SOCIAL SECURITY REFORM INPUT: JOINT FORUM WORKGROUP ON CONTRIBUTIONS

Version: 1.2

Please note this is a draft discussion document and is not a mandated position of the Joint Forum.

SCOPE AND PURPOSE

- The Joint Forum's objective is to gather the views for the industry across a number of different trade association players around Social Security Reform. These players are for example, Life Offices Association (LOA), Association of Collective Investment Schemes (ACI) and the Investment Managers Association of South Africa (IMASA).
- The Joint Forum has broken their Social Security Reform research into different work groups.
- This document is the output of the Contributions work group. It outlines thoughts and views from the industry on Social Security reform regarding contribution elements. The purpose of the document is to find common ground within the industry on shared positions and to identify problems requiring more discussion. Positions are not final.

Contents

Abbreviations

DC – Defined Contribution
DB – Defined Benefit
DSD – Department of Social Development
NT – National Treasury
NSF – National Social Security Fund

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EXECUTIVE SUMMARY

KEY POSITIONS

The Joint Forum supports the following key positions:

A. Support compulsory contributions

- Support the proposal of compulsory contributions
- Level of contribution of 15%, with a set minimum for savings (at least 10% but prefer 12%)
- The level of mandatory contributions to be set in conjunction with provisions for opting out
- Propose: SARS definition of income be used to establish earnings
- Propose: Explicit indexing of all rand-based contribution limits to inflation
- Propose: Increased voluntary contribution option for older ages

B. Compulsory earnings related contributions to National Social Security Fund (although we need consensus on compulsory for whom)

- All formal sector employees should contribute
- Self-employed also be included at outset
- Support household employees entry
- Propose: Eligibility for exemptions for foreigners temporarily residing here

C. Co-Contributions tax proposal

- Support a wage subsidy in concept but feel there are other mechanisms:
- Propose: A co-contribution mechanism to encourage participation and progressively deal with tax relief

D. Opt-out of NSF (for higher earners, e.g. more than R60 000) under certain conditions

KEY CONCERNS

The following requires consideration:

Coverage outside the formal sector: The current proposal of using SARS for collection suits the formally employed. We need to debate what happens for those outside the working and being taxed area. How the unemployed or informal sector will contribute is not clear. The system has to be attractive enough to them. DSD want everyone to benefit but they have not thought about how everyone contributes.

Risk benefit impact of individual cover: We believe there may be unintended impacts of diminishing coverage as we move to standardising a basic benefit for covering individuals. Currently, in practice, a working person often covers his family and parents with group life cover. We must ensure that the coverage breadth is not diluted to say just significantly higher cover on contributor with nothing else for the rest of the extended family, whereas before many received modest cover.

Capacity for collection at SARS: The need to get efficiencies in collection is clear. However, we do not want to threaten the golden goose in doing so. We need to ensure that SARS is given sufficient operating capacity to scale up to go from dealing with 4 million tax payers to the whole country of potentially 45 million or more contributors.

Administrative capacity: The success of the system, in particular if a voluntary component is attached to it, will depend to a large degree on the ability to administer the participants and benefits accurately. This relates not only to the collection of contributions, but also on the ease of participating in system, the reporting of the state of the individual funds and the ability to claim effectively. For example, the ability to settle a funeral claim quickly will have a large bearing on the extent to which people will be willing to replace their current private sector provision. The private sector may play an important role in facilitating the administration of these benefits.

Voluntary eligibility impacts on costs of contributions: An approach to blend voluntary entry by informal workers (or those paying no tax) alongside mandatory contributions by formally employed has potentially unintended impact on cost structures. Firstly, voluntary contributions may require a marketing / distribution strategy to overcome the inertia of people in taking control of their financial well-being. Marketing costs or allowance for incentives to people or advisors may need to be factored in. Secondly, contributions are collected at an individual level which is more costly than at a single paypoint within an organisation. Costing of these two groups will be very different (let alone the selection effects for risk benefits which will be markedly different). In thinking of eligibility for voluntary contribution, how to manage the very different cost structures or agreeing on the appropriate level of cross subsidy between these groups needs careful thought and more research.

