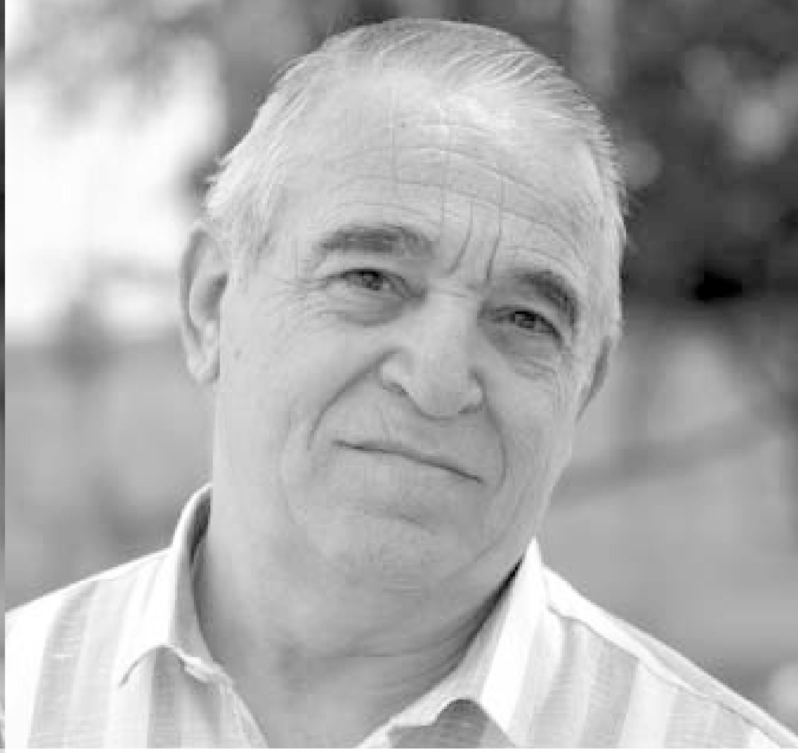
PENSIONS
ADEQUATE & SUSTAINABLE

WHITE PAPER - NOVEMBER 2004



"Our citizens, and future generations in particular, deserve no less"

Foreword

On 1st June 2004 government tasked the Cabinet Committees' Support Unit to head a Pensions Working Group to review work carried out to date on pensions and to submit recommendations on the way forward. This Pensions Working Group presented its report to Government on 5th November 2004.

On behalf of Government, I am pleased to present this Report as a White Paper for national discussion and consultation. It presents the challenges that our Nation is expected to face in terms of ensuring an adequate and sustainable pensions system - as well as the way forward to attain such adequacy and sustainability.

The issue of sustainability and adequacy of our pensions system is a real one. The anticipated dramatic shifts in the demographic structure of our Nation alone demand, as is the case in many other nations, that we look at our pensions system **today**.

Short-term political games would, perhaps, dictate that we should avoid the pensions issue altogether. No doubt, as discussions at the National Commission for Welfare Reform and the Malta Council for Economic and Social Development have shown, pension reform and the solutions for consideration generate passionate and heartfelt debate. It has always been the Government's desire to reach a consensual agreement with the social partners at both the Council and the National Commission. The fact that this was not possible highlights, in no uncertain manner, the complexity of the issues that must be assessed and decided upon. The temptation to avoid change is attractive.

Yet, a position of reinforcing the status quo, is socially irresponsible. My Government will not shy away from its **social responsibilities**; our job is not only to govern the present but also to ensure that the future that we bequeath to forthcoming generations is better than the one we enjoy today.

The recommendations presented in this White Paper, whether as statements of principle or as specific recommendations as the case may be, are guided by a Value System that seeks to secure on the one hand **adequacy** – that is the protection against social exclusion and the guarantee of a decent standard of living upon retirement – with **sustainability** – that is ensuring the financial continuity of the social promise to secure the provision of adequate pensions.

My Government recognises that whilst the process of reform of the pensions system must be holistic, the implementation of measures that will be adopted following the consultation and discussion process needs to be incremental to ensure a smooth transition from the current pensions system to the new one.

The recommendations being put forward for a new pensions system are not immutable. Decisions will only be taken following the assessment of feedback received from the national discussion and consultation process that this White Paper seeks to generate from all sectors of our society. We seek an open discussion on the reform of the pensions system to allow us to design the most appropriate pensions system for Malta.

Our citizens, and future generations in particular, deserve no less.

Lawrence Gonzi
Prime Minister

The National Consultation and Discussion Process

Given the importance of an adequate and sustainable pensions system to both the Nation's social fabric and its economic wealth Government seeks to hear the views of individuals, social partners and other interested parties.

In presenting such views it would be helpful if individuals, social partners and interested parties would:

(i) Identify areas where they believe that the Pensions Working Group may have overlooked relevant information and issues.

(ii) Show where they agree with the statements and recommendations made.

(iii) Submit proposals as appropriate.

In order to render the consultation and discussion process comprehensive the Government wishes to receive such views in writing by the end of **March 2005**.

The written responses are to be sent to the:

Chairperson
The Pensions Working Group
Cabinet Committees' Support Unit
Office of the Prime Minister
Auberge de Castille, Valletta

or

electronic address: pensions@gov.mt

or

Web Site: www.pensions.gov.mt

An analysis of the written responses received will be published following the consultation and discussion process.

Electronic copies of the White Paper together with the appendices can be downloaded from the Web Site: www.pensions.gov.mt.

Executive Summary

The pensions system in Malta, unless reformed, will be challenged to provide adequate pension benefits for future generations in a sustainable manner. A review of the demographic structure of the Maltese Islands shows that by 2050 the population will fall, the 60 years of age and above cohort will increase exponentially in relation to other age groups, and life expectancy of the same cohort will also increase. On the other hand live births have been decreasing steadily since the post war period.

The current Pay As You Go pensions system is directly tied to a nation's demographic structure. The Pay As You Go pensions system is premised on the principle that today's workers will pay for today's pensioners, particularly so in Malta's case given that the Two-Thirds pension introduced in 1979 is yet to mature, and that tomorrow's worker's will pay for the pensions of today's workers. The mathematics of the Pay As You Go pensions system, as has been noted with increasing concern overseas, unravels when the main variable in the equation, that is the labour stock, is clearly seen that it will not perform as predicted.

The challenge is also compounded by the fact that a perception exists in Malta that the provision of a pension is solely the State's responsibility. This perception has induced individual behaviour to take comfort with the fact that the payment of one's individual social security contribution will suffice to render an adequate pension in the future. To a large extent the concept of 'self-help' through saving for retirement has not taken root in Malta.

In the course of preparing this report, the studies commissioned by successive Governments were reviewed: the Camilleri Report (December 1997), the Watson Wyatt Report (August 1998), the National Commission for Welfare Reform Galdes (June 2001) and the Schembri (October 2003) Reports, and the World Bank Report (March 2004). All are consistent in their conclusions. The current pensions system is not sustainable. Benefits will not be adequate. And the principle of 'self-help' must be inculcated to induce people to save to secure a decent standard of living upon retirement.

A decision taken today to refrain from reforming the pensions system in order to safeguard a decent standard of living for future pensioners will only mean a postponement of the decisions that need to be taken. The longer the postponement the more restricted will be the policy options, the harder the impact of the decisions that would be taken, and most certainly, a less adequate benefit secured.

Furthermore, the financial sustainability of the pensions system will be impaired effecting both recent pensioners and future generations as the demographic replacement ratio will not allow for the sufficient collection of contributions to meet the benefits promised to individuals under the current pensions system.

A policy of no reform is, therefore, not an option that can be seriously considered. A policy of radical changes should also, if so possible, be avoided. Despite the challenges that must be faced there is the leeway today to introduce measures incrementally and thereby smoothening their resultant impacts on individuals, employers and the economy as a whole. This, however, can only be successfully attained if the proposed changes for reform are taken within the context of a holistically designed pensions system.

It is, however, pertinent to underline that the changes proposed in this Report, should they be accepted, should not be considered as immutable. The pensions system must be managed in an ongoing manner – with structured periodic reviews undertaken to allow for the implementation of parametrical changes as and when appropriate.

The following are the salient recommendations proposed by the Working Group directed to attain a pensions system that strives to secure a pension that is both adequate and secure for future generations.

Current Pensioners

01. Current pensioners and individuals who will retire prior to the implementation of the proposed changes will not be affected by the recommendations proposed.

Retirement Age

02. The retirement age should be increased to 65 years of age for both men and women. Implementation of this measure will initiate on 1st January 2007. To smoothen the impact of this change it is proposed that this measure is introduced in a scaled manner.

First Pillar Pension

03. The minimum pension guarantee should be annually adjusted to assure its value against inflation erosion. This recommendation should be implemented as from 1st January 2007.

04. The contribution period for the accumulation of the Two-Thirds First Pillar pension should be increased from 30 years to 40 years. This recommendation should be implemented as from 1st January 2007. To smoothen the impact of this change it is proposed that this measure is introduced in a scaled manner.

05. The base-line for the calculation of the Two-Thirds First Pillar pension should be changed from the best consecutive three years from the last ten years for employees and from the average of the last ten years' net income for self-employed persons to the average of the 40 year contributions accumulation history for both employees and self-employed. This recommendation should be implemented as from 1st January 2007. To smoothen the impact of this change it is proposed that this measure is introduced in a scaled manner.

