Pension reform proposals

11 October 2003

Welfare reform

- Commission set up on 21st June 1999
- Commission prepared two drafts latest June 2001
- First Chairman resigned and new Chairman appointed
- Preliminary Draft Proposal for consideration by Commission is being presented today
- Draft Proposal is still subject to updating of Prost model (World Bank model)

Welfare reform

- World Bank has been contacted to assist with the Model and interpretation of results
- Latest statistical data for CIR, NSO and SS has been collected
- Data is being configured in the Prost Model and baseline scenarios are expected to be available within one week
- World Bank representative visited Malta and is due back in November 2003

Welfare Reform

- Preliminary Proposal deals with Pensions and Health Care
- No increase in present level of contributions for most employees
- $^{2}/_{3}$ pension to be retained
- Health care is a social benefit and should not be borne exclusively by employees / employer
- Retirement pensions should not be funded by Government
- Funding for National Health and Pension should be split into two separate contributions

The problem

As we live longer and healthier lives, we need to save more or work longer so that we can make the most of our retirement.

- The ratio of the working age population to persons aged 62 and over is projected to change from 4 : 1 in 2001 to 2.3 : 1 in 2025.
- The declining balance between contributors and beneficiaries will increase the welfare gap.
- NI contributions currently finance a range of benefits other than retirement pensions. These include the financing of the national health service which is a benefit offered to the entire population, and not just to employees and employers.
- The rate of growth of average employment incomes outstrips the growth in the maximum pensionable income. Over the longer term, the replacement of income by the maximum pension for higher-income earners will imply a transition to relative poverty.

Unbundling Social Security

Benefits have been divided into:

- Pension-related
- Health service related
- Other benefits

	2003	2002	2001	Average	Average (Lm '000)		
	Lm'000	Lm'000	Lm'000	Lm'000	Pensions	Other benefits	NHS
Sources of Funds							
Income in respect of Contributory Benefits	199,000	193,400	179,065	190,488	123,817		66,671
Application of Funds							
Contributory Benefits							
Retirement pensions	(86,704)	(84,000)	(78,467)	(83,057)	(83,057)		
Children's Allowance	(14,250)	(14,100)	(15,851)	(14,734)		(14,734)	
Bonus	(9,800)	(9,800)	(9,945)	(9,848)		(9,848)	
Other Benefits	(47,000)	(46,500)	(45,038)	(46,179)	(46,179)		
	(157,754)	(154,400)	(149,301)	(153,818)	(129,236)	(24,582)	-
Administration expenses	(2,643)	(2,674)	(2,518)	(2,612)	(1,430)	(273)	(909)
Health Recurrent Services expenses	(86,567)	(83,113)	(76,742)	(82,141)			(82,141)
	(246,964)	(240,187)	(228,561)	(238,571)	(130,666)	(24,855)	(83,050)
Welfare Gap	(47,964)	(46,787)	(49,496)	(48,083)	(6,849)	(24,855)	(16,379)

Who should contribute?

- Currently paid by the employee, by the employer, and by the State.
- Retirement pensions and other pension-related benefits relate solely to an individual's income earned on retirement.
- We consequently propose that pension contributions should not entail any funding from the State.
- Non-pension contributory benefits (i.e. children's allowances and bonuses) are unrelated to employees' contributions in respect of their own retirement.
- Such expenditure should be deemed non-contributory and financed exclusively through taxation.

Financing health expenditure

The national health service should be financed separately from the pensions framework

- Tri-partite contribution, by the Contributor, Employer, and Government
- Contributor:
  - employees 2% of gross salary, capped at Lm200 p.a.
  - Self-employed 3% capped at Lm300 p.a. with minimum Lm135 p.a.
- Employer – 2% of gross salary, capped at Lm200 p.a.
- Government – 4% of gross salary, capped at Lm400 p.a.
- Government to fund any excess of expenditure over contributions.

Health contribution

We propose that:

- Employers' contributions should be tax deductible;
- All or part of employees' / self-employed persons' expenditure on private health insurance schemes should be tax deductible (capped at value of health contribution);
- Government could implement measures to restrain the escalating cost of health services, or to recover part of such cost;
- Possibly implement measures to tax the value of free medicines at a reduced rate – excluding pensioners, disabled, and residents in homes;
- Possible exceptions:
  - Part-time employees whose spouse holds full-time employment
  - Persons registering for work with ETC, during the first year of registration, who would subsequently contribute at a reduced rate.

Health contribution

- Government may opt to bill an amount (limited to, say, Lm200) to individuals not contributing to the scheme and benefiting from hospitalisation (unless such individuals are specifically exempt under Social Security regulations);

- Individuals of working age who are not in employment but in receipt of income exceeding the minimum wage could be included in the health contribution scheme;

- Revision of the hospitalisation tariffs applicable to non-resident expatriates

- The increase of taxation on alcohol and tobacco products;

- Increased enforcement of no smoking regulations in public places.