ENVIRONMENT AND CONTEXT

This section does not intend to cover the whole structure, previous papers from NT and DSD but just to touch on core issues and trends that affect the contribution element:

South African specific issues

- **Poor preservation of retirement benefits**: The ability for people to encash their retirement benefits on change of employer weakens future retirement security. As the social security system is redeveloped it allows the opportunity for retirement benefits to be used – as they should be - for retirement and not as bridging finance. The proposal of compulsory preservation will change the retirement landscape and will allow for better consistent retirement planning.
- **Contribution flexibility required**: Many South Africans face irregular earning patterns due to high levels of unemployment and underemployment. Any design of the social security system has to allow for flexibility around the timing and allow for periods of low or no contributions. This has an impact on the complexity of administering the benefits and increases the need to have proper access to information on individual benefit levels.

International trends

- **Being SMarT. Emerging International best practice on DC**: Studies on the US Defined Contribution experiences, often in the form of their 401K plans, are emerging to avoid implementation pitfalls, better understand consumer choices and to enhance pension plan design. For a good review of the many behavioural factors that are leading to poor retirement decisions see Mitchell (2003).

  One of these key impacts is inertia, which affects opting in, the fund choices and initial contribution levels of investors. Other elements are conservatism around how these assets are invested. New techniques around optimising the contributions have emerged, such as Thaler and Benartzi's program called Save More Tomorrow (SMarT). For example, this program boosts savings rates and take-up by helping people overcome their savings inertia. Investors are encouraged to start small and commit to a future level of increases. These increases happen when they get pay raises so the impact on take-home pay is not felt.

These behavioural finance developments underpin the importance of program design to boost savings. It supports the call for auto-enrolment (which is what is being suggested with mandatory nature). It is essential that we acquaint ourselves with these new developments as we design the new South African system to build the most effective and sustainable savings system.

- **Managing the demographic risks such as living longer**: Around the world, changes in lifestyle (less smoking, health education), preventative medicine and medical technology breakthroughs are leading to substantially longer lifetimes for individuals. Today, of all the reasonably healthy, 65 year old women in the UK, it is expected that half will make the age of 90 and a quarter will make 96. Social security design needs to be robust enough to accommodate the impact of longevity. In addition, there should be more flexibility around retirement ages (as can be seen in rising retirement ages in Europe) and ability to contribute as long as possible. On the other side of the coin, the threat of HIV/AIDS has an adverse, inverse effect on life expectancies leading to an environment of two extremes.

- **DB and DC contribution level divergence**: In the UK as more firms are closing their DB programs, there is need to make higher employer contributions to the DB plan as opposed to the DC plan. This can lead to perceived inequities which require careful communication to the stakeholders. The DB contribution will depend on the current level of funding and the benefits structure. A DB/DC hybrid may not have, or be able to maintain, equal contributions as suggested in DSD papers.

POSITIONS

We have developed shared positions and outlined support for these positions. In some cases, we have provided alternative suggestions for stakeholders to consider in Social Security Reform.

MAPPING THE SOCIAL SECURITY STRUCTURE

It is instructive to outline what the future tiers of savings will be within the new social security structure. This will allow us to relate our recommendations on contributions.

Table 1: Savings Tiers

Tier	Benefit	Nature	Compulsory	Contribute?
0:	State Old Age Pension (SOAP)	DB	Yes	Non-contributory. Indirectly contribute through general taxes
1:	National Social Security Fund	DC	Yes	On earnings up to R60,000
2:	Private sector	Mostly DC	Yes, could be mandatory	R60,000 to infinity (or possibly a high limit)
3:	Discretionary	DC like	No. Voluntary	R0 to infinity

A. SUPPORT COMPULSORY CONTRIBUTIONS

- **Support the proposal of compulsory contributions**
  The Joint Forum supports the notion of mandatory contributions to the social security arrangement. This contributions should be earnings related and be framed as a percentage of earnings. This goes hand in hand with compulsory preservation to ensure that the leakage of the contributions is limited.

