# OUTLINE OF A SOCIAL SECURITY AND RETIREMENT SAVINGS FRAMEWORK

DISCUSSION DOCUMENT FOR THE INTER-DEPARTMENTAL TASK TEAM ON SOCIAL SECURITY AND RETIREMENT REFORM
[Updated 29 November 2007, incorporating discussions from Basic Benefit Design Workshops on 8 November and 20 November 2007]

## 1. INTRODUCTION

This document summarises progress achieved to date in developing the key design features of a basic social security benefit and a supplementary retirement savings framework.

A proposed framework is outlined for consideration. While there is growing consensus on the key features of such a framework, there are some areas in which the intention of the framework design can be achieved through alternative design options. The options are outlined, but do not necessarily need to be finalised at this point as they are technical features that would benefit from further work and external consultation, while not detracting from the basic framework.

At a high level, the proposed social security and retirement savings framework consists of the following key elements:

**Social assistance** (non-contributory benefits)

- Paid for out of general revenue, aimed at alleviating poverty or providing temporary income support, including:
    - Social old age grant (SOAG)
    - Disability grant
    - Child support grant
    - Foster care grant.

**Social security** (statutory contributory arrangements)

- Funded from contributions, aimed at providing a basic level of income protection in the event of retirement, unemployment, injury, disability or death.
- Key elements:
    - Unemployment insurance
    - Disability and survivor benefits
    - Compensation for occupational injury and disease
    - Basic funded retirement benefit

**Mandatory supplementary retirement savings**

- Additional mandatory contributions to approved private retirement-funding arrangements, aimed at providing sufficient income replacement in old age.

**Voluntary savings and insurance arrangements**

- Additional voluntary contributions to an individual choice of private retirement-funding or insurance arrangements, aimed at providing top-up income replacement and income protection.

The remainder of this document focuses on the design of: (i) the social old age grant; (ii) social security arrangements, in particular the design of a National Social Security Fund (NSSF); and (iii) the mandatory supplementary retirement savings system.

## 2. SOCIAL OLD AGE GRANT (SOAG)

Currently the rand value of the SOAG is determined by a means test, subject to maximum amounts adjusted each year for inflation. The qualifying age for men is 65 and women 60.

Reform proposals with respect to the SOAG include:

- Making non-contributory old age support "universal" (through a combination of either a direct grant payment or providing an equivalent benefit through the tax structure), but clawed-back through the tax system.
- Reviewing the qualifying age – noting: (i) that while 65 is the norm for social security systems in developed countries, many developing countries with social security systems (and lower life expectancies) tend to have a lower qualifying age; and (ii) it is expected that the affordability of the SOAG will tend to be sustained due to offsetting demographic and employment trends, which means that a lower qualifying age may be affordable.
- Formalising the escalation of benefits by linking benefit increases to a specific index (likely to be a combination of CPIX and wage inflation). Given that a successful employment creation strategy may result in an overall decline in average real wages in the economy over time, a combination of wage indexation with a CPIX floor may be considered.

Issues requiring further work include:

- Quantification/modelling of applying an affluence test through the tax system
- Modelling the fiscal affordability of a lower qualifying age
- Proposals on an appropriate index to which to link the escalation of SOAG benefits.

## 3. SOCIAL SECURITY

### 3.1. UNEMPLOYMENT INSURANCE

Currently the Unemployment Insurance Fund provides short term unemployment insurance to all workers who qualify for unemployment related benefits, based on a history of contributions. The UIF currently provides for the payment of benefits to contributors or their dependants (if the contributor is deceased) in instances of unemployment, illness, maternity, adoption and death. The current contribution rate is 2% of earnings, split between 1% from the employer and 1% from the employee, up to an earnings ceiling of approximately R150,000 p.a..

Reform proposals with respect to the unemployment insurance include:

**Contributions:**

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| Contribution rate: | No finality as yet, depending on benefits to be offered. To be either funded through the NSSF contributions or through separate contributions. |

Earnings floor for contributions: None

Earnings ceiling for contributions: +/- R150,000 p.a.

