establishment of an integrated task force (industry and National Treasury) to identify areas for further research and evaluate the feasibility of the proposed National Savings Fund. Limiting the possibilities for failure of this initiative are crucial so that the long-term prospects of raising saving amongst the target group is not damaged.

Although headed "Individual Retirement Funds", Chapter 2 should be read in conjunction with Chapter 1 of this document, as it also has bearing on how we envisage implementation of the NSF concept.

1.9. Summary of Recommendations

1. We **support the concept of a NSF**, as a vital policy measure to facilitate long-term retirement saving amongst National Treasury's stated target group. We do have certain reservations about its design.
2. If a "central fund" concept is pursued for the NSF (which we recommend against in chapter 2), Industry would be willing to investigate a collaborative **national collective investment scheme** with government.
3. We do not recommend the use of **retention bonuses** for the NSF. We recommend that an alternative commitment strategy be devised, as unlimited access to funds will severely undo the longer term objectives of the fund. This may even include shorter periods of compulsion (say min 5 year term) within the longer term nature of the fund. Full tax benefits would only accrue at a specified retirement age or disability.
4. We endorse the tax incentive format and the exemption from RFT, but question whether it is sufficient **inducement** for the target group. Some measure of compulsion may be necessary. This may include 'soft' automatic default options and the provision of payroll facilities through employers, to more penal measures such as fines for employers who do not deduct and pay over minimum contributions to a fund of the employees choice (NSF, occupational fund or IRF).
5. We recommend that modelling of **costs to the fisc** (short term and long term) should be done for both tax formats (current deferred and proposed prepaid) and benchmarked internationally.
6. We recommend that firms be required to grant employees reasonable access to NSF scheme representatives on company premises so that **education** and dissemination of information can be facilitated.

7. We recommend that the ‘no commission’ policy be reconsidered in favour of a **‘low commission’** policy.
8. We support the recommendation to exempt the benefits of the NSF from the “means test” for the **SOAP**.

Chapter

2

Individual Retirement Funds

Democratisation of Retirement Saving

The emergence of individual retirement funds (IRF's) as a result of policy harmonisation across legislation, most notably the Pension Funds Act and the Income Tax Act, is the cornerstone to liberating pension fund provision for those currently excluded, not by incentives, but simply access. The historic view of retirement funds, principally pension and provident funds, as having to be constituted as a "pension fund organisation"[31], adds complexity and additional costs.[32] Retirement annuities, on the other hand, have been the preserve of the Life Industry. While the latter has the characteristics of an individual retirement fund, it enjoys sole shelf space and is consequently expensive.

2.1. International Policy Shifts towards Private Pensions

In the previous chapter, we highlighted examples of shifts in government policy towards individual retirement accounts. Poterba (2003) makes the following observation:

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[31] As defined in the Pension Funds Act No 24 of 1956.

[32] Stakeholder Pension schemes may use trusts or open ended investment companies (OEICs). The latter are also included within the ambit of our Collective Investment Schemes Control Act.

> While the trend through most of the 20th century was toward expansion of the government's role in providing retirement income and health care, projected demographic changes and long-term fiscal constraints point toward a stable or shrinking role of government. Rather than searching for new ways to expand the set of services provided by government, and the set of risks that are insured, there is now pressure to find ways to shift responsibility for retirement income provision from the government to households and to firms.[33]

The German Riester pension reforms of 2001 and 2004 are motivated by these concerns and utilise state incentives to encourage individuals to build up supplementary pensions.

Stakeholder Pensions were introduced in the UK in 2001, the central objective of which is to change the ratio of state to private provision from the current 60:40 to 40:60 by 2050.[34] The target group is the estimated five million people who are not in an occupational scheme and who have earnings between £10,000 and £20,000 per year.[35]

2.2. Utilising Collective Investment Schemes

In our 2004 paper[36], we expounded on the suitability of collective investment schemes as suitable vehicles for IRF's and explained the legislative issues that need to be taken account of in order to implement this. We will therefore not repeat any of that analysis here. However, we underscore our recommendations in the above paper by stating that IRF's stand to become an important component of private pension fund provision in South Africa and recapitulate that collective investments could play a pivotal role in this market.

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[33] See Poterba, 2003, Government Policy and Private Retirement Saving, Massachusetts Institute of Technology and National Bureau of Economic Research. This paper formed the basis for the CES-Munich Prize lecture, November 2003.

