Social Security and Retirement Reform

A Discussion Paper prepared by the Association of Collective Investments for the Joint Forum – Proposals on Incentivisation and Administration

December 2007

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First Things First

Beginning at the beginning

The manner in which we review South Africa's social security and retirement funding framework will speak volumes about us as a people. It will reveal how we reflect on our responsibility towards the vulnerable. It will be evidence of how business views itself in the broader social framework. It will signal how we reflect on our market-based economy. In the delivery of our ideals, efficient policy Integration of state and business in framing simple solutions for complex needs will most effectively ensure success. The result should be our joint values at work as rendered by our Constitution in its preamble, "Improve the quality of life of all citizens…" Foremost amongst its founding values is 'human dignity'[1]. This includes in the Bill of Rights:

> **27. Health care, food, water and social security. -**
>
> **(1)** Everyone has the right to have access to –
>
> *(c)* social security, including, if they are unable to support themselves and their dependants, appropriate social assistance.
> (2) The state must take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of each of these rights.

Adam Smith, summed up human Inter-dependence as follows, "*In civilized society he [humankind] stands at all times in need of the co-operation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons*"[2]. Our social reform should aim at making Smith's 'invisible hand[3]', more visible, as we contemplate segments of society where market machinery is dysfunctional.

Sensitivity to national biases

The great variation in pension plans across the world, following the earliest funded version in Germany in the 1880's, but which only developed into significant social programs following

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[1] Constitution of the Republic of South Africa, No. 108, 1996.
[2] Smith, A, 1776, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book 1, Chapter 2 at page 10.
[3] Adam Smith's economic theory suggested that in pursuing individual interests, individuals, almost unknowingly, benefit society for the greater good. This is the 'invisible hand' of the market model.

the Great Depression, are testimony to the influence of context on design. As Perotti and Schwienbacher (2007) ask, "*Why does Finland have so little pension assets in comparison to Denmark or Sweden? Why does Belgium have so little pre-funding in comparison to the Netherlands or Switzerland so much in comparison to Austria?*"[4] The answer seems to be largely political.

We similarly need to be sensitive to our own biases as we engage benefit design. A more unequal democracy will prefer greater fiscal re-distribution targeted by the state at the poor. A democratic choice of an older segment of the population will favour an inter-generational transfer via PAYG for lost opportunities and hard won political freedom in South Africa. Those participating in South Africa's highly developed capital market will favour a market based approach, while those outside will favour state reliant schemes. Further still, those who might have recollection of the misery following the1929 stock market crash will favour state sponsored social security schemes.

Government has some tough political choices confronting it. What seems expedient today, might impede our ability to grow economically in future, if social security liabilities assume the proportions they have in some other developed nations. When the choices facing a government are limited to raising taxes or reducing security benefits, it finds itself in a no-win political dilemma (see Box 1 below for an example). On the other hand, it is questionable whether we can afford to wait another generation for funded benefits to materialize for the disenfranchised elderly. Fractures in corporate governance of certain schemes and fraud in others will also tend to force the paternalistic hand of government to protect against similar abuses in future. We need to ensure that beyond mandated good governance, our new pension scheme architecture makes it impossible for any scheme manager to ever access pension assets again.

P.T.O.

[4] Perotti and Schwienbacher, 2007, The Political Origin of Pension Funding, University of Amsterdam.

Box 1

Excerpt from: Alan Greenspan, The Turbulent Years (2007)[5]

…Social security was running out of money. During the Nixon administration, when the program had seemed flush with reserves, Congress had taken the helpful step of indexing benefits to inflation. As inflation soared through out the 1970s, so did the cost-of-living increases in people's Social Security checks. The system was in such financial straits that an added $200 billion was going to be needed as early as 1983 to keep the program afloat. The long-term prospects looked even worse.

Reagan had shied away from talking in any detail about Social Security during his campaign- when the question came up, he'd pledged simply to preserve the system. And no wonder. Social Security is truly the third rail of American politics. There was nothing more explosive than Social Security reform: everybody knew that no mater how you dressed it up, any solution was in the end going to involve either raising taxes or cutting benefits from a huge and powerful bloc of voters, or both.

Yet the problem was serious, and leaders in both parties understood that something needed to be done - either that, or face the likelihood of not being able to mail checks to thirty-six million senior citizens and disabled Americans. We were getting down to the wire. Reagan's opening gambit, in his first budget, was to propose a $2.3 billion reduction in Social Security outlays. That raised such a storm of protest that he was forced to back down. Three months later he came back harder, with a reform proposal that would cut $46 billion in benefits over five years. But it was clear that a bipartisan compromise was the only hope. Thus the Greenspan Commission was born…

Finally, we need to factor in the inevitable exogenous financial shocks that long-term saving and benefit systems might have to weather. We do not know how severe these might be, but contingency design considerations should treat them as inevitable.

Principles to design solutions by

Holzmann and Hinz (2005)[6] of the World Bank synthesize the most important reform principles as follows:

1. **Have well-defined retirement-income objectives and reform criteria.** The international discussion on pension reform over the past 10 and more years was dominated by disputes over structure, such as the number of pillars, a near religious

[5] See at page 94.
[6] Holzmann and Hinz, 2005, Old Age Income Support in the 21st Century, The World Bank, Washington DC, at page 34 and 35, quoted verbatim (emphasis our own).

war about the virtue of funded versus unfunded provisions, and the merits of defined-benefit versus defined-contribution plans. Moving the discussion away from structure and toward objectives and clear criteria, when the latter can be productively introduced in a country, should advance the reform process…

2. **Cater to three main groups in society.** Developing countries will have to devise instruments that provide old-age income for three main groups in society: the *lifetime poor*, *informal sector workers* who are at risk of becoming poor once they stop working, and *formal sector workers* who are covered by a formal pension arrangement. Doing so suggests more consideration of noncontributory basic provisions, developing well-regulated and well-supervised voluntary retirement-income instruments, and avoiding mandated systems that are an obstacle to increased formalisation of the labour force.
3. **Keep the formal and earnings-related system small, simple, and universal.** Small refers to the mandated replacement rate, which should be kept modest for reasons of financing and compliance. Simple refers to the design of benefits and the need for the closest possible link between contributions and benefits. Universal refers to the application to all sectors of an economy in order to allow mobility across professions…
4. **Allow for diversification of systems and resources to enhance stability and security of retirement income**. Pension systems are exposed to multiple risks – the most important being economic, demographic, and political risks – and a diversified system should provide more security…
5. **Pay more attention to process in addition to design issues.** The experience with pension systems suggests that very close attention must be paid to the governance structure, with a focus on rules to deal with conflicting interests, the importance of the political economy of reform, and the myriad implementation challenges.
6. **Take account of country circumstances.** A successful pension reform can best be conceptualized as the pursuit of a clearly defined system and reform objectives…