**Benefit:**

Unemployment insurance: Along similar lines to current benefit determination, adjusted to take into account that certain auxiliary risk benefits currently provided for will in future be provided for through the NSSF.

Unemployment social assistance: Continued provision of a (lower) benefit after the unemployment insurance benefit is exhausted, linked to labour centre initiatives.

Further work required on:

- o Qualification criteria
- o Appropriate level of the unemployment social assistance benefit (possibly linked to 50-60% of a minimum wage)

Allowance to be made for ongoing death and disability cover (at a reduced rate) during a period of unemployment.

## 3.2 DISABILITY AND SURVIVOR BENEFITS

Currently there are fragmented arrangements to cover the risk of death and disability. Pension and provident funds make provision for these benefits for their members, at varying levels of cover. For those individuals who are not covered by a fund, or who are self-employed, risk cover is obtained on an individual basis, which may come at a high cost depending on age, health and income.

The design of a comprehensive social security system should be guided by the objective of providing reasonable income protection to prevent poverty due to death or disability of a breadwinner.

This suggests mandatory participation in a pooled risk benefit arrangement, to support social solidarity, proper risk-pooling and the provision of affordable benefits, especially for lower-income workers. It is proposed that these benefits be provided for through mandatory contributions to a National Social Security Fund (NSSF).

While the modelling work in this area has yet to be completed, key features are likely to include the following:

**Contributions:**

Contribution rate: No finality as yet. This will ultimately depend on what risk benefits are to be funded. Initial estimates suggest that funding death and disability benefits will require contributions equal to about 4% of earnings.

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| Earnings floor for contributions: | None |
| Earnings ceiling for contributions: | Aligned with UIF ceiling going forward - in the region of R150,000 p.a.<br><br>It is suggested that this is an approximate level that will result in an earnings-related benefit that will provide protection against poverty. |

**Benefit:**

Death:

No finality as yet

- Option 1: Lump sum (e.g. 3 x annual income)
- Option 2: Annuity income (e.g. 50% of annual salary)
- Annuity income benefits (until maturity) are particularly suited to case of dependant children, but it is not clear what the annuity term should be in the case of a spouse (until retirement or lifetime annuity?).
- Death benefits may need to vary depending on the number of minor dependants (i.e. ensuring a minimum benefit for minor dependants so as to avoid absolute poverty).
- Annuity benefits are better suited to providing income security, but are administratively more complex and more costly.
- Accumulated retirement benefits will be used to offset the risk benefit.
- Death benefits paid only to active contributors. Requires consideration of flexibility in terms of missed contributions.
- The need to impose a waiting period to reduce the risk of anti-selection needs to be assessed (and the need to distinguish between legitimate late-joiners and free-riders). It may be that mandatory contributions reduce the risk of anti-selection, thereby making a waiting period unnecessary.
- An appropriate balance between equity and efficiency in beneficiary identification needs to be developed.

Disability:

No finality as yet.

- Annuity income – set at a level that does not incentivise false claims through voluntary unemployment (e.g. 50% of annual salary).
- A consistent, tight definition of disability is critical.
- Requires consideration of mechanisms to manage the prevalence of disability claims.
- Should cater for continued contributions to funding of death and retirement benefits.

**Possibility of exempted funds:**

The approach of no individual or group opt-out – and hence mandatory contribution to the funding of basic risk benefits through the NSSF – is most supportive of true social solidarity, proper risk-pooling and the provision of affordable benefits for lower-income workers not currently covered by existing schemes.

However, the following concerns have been raised about a centralised fund:

- It may not be supportive of cost efficiencies (economies of scale may be limited above a certain size, due to administrative complexities);
- It would undermine the flexibility, customisation and democratic oversight that is possible through employer, union or industry risk benefit structures;
- It would be disruptive of existing arrangements and undermine system diversification;
- Abandoning the link between employer, union or industry group contributions and claims experience would undermine the incentives for groups to provide disability and HIV management programs; and
- The cost of cover in a national fund is likely to be considerably higher than those found in most existing group schemes because of the extension of coverage to lower income individuals, which group tends to have higher mortality rates.