[34]See Jarvis, 2001, Stakeholder Pensions, Business and Transport Section, House of Commons Library.

[35] See Jarvis, 2001, Stakeholder Pensions, Business and Transport Section, House of Commons Library, at page 7. "Although this constitutes the main target group…the new tax regime which breaks the link between earnings and pension contributions, and the government's decision to accept partial concurrency, mean that many people outside this target group are also able to join a stakeholder scheme.

[36] ACI, 2004, New Option for Retirement Saving in South Africa.

2.3. Take-Up of Individual Retirement Funds

When individuals are left to make independent choices about a new retirement saving vehicle, take-up could be slow, even with incentives. Take-up of the Riester pensions has been retarded, as mentioned before, by excessive regulation. Notwithstanding this, it took a decade to popularise a general subsidised dedicated savings program in Germany, which was directly deducted from payroll (*Vermögenswirksame Leistungen*) which now enjoys wide support. The experience in the US was identical, where IRA's needed equally long to be accepted by a large share of households.[37]

IRF styled vehicles took a while to gain acceptance overseas.

We therefore need to temper our expectations as to the rapidity with which IRF's may be accepted, although there is certainly an element of pent-up demand. The public are currently enraged about costs associated with retirement annuity products and are likely to scrutinise costs of any new products carefully. Given the latitude to transfer between these funds, as recommended in the discussion paper, many may wish to seek alternative harbour for their retirement savings.

The inclusion of collective investments as IRF's through legislation has the distinct advantage that the product is already well understood in the market and would hold little uncertainty for many targeted by this policy initiative. Here we refer to the self-employed and the many working for smaller businesses where occupational schemes are not viable. The benefits of daily pricing in the press and regular performance reporting, would make collective investment schemes a particularly cognitive means of preparing financially for retirement.

[37] See Börsch-Supan, 2004, Mind the Gap: The Effectiveness of Incentives to Boost Retirement Saving in Europe at page 27.

2.4. Distribution

Distribution is essential to success.

Distribution will be crucial, and most success will probably be achieved by educating employees and offering smaller firms simple solutions off their payroll facilities. Stakeholder Pension legislation imposes penalties on employers who do not offer employees (more than 5) access to representatives of the scheme and deducting contributions from wages and paying them to an employee's stakeholder pension. Employers are not required to contribute but can be fined for non-compliance. Fines of up to £5000 for an individual acting as an employer and up to £50, 000 for a company can be imposed.[38]

One-on-one sales will be far slower by virtue of the lack of attractiveness to brokers. Financial institutions will need to find creative ways to structure distribution partnerships. For this reason, commission needs to be permitted, which allows for such partnerships. We recommend that National Treasury allow free market forces to optimise the options available to contributors.

2.5. Costs and Commissions

The ACI has always had strong views on the need for full disclosure of costs and commissions. The strong press that has been given to these issues has contributed positively to developing awareness amongst the public and has benefited those who have strived after offering value in the market. We therefore recommend that National Treasury look to the market for optimisation on these issues. This will preclude the unintended consequences often associated with limiting the market.

Table 3a below sets out the summary of charge comparisons in South Africa as per Rob Rusconi's report (based upon maximum charges). Table 3b and 3c illustrate the range of improvement in *Charge Ratio* and *Reduction in Yield* which can be realised at lower and more realistic (in terms of actual charges levied in

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[38] See Jarvis, 2001, Stakeholder Pensions, Business and Transport Section, House of Commons Library.

the market) charges, notwithstanding the fact that allowance is still made for a modest commission (1% as minimum) for distribution costs. On almost all measures, unit trusts in Table 3c better the charge performance of existing retirement funds (both wide and narrow range) in Table 3a.

Table 3a: Summary Comparison of South African Savings Channels[39]

	Charge Ratio		**Reduction in Yield**	
Channel	**Low**	**High**	**Low**	**High**
Retirement funds (narrow range)	17.0 %	27.1%	1.04%	1.65%
Retirement funds (wide range)	13.4%	38.4%	0.81%	2.36%
Individual policies	26.7%	43.2%	1.50%	2.8%
Unit trust products	22.3%	32.5%	1.2%	1.95%

Note: These figures are not designed to be directly comparable. Definitions of ranges, in particular, have been determined in different ways and are intended to give a reasonable impression of the spread of results.