06. A strong compliance regime is put into place in order to safeguard honest and hard working persons as well as to deter abuse, fraud and mis-use. Action should be taken with immediate effect.

07. The Two-Thirds First Pillar post-retirement pension income is annually built up for all pensioners on an annual uniform basis. The annual uniform basis to be applied should be the Retail Price Index. This recommendation should be implemented as from 1st January 2007.

08. A person may continue to opt to work beyond the new statutory retirement age whilst enjoying the Two-Thirds First Pillar (and Second Pillar) pension with no capping on income earned subject to the payment of the First Pillar contribution. This measure will come into effect in tandem with the recommendations proposed on the retirement age.

09. The current invalidity pensions scheme should be reviewed with a view to tighten the eligibility criteria as well as to adopt the principle of 'rehabilitation or alternative work before pension'.

10. The ceiling of the First Pillar's Maximum Pensionable Income should be the current Maximum Pensionable Income adjusted yearly to reflect inflation. This recommendation should be implemented as from 1st January 2007.

11. The Class I and Class II contributions should remain unchanged.

12. Part of the Social Security Contributions should finance health services. This should be determined as early as possible in 2005.

13. A ring-fenced account for contribution benefits and pensions, with appropriate transparent governance should be established. This recommendation should be implemented as from 1st January 2007.

14. Non-contributory benefits should be financed through the Consolidated Fund. This recommendation should be implemented as from 1st January 2007.

15. A policy instrument that takes into account parental responsibilities in relation to child bearing and child raising periods by providing for the phased crediting of the individual's contributions as well as the payment of voluntary contributions under established conditions should be introduced. This policy measure should be determined in 2006 and introduced as at 1st January 2007.

16. A policy instrument that removes those elements in the pensions system that encourage periods of inactivity within the informal economy when people need to be attracted to participate in the labour market should be introduced. This policy measure should be determined in 2006 and introduced as at 1st January 2007.

17. A policy instrument that accounts for 'credits' for the undertaking of unpaid periods of training, re-skilling and continuous development should be introduced. This policy measure should be determined in 2006 and introduced as at 1st January 2007.

Second Pillar Pensions Scheme

18. The new pensions system should include a Second Pillar Pensions Scheme to increase one's pension income to enhance one's standard of living.

19. The Second Pillar Pensions Scheme should apply to both employees and the self-employed.

20. Measures to provide for financial protection to Second Pillar Pensions Scheme contributors and pensioners against fraud, mis-use, insolvency, etc must be introduced and should be designed in a manner that places the least burden on the stakeholders.

21. The annual contributions into a Second Pillar Pensions Scheme should not be taxed on an annual basis but a maximum tax, established at a fixed percentage rate, should be paid upon the maturity of the Scheme.

22. The Second Pillar Pensions Scheme should be mandatory. Nevertheless, it should be introduced in a transitional manner with the Second Pillar Pensions Scheme first introduced on a voluntary basis as from 1st January 2006.

23. The Malta Financial Services Authority (MFSA) and Government should work with the private sector financial firms to encourage them to introduce a scheme that will allow owners of life endowment and similar policies to convert such policies into the Second Pillar Pensions Scheme. Action should be initiated in 2006 and once agreement is reached a caveat should be set to allow owners of such policies who take up this option to post date subscription to 1st January 2006.

24. The determination of the parameters of the proposed mandatory Second Pillar Pensions Scheme should be taken on the basis of intensive actuarial studies that Government should commission through the MFSA. Government should commission this study through MFSA in tandem with the consultation process.

25. Indications through the modeling carried out are that a mandatory Second Pillar Pensions Scheme should be in place by 2010. Government should take all necessary action to establish the appropriate mechanisms to enable the introduction of the mandatory Second Pillar Pensions Scheme by 2010. Nevertheless, the Government should in 2009 undertake an assessment to determine whether the prevailing conditions at that point in time are such that necessitate the mandatory introduction of this Pillar by 2010.

Third Pillar Pensions Scheme

26. The new pensions system should also provide for a Third Pillar Pensions Scheme which shall be a voluntary option directed to complement pensions income which should be introduced as from 1st January 2006.

27. The annual contribution to the Third Pillar Pensions Scheme should be non-taxable up to a capped limit. The income derived on the maturity of the scheme should be subject to income tax based on the individual's PAYE rate.

Regulation of the Second and Third Pillar Pensions Schemes

28. The regulation of the Second and Third Pillar Pensions Schemes should be entrusted to the MFSA operating under the Special Funds (Regulation) Act 2002. Such authority should be provided to the MFSA with immediate effect so that the necessary work for the introduction of a voluntary Second Pillar and a Third Pillar Pensions Scheme is completed in 2005.

29. Entry of private sector insurance firms into the Second Pillar Pensions Schemes provision must be subject to strict entry and performance criteria that must be met at all times by the said firms.

30. The Second Pillar Pensions Scheme contributions paid by the employer must be strictly separated from the said employer; with the pensions fund established as an autonomous 'ring-fenced' asset.

31. The Second Pillar Pensions Scheme should be managed on the prudent-person principle together with (a) the inclusion of specified limitations to determine the diversification parameters of the investment portfolio, and (b) restrictions to limit the private sector insurance firm managing the portfolio to invest in its own assets or subsidiaries.

Periodic Review of the Pensions System

32. The new pensions structure once introduced cannot be considered to be etched in stone – immutable to review and change. The pensions structure must be continuously under review so that parameterisation, calibration and changes are undertaken incrementally and in an evolutionary manner.

    The first periodic structured review of the pensions system should be carried out in 2009.

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Graphs, Tables and Charts

Graphs

Tables

Charts

Glossary

Adequacy	Provision of pension income that prevents social exclusion and assures a decent standard of living
BEPG	Broad Economic Policy Guidelines
Class I Contributions (Employees)	10% by the State, 10% by the Employer, 10% by the Employee subject to an established minimum and maximum contribution
Class II Contributions (Self- Employed / Self Occupied)	15% of the earned / annual income subject to an established minimum and maximum contribution. The contribution payable by the State is equivalent to 50% of this contribution.
COLA	Cost of Living Allowance
DrSS	Director of Social Security
DSS	Department of Social Security
EU	European Union
First Pillar	Public earnings related schemes (State Grant (Government), Employer, Employee)
MCESD	Malta Council for Economic and Social Development
MFSA	Malta Financial Services Authority
MPI	Maximum Pensionable Income
NAPE	National Action Plan for Employment
NCWR	National Commission for Welfare Reform
NI	National Insurance
NSO	National Statistics Office
PAYE	Pay As You Earn
PAYG	Pay As You Go
PROST	Pensions Reform Options Simulation Toolkit
PWG	Pensions Working Group
Second Pillar	Pensions schemes that are invested in funds managed by either Government or the Private Sector (Employer, Employee)
Self-Employed	Unless otherwise specifically stated in the document the term self-employed incorporates the self-employed and the self-occupied as defined in the Social Security Act
SPPS	Second Pillar Pensions Scheme
SSA	Social Security Act, 1987
SSP	Social Security Pension
Third Pillar	Individual Retirement Provisions
TPPS	Third Pillar Pensions Scheme

CHAPTER 01

Introduction

01

SUMMARY

01. **Presents the Terms of Reference of the Pensions Working Group.**

02. **Presents the Constitution of the Pensions Working Group.**

03. **Presents the Methodology Applied by the Pensions Working Group.**

01.1 The Terms of Reference of the Pensions Working Group

On 1st June 2004 the Prime Minister constituted a Pensions Working Group (PWG) tasked with the following terms of reference:

(i) To review all work carried out by successive administrations on pensions reform.
(ii) To review international trends on issues and solutions provided for pensions reform.
(iii) To identify the challenges facing the Nation to secure a pensions system which is both adequate and sustainable.
(iv) To review the current pensions system in terms of retirement pensions though excluding pensions falling within ad hoc occupational pensions systems such Service Pensions, Armed Forces of Malta, etc.
(v) To submit in terms of (iv) above proposals and recommendations for Government's consideration for a pensions system that will secure adequacy and sustainability for future generations.
(vi) To undertake appropriate modeling and simulations on the recommendations presented in (v).

01.2 The Constitution of the Pensions Working Group

The PWG was constituted as follows:

Chairperson	David Spiteri Gingell Manager Cabinet Committees' Support Unit, Office of the Prime Minister
Members	Joe Ebejer Permanent Secretary Ministry for Family Affairs and Social Solidarity
	Edward Gatt Director General Ministry for Family Affairs and Social Solidarity
	Leonard Callus Policy Co-ordinator Prime Minister's Office.

The PWG in the undertaking of its work was assisted by the following organisations:

Department of Social Security
Malta Financial Services Authority
National Statistics Office
Management Efficiency Unit
World Bank.

01.3 The Methodology Applied by the Pensions Working Group

In preparing its Report the PWG applied the following methodology.

First, it carried out consultation and discussions with various persons within Government. The persons consulted are shown in **Appendix I**.

Second, it reviewed reports prepared by the Malta Council for Economic and Social Development (MCESD) and the National Commission for Welfare Report (NCWR) and representations submitted to both bodies by various social partners. It also reviewed international reports on pensions reform. The documentation reviewed is shown in Appendix XII.