Consideration needs to be given to achieving the equity objectives of mandatory risk-pooling, while finding ways to address the efficiency concerns highlighted above – including the possibility of allowing certain approved funds to be exempt from contributing to NSSF risk benefits, provided that there is a mechanism for risk equalisation if there is a substantial difference in risk profiles across exempt funds and the NSSF.

## 3.3 BASIC FUNDED RETIREMENT BENEFIT

Currently retirement savings arrangements are fragmented. A large proportion of the formally-employed contribute to pension and provident funds, but contribution rates vary and coverage rates decline for lower income levels. The costs of private retirement funding arrangements, especially for low income workers and members of smaller funds, have been found to be unacceptably high.

The key reform proposal entails mandatory contribution towards funding a basic retirement benefit that is designed to ensure a minimum level of income protection in old age over and above the SOAG. A high degree of benefit assurance is important, given the income protection objective. This suggests mandatory participation in a pooled retirement benefit arrangement provided by a National Social Security Fund (NSSF).

In designing a system to ensure reasonable income protection in old age, the following objectives are considered key:

1. **Adequate income replacement rates:**
    - International standards suggest a target replacement ratio of at least 40%
    - This suggests a contribution rate of around 10-12% of earnings towards funding of retirement benefits, although replacement rates will vary depending on length of contribution and growth of earnings.
    - Lower-income individuals can expect to achieve a higher replacement ratio, through the combination of contributory savings and a basic pension provided by the SOAG. This helps to prevent absolute levels of poverty in old age.

**2. Redistribution:**

- This reflects the extent to which the ratio of retirement benefits to retirement funding contributions is higher for lower-income individuals than higher-income individuals (which will generally result in higher replacement rates for lower-income individuals than those of higher-income individuals)
- Redistribution in the proposed framework is achieved through:
  - The non-contributory SOAG
  - The contribution subsidy framework

**3. Risk sharing:**

- This reflects the extent to which investment and longevity risk are shared between individual members and government. A well-designed system should diversify the risk rather than expose either member or government to excessive risk, at reasonable cost.
- A number of variations are possible that share risks between individuals and government, but a hybrid approach that combines a mix of defined benefit (DB) and defined contribution (DC) elements in the overall system design is favoured.

The key proposed features of the NSSF basic retirement benefit include:

**Contributions:**

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| Qualifying criteria: | Further work is required on:<br>o Qualifying age (both lower and upper bounds)<br>o Qualifying work categories |
| Contribution rate: | In the order of 10-12% of pre-tax earnings. |
| Qualifying earnings: | The definition of qualifying earnings requires further work and careful consideration. While using the same definition as is used for income tax purposes will ease consistency, there is an argument that social security contributions should be based on core earnings. |
| Earnings floor for contributions: | Option 1: No earnings floor (i.e. contributions equal to 10-12% of all earnings)<br><br>Option 2: Contributions based on earnings above a floor, such as R12,000 p.a. (i.e. contributions equal to 10-12% of the amount earned above R12,000 p.a.). The contribution floor may usefully be linked to a minimum wage.<br><br>This issue is related to the design of a contribution subsidy framework. Option 1 must be coupled with significant subsidisation of contributions by low-income workers, to avoid a negative impact on take-home pay for low-income workers. |

The disadvantage of Option 1 is that it results (in combination with the SOAG) in very high replacement rates for low-income individuals and a skewed subsidy curve.

The benefits of Option 1 are that it allows for significantly improved prospects of wealth accumulation for low-income workers and (if linked to at least a partial lump sum benefit) potential inter-generational wealth transfer in low-income families. A fully proportional contribution is also consistent with practice among current retirement funding arrangements and UIF contributions.

Consideration needs to be given to:
(i) the extent to which the level of subsidisation implicit in Option 1 is an appropriate form of support for wealth accumulation; and
(ii) the extent to which, even though subsidised, the level of contribution implicit in Option 1 is likely to lead to resistance from low-income individuals if perceived as income foregone; and if compulsory preservation of the accumulated contributions is perceived as denying access to individual wealth.