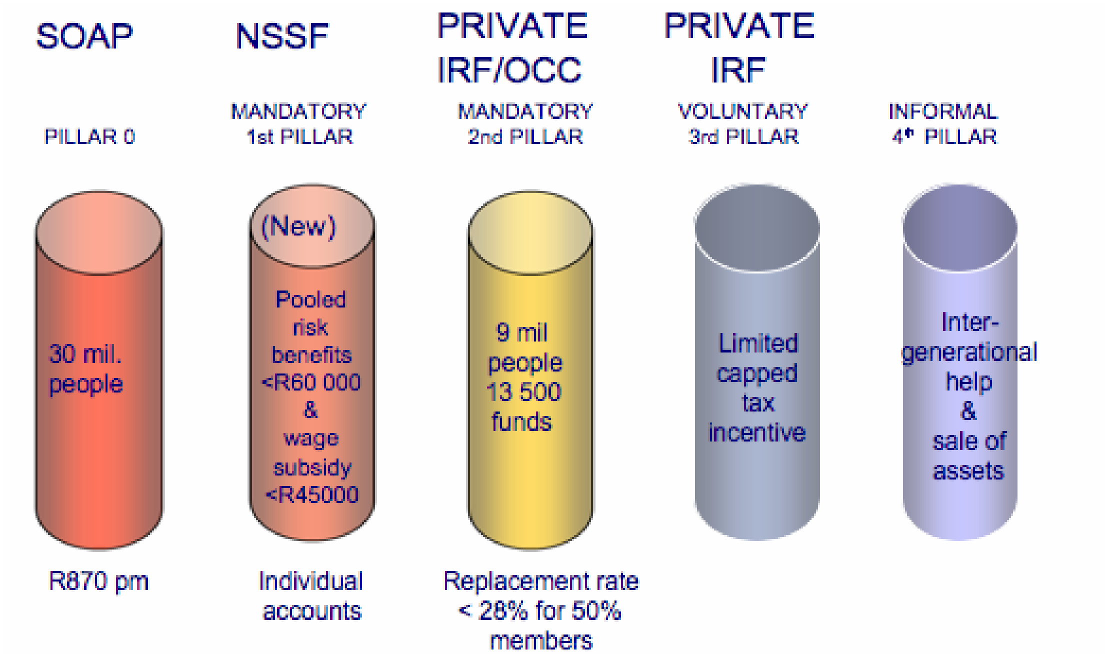
We believe that the above are practical, well grounded principles which should be kept in mind as we consider options for change. We therefore suggest a tick box approach when evaluating proposals on the table for discussion. There might well be other principles that should be included in Table 1:

	Lifetime Poor	Informal Sector	Formal Sector
Clear objectives & criteria			
Simple			
Portable			
Risk diversified system			
Focus on process			

Framework for Social Security and Retirement Reform

Based on our understanding of National Treasury's second discussion paper the envisaged structural reform would, based on the World Bank multi-pillar model, integrate as follows into the existing social security and retirement framework.

Figure 1: Structural Reform Fit on Existing Social Security and Retirement Landscape



The main recommendations in this proposal are:

1. A **wage subsidy**, paid to employers as a rebate from SITE;
2. A **mandatory** employees' social security contribution, to finance basic risk (UIF, disability and death) and retirement saving, collected via monthly PAYE system;
3. **Collective** administration of the system, using national data warehousing;
4. Reform of the **governance and regulation** of the retirement fund industry, who will provide supplementary occupational and individual retirement saving;
5. **Reforms to the tax model** to improve simplicity and equality, while maintaining an incentive.

Areas of Agreement, possible Disagreement and those requiring further Information / Research

Rather than commenting on the many issues raised by an extensive reform initiative such as this, the Association of Collective Investments (ACI) would like to highlight areas on consensus, possible disagreement and those where we would like to have further information at our disposal to fully assess the proposal. We trust that this will enable National Treasury and the Interdepartmental Task Team on Social Security and Retirement Reform (IDTT) to quickly assess where further consensus needs to be developed and where we should waste no further energies on debate. For ease of reference, a tabulated response is given below.

Table 2: ACI Responses to Reform Proposals

PROPOSAL	AGREE	POSSIBLY DISAGREE	FURTHER RESEARCH
Wage subsidy [amended to include co-contribution]	√		√
Mandatory retirement saving and preservation	√		
Collective administration	√		√
Reform of regulation and governance of retirement fund industry	√		
Increased powers for Registrar	√		
Continuation of tax encouragement of retirement saving, but capped / tapered	√		√
Stricter governance, disclosure and code of conduct for trustees	√		
Universal basic pension [prefer targeting of all 'last resort relief grants'		√	√
Accreditation and standardization of retirement funds and limited service providers [latter very problematic]	√	√	
Post retirement medical contributions [not our area of expertise]			

Price control [has benefits, prefer target range]		√	√
Basic State pension - DB based on indexed lifetime earnings [prefer DC or hybrid DB]		√	
Earnings floor for contributions [inequitable]		√	
Mandatory participation national fund [prefer mandatory pooled risk benefits only]		√	
Opt out for accredited schemes	√		√
Extension of UIF benefits & mechanisms	√		
Aligning of disability and survivors arrangements	√		
Collection by SARS / individual accounts [SARS not to be overwhelmed]	√		√

Pillar 0: Universal Basic Pension

The World Bank pillared model has traditionally been used in the context of pension fund design. It should, however, be used as a means for evaluating the integrated social security systems of South Africa, which includes old age income provision.

Pillar 0 design should take cognizance of all vulnerable members of South African society in meeting basic needs necessary for sustaining life. The development of a national poverty line is one way of benchmarking poverty, despite its inadequacies. Used as a broad measure, it will be fairly arbitrary and should rather be used for targeting specific relief within this pillar. Disability grants, child support grants, care dependency, foster care, UIF benefits, State Old Age Pension (SOAP) all fall into this category of relief. Viewed on this basis, it is questionable whether one of the relief mechanisms, i.e. old age income relief can afford to enjoy special non-targeted distribution across the entire population base. It is also intuitive, that no matter how simple a claw back mechanism might seem in theory, it is always more difficult to 'gather than distribute'.