Third, in designing the recommendations to the pensions system the PWG was guided by the Value System established for pensions reform and introduced by the European Union at the Gothenburg Council (2001). This Value System is-directed to address:

> *"... the future evolution of social protection from a long term view, giving particular attention to the sustainability of pensions systems ... for the ability of pensions systems to meet their social objectives, namely to provide adequate and fair income to older people to prevent poverty in old age".*[1]

The key elements of the Value System, which are presented in Appendix III, are:

(a) attaining adequacy of pensions to ensure that older people are not placed at the risk of poverty and that they may enjoy a decent standard of living;
(b) promoting of solidarity between and within generations;
(c) ensuring the financial sustainability of pensions system; and
(d) modernising the pensions system in response to changing needs of the economy, society and individuals.

Fourth, the PWG requested the Management Efficiency Unit to carry out a Social Impact Assessment on the Report presented to Government.

Fifth, the PWG worked closely with the World Bank to discuss the conclusions it reached in its March 2004 Report. The World Bank report and the econometric models simulated in its formulation constitute the primary base-line against which the proposals in this Report are benchmarked. It is to be noted that PWG has complemented this study by the undertaking of various models and simulations also undertaken in conjunction with the World Bank to look at the projections onto the financial liabilities arising from options considered and the recommendations put forward. **Appendix IV** presents the major assumptions supporting the econometric modeling simulated on PROST.

Sixth, the PWG presented its Report to the International Social Security Association (ISSA) of the International Labour Organisation for review.

In putting forward it proposals the PWG recommended both specific recommendations where so possible, and principles which in turn are to guide the design of the supporting policy instruments.

01.4 Acknowledgements

The PWG thanks all persons and organisations that assisted it through the provision of information, discussion of issues, and specific studies carried out on its behalf. The conclusions of the Report are, however, the views of the PWG.

1 pg 10, Joint Report by the Commission and the Council on Adequate and Sustainable Pensions, ECOFIN 76, SOC 115, 7165/03, 10th March 2003, Brussels

CHAPTER 02

The Need for Change

02

SUMMARY

01. **Establishes the rationale of why the pensions system needs to be reviewed.**

02. **Provides a short review of the existing pensions system.**

03. **Provides a comprehensive overview of the findings of studies on the pensions system since 1997.**

04. **Presents the rationale behind the design of the principles and recommendations underpinning the proposed pensions reform.**

02.1 The Rationale for Change

The issue of pensions reform is, as the debate over the past years has demonstrated, one of the cornerstone public policy issues that Malta must address. In truth, this is a phenomenon that is not limited solely to Malta. Most developed nations recognise that the framework for the provision of adequate and sustainable pensions requires review and strengthening to address clear emerging challenges – ranging from multiple demographic factors, for example, population aging and low fertility with their implications for the labour market to the ensuing public finance pressures to mention a few. Indeed, several states in the European Union have over the past decade embarked on major reforms of their respective pensions systems.

It is pertinent to say that broad consensus exists in Malta amongst the social partners that to ensure adequate and sustainable pensions for tomorrow's older population, that is, today's younger generations, the pensions system needs to be reformed. The various studies and reviews carried out by successive administrations from 1997 to date underline the very important conclusion that unless appropriate and timely reform is introduced the pensions system will run into financial difficulties as contributions revenue will be insufficient to cover benefits expenditure.

The retention of the status quo is not a policy option. A policy of no reform will increase the pressures on the country's public finances. On the other hand increasing contribution rates will effectively increase the costs of production thereby impacting on the competitivity of our economy. But the issues are not solely of an economic and financial nature. As importantly, a policy of no reform will seriously undermine the social value of ensuring that aging people will over time continue to receive pension benefits that will guarantee a decent standard of living.

Hence, the design of a solution that establishes a pensions system that secures adequacy and sustainability is not a simple matter as a multitude of issues transcending many policy areas need to be taken into account.

It must be stated in the most direct way possible that a policy of no reform is expected to lead to, at least, one negative social outcome.

The first relates to the cohorts benefiting from the existing pensions regime. As inflation gradually erodes the value of today's pensions, the danger of pensioners experiencing reduced purchasing power and a concomitant reduced standard of living becomes a stark reality. This is an issue that cannot be either ignored or disguised.

Local and international studies confirm that unless a policy of pensions reform is embraced, the true value of pensions received under the existing pensions system by persons who today are forty-five years and below will be so devalued that the adequacy of the pension earned will be in doubt.

A review of statements made locally sometimes attempt to make a case that there is no crisis in the immediate and medium term. The stand that today's young generations have no reason for concern and thus there should be no change may sound attractive. This, however, will imperil the prospects of future pensioners. A Government's responsibility is not only that of safeguarding the present but also that of ensuring a secure future for forthcoming generations.

A delay to reform the pensions system will, undoubtedly, achieve one goal: the transfer of a burdened legacy by this generation to future generations. Today, the Government, political institutions, social partners, and individually as citizens and parents, still have sufficient flexibility to undertake measures in a gradual but sustained manner directed towards introducing a pensions system that will ensure a decent standard of living.

The longer a decision to embark on the necessary changes in our pensions system is postponed the more opportunities are lost to smoothly phase in the necessary reforms, and ultimately, the tougher the decisions become, seriously prejudicing the pensions system as it is understood today and is wished to be in the future. This is not an inheritance that Malta should contemplate, let alone facilitate.

It is not surprising to find that while broad consensus may exist on the need to safeguard adequate and sustainable pensions for future generations, there are differing views as to the causes and the measures to be taken.

Indeed there is no single ready model that can be adopted. The issues in this area are varied and complex. The way forward needs to include a number of policy instruments addressing the social and economic domains. Solutions adopted abroad provide us with an excellent insight on the options available to address this fundamental policy matter. Whilst, foreign models will not work if transported slavishly and without ensuring their adaptation to local characteristics, there are, nevertheless, a number of fundamental principles that should underpin the new pensions system - whatever ultimate form it will take. These are discussed hereunder.

01. The new pensions system and the nation's fiscal strategies cannot be assessed independently of each other. The long-term requirements of fiscal policy must be considered in view of the fact that public pensions are today completely financed on a Pay As You Go (PAYG) basis.

    The demographics projections clearly show that the population will decrease, that the 60 years and over age cohort will increase exponentially relative to other cohorts and that people are living longer. On the other hand birth rates continue to steadily decrease.

    The PAYG is directly linked to the demographics replacement rate. Thus, it so follows, that a continuation of the payment of contributory pensions and benefits on the current system will increasingly continue to burden public expenditure as the contributors decrease due to the above mentioned demographic changes.

02. Pensions schemes have always been conceived to be as self-financing as possible. However, various studies undertaken since 1997 show that the PAYG financing formula, even with changed parameters, will not address the issue of long term sustainability by ensuring that a new pensions scheme will largely, if not completely, finance itself.

    The continued prevailing belief or perception that the provision of a pension is the sole responsibility of the State must be challenged. Individuals too are responsible for ensuring that they take the required decisions during their working life to assure themselves of a decent standard of living during retirement. The concept of self-help is one that requires full consideration. The question, thus, becomes that of determining what the appropriate responsibility of the State should be in ensuring adequate pension provision.

03. Pension schemes need to be as self-contained and transparent as possible. In this regard there needs to be a clear distinction in the PAYG financing scheme between contributory and non-contributory benefits thereby establishing in the most direct manner an 'iron' ringed fence that ensures that finances paid by contributors for their pensions do in actual effect result in subsequent pension benefits. One of fundamental issues to be addressed is the degree, if at all, that contributory revenue collected from the PAYG scheme is to be channeled to the health services system - which today is substantially funded through the PAYG.

04. Reform is still necessary irrespective of the issues of adequacy and sustainability. The current pensions system developed in an incremental manner over the years reflecting a traditional market behaviour where men are the main breadwinners. The governing framework of the current pensions regime is complex, unwieldy and at times inhibitive to particular sectors of the labour market. The current social security system may lead to discrimination against women and the elderly, and provides little incentive for them to remain in the labour market. Employment participation rates need to be expanded and thus, provide for a major contribution to improve the financial sustainability of the pensions system in a context of an aging population. The measures to achieve an expanded workforce range from increasing gender participation to lengthening the working life on a voluntary or mandatory basis.

05. The individual ought to be able to go beyond the restrictions placed by the current pensions system which determines the quantum of the pension received and thus should be free to choose to invest to attain a pension that is beyond the statutory entitlement.

The pensions system proposed in this Report is designed to respond to these principles. It is pertinent to underline, however, that the proposals made in this Report as directed in the Terms of Reference submitted to the PWG are directed to address the macro and fundamental issues that emerge from the current pensions system and propose recommendations towards their resolution.

Thus, the Report, does not make reference to sectoral and specific related issues of persons benefiting from existing occupational schemes as well as anomalies of the current regime. Nevertheless, it is the PWG's considered opinion that where such specific issues exist these should be addressed in the technical work that Government will carry out once it determines the changes that are to be adopted to the pensions system.

02.2 The Current Pensions System in Malta

Malta has a long tradition in the provision of pensions. At the end of the 19th century, the first Government sponsored pensions schemes were introduced – firstly for the Malta Police Force and subsequently for the Civil Service.