This issue is inter-connected with considerations regarding the definition of qualifying income. The definition of qualifying income may be such that it does not necessitate putting in place a contribution floor.

Earnings ceiling for contributions: R75,000 p.a. (linked to 50% of the UIF contribution ceiling); with the (default) option of continuing to contribute to the NSSF basic benefit up to a higher earnings ceiling of R150,000 p.a. (linked to UIF ceiling).

Further work is required in terms of estimating the impact on the flow of contributions to various parts of the retirement funding system. The guiding principles in finalising the contribution ceiling are risk diversification in terms of:

- Appropriate system diversification (i.e. not creating systemic risk by placing too great a proportion of retirement savings assets in one central fund);
- An appropriate limit on the level of underwriting risk carried by government (i.e. government should aim to provide a high level of assurance of a basic retirement benefit (however defined); but underwriting benefits beyond this point would create excessive fiscal risk); and
- Avoiding significant transition risk (i.e. the public policy focus is to provide an assured basic benefit; public provision beyond this point runs

the risk of introducing a high level of transition risk in terms of industry restructuring, without a clear public policy rationale).

Estimates of the impact of various contribution ceiling scenarios will also be influenced by decisions on exemption of certain qualifying funds, discussed below.

**Benefit determination:**

Option 1:

A pure DB scheme: benefit defined as an accrual based on average lifetime earnings (subject to mechanisms for automatic adjustments to retirement age and benefit levels, depending on demographic and economic changes). [Issues to be considered include whether a single-life or joint-life annuity is provided – and modelling of the corresponding accrual rate]

Option 2:

A DB scheme based on an indexed minimum benefit with a potential smoothed bonus based on market performance:

- Provides a guaranteed minimum benefit, which is equal to contributions multiplied by an index-linked factor equal to either: (i) price inflation plus 2 or 3%; or (ii) wage inflation; or (iii) a combination of price and wage inflation.
- Allows scope for potential up-side investment returns, by applying smoothed bonuses based on a rolling average of market performance.
- On retirement, accumulated contributions and investment return are converted into an annuity based on government-determined annuity rates (to provide individual protection from market and longevity risk at the point of annuitisation), using a standard community rate (i.e. equal annuity rates for men and women).

Considerations:

- There is a trade-off between the higher degree of benefit certainty contained in Option 1 and the provision that is implicit in Option 2 for NSSF members to share in the potential up-side of higher economic growth.
- The ability for Option 1 to be run as a funded system has been questioned. If returns on invested funds exceed the defined benefit, then there will be pressure to payout the excess through higher pensions. This is catered for in Option 2 by explicitly allowing for a smoothed bonus system where returns on invested funds consistently exceed the guaranteed minimum benefit. For Option 1, the alternative is for government to release the excess

to the fiscus, but the justification for this may be difficult to communicate.

- Option 1 could be run on a PAYG basis, but this raises issues of perceived political risk and perceptions that the system is a social security *tax*, rather than a *contribution* funding future benefits.
- In Option 2, contributors have a greater interest in the performance of the fund, as it impacts directly on their retirement benefit. This may strengthen the NSSF governance framework, over and above the necessary conditions of strong accountability and sound governance structures.

The advantages and disadvantages of the options require further development and consideration.

**Form of benefit:**

Lump sum:

Limited to an absolute Rand amount (the lump sum allows for inter-generational wealth transfer in low-income families), subject to accumulated benefits providing at least a minimum level of income in old age. (Alternatively, a lower limit on lump sum cash benefits, with the balance invested in an income draw down product)

Annuity:

Annuity provided according to DB formula or according to a government-determined annuity rate (using a standard community rate).
[Consideration must be given to accrued rights being preserved for former spouses (clean break principle) and widows (joint-life annuities)]

**Exempt funds:**

Consideration is being given to exempting members of large occupational and bargaining council funds from contributing to the NSSF basic retirement benefit.