  The Joint Forum does not want to be prescriptive on specific limits and thresholds but require the stakeholders to take heed of the following principles:

  - **Sufficient scale in private sector**: There is a trade-off with the private sector in setting a high mandatory limit for diversion to the NSF. It means splitting the retirement capital between occupational schemes and the national fund. Too high a limit will carve too much out of existing funds which will make other portions (and the industry itself) sub-economic. This risk is obviously tempered if there is a provision for a portion of the contribution to be saved in private sector vehicles.
  - **In the net is better than out of the net**: The concern around the current uncapped tax relief on contributions must be tempered with the advantage of keeping the savings in the retirement net. By being in the net, these regulated savings become highly visible to the tax authorities; there is the oversight of prudential investment guidelines and exchange control. There are thus significant advantages to the country in having a reasonably substantial tax deductibility limit on contributions. What may need to change is the extent of the relief on these contributions. Ideas around this are provided later.

- **The level of mandatory contributions to be set in conjunction with provisions for opting out:**
  At what level contributions will be mandatory is a dimension which requires debate. Many are seeing this as just up to the Tier 1 level; however this could be extended to the Tier 2 level as well. This would ensure that people have significant social security benefits beyond the default level of the NSF. Other jurisdictions, like Australia, have had a successful experience of higher limits of mandatory contributions. To balance the loss of freedom regarding making these contributions, they have given citizens the “freedom of choice” as to where they can allocate these amounts.

  Higher mandatory limits would increase the universality of the system. Given the poor coverage in South Africa, we support the need to widen the retirement net. To prevent adverse impacts on the current private sector involvement in the retirement space, these higher contributions outside of Tier 1 would need to make use of Tier 2 private sector capacity. We recommend that higher mandatory limits be explored in conjunction with the provision of freedom of choice for individuals. Allowing them the ability to opt out to accredited administrators and investment managers with these higher prescribed contributions.

- **Level of contribution of 15%, with at least 10% minimum for savings (prefer 12%)**
  The Joint Forum supports the proposed 15% contribution level. This compares well with the current experience in the industry of an overall contribution rate of 15.2% with 11.3% in savings (As per Sanlam 2007 EB survey).

Table 2: Sanlam survey current level of contributions in SA

Key indicators

	2007	2006
Employer contributions	9.7	10.0
Death benefit premiums	(1.8)	(1.9)
Disability benefit premiums	(1.1)	(1.4)
Administration and operating costs	(1.0)	(1.2)
Retirement provision	5.8	5.5
Employee contributions	5.5	6.0
Total provision for retirement	11.3	11.5

Source: Sanlam Employee Benefits Survey 2007

This 15% excludes the further 2% of income payable to the National Unemployment Insurance scheme.

What we believe is critical, is not the level but how this money is allocated. We recommend the spread between risk and investment benefits is clarified upfront.

Contributions and investment growth drive the level of benefits. The Joint Forum supports the level of contribution that has been discussed but calls for a ring fencing of savings benefits by proposing a minimum allocation of the contribution of at least two thirds to building investment savings. We recommend 12% be allocated to savings (at least no less than 10%).

The social security reform is far reaching in that it is also looking to consolidate other current social security programs like unemployment insurance, occupational health compensation and road accident compensation. This is a very wide agenda of risk benefits. The pressing social needs of South Africa could result in a large claim on cost and quantum of risk benefits.

An equitable balance needs to be struck between risk benefits and retirement benefits. The sobering statistic, presented by the Actuarial Society of South Africa, that half of current 15 year olds will not live to 65 shows that death benefits cannot be ignored in the South African context. Likewise, the cross subsidies for those who reach retirement could be excessive if most of their savings have gone towards a common pool for risk benefits leaving them with weakened retirement security.