[39] See Rusconi, R, 2004, "*Costs of Saving for Retirement - Options for South Africa*", at page 105.

Table 3b: Unit Trust Product Sensitivity to Initial Charges Assuming an Annual Management Charge of 1,5%[40]

Initial	Charge Ratio				Reduction in Yield			
Charge	10yr	20yr	30yr	40yr	10yr	20yr	30yr	40yr
5.7%	12.21	18.87	25.53	32.06	2.74	2.10	1.88	1.78
3.42%	10.09	16.91	23.72	30.42	2.23	1.85	1.73	1.66
1.14%	7.96	14.95	21.92	28.78	1.74	1.62	1.57	1.55

Table 3c: Unit Trust Product Sensitivity to Initial Charges Assuming an Annual Management Charge of 1,0%[41]

Initial	Charge Ratio				Reduction in Yield			
Charge	10yr	20yr	30yr	40yr	10yr	20yr	30yr	40yr
5.7%	10.10	14.74	19.52	24.38	2.24	1.59	1.38	1.27
3.42%	7.92	12.68	17.58	22.55	1.73	1.35	1.22	1.16
1.14%	5.75	10.62	15.63	20.72	1.24	1.11	1.07	1.05

2.6. Administration

Given the opportunity to participate in the retirement fund market, some collective investment companies will most likely seek economies of scale for the additional administration responsibilities imposed through, for example, the provisions of section 37C of the PFA. The development of a joint administration capability is likely to emerge. Those with in-house facilities may utilise existing structures (LISPs).

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[40] The Association of Collective Investments expresses its gratitude to Mr Rob Rusconi for running these numbers for us.

[41] This is the annual charge allowed for Stakeholder Pensions. (Regulation 14(3)).

2.7. The National Savings Fund and Individual Retirement Funds

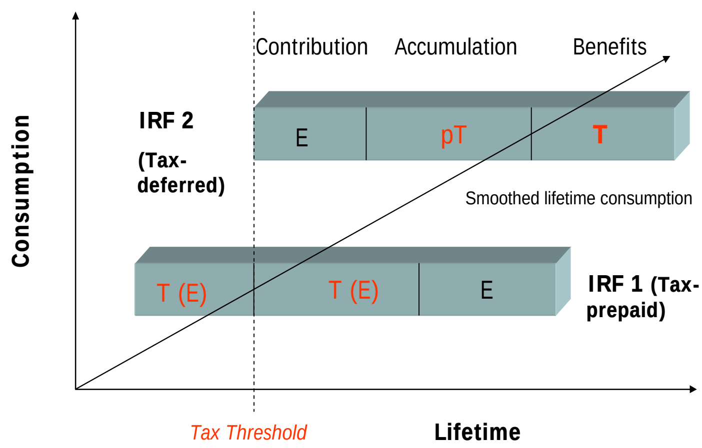
We recommend that National Treasury give serious thought to using the concept of an IRF in a second format to deliver the objectives of the proposed NSF. We make this recommendation for the following reasons:

Democratise the NSF

1. Simplicity – it will be much easier to implement the same concept on a decentralised basis via existing financial institutions. A product standard could simply be issued by National Treasury, like CAT standards are issued for ISA's.
2. It may be very difficult for a new central fund (NSF) to beat the economies of scale that financial institutions have already attained, given the fact that it may take some time for "critical mass" to be achieved, and given the difficulty of inducing the saving habit within the target group.
3. There exists the potential for "reputation risk" to government in a central NSF during periods of market under-performance (even if heavily weighted in bonds) which many companies and fund managers have experienced. If a decentralised, diversified route is followed, it protects the initiative from severely damaging public opinion that might ruin the long-term prospects of this initiative.
4. Introducing a new tax format (TTE) will cause portfolio shifts in the South African economy. A decentralised approach limits (not eliminates) this disruptive effect if various institutions have their own version of the product to offer. Our earlier figure is amended to

graphically illustrate the congruency of this proposal below:

Figure 6.
Lifetime Consumption - Complimentary IRF's



2.8. Conclusion

We are supportive of the proposal to allow IRF's. It will open up the market considerably and benefit contributors through accessibility, flexibility and affordable costs. Collective investment schemes should be included as a solution in the market. We furthermore recommend that government consider utilising the IRF concept to meet the objectives of the proposed NSF too. Our concurrency recommendation for contribution limits will no doubt provide scope for much debate as it did in the UK with the Stakeholder Pensions, but needs to be considered as a congruent means within existing policy measures to raise long-term saving.