Conditions:

- Cost efficiency (likely to be linked to funds being of sufficient size to generate scale economies).
- Closed-funds only – i.e. large occupational and bargaining council funds (open-funds are excluded from qualifying as exempt funds as they create the risk of anti-selection through individual opt-out)
- Minimum benefit guarantees.
- Minimum governance standards.
- Exemption on application (with periodic renewal), based on objective criteria, subject to review.
- On retirement, the accumulated benefit (up to a ceiling) transferred to the NSSF for conversion into an annuity based on government-determined annuity

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| | rates (to provide protection from market and longevity risk). |
| Benefits of exemption: | - System diversification.<br>- Reduced disruption to existing large and relatively efficient arrangements.<br>- Avoids complications of transfers from existing large DB funds. |
| Downsides of exemption: | - Added complexity of system design<br>- Loss of scale in the central fund<br>- The potential for minor difficulties or major failure of government-endorsed arrangements.<br>- Raises the stakes for private-sector entities seeking to gain access to a few very large funds, because the middle-and lower-market is removed. |

## 4. MANDATORY SUPPLEMENTARY RETIREMENT SAVINGS

This entails mandatory contribution, over and above the earnings ceiling applied for contributions to the basic funded retirement benefit, to an approved private retirement-funding arrangement (referred to as an accredited retirement institution (ARI), but this could include both retirement funds and retirement savings product providers).

This is designed to ensure an adequate income replacement ratio in old age across a reasonable income range. Absolute benefit assurance is less important, suggesting that individual choice should be offered to individuals wishing to pursue the potential of higher market returns in an individual DC account.

**Contributions:**

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| Contribution rate: | 10-12% of earnings that fall between the earnings floor and the earnings ceiling |
| Earnings floor for contributions: | Earnings above the basic retirement benefit ceiling (i.e. 10-12% of the amount by which earnings exceed R75,000 p.a.) |
| Earnings ceiling for contributions: | To be finalised. In the range of R700,000–R1 million p.a., based on the approximate level above which there ceases to be a public policy priority in ensuring a continued replacement ratio of at least 40%. |

**Form of benefit:**

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| Lump sum: | Limited to about one third of accumulated benefit on retirement (consistent with current practice). [Alternatively, a lower limit with the balance in the form of an income draw down product] |
| Annuity: | Purchased from an accredited private provider. |

Consideration needs to be given to ensuring efficiency and cost-effectiveness in the private annuity market.

**Provider choice:**

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| ARI qualifying criteria: | - Sufficient size to generate scale economies.<br>- Governance, conduct and product standards.<br>- Can take the form of an industry fund or mutual pension fund (open fund). |
| Benefits of choice: | - System diversification<br>- Individual flexibility |
| Downsides of choice: | - Loss of scale in the central fund (not significant)<br>- Potentially higher costs than in the central fund<br>- Must establish stronger regulatory framework & skills<br>- Potential for governance failure |

**Default provider:**

Consideration needs to be given to the default option in the event of an individual not making an election. The default option could either be the NSSF (in a DC individual account), or could, as is done in some countries, be allocated depending on the lowest-cost ARI provider at that point in time.