We therefore recommend that relief for the vulnerable be developed on an integrated basis and that in the context of pension reform, SOAP is made more meaningful in quantum (currently R870 pm), but remains targeted. It is *de facto* South Africa's PAYG pension solution, but should continue to be funded out of general tax revenue. This ensures a broad contribution base, rather than administering an additional social security tax with the complexity of calculating progressivity and representivity (natural vs juristic persons).

Table 3: Percentage distribution of population receiving social grants by sex (2007)[7]

Type of social grant	Male	Female	Total	
				%
Old age pension	628 998	1 738 322	2 367 320	21,2
Disability grant	606 242	580 251	1 186 493	10,6
Child support grant	3 576 534	3 616 392	7 192 926	64,5
Care dependence grant	95 992	86 373	182 365	1,6
Foster care grant	8 981	14 204	23 185	0,2
Grant in aid	39 162	63 160	102 322	0,9
Social relief	18 112	21 533	39 645	0,4
Multiple social grants	24 936	31 211	56 147	0,5
Total	**4 998 958**	**6 151 447**	**11 150 404**	**100,0**

7 Stats South Africa, 2007, Community Survey 2007, RSA, at page 35.

Pillar 1: Wage Subsidy

The wage subsidy proposed by National Treasury in its second discussion paper of February 2007, is the cornerstone policy proposal upon which the social security reform for low income workers is to be built. It is primarily a means to include the lowest earning members of the workforce in full social security benefits and retirement funding, without pushing up the cost of employment or discouraging the development of formal employment. It also has a number of additional benefits:

1. Seamless re-distribution mechanism via the tax system, implemented as a 'negative tax';
2. It therefore extends the progressive continuum of the income tax system;
3. Demand-side stimulant for low wage jobs, if directed at employers;
4. Active labour market policy directed at correcting structural flaws in the market;
5. Underpins a 'living wage' in low-wage occupations.

However, introducing a structural change to the funding of employment such as this, becomes a fixture in the economic structure of labour provision. Once introduced, it cannot be scrapped without causing a severe shock to the economy. It is permanent, and therefore needs to be thoroughly considered and debated.

Economic Rationale for the Wage Subsidy

The challenge being faced by modern market based economies is that despite healthy growth, unemployment and income inequality is not decreasing. Adam Smith's 'invisible hand' works well where there is structural uniformity and efficiency, but not so where there are structural flaws in the composition of labour supply. The rate of technological advance and globalization are opening up the fractures further. The other side of the coin is that for long - term growth to be maintained and be structurally sound, poverty, inequality and income vulnerability need to be reduced. Learning and skills accumulation, improved social cohesion and crime reduction are obvious components of a structurally sound economy.

Structural flaws in the economic growth dynamic are not South African inventions. Despite the recovery of the 1980's and 1990's in OECD member countries, these economies were plagued by high and long-term unemployment. Active labour market policies (ALMPs) and interests in wage subsidy schemes were revisted[8]. The biggest problem of the unemployed and 'once-employed' is disconnectedness. The longer the lapse in employment, the greater its impact. ALMPs attempt as one of the objects to reconnect employers and potential employees. This specific aspect is not addressed in the National Treasury formulation for the broad based wage subsidy. Treasury's proposal does however make formal employment much more attractive and should encourage active interest from the labour supply side to seek integration into the formal work force. But as it stands, it does not address the informal sector.

The theoretical or empirical effects of wage subsidies are however ambiguous in the literature[9]. Smith (2006)[10] summarises international experience with employer-side subsidy programmes and notes, "…*employer-side subsidies, however popular, are generally ineffective at encouraging new employment*.[11]" Bucher (2007) examines the impact of wage subsidies targeted at the long-term unemployed and concludes, "*Although wage subsidy programs may improve hiring and employment prospects of the targeted group, the net effect on unemployment is ambiguous*.[12]" We therefore need to be careful when we bundle potential benefits that a wage subsidy might present. The breadth of the social security reform might have supply side effects by encouraging the unemployed to pursue employment opportunities more aggressively, but this is uncertain. The "informal worker" would also need to be catered for – a typical obstacle in subsidy programmes.

Some of the indirect effects observed in the wide assortment of wage subsidy programmes include:

1. **Deadweight loss** - in our case this would be those instances where the cost of the social security contribution could have been absorbed by the employer/employee anyhow and need not have been subsidized. Broad based schemes are known to have large deadweight losses[13];
2. The **substitution effect** – where subsidized employment substitutes for non-subsidised employment. Careful consideration would need to be given to the taper effect on the rebated wage subsidy from the tax scale so that 'lower earning' non-

[8] The average share of ALMP's share of labour expenditure has grown as countries have sough to strengthen active rather than passive policies.
[9] See, Lee, JK, 2005, Evaluation of and Lessons from Wage Subsidy Programmes in OECD countries, OECD, at page 2.
[10] Smith, C, 2006, International Experience with Worker-side and Employer-side Wage and Employment Subsidies, and Job Search Assistance Programmes: Implications for South Africa, HSRC, at page 21.
[11] Emphasis our own.
[12] Bucher, A, 2007, Wage subsidies targeted to the long-term unemployed, Universite' du Maine, at page 22.
[13] For Australia, Belgium, Ireland and Netherlands, such effects are estimated at 90% and in Sweden 60%

subsidised workers are not replaced with low earning subsidized workers.

3. The **displacement effect** - crowding out effect by subsidized sectors of non-subsidised sectors. As the National Treasury proposal is broad based, this is not a great concern, but it could theoretically incentivise the structure of the employment market towards low wage jobs and motivate in favour of labour, in the labour / capital choice by employers.

While studies reflect that these effects are substantial, proponents of wage subsidies argue that the longer term general equilibrium effects are ignored. The arguments made are that in a general equilibrium framework the substitution effects tend to target long-term unemployed rather than short term unemployed, transforming ‘outsiders’ in the labour market into ‘insiders’. The equilibrium rate of employment is therefore lowered, because the labour supply is higher. It is not clear whether this dynamic will have any impact in the South African proposal. By contrast it should improve the adhesion of the short term unemployed to the labour market as they will want to and will find work more easily. Only if the overall demand for low wage labour rises is any effect likely to be felt. Thought needs to be given to first time work seekers so as to shorten their canvassing period to prevent migration into long-term unemployment and encourage the ‘adhesion properties’ of the subsidized social security package.