We propose that a minimum allocation of savings be entrenched as part of the design to give people confidence to contribute in the system. They would do this in the knowledge that sufficient proportion of their earnings will go into their retirement savings pot.

- **Propose: SARS definition of income be used to establish earnings**

The definition of income on which these mandatory contributions are to be established needs to be clear. There is a potential that latitude on the definition such as only on basic salary and ignoring bonuses, will lead to abuse in time by some to minimise these mandatory contributions and maximise take-home pay. We recommend that the SARS definition of income is used given SARS's experience in defining income. This will also standardise definitions around collection of other levies like the skills development levy or UIF contributions (that covers even household workers).

Some might say there is a downside in that an irregular pattern of contributions could complicate administration. This is spurious as the social security system should be able to handle people with irregular income (such as seasonal labourers and self employed consultants). This should be part of the design of the administration and reconciliation system.

- **Propose: Explicit indexing of all rand-based contribution limits to inflation**
  The enemy of retirement benefits is the loss of purchasing power parity. Contribution limits need to keep pace with inflation. We recommend that all rand-based limits be indexed explicitly to an appropriate inflation measure. This should be based on salary inflation if possible.

- **Propose: Increased voluntary contribution option for older ages**
  Since the retirement system in the past was leaky, we recommend that older people be given the opportunity to contribute more in order to catch-up. For example, we propose an optional higher contribution limit, of up to say 25%, be allowed for those 45 years and older. This could also take the form of a scale of different rates per advanced age band.

  The lack of preservation in South Africa is well noted. The mandatory contribution rate will be chosen to provide reasonable benefits on the assumption of an appropriate limit payable across people's lifetimes. Older people who have not had access to a retirement fund or who did not preserved benefits will have insufficient retirement capital. They will need the opportunity to make additional contributions to address the legacy issues and plug shortfalls.

  We recommend that this option be offered to all older South Africans to focus their minds on their retirement savings. This should be put in place irrespective of any transitional arrangements for such savers. Such as, no change in social security arrangements for those currently over the age 45.

B. Compulsory earnings related contributions to National Social Security Fund (although we need consensus on compulsory for whom)

The scope of who will pay these contributions needs to be determined. Previous papers have suggested encompassing all formal sector employees with household employees and the self-employed being phased in over time. In addition, thought must be applied to the scope of nationality for eligibility of benefits. We support the following:

- **All formal sector employees should contribute**
  The formally employed who are already tax paying and dealing with SARS would be easy to bring into a contributory system.
- **Self-employed also be included at outset**
  The government has highlighted the concern about a lack of universality of benefits. The formally employed have more access to retirement and group risk benefits. The self-employed group cannot be neglected.

There is a need to create an attraction for self-employed people to want to register and enrol in the system. This could be done by rethinking the tax benefits to reframe them as co-contributions by the government (See the next section, section C.)

In addition, smaller employers may be concerned about a potential increase in costs with the entry of this social security system. There is a risk that, coupled with concerns over labour legislation, any discrepancies in treatment will accelerate the practice of outsourcing and treating workers as contract employees. Ensuring that all South Africans contribute will minimise any arbitrage between sectors. Notable delays in bringing in the self-employed in increases the risk of changing employee contract status in the interim period.

- **Support Household employees entry**
  This group needs to be brought into the retirement net but often many are low income earners not paying tax. It may be opportune to explore other ways of collecting their contributions such as through the unemployment insurance system. This may require a delay incorporating these workers until the planned changes in unemployment insurance system occur and are aligned with the social security system. This would allow a total benefits package to be presented to these workers through a single collection vehicle.

- **Propose: Eligibility for exemptions for foreigners temporarily residing here**
  The Social Security system is there to provide South Africans with future certainty. The goal is to cast a wide net but in doing so there will be some who should not be in the net. Foreigners who come on a contract temporarily to this country will want to be exempted. They do not see the wisdom of saving 15% of their earnings for a retirement in South Africa when they do not intend to settle here. To prevent any barriers to attracting international skills, we recommend that treatment of how to handle such a group is considered.