2.9. Summary of Recommendations

1. We endorse the initiative to **harmonise retirement fund legislation** to standardise retirement options and incentives, thereby improving equity in the market.
2. We recommend the **inclusion of collective investment schemes** as highly suitable vehicles for the introduction of IRF's.
3. We caution against **excessive regulation** which could dissuade potential contributors from participating. We need to eliminate the frustration and suspicion that "fine print" causes for unsophisticated as well as sophisticated investors.
4. We suggest that market forces are particularly well developed to optimise **costs and commissions** through amongst other factors, the strong press they receive in South Africa. The ACI has always had strong views on the need for full disclosure and this should be mandatory and standardised.
5. We recommend that firms be required to grant employees reasonable access to IRF scheme representatives on company premises so that **education** and dissemination of information can be facilitated.
6. We recommend that firms which fail to comply with the provision of **payroll facilities** for the deduction of contributions, be fined for non-compliance.
7. We recommend that the IRF concept be expanded to include a **second tax format**, catering to the objectives of the NSF. A set of standards issued by National Treasury could be used to qualify the eligibility parameters. This could also be offered by employers as an addition to existing occupational funds, limiting the disruptive effects of a central NSF.
8. We recommend that the current tax-deferred incentive and proposed tax-prepaid incentive be integrated on a **concurrent basis** for all and that the incentives be counter balanced for maximum efficiency as a policy incentive and with respect to

balancing costs to the fisc over the short (deferred) and long term (prepaid).

Annexure

1

The South African Retirement Fund Landscape

The Association of Collective Investments sees no need to add further comment on this subject, given our previous submissions and the information contained in National Treasury's discussion document.

Annexure

2

Access, Compulsion and Preservation

Paragraph	Recommendation	ACI Response
1.6.1.	Saving for retirement to be encouraged rather than compulsory.	We support the Taylor Report recommendation for some form of compulsion, notwithstanding our support for the measures mentioned in para. 1.6.1.1 and 1.6.1.2.
2.5.1.	Establishment of a National Savings Fund.	We are supportive of this initiative, subject to our fuller commentary in chapter 1.
2.5.1.1.	Exempt NSF benefits from the means test for SOAP.	We agree.
2.5.1.2.(a)	NSF - incentivisation through affordable admin costs.	Modelling needs to be done and various options explored, such as outsourcing components of the fund (admin, systems etc.) Substantial deposits into the NSF would be required to sink system and staff costs necessary to set up such a facility.
2.5.1.2.(b)	NSF - incentivisation through competitive returns.	Bond returns may not always be that attractive. It is therefore optimistic to assume that in the long-term, the NSF will necessarily seem appealing on grounds of performance. The calculation and funding of retention bonuses is complicated and we advise against it.
2.5.1.2.(c)	NSF – wide accessibility	Distribution key. See our comments in Ch 1.

Paragraph	Recommendation	ACI Response
2.5.1.2.(d)	NSF – permit irregular contributions	We agree.
2.5.1.2.(e)	NSF – exempt from Retirement Fund Tax	We agree.
2.5.1.2.(e)	NSF – TTE tax format	We agree. See our more extensive comments in Ch1.
2.5.1.2.(f) – (h)	NSF – anti-abuse measures.	Reaching the target group is essential. It may also be integrated for concurrent utilisation with existing schemes within policy limits to raise savings at affordable costs to the fisc. See Ch 1.
3.5.1.	Tax harmonisation of employer and non-employer linked retirement funds.	We agree.
3.5.2.	Unfair discrimination	We support legislating against unfair discrimination.
3.5.3.1. & 3.5.3.2.	Choice of membership	The elective freedom of the employee should be protected as far as possible.
4.1.	Emergence of Individual Retirement Funds (IRF's)	We agree.
4.2.1. – 4.2.7.	Features of IRF's	We support the proposals.
4.2.8.	IRF's – no commissions payable.	We support a low commission policy, driven by market forces. We question how these funds will be distributed without a basis to pay for that distribution if commissions are not permitted by legislation?
6.5.1.	Ancillary benefits	We agree, but disagree that the provision of ancillary benefits should be mandatory. Surely, the provision of low-cost retirement savings is the first priority. Many ACI members would be willing to provide low cost retirement savings, but have no expertise in some of the other areas.