Lastly, introducing a wage subsidy across the economy will create a massive windfall effect. While this will have a positive short to medium term effect, the long term effect might be diluted as the market factors it into the wage structure. A deadweight effect might result as employers absorb the subsidy into wage escalation and absorb the subsidy into their margins. This would result in a return to the income disparities between labour of different skills as non-subsidised labour receive greater percentage increases in salary relative to subsidized employees.

Cost implications for the Fiscus

Not only the initial cost, but also the ongoing cost of a wage subsidy needs to be better understood. Fixing the subsidy to the cost of benefit or indexing the subsidy are likely to further induce the deadweight impact of the subsidy. Thought should therefore be given to using the subsidy as a variable policy lever, with the ability to taper down the massive windfall gain. This will allow for a review of the effectiveness of the subsidy and dynamically reduce what could become a significant deadweight loss.

The assumption in National Treasury’s funding of a basic pension via a wage subsidy is that only working people will be entitled to it. This tends to be work in the formal economy. For the sake of equity, however, anyone who works or it can be argued, can make a contribution to the basic pension scheme, should be able to do so – this would be in the national interest. If there exists post 2010 a comprehensive social security system, people cannot be barred from contributing because they did not perform ‘approved work’. They should be entitled to save via individual accounts for long -term benefits and also enjoy the coverage of pooled risk benefits. This ‘something for something’ principle cannot be denied the many diligent casual workers and savers (who would now be incentivised to migrate their savings to the longer term basic pension scheme) in our communities. This implies that the subsidized base of wage earners or pension contributors might be significantly broader and the impact of the ‘negative tax’ on ‘positive income tax’ would need to be modeled using various take-up scenarios. It also introduces another inequity if those working in the formal sector get a fully subsidized basic pension below the tax threshold. That creates an entitlement which others in less formal work environs should be able to claim too. The only way around this is to not provide anyone with a ‘something for nothing’ subsidy, but a ‘something for something’ co-contribution. This moves the incentive from an entitlement for being employed, to an incentive to save for your old age – a vast difference. Based on affordability, such a ‘something for something’ incentive structure might include a basic flat rate credit per year in addition to the matching contributions. An individual who fails to avail themselves of such a benefit for the duration of their lives due to abject poverty is then a clear-cut candidate for Pillar 0 support via relief mechanisms such as the SOAP.

Pillar 1: Collective Administration – Basic Funded Pension Scheme

Putting the pieces together

Administrative and implementation issues are easily underestimated or undervalued in the discussion of pension fund reform. Yet, it is this part of the discussion that translates ideologies into likely realities or falsities and we believe this discussion should happen alongside the debate on multi-pillar structures, benefit design and rationalization of existing occupational funds. If it is deemed important for people to have a sense of shared responsibility in planning for their old age and life's risks, how will that be conveyed to the public in the materialized scheme format?

Some of the features of modern reform that fit this objective include:

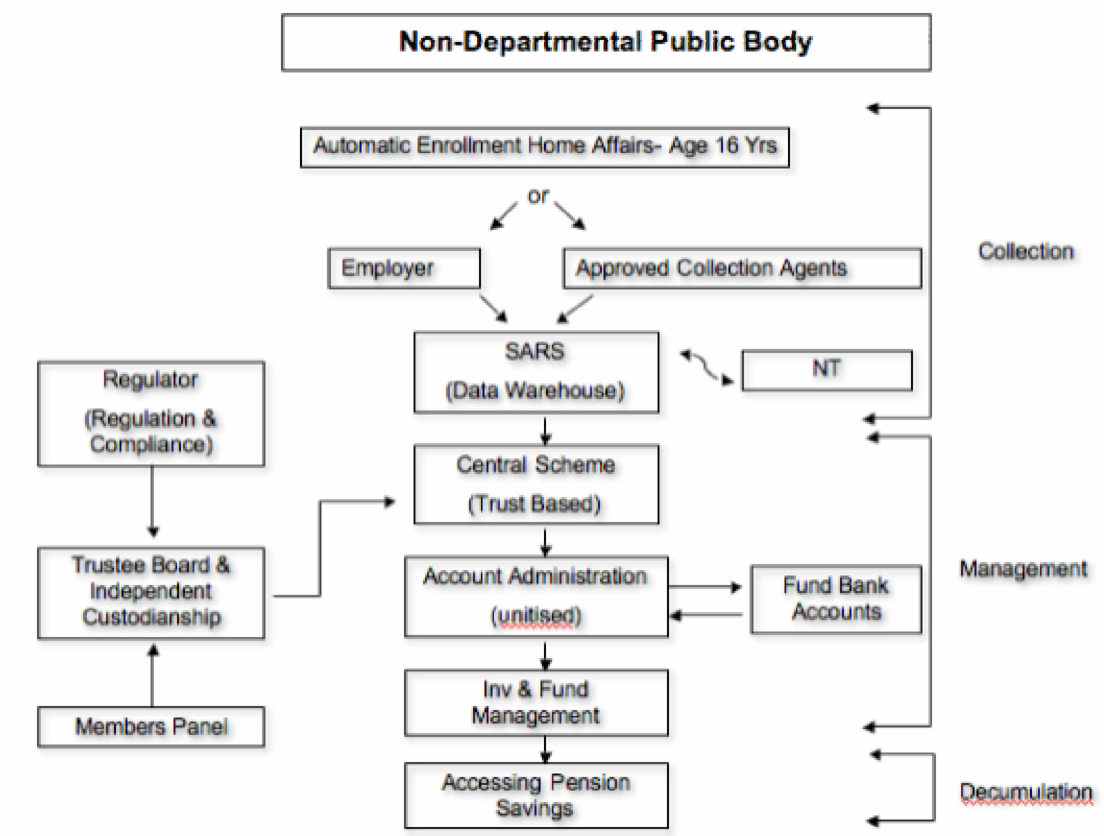
1. Introduction of personal accounts (part of government proposals)
2. Unified collection and collation of social contributions (proposed via SARS)
3. Issuance of social security cards (not discussed yet)

Then there is the issue of deciding on the integration of the flow of data and the flow of money. The centralization of data is essential to the integrity of the system and economies of scale, whereas the flow of money need not be centralized, especially if it will introduce new costs. The schematic diagram below illustrates a basic pension scheme using personal accounts linked to a 'social security number' – we propose the individual's ID number. The attractiveness of using the ID number as the descriptor, is that via the national data warehouse, even pension fund schemes in pillars beyond the basic fund can be consolidated under one number, allowing better data for future analysis, as well as measurement and management of incentive effectiveness and budgeting. All financial services accounts in the private sector already have the ID number as a field for every account.