  Aligned to this is the determination for eligibility of social security benefits. For example, are non-South African citizens who eligible for any benefits? Would this only be of they contributed? If so, what are the minimum contribution periods to be eligible for benefits? This is out of scope of this document but it needs some thought.

C. CO-CONTRIBUTIONS TAX PROPOSAL

- **Support a wage subsidy in concept but feel there are other mechanisms:**
  There is a need to gain acceptance with employers and the public with the new social security system. The proposed wage subsidy is one of these ways to ensure that labour costs are not seen to rise. This would be payable to employers to support the introduction. The disadvantage of this approach is that it helps big employers but not the self-employed or smaller entrepreneurs.

  We have not commented on the wage subsidy as we know that there are other plans being considered in this space. In the midst of this debate, we would like to propose another approach to reframe the contributions and to build the perception of value being added.

- **Propose: A co-contribution mechanism to encourage participation and progressively deal with tax relief**

Three concerns dog the current social security reform:

- Concern about widening the net and getting people to contribute to the system
- Concern about the introduction setting back job creation and the need to support employers
- Concern about tax incentives are skewed in relation to the need of the people. The rich get the tax breaks whilst there is less incentive for low income earners with their lower tax rates.

A mechanism that could address these issues is the formulation of the tax credit into a co-contribution by the government. By this we mean that the individual who is saving will get additional contributions from the State credited to his/her account. These credits could be skewed to be worth relatively more to the low income earners and less so for the wealthy.

There is already a precedent in South Africa for co-contributions by the State to bolster savings. The ACI have developed the Fundisa concept (see http://www.fundisa.org.za/) for saving for education where there is a partnership with government who will credit the learner's account.

Co-contributions are enabling for low income earners as they perceive they are directly receiving assistance. For example, the State is giving you R3 for every R1 you put in. There will be a demand to register to get access to this apparently "free money" that is co-contributed. This is obviously not free money but just the repackaging of the existing tax relief.

Exploring the incentivisation

Gross income (Rs)	**43,000**	**112,500**	**180,000**	**250,000**	**350,000**	**450,000**
2007/8 income tax	-	12,510	29,385	50,385	85,385	123,385
15% contributions	6,450	16,875	27,000	37,500	52,500	67,500
Marginal tax rate	0%	18%	25%	30%	35%	38%
Value of tax-break	-	3,038	6,750	11,250	18,375	25,650
Proposed relief rate	75%	65%	55%	45%	35%	25%
Value of tax-break	4,838	10,969	14,850	16,875	18,375	16,875

The full 15% contribution should be incentivised, and it makes sense to use tax-incentives where possible:

- Consider six individuals earning annual incomes of between R43,000 and R450,000 (See Table above).
- The required 15% total contribution works out at between R6,450 and R67,500 for each.
- For four of the individuals, contributions amount to less than their income tax, making a tax-incentive feasible.
- For the other two individuals, contributions amount to more than their income tax, requiring non-tax incentives.
- To avoid arbitrage, incentives should be consistent, whether implemented as tax-incentives or non-tax incentives.

So currently, tax incentives are skewed between participants. To provide more value at the low earning end, a reducing relief rate could be used. This would give less relief for high income earners but still provide them with tax incentives. The Fiscus's gains could then be redeployed to the lower income earners. In addition, these gains can be framed as additional co-contributions into their accounts.

- Consider again the six individuals earning annual incomes of between R43,000 and R450,000.
- Given their marginal tax rates, the value of their current tax-incentives ranges between nil and R25,650.
- Incentives can be made more equitable by implementing reducing tax relief rates on the 15% contributions.
- For example for the six individuals, relief rates could range from 75% (for low-incomes) to 25% (for high-incomes).