Since the introduction of self-Government in 1921, an array of social security measures were introduced. These are listed in Appendix V. Three key pieces of legislation were introduced in the post-war period:

- The Old Age Pensions Act (1948). This law provided for a non-contributory means-tested payment of pensions to those over 60 years of age.
- The National Assistance Act (1956). This law provided for a non-contributory social and medical assistance on a means-tested basis to heads of households who were for some reason unable to work.
- The National Insurance Act (1956). This law provided for a scheme of social insurance. It was funded in a tripartite manner through contributions by the employee, the employer, and the State. The scheme was compulsory and eligibility was contingent upon certain contribution conditions. The scheme covered sickness, occupational injuries and diseases, unemployment, widowhood, orphan-hood, and old age. It was extended to the self-employed in 1965.
- The amendments to the National Insurance Act (1979). These amendments provided for the introduction of the Two--Thirds pensions system.

In January 1987 the above mentioned laws were consolidated into the Social Security Act (SSA) - today, Chapter 318 of the Laws of Malta. A number of further benefits are now incorporated into this Act.

The SSA consists of thirteen parts, each divided into a number of sections that in total number 136. Most sections specify the entitlement conditions to various benefits. Others spell out administrative and enforcement procedures, while others provide for the establishment of Boards and Committees. The Director of Social Security (DrSS) is vested with certain discretionary powers. Applicants may, however, seek redress from the Umpire or in the Civil Courts, whilst the DrSS can also seek redress from the Umpire's decision in the Civil Court.

The SSA provides for two basic schemes:

(a) The Non-Contributory Scheme where entitlement depends upon the satisfaction of a means test.

(b) The Contributory Scheme where entitlement depends upon the satisfaction of specific contribution conditions.

Whilst the provision of a network of social non-contributory benefits to those in need, including the elderly, is guaranteed, for the purpose of this Report, the part of the SSA that requires attention is the Contributory Scheme.

Contributions are payable by all gainfully occupied persons between the age of 16 and the age of their retirement. The retirement age under the SSA is 61 years for men and 60 years for women. Employment between the ages of 61 and 65 years is possible without prejudicing one's pension rights and without the need to pay contributions subject to an earning ceiling pegged to the minimum wage. The minimum wage ceiling is subsequently removed at age 65 and no contributions are due.

The scheme allows for different types of contributions in order to extend coverage to all types of persons in employment. Employed persons pay what are known as Class One contributions, while the self-employed pay Class Two contributions.

With regards to Class One contributions, any person employed under a contract of service in Malta is considered to be in insurable employment and subject to the payment of these contributions. For each person, a tripartite contribution is payable: the employed person, the employer and the State each pay 10% of the basic salary of the employee; with the contribution capped to a maximum wage ceiling. On the other hand, the rate of Class Two contributions is equally shared by the State and self-employed persons.

Generally speaking pensions are determined by a formula based on the average of the best three consecutive calendar years out of the last ten years basic wages in the case of employees; and the average of the last ten years' net income in the case of self-employed persons. The pension amounts to two-thirds of this average wage or income. In both instances the pensionable income is capped at Lm6,750. The full weight of a pension is payable to a person who has paid or has been credited with a yearly average of 50 contributions over a 30 year contributions period. Fewer years of contribution result in linearly reduced pensions, with the minimum years of contributions paid required to collect a pension set at nine years.

A critical feature of the Maltese pensions system is the capped maximum pensionable income. The gross average weekly wage is Lm97.54 (Lm5072.08 average annual wage). The mentioned ceiling is currently, 33% higher than the average annual wage. Following the receipt of the pension, the pension income is subsequently increased by a cost of living increase statutorily provided by Government on an annual basis.

Crediting of contributions is allowed during certain contingencies; mainly:

- A widow, where such widow is not gainfully occupied for any period during which she does not remarry.
- An ex-member of the Malta Police Force or the Armed Forces of Malta who retires on a service pension on completion of the full service prior to reaching pension age, for any period during which he or she is not gainfully occupied and has not yet reached pension age.
- A person who goes abroad as a volunteer worker on projects in the areas of human welfare and development and environmental protection for any period he or she is performing such volunteer work and has not yet reached pension age subject to statutory defined criteria.
- A person who is entitled to sickness, injury, or unemployment benefits or to an Invalidity Pension.

The following classes of persons are statutorily exempt from the payment of contributions:

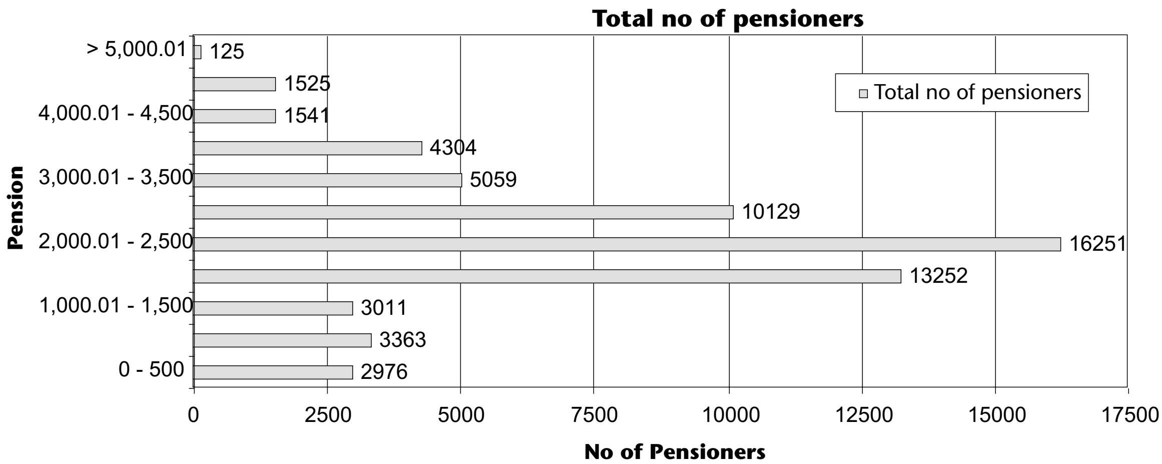
- Persons in full time education or training.
- Non-gainfully occupied married persons whose spouse is alive.
- Persons in receipt of assistance under the non-contributory scheme.
- Non-gainfully occupied persons whose total annual income does not exceed a given ceiling (Lm430 or Lm630 per annum for single or married men respectively).
- Gainfully occupied self-employed persons whose annual income falls below Lm390 per annum.

Bilateral reciprocal agreements on social security have to date been signed with the UK (1956), Australia (1991), Canada (1992), The Netherlands (2002). An agreement also exists with Libya (1990) that permits Maltese workers in Libya to pay their National Insurance Contributions in Malta.

Following Malta's accession to the EU, Malta is governed by EC regulations 1408/71 and 574/72 vis a vis member states coordination on social security matters.

The total number of pensioners as at 31st December 2003 stands at 61,536. Graph 01 below shows how pensioners are distributed against pension income received.

Graph 01: Pensioners and Pension Income Received as at 31st December 2003[2]



As can be seen from the above graph the majority of pensioners earn a pension income of Lm1,500 to Lm3,000. 21.5% of pensioners earn a pension income of Lm1,500 to Lm2,000. 26.4% of pensioners earn a pension income of Lm2,001 to Lm2,500, whilst 16.5% earn a pension income of Lm2,501 to Lm3,000. The number of persons earning a pension over Lm5,000 is explained by the fact that arrears were issued to them during 2003.

Further analysis of the benefits and beneficiaries of the current pensions system is shown in **Appendix VI**.

02.3 The Path to Pensions Reform

Since the mid 1990s, successive administrations realised that a serious assessment of the adequacy and sustainability of the existing pensions system in terms of current as well as future pensioners was warranted. To a large part, both the Labour and Nationalist administrations believed that, given the criticality of the issue under review, a determination on a way forward should be sought through formal social partners - government institutions in order to achieve, if so possible, the broadest consensus for the recommendations to be adopted.

The first major review of the pensions system was commissioned in December 1997 by the Malta Council for Economic Development (MCED). Mr Reno Camilleri was invited by MCED to chair a committee constituted of the Trade Unions, the Pensioners' Association, the Malta Employers' Association, representatives of the Social Security Department, the Economic Planning Division, the Central Bank of Malta and, "at a later stage", the Office of the Prime Minister with the following terms of reference:

"… to report on anomalies in the operation of the Social Security Act concerning pensions and on the so called""welfare gap", on the difference between the total amount of the contributions under the Act and total expenditure made in the form of pensions and other benefits made also under the same Act. The group was supposed to continue the work which had started some time in 1992 / 93. Since the stage that had been reached could not be ascertained, it was decided to consider this study as a new assignment."[3]

The conclusions reached and articulated in the Camilleri report are that:

> *"… (the report) recognises that the growing fiscal impact of the social security system is a mathematical certainty that cannot be totally blamed on Government except in so far that no proper assessment seems to have been attempted on what the future situation will be.*
>
> *… An official decision whether or not to proceed with a reform strategy should be taken immediately for two reasons. First, because any changes in the parameters of the existing system may bring along with it necessary adjustments of a fiscal, economic or social character and, the longer the delay in solving the system's imbalance, the more drastic the steps that must be taken. Secondly, it is important that any reform be phased in over a period of time."*[4]

The Camilleri Report puts forward a number of strategic principles that Government should consider positively in order to reform the pensions structure. The recommendations are both institutional and parametric in nature.