For ease of valuation and simple, regular reporting, the scheme should be unitized.

Figure 2 is an example of how the component parts of the basic pension scheme might fit together.

Figure 2: Schematic of Component Integration for Basic Pension Saving Scheme



Governance and Regulation

Governance should be performed by a non-departmental public body with its own executive. During the implementation phase, these persons should be responsible for managing all aspects of the design parameters, reporting to the inter-ministerial task team.

The Board of Trustees may be augmented with a members' representative panel to offer broader member representation. This panel will then be represented by a designated number of trustee seats on the Board. Pension fund assets should be held by an independent custodian.

We do not support the development of a separate statutory body outside of the Financial Services Board (FSB) to regulate the new pensions environment. This segments the regulatory function (based on product) and thereby limits economies of scale, insight into market practice and surveillance. The powers and resources necessary to meet the challenges of the new environment should be afforded the FSB. We should, however, be aware of two dynamics. Firstly, regulation developed in a crisis will tend towards over-kill and inevitably need to be fine tuned again later. Existing occupational funds have provided many formally employed South Africans with a good, although not perfect solution over 50 years. Recent unfortunate failures in the industry, which might range from outright fraud to indiscretion, might bias our re-write of the Pensions Fund legislation too severely. A balance between creative improvement and damaging design decisions needs to be struck. Secondly, sometimes several regulators are better than one. A solitary regulator will tend to become risk averse as he or she tries to guard against every conceivable negative outcome, creating a crushing compliance burden and becoming increasingly isolated from market dynamics. There should therefore be some balance struck between the roles of the Regulator, the Board of Trustees and the executive responsible for the management of the scheme of arrangement. Sharing of responsibility and having representation from each on an advisory panel to the Regulator will help to balance these dynamics. Lastly, we should accept at the outset that a new system such as this will require much fine tuning once implemented. A new Pension Fund Act should therefore allow flexibility by legislating principles and allow details to be defined in regulation, where it can more easily be amended.

Contributions

The difficulty of enrollment when beginning saving for a pension, might best be overcome by making the process automatic at the time of applying for an identity document and using the ID number as the social security number. This will ensure that accounts (social security and pension account number) are opened for all citizens and some literature is given to them concerning the social security and pension scheme. Contributions then simply become one of calling on an approved distribution agent in the future and making either ad hoc or monthly contributions. Alternatively, employers will be able to electronically forward data to the central data warehouse. On this basis, the accounts will be portable between employers and between periods of employment, self-employment and economic inactivity. It means that full participation in the social security scheme then equates to ‘automatic enrollment’ for the informally employed, and ‘compulsion’ for formally employed employees. This will not fully overcome the saving inertia that so many experience, but will certainly remove the fear and tedium of administration that hinders the opt-in process.

Design of personal accounts

Objectives for the design of personal accounts are summarized as follows:

1. The burden on employers should be minimal. Many smaller employers currently have no occupational scheme for their employees precisely for this reason – they do not have the infrastructure to support or advise on retirement saving.
2. Accounts should be fully portable for life across employers, periods of employment and self-employment. This should be seamless. Any administrative friction that is

generated by moving from public to private employment, between sectors in the economy or employment, unemployment and re-employment would be to fail in the design.

3. There should be aspects of choice to encourage engagement with the issue. We return to this below.
4. There should be maximum access and visibility of account balances to encourage participation and persistence.
5. System stability and structural integrity might be improved by hybridizing the collective central design with decentralized components, without sacrificing on costs and economies of scale.

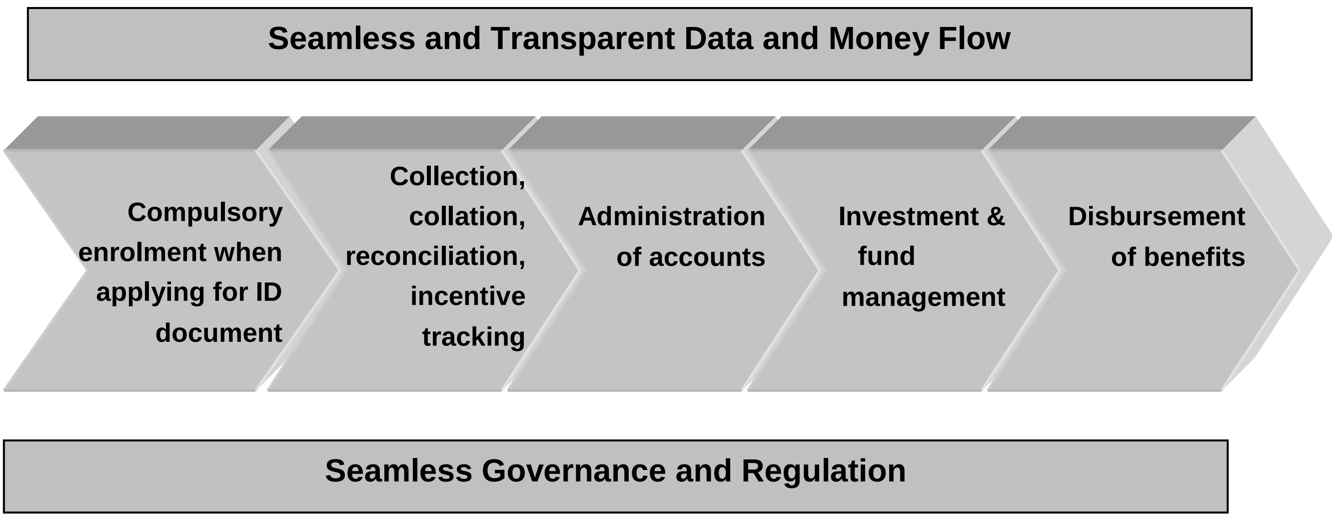
Centralised versus Decentralised Model (both with competition)

The above model allows for flexibility from the administration phase. For example, investors could be given a choice of administrators (or a default) after a tender process, which outsourced, would substantially speed up delivery. Similarly, fund management could be outsourced. In the decumulation phase, a drawdown facility could be availed (algorithmic or living annuity) until say, age 75, whereafter an annuity could be purchased. Alternatively, an annuity could be purchased at the designated earliest retirement age (55 yrs). (Differences in annuity options for Pillar 1 and 2 discussed in footnote 15). Both of these options can be facilitated by the administrator.