Retirement pension

Based on a fixed contribution multi-tier actuarialised system

- Tier 1 – guaranteed minimum pension – $^{2}/_{3}$ of national minimum wage

- Tier 2 – incremental pension up to $^{2}/_{3}$ of max. pensionable income or $^{2}/_{3}$ of average incomes in the last 10 years before retirement.

- Tier 3 – optional contributions to schemes / products of the contributor's choice

Tier 1 may eliminate ad hoc adjustments and top-ups within the Social Security system.

Grandfather conditions applicable to certain public sector employees (pre-

Tier 3 pension instruments

Replacement ratio is currently a problem

- A 30-year old employee now earning Lm6,000 p.a. can retire in 2034 with nominal income of Lm17,400 (assuming a 3.5% average annual income growth)
- The maximum pension in 2034 is projected at Lm7,100 (assuming a 2.5% average annual inflation rate)
- The projected replacement ratio on retirement is of 41%.

Tier 3 is an alternative savings mechanism

Tier 3 instruments can be eligible for fiscal incentives through accreditation.

A possible contribution framework

Estimates of approximate contributions:

- Employee and employer — 8% of income from each of employee and employer
- Self-employed — 12% of income
- Increased enforcement on collection function is necessary

Pensionable period to be extended to 35 years

Pension indexation to be linked to an inflation index

Estimates need to be confirmed by World Bank actuarialised calculations

Female contributors

Frequently cannot accumulate sufficient contributions:

- Contributor may be allowed to assign her accumulated pension contributions to another account
- Introducing schemes whereby Government would credit missing contributions during a restricted period of absence (e.g. 2 years) from the labour market

Financing retirement pensions

- Revised pension system could be set up as:
  - PAYG
  - Funded scheme
- Funded scheme:
  - Major advantage: Contributors have the comfort that their contributions are backed by underlying assets, and are not dependent on a generational contract
  - Major disadvantage: Scheme requires initial funding and transition cost may be significant.

Retirement age

- Female retirement age to increase to 61 in 2004
- Retirement age to increase to 65 in 1-year steps, once in every 4-year period
- Implementation options:
  - Mandatory for all persons currently of working age
  - Mandatory for all persons up to 44 years old, with persons aged 45 and over retaining the right to choose a variable retirement age between 61 and maximum retirement age.
- Early retirement schemes may need to be curtailed, or at least, provisions may need to be made for shortfalls in early retirees' pension accounts to be funded on application of early retirement policies
- Removal of income restrictions currently applicable to pensioners

Impact assessment

Contributors

- Value of contributions: Contributors would be contributing annual amounts in essence equivalent to the level of contributions under the current system, except for contributions in respect of individuals in the higher income brackets.

- Retirement age: Contributors below the stipulated cut-off age would be retiring at age 65. It may be argued that in the younger age brackets, individuals may be less sensitive to an extension of the duration of their working life, and this may even be welcomed by some individuals.

- Fiscal incentives: Contributors might be incentivised to increase their savings rate (in the form of tier 3 pension schemes), hence improving their eventual replacement ratio.

Impact assessment

Employers and self-employed persons

- Value of contributions: The contribution impact on employers and self-employed persons would essentially be equivalent to that applicable to employed contributors. This could imply an adverse financial impact in the case of employers of individuals in the higher income brackets.

- Retirement age: Employers might welcome the opportunity to retain the services of key employees beyond the currently-mandated retirement age, and as the demographic profile changes in future years, this amendment may avert, at least in part, labour shortages driven by the contracting working age population.

Impact assessment

Pensioners

- In the case of existing pensioners, the generational contract would be sustained.

- The removal of the income restrictions currently applicable to pensioners could possibly have a favourable impact, in that it could provide an incentive to individuals to engage in economic activity after their retirement, or alternatively could enable individuals to regularise their position.

Impact assessment

Government

- Government as an employer will be impacted to the same extent as other employers, depending on the mix of remuneration levels among public service employees.
- The impact on public finances may be expected to include:
  - Savings arising from the elimination of Government's current contributions to the NI system (approx Lm66 million in 2003);
  - Increased fiscal revenue (unquantified) arising from income in the years corresponding to individuals' extended working life period;
  - Increased fiscal revenue (unquantified) arising from taxable income earned by pensioners opting to retain post-retirement economic activity;
  - The full cost of childrens' allowances and bonuses (approximately Lm24 million in 2003);
  - An amount, estimated at approximately Lm48.0 million (for 2001), equivalent to Government's contribution towards the financing of the national health service;
- Fiscal leakages (unquantified) resulting from fiscal incentives;
- The net outcome of these factors should be considered in the light of the current welfare gap (approximately Lm48 million) which is a burden on public finances.

Outstanding work

- World Bank computation of actuarial calculations.
- Updating and revision of existing World Bank model to simulate the impact of these measures.

This work will be carried out during Oct / Nov 2003.

- A reformed pension system should still be reviewed periodically, say, every five years.

Thank you