Annexure

3

Benefits, Contribution Rates and Member Protection

Paragraph	**Recommendation**	**ACI Response**
Para. 2.4.	Provisions of Pension Funds Second Amendment Act, 2001, be preserved. (Proviso inflation proofing)	Collective investments can only provide defined contribution, savings only format. Funds can be tailored to provide inflation proofing in years closer to retirement and during retirement. Savers could be given the option to switch to "income protection" funds at their discretion.
Para. 3.4.	Benefit packages	We do not support mandatory package provision. Those providers who believe that they can provide these options at attractive prices should be allowed to do so, but compelling all providers will introduce barriers to entry for low cost saving options.
Para. 3.5	No minimum rates of contribution	We agree. Providers should be allowed to compete for accessibility and affordability options amongst potential savers.
Para 3.6.3.	Variable rates of contribution	We agree.
Para. 3.7.3.	Preference for annuity benefits	The ACI has favoured the gradual drawdown of benefits too. However, should this not be limited to the NSF concept? Savers would then have the advantage of both payout formats.

Paragraph	Recommendation	ACI Response
3.11.	Compulsory preservation on change of employment.	Provided there are hardship clauses. To simplify this, those in temporary unemployment may be allowed some form of annuity drawdown rather than a lump-sum.
3.12.3.	Rules pertinent to 3.11.	We agree.
3.15.1.4.	Housing finance limited to provision of guarantees	We agree. The Collective Investment Industry would not issue guarantees, but allow investors to pledge their savings as collateral with banks.
3.15.2.3.(a)	Guarantees limited to housing	We agree.
3.15.2.3.(b)	NSF – full liquidity i.t.o. withdrawals	Problematic when considering the challenge to induce saving. Allowing unrestricted access will exacerbate the difficulty. Our comments on compulsion in Ch 1 (para. 1.6.) indicate that research supports the notion that people may appreciate being protected from their own lack of discipline.
3.16.5.	Permissible deductions	We agree. Under new legislation however, housing loans would not be permitted.
3.17.	Divorce	We support the proposals.
3.18.3.1.	Fund members to update beneficiary details every five years. These wishes are to be followed unless trustees find there are compelling reasons to do otherwise.	We support the proposal.
3.18.3.2.	Section 37C process difficulties to be minimised.	We agree.
3.18.3.3.	Benefits to be paid to dependants as income (if cost efficient). Management board to have discretion to set up a trust if deemed prudent for a beneficiary.	We agree, but think that consideration should be given to making this mandatory for the NSF concept. Why should higher income earners not be allowed access to their capital?
3.19.	Payments of benefits on disability	We support the proposals. However, we prefer the Taylor Report recommendation that a minimum disability benefit be prescribed. It is exceedingly difficult in practice to assess each case and review it from time to time. Rather than a percentage

		of earnings which is difficult to prove or determine for those with irregular income, we would recommend a drawdown percentage of the remaining balance.

Annexure

4

Governance and Regulation

Paragraph	Recommendation	ACI Response
5.6.2.	Members of funds to be given right to at least 50% of the fund's board of trustees.	In an IRF this cannot apply. The members will be unknown to one another. Allowance will have to be made for professional trustees in the legislation. The Collective Investment Schemes Control Act requires balloting of members for any changes to fund parameters. It should therefore be borne in mind that a fully democratic system already exists for collective investment schemes to which could be added a trustee board.
5.6.18	Remuneration of trustees permitted.	This ties in with our recommendation for para 5.6.2.
5.6.21	"Cooling off" period	We are supportive of this recommendation. However, it would have to be disclosed to the investor that for the term of the "cooling off" period, the investor's funds would have to be deposited in a money market fund, to avoid exposure to market risk.