Visualising Basic Processes

A basic flow chart of macro-components of the process of retirement fund accumulation and decumulation may be rendered as follows:

Figure 3: Basic Process Flow



While seamlessness is important, so too is the visibility of processes to the public. There should be 'line of sight' for money entering the system and its translation into benefits. At no time should the public be allowed to develop a perception that there is a "black box" computation and assignment of benefits. This will severely undermine the public's willingness to pool risk or save. This implies that benefit design should be either defined contribution or a hybridized defined benefit scheme.

Visualising the Fit of Component Parts

The Department of Works and Pensions in the UK, is similarly busy with a revision and simplification of its retirement architecture. One of the key reforms for 2012, is the introduction of the Personal Accounts Scheme – a scheme specifically aimed at "*the millions of people who are currently without access to good quality workplace provision*"[14]. While the details of their reform are not going to be discussed, the debate surrounding the administration model is insightful. Their objectives are similar to our own – low costs, simplicity and portability. Not having the complex legacy of the UK systems, we may well examine what aspects and features of this intervention might be incorporated into a new South African basic pension. What we should primarily be concerned with, are those not falling within the provision of occupational schemes. Simply shifting savings around would not be effective – we want <u>more</u> people to save.

Figure 4 illustrates a fairly centralized administration model where the administration, fund management and annuities are outsourced to the market. It is an attempt to combine the benefits of centralized economies of scale, healthy competition in the provision of services and the ability to roll-out the scheme rapidly, using existing industry competencies.

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[14] Department of Work and Pensions, 2007, Personal Accounts: a new way to save. Summary of responses to the consultation, at paragraph 2 in the Executive Summary.

Figure 4: Model A - Centralised with Competition

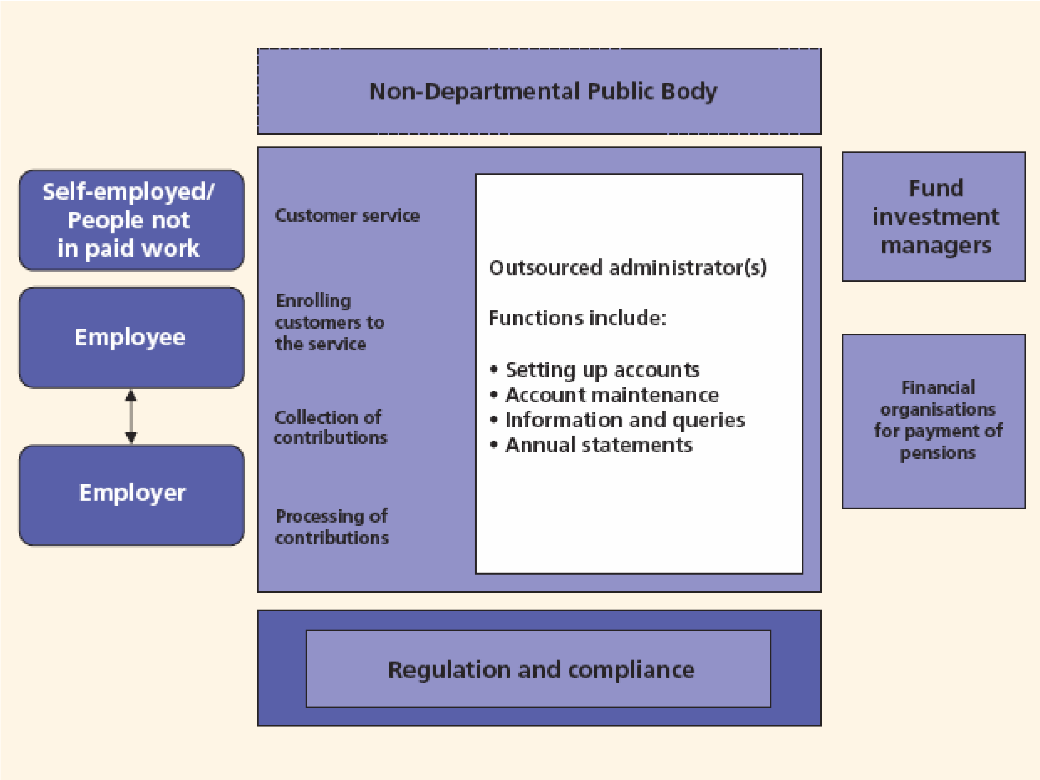
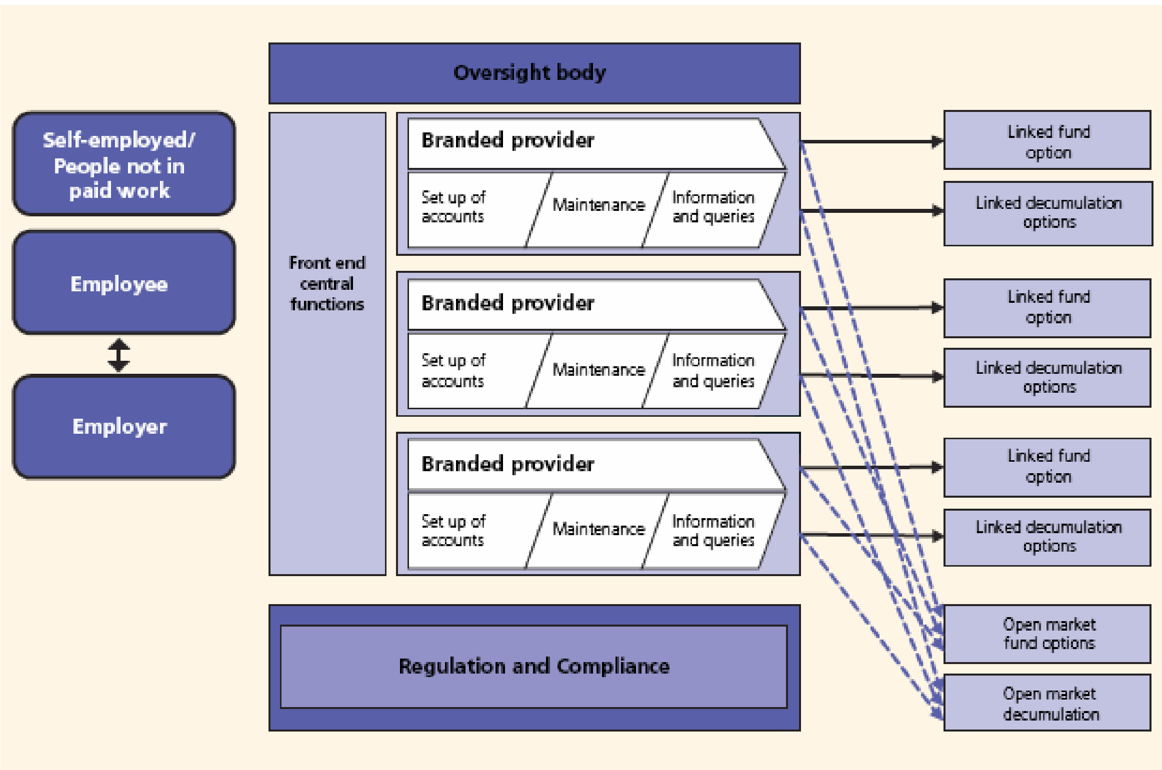