In terms of the former, the Camilleri Report recommends that the a long term solution should be "a two tier pension scheme with Government and the private sector participating in this new initiative"[5], wherein:

> *"… the introduction of a partially funded private pension scheme to supplement government's PAYG scheme may prove to be an advantageous approach.*
>
> *… any action by government to introduce a private pension scheme should not be perceived by workers as a government's plan to shed its responsibility for social security. Government must inevitably remain the ultimate guarantor of the pension promise."*[6]

The Camilleri Report, whilst discussing various models of how the Second Pillar could be introduced, makes no specific recommendations in this regard other than that a Second Pillar would require strong governance and that a "task-force with more narrowly defined terms of reference must identify these issues (of governance) and must also propose plausible solutions to the more relevant problems concerning coverage, contributions, investment, etc."[7]

In terms of the latter, the Camilleri Report perceives parametric solutions, essentially as short-term measures or adjustments to the present system. Among the more important are the following:

(i) Placing women workers on the same retirement age as men with immediate effect.[8]

(ii) The pensionable age should mandatorily be 64 for both women and men; going up by one year every two years.[9]

(iii) The maximum yearly salary for pension purposes should be retained at the existing level of Lm6,750 for the next three years; after which period the ceiling should be raised in accordance with the salary of the President of the Republic or else Government may determine what the maximum salary for pension purposes should be.[10]

(iv) Existing arrears of contributions will continue to be the same subject to a 5% penalty with future arrears to be subject to a penalty of 1% per month.[11]

(v) Financial considerations dictate that the issue of the reckonable period[12] for establishing the average earnings on which a pension is calculated needs to be faced to address the financial problems "linked to the present pensions scheme which if remain uncorrected, will create acute problems in (the) future".[13]

(vi) Everyone should assume responsibility for providing for his own needs on retirement so that the State's contribution should be wholly directed to those who need it most and that self-help should be a basic determinant of the national welfare system with the first tier directed at ensuring a guaranteed pension to all workers.[14]

In February 1998 the Forum For A Better Economy issued 'Value 2000: Focusing Resources for Superior Competition'. The document was directed to stimulate discussion and consensus building among social partners with regards to socio-economic development as well as the vision to be adopted by the Nation. The document focused primarily on issues and recommendations related to the economy, competitiveness and the focus to be adopted by the Nation.

Nevertheless, it does make specific reference to Government's role as the "provider of a safety net". In this regard the document promotes a social security system that fosters independence with characteristics that include, amongst others, long term financial sustainability by ensuring that society is capable of carrying the burden over the long term period.[15]

The document states that:

"- *government should avoid the trap of short-term orientation. Money is being spent to deal with today's problems but very little is done to prevent the problems; & Problems should be tackled holistically &*

- *(there should be) continuous assessment of the impact of our social security system;*

- *(there should be) continuous assessment of the changes taking place in society. New problems like social exclusion and (the) poor are being created and old types of poverty eradicated."*[16]

Moreover, the document places the need to foster independence as the "biggest challenge":

"The system should adopt a flexible approach which includes self-help (efforts to meet challenges on one's own), mutual help (efforts by members of society to help one another) and public help (public service).

People should be encouraged and not penalised for opting to self-help and mutual help rather than public help."[17]

In 1998, the Labour administration in Government, supported by sponsoring insurance companies Middle Sea Insurance Limited and Mid-Med Life Assurance, commissioned an international firm of actuaries and consultants, Watson Wyatt Limited, to:

"… prepare a report on pension provision in Malta from an actuarial perspective & (and) to report on pension provisions in other countries…".[18]

The report, presented to Government on 4th August 1998, concluded that:

"The most likely scenario is that pension costs based on current benefits will increasingly exceed pensions contributions based on current contribution levels. & (and that) it is only in about 10 years' time that the shortfall increases significantly and the current scheme's finances deteriorate."[19]

Watson Wyatt Ltd proposed both parametric as well as institutional changes to the pension scheme design. In terms of parametrical changes, Watson Wyatt Ltd proposed that the current pensions structure is amended as follows:

" … pensions are limited to increase by not more than the rate of increase in prices taken to be 3% pa.

- *The same pension age of 65 is adopted for both men and women.*

- *The overall rate of contribution from employers and employees is increased by 1% of the wage bill (perhaps 0.5% from employers and 0.5% from employees)."*[20]

With regards to institutional changes, Watson Wyatt Ltd proposed:

> *"In summary our view is that if the state pensions scheme is modified to ensure that it is financial self sufficient then there is a strong case in Malta for a second tier pension. We would suggest that the features of a reformed pensions system be:*
>
> - *The state PAYG system providing a basic "safety net" level of pension.*
>
> - *A second tier providing additional pensions.*
>
> - *The second tier pension should be on a funded basis.*
>
> *We think that if such a system is envisaged then there should be considerable attractions in the second tier pension being on a defined contribution basis sponsored by the private sector (i.e. employers, unions, and individuals) and on a personal basis. Our reasons for suggesting this approach centre around the need for a flexible system which avoids as far as possible duplication of administrative effort and which is clearly understood by the Maltese public."*[21]

Following its re-election in 1998, the Nationalist Government placed the issue of a pensions system that secures sustainable adequacy as one of the major public policies that required review and assessment. On 21st June 1999, the Prime Minister appointed a National Commission on Welfare Reform (NCWR)[22] with a comprehensive set of terms of reference directed to:

> *"recommend new legislation that would (a) be simpler, (b) ensure an equitable distribution of benefits without lessening their present levels to those beneficiaries for whom such benefits were originally intended, (c) provide for a system of administration of such benefits that would promote efficiency and efficacy at less input costs while securing against abuses and waste, and (d) ensure projected financial sustainability to beneficiary and contributor alike, both private and state owned."*[23]

The full set of the terms of reference as well as the constitution of the NCWR are presented in **Appendix VII**. In the undertaking of its work the NCWR was tasked to "refer to the reports commissioned by the MCED and the Forum for a Better Economy".[24]

The NCWR by the end of 1999 drew up, for illustrative purposes, preliminary scenarios and analysis of the Maltese pensions situation on the basis of the World Bank econometric model called Pensions Reform Options Simulation Toolkit (PROST). The results of the preliminary scenarios "broadly confirmed the concerns with regard to pensions funding which had been expressed and quantified by the Camilleri Report of 1998 that had been presented to the MCESD."[25]

A Report titled 'Interim Report' which placed the context for the pensions reform and the arising issues as well as proposing next steps was prepared by the NCWR in December 2001 and presented to the Prime Minister on 23rd March 2002.

The then Chairman of the Commission subsequently presented a Working Document for discussion purposes setting out a draft new pensions system. The document proposed, amongst others, the following changes in the pensions system[26]:

(i) Retirement age is to be extended to 65 years for both men and women, and is to be achieved within a period of ten years.

(ii) The 2/3 Social Security Pension (SSP) is to be calculated on the average wage / salary earned over the last 30 years.

(iii) Entitlement to a full pension is to depend-on a person satisfying the condition of 40 contribution years and of an average of 50 contributions per annum over the said period.

(iv) No person is to receive less than the Minimum National Pension – equivalent to 4/5 of the National Minimum wage for married persons and 2/3 for any other person.

(v) There should be only one category of pension arising from work; i.e. the 2/3 pension.

(vi) Once the 2/3 SSP is determined, this should not thereafter be changed but the pensioner will have the additional benefit of (a) an automatic cost of living increase per annum equivalent to 75% of COLA, (b) the proceeds of his maturing private insurance.

(vii) There should be no abatement of the 2/3 SSP by any service pension due to the person, provided that the right to such service pension has been acquired after 2001.

(viii) The limit of the 2/3 SSP at retirement should be 2/3 of the statutory salary of the President of Malta, provided that the gap (between today's maximum and the new maximum) is to be reached over a period of 10 years.

(ix) The June and December bonus payments should not continue to be paid.

(x) The contribution should be applied as follows: in the case of employed persons, 7% of the Employer's contribution, 7% of the Employee's contribution and the State's 7% contribution will go towards the Social Security Fund, whereas the remaining 3% of both the Employer's and the Employee's contribution will go towards a Private Insurance. In the case of the self-employed, 10% of their contribution and the State's 5% contribution will go towards the Social Security fund, whereas 5% of the self-employed's contribution will go towards a Personal Insurance.

(xi) In view of the above, there should be introduced a Mandatory Private Insurance in the name of the contributor to be placed with insurance providers in Malta as may be specifically licensed by the MFSA.

(xii) Employed or self-employed persons over 45 years of age should be given the option either to accept the Scheme or choose a modified version which retains most aspects of the existing system.

(xiii) The conditions for existing pensioners should remain unchanged except for one aspect, namely in those cases where the existing ceiling has been reached, the automatic cost of living increase shall be 75% of COLA per annum together with a further increase every four years which should be equivalent to 1/4 of COLA increases in the said four years.

(xiv) The new scheme should be applicable to all Government employees who are entitled to receive a service pension except that (a) the 3% covering a private pension should not be paid by the employee or the employer, and (b) the abatement of the 2/3 SSP by the uncommuted service pension should be applicable irrespective of when the right to such service pension was acquired.

The Working Document was reviewed and discussed by the NCWR. The social partners presented written statements. Following the submission and review of the feedback, Government concluded that further review and work was required prior to reaching a conclusive position on its part.