7.5.	Regulation 28 amendments	We are generally supportive of these recommendations. We assume that 7.5.4. proposes something similar to what the current regulations seek to achieve, by stipulating maximum asset class limits. If default quantitative limits are too detailed, they can be self-defeating.
7.6.1.	Regulator to suggest benchmarks for performance of asset managers	We question whether this is the role of a regulator? There would be no harm in publishing a list of eligible benchmarks and their meanings, as long as it is not limiting.
7.6.2.	Trustees to monitor performance against benchmarks	Agreed. Currently the practice for retirement funds.
7.6.3.	Declaration by trustees concerning socially responsible investments (SRI)	Agreed.
7.6.4.	SRI up to 10% either directly or collective investment or private equity. Return not to be less than inflation.	Valuation can be an issue. However, it is extremely difficult for a fund manager to make a determinative statement regarding whether the rate of inflation will be matched, which is what the trustees would ask for assurance on, were it to be stipulated.
7.6.5.	Conditions for investment choice	This is a valid concern, but we would caution against limiting what could end up as differentiated, creative and helpful solutions for contributors. Providers may as an example, want to offer lifestyle choices based on age (early, mid life or mature) portfolios. Being prescriptive could damage the development of good retirement solutions.

Annexure

5

Voluntary Retirement Saving Accounts in the United States

Background information to 401(k) schemes and Individual Retirement Accounts (IRA's).

Voluntary retirement saving accounts (VRSAs) can be described by several of their key characteristics. These are the rules governing account contributions, particularly whether the contributions are mandatory or voluntary and the limits on contributions, the rules governing asset allocation for the funds held within the account, and the rules that apply to distributions from these accounts.

There is a wide spectrum of options on each of these dimensions, ranging from required contributions, fixed portfolios during the accumulation phase, and required annuitization or other compulsory payout schedules, to voluntary contributions, full discretion for the account holder with respect to investment choices, and opportunities for voluntary withdrawals without restriction at retirement.

The U.S. has a wide range of tax-deferred retirement saving programs. The two largest are Individual Retirement Accounts (IRAs) and 401(k) plans, which are named after a section of the Internal Revenue Code. IRAs, which were introduced in 1981 as part of the Economic Recovery Tax Act, expanded rapidly until 1986. The Tax Reform Act of 1986 reduced the tax benefits of contributing to IRAs for high-income taxpayers, but the resulting confusion about the tax status of contributions seems to have discouraged many households who were still eligible for favourable tax treatment from contributing. Today, individuals can make voluntary contributions to IRAs of up to $3000 per year. IRAs can be established with virtually any financial institution and they are not related to the individual's employer, so they are fully controlled by individuals. There are minimal restrictions on the set of assets that can be held within an IRA. Complex derivative securities, for example, may not be part of the IRA portfolio.

In contrast to IRAs, 401(k) plans are employer-based. An individual can decide to participate in a 401(k) plan if his employer offers such a plan, but not otherwise. Also in contrast to IRAs, 401(k) plans have experienced rapid and continual growth in the period since the early 1980s. The most recent official information on 401(k) participants, provided by the U.S. Department of Labor (2001), shows 37 million "active" (non-retired) participants in 1998. Projecting past trends in the number of participants, however, suggests that the number of current participants exceeds 40 million.[42]

The United States instituted tax-prepaid savings plans in 1998 in the form of Roth individual retirement accounts (IRAs); they are a companion to the above "standard" IRAs that have operated on a tax-deferred basis since the 1970s. Roth IRAs allow much smaller maximum annual contributions than the UK scheme, and they are not available to very high income earners. Restrictions include a five-year holding period, during which withdrawals

[42] Cited directly from Poterba, 2003, Government Policy and Private Retirement Saving at page 6.

of earnings trigger taxes and penalties, and a minimum age for tax-free withdrawals.

Another Roth IRA feature has made them very popular — the ability to shift funds to them from standard IRAs. A dollar of contribution room is worth considerably more in a Roth IRA because the prepaid tax does not count against the limit there, while part of a standard IRA must later be given up in tax. “Qualified” distributions from a Roth IRA are not included in the individual’s taxable income. The qualifications are that the earliest contribution has been in the account for at least five years and that the taxpayer is older than 59½ or has died or become permanently disabled. (Other qualified purposes for withdrawals, if the five-year test is met, are postsecondary education expenses and withdrawals towards a first-time home purchase.) Taxpayers who withdraw funds without meeting these qualifications bear an early-withdrawal penalty and tax on the cumulative investment return. Other key features, such as the age and other restrictions on withdrawals, suggest the intention of encouraging retirement savings. And other features indicate a desire to restrict the largest benefits of additional tax-recognized saving to lower- and middle-income taxpayers.[43]

Beginning in 2006, Roth IRA’s will be incorporated into 401(k) plans as an integrated option. This will allow employees to save after-tax dollars in a separate account under their traditional 401 (k) plan. Distributions from the account are generally tax free, once the participant reaches the age of 59,5 years. An employee’s annual elective deferrals and designated Roth 401(k) contributions combined may not exceed $15 000 in 2006. Roth IRA’s are only available to individuals below a certain income level and contributions must be maintained in a separate account within the employee’s 401(k) plan.