In more detail:

- For example, the individual earning R180,000 pays income tax of R29,385, less 55% of R27,000.
- This can easily be translated into a non-tax incentive, for example a co-contribution of 55% of R27,000.
- The marketing message is clear: government will contribute as much as R3 for every R1 you contribute
- The political message is also more palatable: the value of the government contribution is similar for rich and poor

Assessing the appropriate relief rates would need input from National Treasury and further modelling. Nevertheless, this proposal addresses the concerns identified at outset: it will encourage take-up, support low income earners and more appropriately focus tax incentives. The key is to not to remove the tax incentivisation but to dampen the level of relief for the high income earners to boost solidarity and equity.

D. Opt-out of NSF (for higher earners, e.g. more than R60 000) under certain conditions

These mechanics are covered by the private sector group but we stress that this is an essential element of a mandatory contributory system.

References

Actuarial Society of South Africa (August 2007) Social Security and Retirement Fund Reform Conference proceedings.

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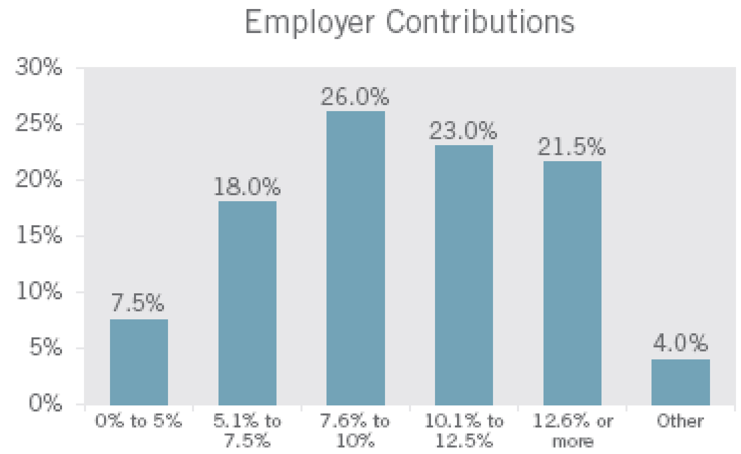
Sethi-Iyengar, Huberman Jaing (2004) How Much Choice is Too Much? Contributions to 401 (k) Retirement Plans, Chapter 5, Pension Design and Structure, July 2004, pp. 83-97(15), Oxford Scholarship Online Monographs.

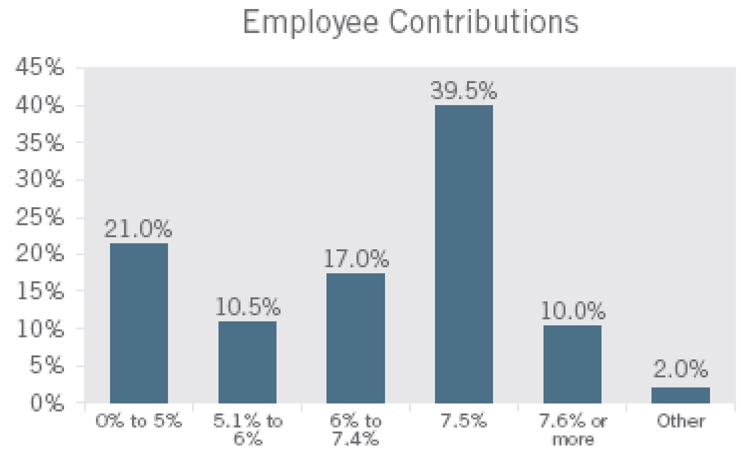
APPENDIX: CURRENT DC CONTRIBUTION RATES

The tables below give an indication of the spread of contribution rates for defined contribution funds. These include administration and risk benefits. The assessment of these average costs is split out in the table in the main document.

Table: Sanlam Employee Benefits Survey current level of contributions in SA
Defined Contribution data, 2007.



The average employer contribution is 9.67%. This is down from 9.95% in the 2006 survey.



The average employee contribution is 5.5%, down from 5.95% in 2006.

Source: Sanlam Employee Benefits Survey 2007