Following further review work, in October 2003 the new Chairman of the NWRC presented, amongst others, the following proposals relevant to pensions reform:[27]

(i) Funding for national health and pensions should be split into two separate contributions.

(ii) The 2/3 pension is to be retained.

(iii) Retirement pensions and other pension related benefits should relate solely to an individual's income earned on retirement.

(iv) Pension contributions should not entail any funding from the State.

(v) Employee and employer contributions should be 8% of income respectively.

(vi) Self-employed contribution should be 12% of income.

(vii) Contribution to health should be:
- Employee: 2% of gross salary, capped at Lm200 annually;
- Self-Employed: 3% capped at Lm300 annually with a minimum of Lm135;
- Employer: 2% of gross salary, capped at Lm200 annually;
- Government: 4% of gross salary capped at Lm400 annually.

(viii) Non-pension contributory benefits (i.e. children's allowances and bonuses) should be unrelated to employees' contributions in respect of their own retirement; with such non-contributory expenditure to be financed exclusively through taxation.

(ix) Retirement pension should be based on a fixed multi-tier actuarlised system as follows:
- Tier 1: guaranteed minimum pension at 2/3 of the national minimum wage;
- Tier 2: incremental pension should be up to 2/3 of maximum pensionable income or 2/3 of average incomes in the last ten years before retirement;
- Tier 3: optional contributions to schemes / products of the contributor's choice (Tier 3) which will be eligible for fiscal incentives through accreditation.

(x~~i~~) Pensionable period should be extended to 35 years.

(xi) Pension indexation should be linked to an inflation index.

(xii) Women contributors should be allowed to assign accumulated pension contributions to another account and to allow them to credit missing contributions during a restricted period of absence from the labour market.

(xiii) Revised pensions system should consist of a PAYG and a funded scheme.

(xiv) Women retirement age should increase to 61 in 2004 and retirement age should increase to 65 in 1 year steps once every four year period.

(xv) Removal of income restrictions currently applicable to pensioners.

(xvi) Tier 3 instruments could be eligible for fiscal incentives through accreditation.

(xvii) Early retirement schemes may be curtailed.

In November 2003 following discussions held with the Ministry of Finance, Government provided the following guidelines for the reform of the pensions system[28]:

(i) A lowering of the contribution rate - directed to separate pensions from other benefits. Since the original social security contribution was expected to cover a wide range of social benefits, the health contribution is to be separated and ring-fenced. Contribution rates for employeeswere proposed to be at 8% instead of 10% with Government to contribute 9% in place of 10%. The self-employed were proposed to contribute only 12% instead of 15% with Government 6% instead of 7.5%.

(ii) A gradual increase in the retirement age from 61 to 65 years for both genders to be fully phased in by 2015.

(iii) A gradual change in the minimum years of contribution required for the 2/3 pension to 35 years from 30 years to be phased in by 2015.

(iv) A gradual change in the averaging period used for calculating the value of the pension to the average of the last 10 years from average of the best 3 in the last 10 years. This change was to be fully phased in by 2015.
(v) A change in the indexation of the pension after retirement from full indexation to wage growth to revising pensions every 5 years by a percentage of the increase in the average salary paid to government employees.

The difference in contributions between that paid under the current system and the contributions recommended in (i) above was to be channeled towards the financing of healthcare services.

The NCWR in late 2003 invited the World Bank to carry out the appropriate econometric simulations to test the viability of the guidelines proposed by the Government. It is to be noted that the econometric findings arising from the simulations run by the World Bank constitute the base-line upon which the recommendations to the pensions system proposed by the PWG in this Report should be bench-marked.

The World Bank presented its report to the NCWR in March 2004. The World Bank concluded as follows:

> *"The current pensions system suffers both from issues of fiscal non-sustainability and low pensions in the long run. The scenario reflecting the Government guidelines remedies the low pensions by lifting the ceiling on income subject to contributions, but this puts even more pressure on the deficit. The reform proposal begins to bring the system into balance, but does reduce pensions considerably. Excluding those over the age of 45 from this reform costs a maximum of 2% of GDP."*[29]

In evaluating the guidelines provided by Government, the World Bank argued that:

> *"In addition to fiscal sustainability and adequacy, pensions systems also are judged on whether the design of the pensions system encourages behaviour on the part of the labour market participants, which might be costly to society. While it may not be possible to remove all the disincentives within the pensions system, the pensions system should try to be as neutral as possible and minimise any adverse impact or incentives. In the case of Malta, there are several features within the pensions system, which could be reconsidered."*[30]

In this regard the World Bank placed the following for consideration:

(i) The accumulation of 30 years contribution for the Two-Thirds pension whilst the average length of service stands around 38 years may incentivise workers to seek invalidity benefits and disincentivises workers to remain within the pensions system.[31]
(ii) In the case of self employed the link between contributions and benefits is broken. This may result with self-employed persons under-declaring earnings during the early working years, knowing that this saves them money without effecting their pension, and then raising their income substantially in the years which count towards the pension.[32]
(iii) The adoption of total wages (cash, overtime and in-kind payments) as the tax base, same as the base for the income tax.[33]
(iv) The increase in the contribution of the self-employed to 20%, the same as employers' and employees' contributions taken together and that 50% of this to be deductible from income taxes which would result in equivalent treatment to that of employees.[34]
(v) The receipt by contributors of benefits proportional to their period of contribution.[35]
(vi) The reduction of the minimum contribution for part-time workers to make contributions and benefits commensurate with actual earnings.[36]
(vii) The removal of disincentives for workers to continue working beyond the minimum retirement age.[37]

The econometric simulation by the World Bank of the reform proposals as represented by the Government guidelines indicate that the "deficits (will be) completely unsustainable" as in the longer term higher pensions will have to be paid.[38]

Thus, the World Bank concluded that the scenario based on the "government guidelines ~~was~~ was not sufficient to bring the system to fiscal sustainability".[39]

In conjunction with the Technical Team that was constituted of representatives from the NCWR and the MCESD, the World Bank developed a stronger proposal over and above the guidelines established by Government – which include:

(i) A further rise in the retirement age beyond age 65 in line with future improvements in life.
(ii) Indexation for pensions post-retirement to inflation rather than the 80% inflation and the 20% wage growth contribution.[40]
(iii) The pension is based on full lifetime career earnings.[41]
(vi) The target pension for a full career is two-thirds of net wage rather than two-thirds of gross wage.[42]
(vi) Defining a full career and therefore a full pension as a 45-year contribution period.[43]

Moreover, the World Bank ponders the option that to "better protect benefits" in the long run:

> *"… workers older than 45 at the time of the reform (will) retain their old benefit structure.*
>
> *Under this option, the proposal (of the World Bank) will apply to all those at age 45 and under. However, there are small components of the proposal that will apply to those above the age of 45. The retirement age will be raised to 65 and will apply to those above the age of 45 & The indexation of pensions post retirement will be based on inflation right away and the ceiling on contributions and the maximum pension will begin to rise right away as well."*[44]

The World Bank, nevertheless, states that "despite the fiscal improvements in each of these options, all of them result in a significant drop in benefits."[45] The World Bank argues for the establishment of a mixed pensions structure that with regards to the:

(i) First Pillar (the existing PAYG system) contribution rates will remain unchanged.
(ii) Second Pillar (a funded pension scheme) contributions will amount to 2% each from employers and employees and 3% from self-employed in 2005, rising gradually to 5% each from employers and employees and 7.5% form the self-employed by 2020.[46]

In essence, all of the reviews carried out since 1997 reach the same basic conclusions; that:

(a) the current pensions system is not sustainable in the long term; and
(b) that the adequacy of the pension benefit will be seriously undermined over time.

Whilst the solutions proposed vary, they, nevertheless agree, on the following fundamental principles:

- the retirement age should be raised;
- that the concept of 'self-help' must be inculcated and that, in this regard, a Second Pillar should be introduced; and
- the reckonable period for establishing the average earnings on which a pension is calculated needs to be reviewed.

02.4 Next Steps

As demonstrated in the above section successive administrations were aware that the current pensions system had to be reformed to meet medium and long-term challenges and a number of working parties were set up and consultancies commissioned to present recommendations for a way forward.

To the authors of this Report, there is no doubt that the reform of the pensions system requires resolute action. The importance and pervasive impact of pensions reform across all sectors of society warrants a constructive national discussion and consultation process prior to a conclusive determination by Government on the policy instruments to be applied. The PWG recommends to Government that this report should be issued as a White Paper in order to facilitate such a process.

Decision of Principle: 01

Government should positively consider issuing the Report of the Pensions Working Group as a White Paper to facilitate the national discussion and consultation process required on this important matter.

Thus, there is no doubt that the pensions issue needs to be tackled now. In this regard, the PWG recommends that the Government should be guided by two premises.

The first, is that the process of pensions reform must be holistic in both its design and formulation to ensure a robust framework that secures adequacy and sustainability.

The second, is that the implementation of the new measures should, as far as possible, be staggered and phased.

Decision of Principle: 02

Whilst the process of pensions reform must be holistic in its design and formulation, implementation of measures constituting the new pensions system should, as far as possible, be staggered and phased.