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[43] Directly cited with minimal amendment from Kesselmann and Poschmann, 2001, A New Option for Retirement Savings: Tax-Prepaid Savings Plans, C.D. Howe Institute at pages 35 and 36.

The US Administration is proposing to replace the traditional Individual Retirement Accounts (IRAs) with two new TEE instruments, one specifically for pension saving (Retirement Saving Account) and another for general saving purpose (Lifetime Saving Account). Contribution ceilings would be in both cases higher than the current limit for IRAs.[44]

[44] See Antolin, Serres and Maisonneuve, 2004, Long-Term Budgetary Implications of Tax-Favoured Retirement Plans, OECD, at page 18, footnote 30.

Annexure

6

UK TESSA's and ISA's

Background information to Tax Exempt Special Savings Accounts (TESSAs) and Individual Savings Accounts (ISA's).

The UK has an extended history of using tax incentives to encourage saving in various forms. Most important are the Tax Exempt Special Savings Accounts (TESSAs) and Individual Savings Accounts (ISAs). Both of these products allow individuals to save over a short time horizon, as well as to fund their retirement. What the schemes have in common with Individual Retirement Accounts is that they allow income and capital gains accruing to funds held in the accounts to be received free of tax, and so aim to promote private saving through increases in the net rate of return. TESSAs were introduced in 1991 and were subsequently replaced by ISAs in 1999 (i.e. no new TESSAs could be opened once ISAs had been introduced). Over the intervening period the remainder of the savings environment was, in the context of recent UK savings policy, relatively stable. In particular, the three-tier system of pension provision was already established. The first tier was comprised of a Basic State Pension, supplemented by means-tested benefits for those with low entitlements and/or little additional income. At the second tier workers could choose between a state earnings related pension or (tax privileged) private provision either in the form of a personal pension (introduced in 1988) or, where available, an occupational scheme. The third tier consisted of additional voluntary savings to supplement provision from the lower tiers. Though not strictly speaking *retirement* savings vehicles, TESSAs and ISAs are accounts opened voluntarily and over and above any wealth accumulated through the pension system, and so can be considered as part of the third tier. When TESSAs were introduced it was already possible to make some short-term savings in a tax-privileged

form using a Personal Equity Plan (PEP). As the name suggests, funds held in PEPs had to be held in equities although these could be held either directly or in trust. Contributions into PEPs were paid from net income, but relative to other means of holding shares the accounts were tax privileged since any interest income or capital gains accruing to the fund was tax exempt. Contributions to TESSAs were also paid from net income but in contrast to PEPs these accounts provided tax relief for interest income accruing to funds held in designated bank or building society deposit accounts. Also unlike PEPs, this tax advantage could be received only if the capital remained untouched for five years; early withdrawals would pay back the tax advantage but attracted no further penalty.

ISAs replaced both TESSAs and PEPs from April 1999. The ISA is a tax privileged savings vehicle for cash deposits, or for holdings of stocks and shares either directly or in trust, or for both cash and equities. Like both TESSAs and PEPs, contributions to ISAs are paid from net income. The absence of a statutorily fixed holding period is the main difference between a cash ISA and a TESSA. The option of holding cash or safe interest bearing accounts and so avoiding stock market risk, is what differentiates the product from a PEP. Like TESSAs and PEPs before them, ISAs were restricted in terms of the total amount that could be invested in an account in any one year. Indeed, the introduction of ISAs actually reduced the maximum amount that an individual could save in a tax advantaged non-pension form. An individual holding a TESSA and a PEP could save up to £7,800 a year in these accounts, or £9,000 if the TESSA was in its first year. ISA saving is limited to £7,000 per year, of which at most £3,000 can be in cash. ISAs are unlikely to constrain many savers, particularly amongst those with lower incomes who were a target for the new policy. ISAs can be seen as giving expenditure tax treatment on all accessible savings for the majority of households in the UK.[45]

[45] Attanasio, Banks and Wakefield 2004, Effectiveness of tax incentives to boost (retirement) saving: Theoretical motivation and empirical evidence.