## 5. COMBINED CONTRIBUTION FRAMEWORK

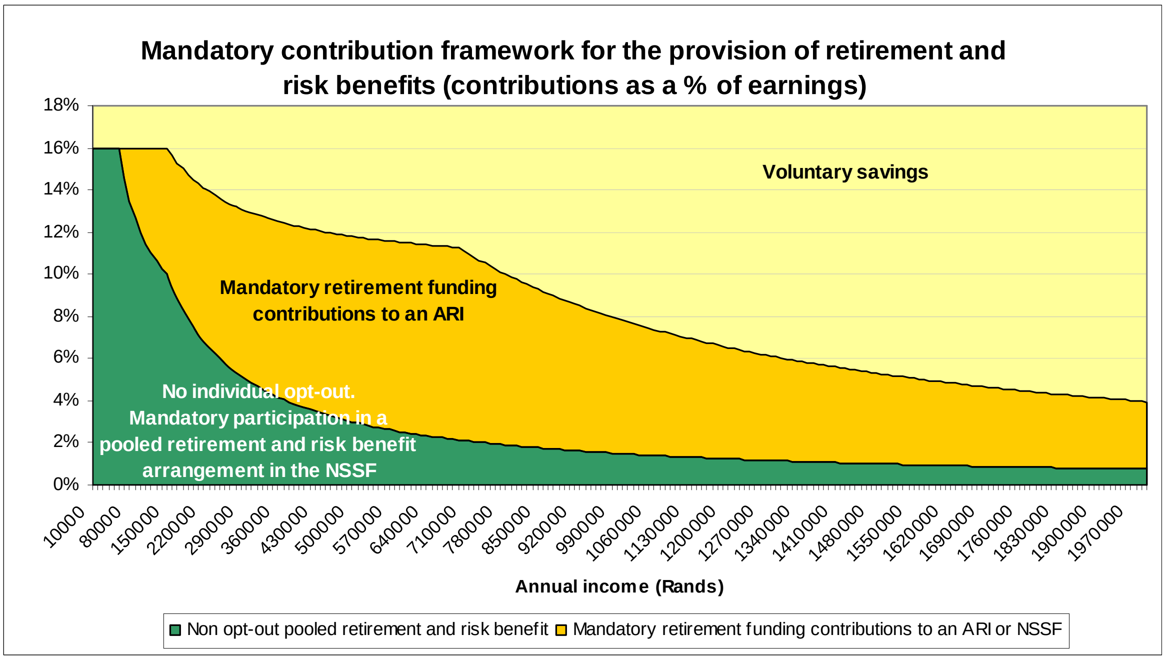
An illustration of a contribution framework for social insurance and retirement funding, by income level, (based on certain assumptions) is illustrated in Figure 1 below.

It is estimated, based on initial calculations of the contribution rate necessary to fund basic death, disability and unemployment benefits (assuming unemployment benefits are provided within the NSSF), that the total contribution rate will have to be in the region of 16% of earnings, up to an earnings ceiling of R150,000 p.a.. With the possible exception of members of exempted funds, these contributions will be channelled completely to the funding of pooled basic retirement and risk benefits in the NSSF up to R75,000 p.a., so as to provide additional protection against poverty in old age and in the event of death, disability or unemployment of a breadwinner. Above R75,000, an individual may choose to channel retirement funding contributions to an ARI, while contributions to the funding of pooled risk-benefits in the NSSF continue up to the ceiling of R150,000.

Additional mandatory contributions to the funding of retirement benefits, in an ARI, at a rate of 10-12% of earnings, are required up to a second earnings ceiling (assumed to be R700,000 p.a. in this illustration). Above this point, retirement saving is voluntary.

Figure 1 illustrates the system diversification achieved between contributions to the NSSF, ARIs and voluntary savings.

**Figure 1:**




## 6. AREAS REQUIRING FURTHER CONSIDERATION

In addition to the options and issues raised in the outline above, consideration needs to be given to expanding the basic framework to include the following issues:

- The possibility of tying the contribution floor to the introduction of a minimum wage. The minimum wage could also be used as a benchmark against which to assess the appropriate level of other amounts/ceilings, e.g. the social old age grant, the unemployment social assistance grant; the minimum level of income benefits in retirement.

- The possibility of introducing medical scheme contribution protection, through a mandatory levy on medical scheme contributions, which are channelled to the NSSF. Given the current voluntary nature of medical scheme contributions, this would require measures to address anti-selection, such as an extended waiting period.

- Trade-offs of introducing a lower retirement age in the NSSF – namely assessing whether the lower cost of risk benefits that this implies then supports a longer annuity period.

- Funding options – i.e. the degree to which a PAYG element is introduced over and above the unfunded SOAG. Specifically: (i) the feasibility of a PAYG DB basic funded retirement benefit; or (ii) the possibility of partial funding if the government subsidy in a funded system is in the form of a notional (accounting) credit to an individual's NSSF account (creating an explicit government liability) rather than a cash credit (i.e. a government expenditure). These issues require consideration also within a broader fiscal policy framework.