2 October 2004, Ad hoc Report, Department of Social Security
3 pg (i), Averting the Pensions Crisis: The Case of Malta, Reno Camilleri, March 1998
4 pg, (iii), ibid
5 pg 41, ibid
6 pg 31, ibid
7 pg 32, ibid
8 pg 48, ibid
9 pg 49, ibid
10 pg 52, ibid
11 pg 54, ibid
12 In the case of an employee a pension is calculated on the average income of the salary of the best three consecutive years in the last ten years. In the case of a self employed the average is worked on the last ten years.
13 pg 58, ibid
14 pgs 59-60, ibid
15 pg 56, Value 2000: Focusing Resources for Superior Competition, Forum for a Better Economy, Department of Information, February 1998
16 ibid
17 pg 57-57, ibid
18 pg 1, Pension Provision in Malta, Watson Wyatt Ltd, August 1998
19 pg 3, ibid
20 pg 12, ibid
21 pg 5, ibid
22 NCWR was chaired by Mr Anthony Galdes from its constitution to November 2001. Mr Joseph Schembri is the current chair.
23 Pg 2, National Commission on Welfare Reform, Terms of Reference, 21st June 1999
24 pg 1, ibid
25 pg 1, Situation Report on the Work of the National Commission on Welfare Report, A P Galdes, 27th March 2002
26 pg 1 – 16, Chapter 2, Working Document, Office of the Chairman of the National Commission for Welfare Reform, 19th June 2001
27 Pensions Reform Proposals, National Commission for Welfare Reform, 11th October 2003
28 4.02, The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004
29 5.02, The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004
30 2.08 (i), ibid
31 2.08 (ii) ibid
32 2.08 (iii) ibid
33 2.08 (iv), ibid
34 2.08 (v), ibid
35 2.08 (vi), ibid
36 2.08 (vii), ibid
37 2.08 (viii), ibid
38 4.03 (i), ibid
39 4.05 (i), ibid
40 4.05 (2), ibid
41 4.05 (3), ibid
42 4.05 (4), ibid
43 4.05 (5), ibid
44 4.08(i), ibid
45 4.11(i), ibid
46 Explanatory Note Regarding the World Bank Proposal on the Reform of the System of Pensions in Malta, MCESD

CHAPTER 03

The Challenges

03

SUMMARY

Reviews the Challenges that need to be faced:

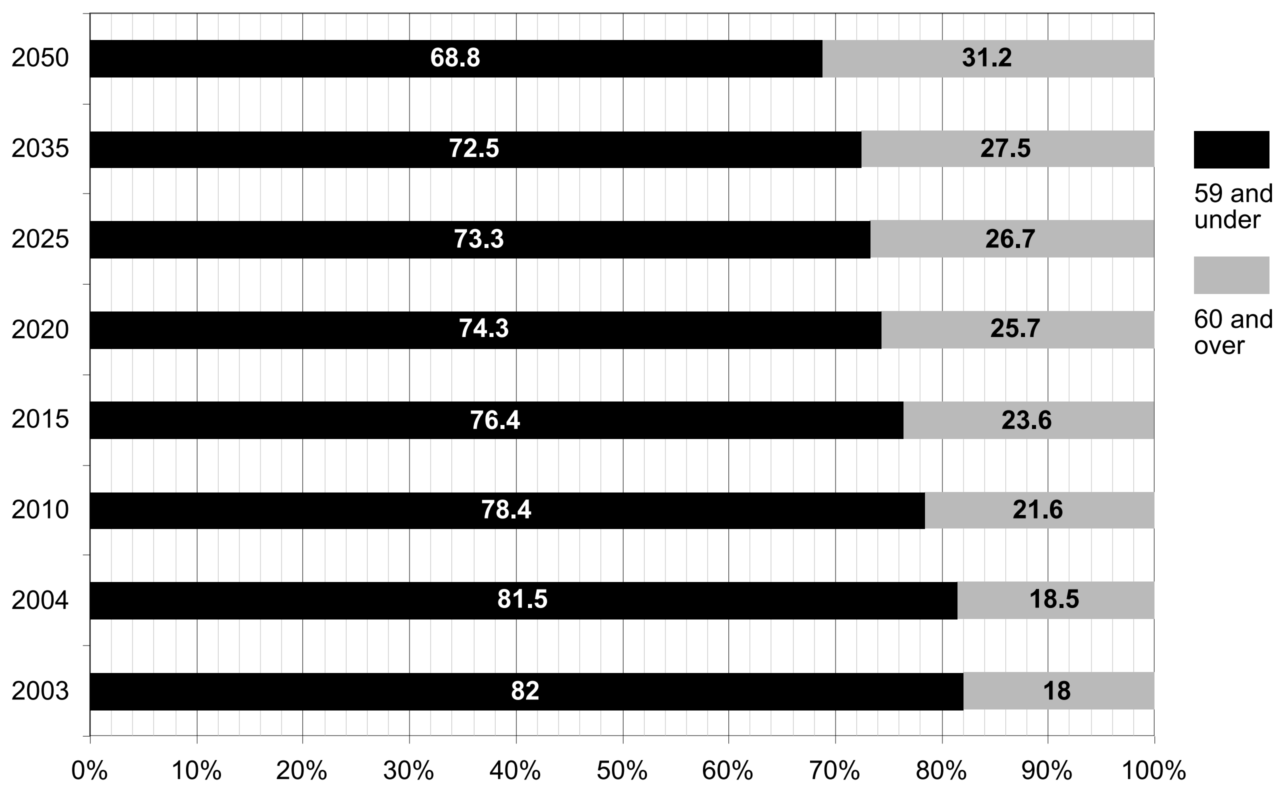
01. Population Aging.
02. Birth Rates.
03. Life Expectancy.
04. Employment Participation.
05. Changing Gender Roles.
06. Economic Performance and Wealth Generation.
07. Adequacy.
08. Financial Sustainability.
09. Education and Life-long Learning.
10. Savings.

03.1 Population Aging[47]

According to the National Statistics Office the Maltese population as at 2004 stands at approximately 389,000. This is expected to peak in 2015 when it reaches 394,600 persons. Subsequent to that, the Maltese population is expected to decrease to approximately the current level in 2025 and then rapidly fall to 369,900 and 333,800 in 2035 and 2050 respectively. This marked decrease in the Maltese population in 2035 and 2050 constitutes a fall in the population on 2004 of 5.2% and 14.3% respectively.

The changes in the demographic structure that the Maltese population will experience is compounded by the fact that the population will increasingly age as it decreases. As depicted in Graph 02 below persons over the age of 60 as at 2003 stand at 18% of the population. The ratio of the 60 years and over cohort in proportion to the population will increase steadily over the projected period reaching 21.6% in 2010 (20% increase on the 2003 figure), 25.7% in 2020 (42.7% and 17.6% increases on 2003 and 2010 figures respectively) to 31.2% in 2050 (73%, 44.4% and 21.4% increases on 2003, 2010, and 2020 figures respectively).

Graph 02: Projected Demographic Structure of Maltese Population till 2050



The World Bank report states that if the working age population is assumed to be all those above age 15 and retirees, there should be 3.9 workers per retiree. At the demographic peak, however, the World Bank estimates that there will be no more than 1.3 workers per retiree – with the consequential impact on the actual pensions system being far more drastic:

> *"In the future, the projections suggest that there will be 1.0 worker per 2/3 pensioner. The difference from the demographics arise from the fact that the labour force participation rates of those below 25 and definitely below the age of 20 will be quite low in the future, further limiting the number of workers available to support the same stock of old age pensioners".*[48]

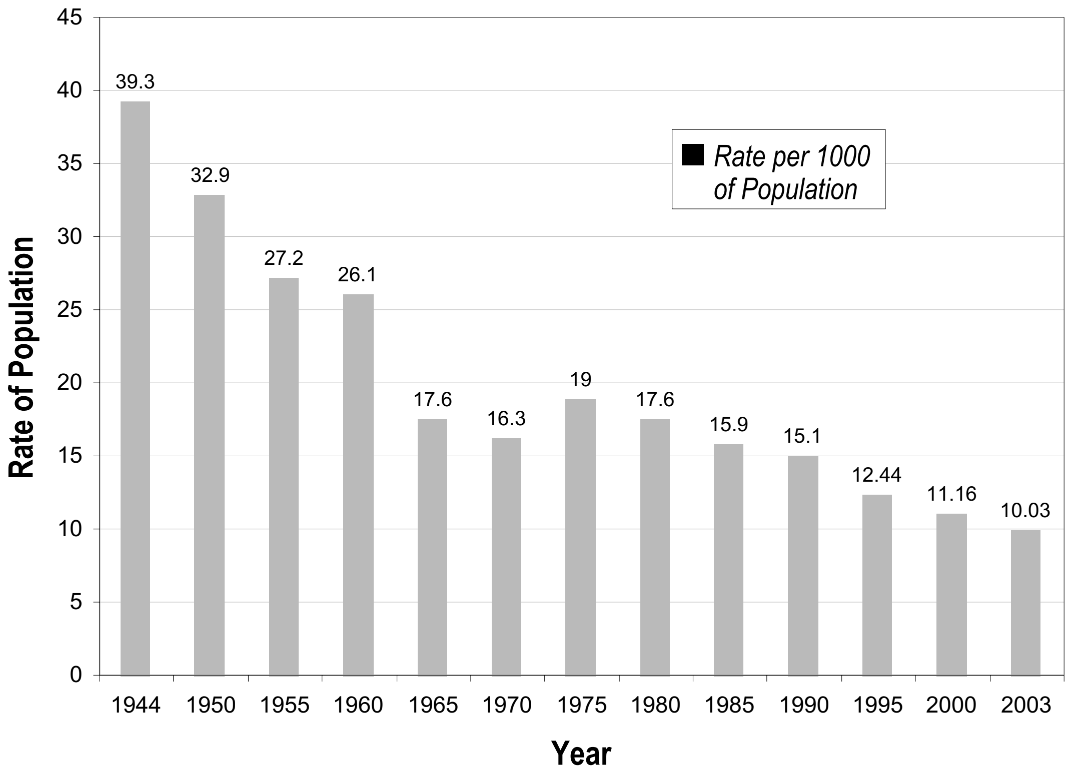
03.2 Birth Rates[49]

The issue of fertility sits between the aging population issue and the labour supply. Similar to trends in Europe, where fertility rates fell drastically from approximately 2.5 in 1955 to 1.5 in 2000[50], Malta too has experienced a sharp decline in fertility rates between the immediate post war period and today.