Table 1. Effectiveness of Tax-Favoured Retirement Saving plans in promoting saving				
Author(s)	Measure of effectiveness	Data[1]	Results (share of contributions that represent new saving)	Period
Venti and Wise, 1990, 1991	Change in wealth of those who contribute to IRAs as compared to non-contributors.	CES and SIPP	100 per cent	1982-1986
Gale and Scholz, 1994	Changes in wealth of those who contribute to IRAs as compared to non-contributors.	SCF	Negligible	1983-1986
Attanasio and DeLeire, 2002	Changes in consumption of new contributors to IRAs as compare to people who had already contributed.	CES	10-20 per cent.	1982-1986
Poterba, Venti and Wise, 1995, 1996a,b	Changes in financial assets for those eligible for 401(k)s as compared to the group of ineligibles.	SIPP	75-100 per cent	1984, 1987, 1991
Engen, Gale and Scholz, 1994, 1996	Changes in total wealth, measured as financial plus housing wealth, of those eligible for 401(k)s as compare to the group of ineligibles.	SIPP	0-10 per cent.	1984, 1987, 1991
Engen and Gale, 2000	Changes in wealth of those eligible for 401(k)s as compared to the group of ineligibles, but allowing the effects of 401(k)s to vary by earning class over time and using a variety of functional forms for the dependent variable that are more robust to differences in initial asset position and to economy-wide effects that raise or lower all asset values proportionally, or have different effects across earning classes.	SIPP	Low income people: 100 per cent. High income people: 0 per cent.	1984, 1987, 1991
Pence, 2002	Changes in the wealth of 401(k) eligible and ineligible households over the 1989-1998 period controlling for the bias that higher taste for saving of eligible households would introduce by constructing subjective measures of saving taste from questions on the SCF and by transforming the wealth measure with the inverse hyperbolic sine.	SCF	5-10 per cent.	1989-1998
Benjamin, 2003	Changes in wealth using propensity score sub-classifications.	SIPP	Around 25 per cent. But renters, non-IRA holders: 100 per cent.	1984, 1987, 1991

1. The abbreviations stand for: Consumer Expenditure Survey (CES), Survey of Income and Program Participation (SIPP) and Survey of Consumer Finances (SCF).

Source: Antolin, de Serres and de la Maisonneuve, 2004, “Long-Term Budgetry Implications of Tax-Favoured Retirement Plans”, OECD, at pg 33.

Table 4. Age and income profile of participants to private pension plans

United States, 1997

Panel A. Average income per employee and participants

	Under 30	30 to 44	45 to 59	60 and Over	All Ages
Average income per employee $	23137	44523	52698	41588	39704
In % of average income across all employees	58.3	112.1	132.7	104.7	100.0
Average income per contributor $	32937	52911	60612	51652	50964
In % of average income across all contributors	64.6	103.8	118.9	101.3	100.0
In of average income of employees in same age group	142.4	118.8	115.0	124.2	128.4

Panel B. Percentage of workers participating by age and income level

	All Earners				
Income range	**Under 30**	**30 to 44**	**45 to 59**	**60 and Over**	**All Ages**
Under $20,000	18.7	26.4	27.5	21.6	22.0
$20,000 to < $40,000	52.9	57.2	60.1	45.6	55.7
$40,000 to < $80,000	67.4	70.0	73.7	56.2	69.8
$80,000 to < $120,000	78.9	79.0	82.2	58.6	78.7
$120,000 to < $160,000	76.8	80.8	80.0	61.7	78.4
$160,000 and Over	79.2	79.3	78.3	54.8	75.7
All Income Groups	34.8	57.9	64.0	41.5	51.0

Source : CBO (2003).

Source: Antolin, de Serres and de la Maisonneuve, 2004, “Long-Term Budgetary Implications of Tax-Favoured Retirement Plans”, OECD, at pg 48.

Average income per employee £
In % of average income across all emp
Average income per contributor £
In % of average income across all con

Source: Antolin, de Serres and de la Maisonneuve, 2004, "Long-Term Budgetary Implications of Tax-Favoured Retirement Plans", OE