Figure 5 illustrates a much more decentralized system, which also allows for greater freedom of choice for the investor. After consultation and careful consideration, this model was abandoned in favour of the former recommended by the UK Pensions Commission, mainly because it was felt that the additional complexity would probably add another 25% to costs.

Figure 5: Model B - Decentralised Branded Solution



Both models offer the ability to implement relatively quickly, and include the benefits of competition in the efficient delivery of services, but how competition works in them is different. In Model A, the Board of Trustees takes responsibility for agreeing contracts with financial services companies, be they administrators or fund managers. The board acts in members' interests and tries to ensure the best outcomes for them. In Model B, companies compete to get individuals to join their scheme. As people can switch between providers they can move to one with the lowest charge or the best service according to their judgment. This implies that investors are well informed about the market. However, the marketing expenditure in this model is likely to drive up costs.

Integration with Existing Occupational Schemes

As we mentioned earlier, the purpose of the reform should not end up in a moving around of existing savings, but broadening coverage and deepening the benefit structure. Its first priority therefore should be the inclusion of new savers. The risk benefits should therefore be costed separately - to which every employee will contribute, the amount of this then equaling a 'basic wage subsidy' minus a minimum regular/annual contribution by any contributor (formal and informal) (i.e. excluding the saving component). If existing schemes are able to offer better and cheaper saving benefits, then why should contributors not be allowed to opt out? If they leave the services of the employer, mandated persistence will mean that joining the state basic pension scheme is open to them. Those employers that wish to dissolve their schemes in favour of the state scheme would be free to do so and there may be many who do – in itself leading to rationalization. No employer should be permitted to compel an employee to join or remain in an occupational scheme, leaving employees the freedom to elect to save in a scheme into which they have already automatically 'enrolled' when they turned 16yrs old. This will result in a healthy competitive balance where benefits and cost savings which will drive a natural selection process.

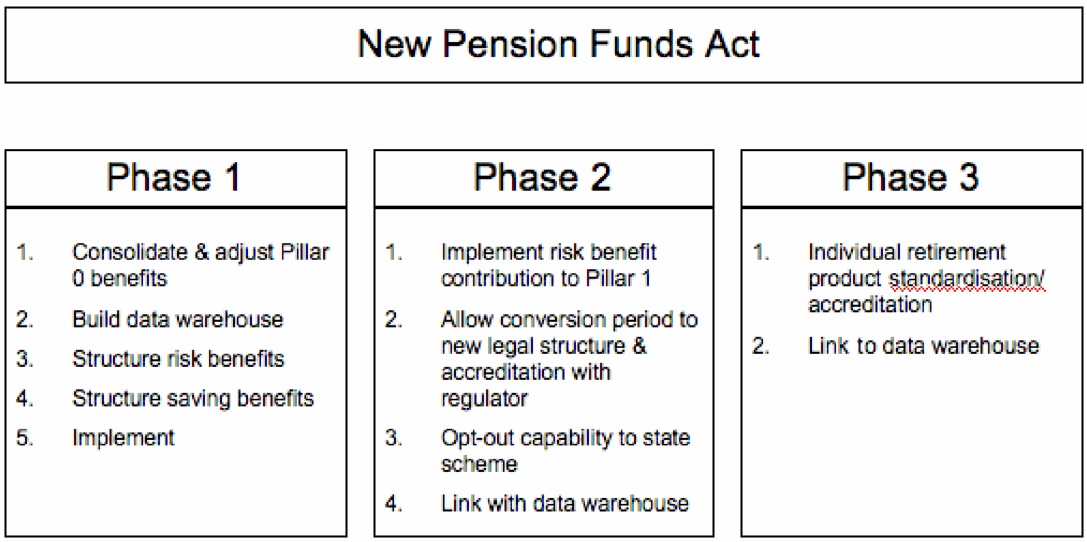
Inter-operability with private sector schemes

The personal account system will allow descriptor account number (ID number) to be linked to other retirement products utilized by the individual via the central data warehouse. If a new standardized legal structure is imposed upon the retirement fund industry along the lines of that suggested by the Department of Social Development, it would be possible, to ultimately allow for inter-operability (seamlessness) between providers (State / private sector) and incentive integration, although it would be unlikely for Pillar 3 as discussed on page 24.

The first step is to set up the basic state pension scheme with its pooled risk benefits and savings function, operating via a central data warehouse. Thereafter, following a period allowing for the conversion of legal structure for existing occupational schemes, the option for rationalization from the private sector will be possible. Many smaller occupational schemes will during such a transition period, no doubt opt-in to the state scheme, having seen it in operation and not wanting to be laboured with conversion processes.

The ability to consolidate retirement reporting in a central data warehouse should also allow for flexibility in incentive management. Those who start late in life with saving for retirement or have to recover from a long period of unemployment, should during better years, be afforded the opportunity to avail of cumulative ceiling limits. This would make sense in a country such as our own with the inequities of the past. Without a central data warehouse for all retirement product information consolidation, a second prize would be to allow accelerator bands of contributions over certain ages (say 45 yrs). For these, however, there can be no cumulative measurement, only annual limits.

Figure 6: Basic Implementation Prioritization



Pillar 2 & 3: Tax Design

We have already made the point that the system should be seamless. The fact that it may be broken down into pillars according to an established model, does not mean that it should be built as separate silos. It would not be representative of life or society, where its members might move bi-directionally during the course of a 60 to 80 year lifespan.

Pillar 0 is the safety net of last resort. Pillars 1 to 3 are progressive and inter-operable necessities. It is therefore essential that incentive structures should be simple, seamless and equitable (between generations[15], categories of employment and phases of life - taking cognizance of the idiosyncratic nature of income).

So while we use the word, 'tax' in relation to pension fund saving, it is a sub-set of the overall incentive structure and should be carefully integrated with other mechanisms, for example:

1. **Pillar 0** – **no relevance** to an incentive (grant based safety net)
2. **Pillar 1** – *Firstly*, a basic wage subsidy to pay for **risk cover** (but will need to be allocated to all contributing 'employees' or more accurately, contributors. Anyone who can make a regular minimum mandatory contribution (activation payment) towards the risk benefits, will qualify for a 'wage subsidy' payment to their account by government. The level of the mandatory contribution component should be based upon poverty line modeling and affordability. The objective of extending the coverage of this benefit to the broadest possible extent, means that it should not be ambitious in quantum and begin very conservatively. *Secondly*, a **co-contribution mechanism** funded from the wage subsidy allocation or budget, incentivising individuals to save

[15] We should mention annuities as a case in point here. While forced annuitisation may be optimal for an individual, it may not be socially optimal. It eliminates unintended bequests and slows down capital accumulation and therefore economic growth below the social optimum. (See Pecchenino and Pollard (1997)). In South Africa we are not merely concerned with income inequality, but also the creation of capital wealth, which is fundamental to transforming the structural inequities of the past. Mandated annuitisation without any lump-sum provision, ignores the need for inter-generational transfers, as it is by definition a closed system. An intermediate 'draw-down' phase up until the age of 75 yrs (capped) may also smooth the flexibility of the model, with compulsory annuitisation at 75yrs. The lump-sum and draw down options should be voluntary, with the flexibility to annauitize benefits at 55 yrs. Pillar 1 should provide for a compulsory, inflation linked life annuity, whereas Pillar 2, full flexibility in the choice of annuity type e.g. level, with profit etc.

and assume responsibility for their old age. The message to the public is, there is '*something for something*' the moral responsibility of the government towards the very poor having been discharged under Pillar 0.

3. **Pillar 2** – mandated contributions to say 15% of income, with an accompanying (but muted[16] and capped) tax incentive (EET) as a *quid-quo-pro* for having sacrificed short-term priorities in favour of the longer term. The objective is affordable breadth of coverage.
4. **Pillar 3** – rather than bluntly capping pillar 2 tax incentives, a transition to Pillar 3 (voluntary saving) can be made via a tax pre-paid incentive (TEE_t). Equitable design has to take cognizance of the fact that sufficient provision of retirement income cannot be determined on a 'one size fits all' basis. Depending on lifestyle, economic productivity after today's formal retirement age limits, and even age after retirement, varying levels of disposable income are needed. Individuals should be encouraged to save for the variable circumstances of their senior years. The economic growth South Africa is experiencing and the rapid improvement of many household circumstances can result in a substantial under estimation of savings needed for later years. There should therefore be a mechanism, beyond the basic broad coverage encouraged in the above pillars, to defer discretionary expenditure and even transpose short term saving into asset classes structured for the long term. Government has diminished obligation towards this category of saving and should therefore collect its tax on contributions up-front at the standard progressive rates. Accumulation should be tax free and depending upon policy issues associated with balancing the subsidization of long-term saving over short and medium term assets, set an exit tax rate. Good data for integration of these policy levers is essential and will be substantially enabled by the expanded data warehouse model discussed above.

The Validity of Tax Incentives

Academic opinion on the subject is divided. For the sake of brevity, we will not repeat the many opinions on the matter here as we know that National Treasury is well aware of them. We would, however, like to state that most countries use tax incentives to encourage pension saving as a means to focusing the public on the importance of saving for their unproductive years. The tax incentive provides, as it were, a substitute short-term benefit (in the EET model) for the long-term 'grudge purchase' of income security. The divided empirical evidence should be balanced by knowledge that this seems intuitively correct. At the very

[16] Precautionary savings tend to be less sensitive to changes in after-tax rates of return than life cycle savings (Bernheim, 2002, 1199). So, for example, the less precautionary the motive (Pillar 3), the greater the tax incentive should be in theory, albeit it an unpopular political choice.

least, tax incentives re-structure savings in favour of the long term[17].

Matching Tax Incentive Formats (Pillar 2 and 3)

Ageing populations with longer life spans has resulted in the adequacy of household savings for retirement becoming a major policy issue in developed countries. Successive reforms have reduced the generosity of public pension systems and to therefore balance the policy see-saw, so has the debate around individual retirement saving grown. These policy pressures are evident in South Africa too, as breadth of coverage has to be balanced with vertical equity in system design. Pillar 3 cannot therefore be simply “shrugged off”. In countries such as the United States, United Kingdom, Switzerland and the Netherlands that have either a long tradition or mandatory scheme, assets in retirement plans now equal 100% of GDP. European countries such as Germany, France and Italy, which still run generous public systems, have retirement assets below 10% of GDP[18].

We have discussed the policy choice of incentivising retirement saving on a EET basis versus TEE in a 2001 and 2005 submission to National Treasury. Essentially, the methods are the same when measured as a cost to the fiscus, if one assumes a discount rate equal to the investment return. The drawback of the TEE method is that individuals (world-wide) tend to be skeptical about government promises not to tax saving (at the decumulation or accumulation phases) at some point in the future. However, in a well integrated incentive model, this behavioural consideration is mitigated by the fact that there is horizontal equity in the incentive structure (everyone is allowed to participate in the EET benefit) between all savers and the risk of broken promises is worth accepting.

[17] Savings incentives have a stronger effect among lower-income savers whereas contributions by high-income households are more likely to represent portfolio shifts of existing savings. (Benjamin 2003).
[18] See, Fehr and Habermann, 2007, Individual Retirement Accounts, Self-control and Intergenerational Welfare, CEBR, University of Wuerzburg, at page 1.

Conclusion

We have tried above to focus on principles rather than detail and empirical limits. We trust that the December workshop will enable broad discussion, balanced by holding before us the three segments of society we mentioned at the outset: the lifetime poor, the informally employed and the formally employed. We have offered a view of what aspects of such a new landscape might look like. It is an attempt to paint a picture together, not provide a fixed position. We hope that the workshop in Magaliesburg will be less about fine detail, but rather about developing consensus on what the overall picture of a new social security and retirement system might look like, based on the initial work of the Department of Social Security and National Treasury. Once we have consensus on what the architecture looks like, it will be a much easier task to tweak details and model empirical consequences. Thereafter, we will simply be debating how best we compromise within fiscal and practical constraints to best achieve our joint vision.