The peak was reached in 1947 with live births standing at 11,612 – although in terms of crude birth rate (that is the number of live births per 1,000 population) the peak was reached in 1944 at 39.3. By 1960 live births and the crude birth rate fell to 8,565 and 26.1 respectively. By 1970 these fell further to 5,314 and 16.3 respectively. A marginal increase was registered in 1980 where live births and the crude birth rate increased to 5,602 and 17.2 respectively.

By 1990 this positive trend was reversed with live births and the crude birth rate falling to 5,368 and 15.1 respectively. By 2000 this deteriorated further to 4,255 and 11.16 respectively. In 2003 live births and the crude rate stood at 3,902 and 10.03 respectively.

Graph 03: Live Births between 1944 and 2003



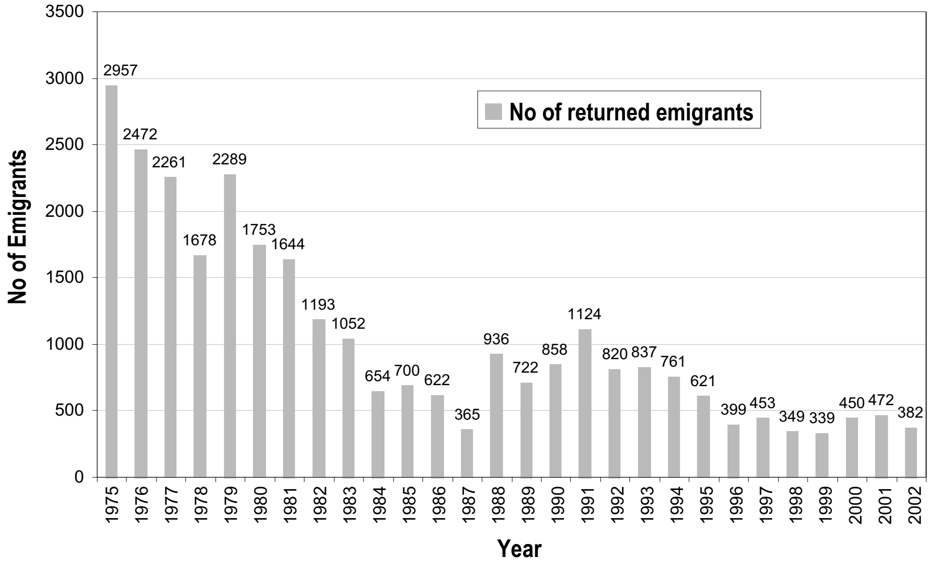
In terms of future birth rates, projections show that the 0 to 4 age cohort which stands at 5.1% of the Maltese population as at 2004 will marginally increase to 5.5% by 2015. This cohort will, however, fall sharply to 4.3% by 2035; with a slight increase to 4.5% in 2050 – a 0.8% and 0.6% decrease respectively on the 2004 figure.[51]

The change in birth rates directly contributes to changes in the age pyramid – which in turn has a direct impact on the current sustainability of the pensions system as people live longer whilst the supply of new labour diminishes due to a shrinking human resource base.

The decrease in fertility rates raises the question of whether the population decrease can be mitigated by an increase in returned emigrants and the provision of employment licenses to expatriates respectively.

Graph 04 below shows the number of returned emigrants since 1975. The number of returned emigrants started to decrease from 1980 onwards, falling from 2,289 in 1979 to 382 in 2002.

Graph 04: Returned Emigrants since 1975 and 2003

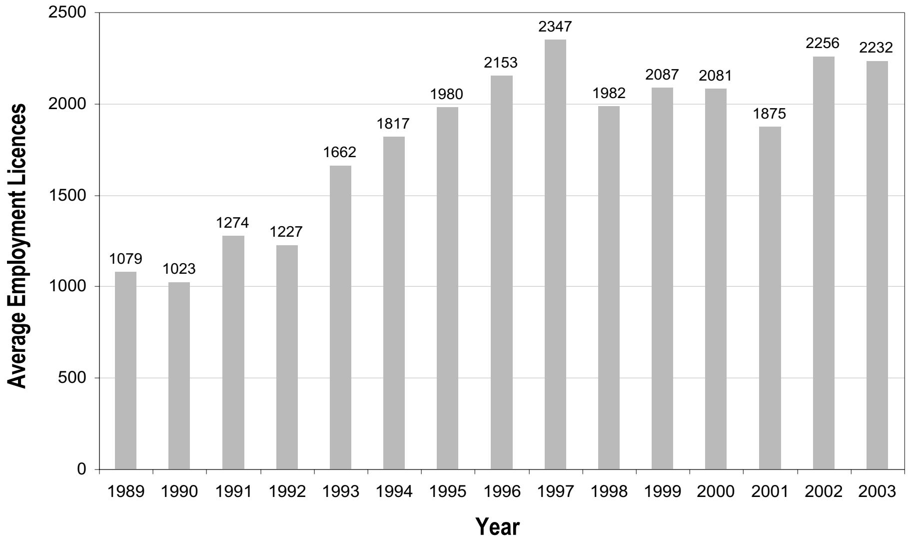


** Note: Statistics form the National Statistics Office*

The decrease in returned emigrants may be explained by the fact that the mass surge of emigration that occurred in the post-war period petered out over time thereby impacting the degree of first generation emigrants that returned to Malta.

Graph 05 shows the number of employment licenses issued to expatriates since 1989. Whilst this has increased steadily between 1989 and 1997, the number of licenses issued have subsequently stabilised.

Graph 05: Employment Licenses to Expatriates



** Note: Average Statistics as at end of each year from the Department of Citizenship and Expatriate Affairs*

It is too early to assess whether the labour force will increase~~s~~ as a direct consequence of the freedom of movement principle arising from Malta's entry into the European Union. Moreover, an issue that will require policy consideration in the relatively short term is the impact of the increasing number of individuals that are provided with a refugee status on the labour market.

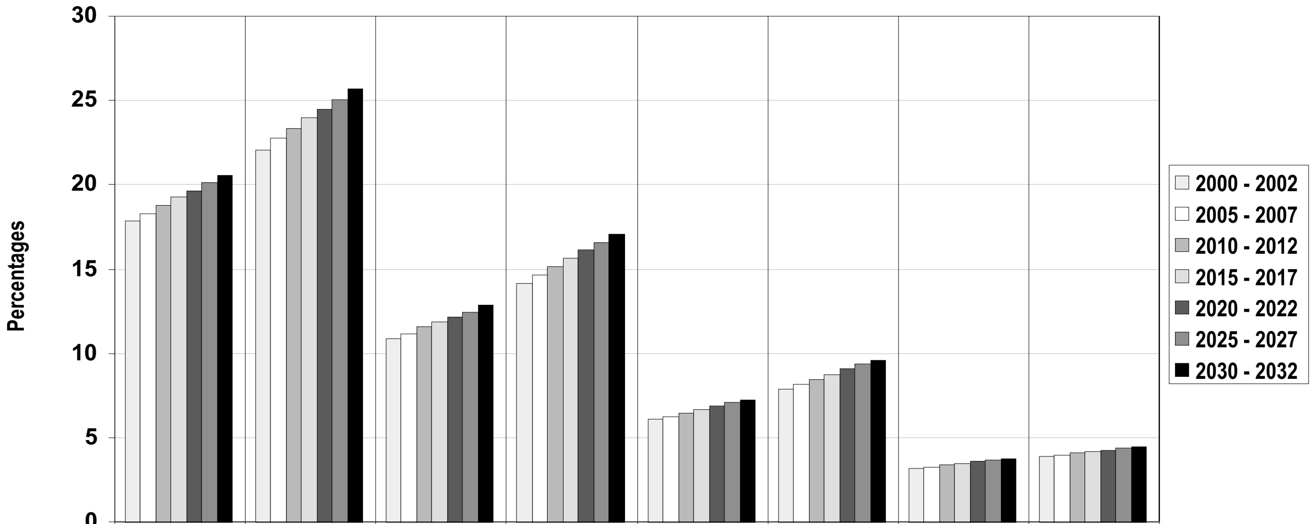
03.3 Life Expectancy[52]

The demographic structure referred to earlier is also effected by the longevity expectation of the new born and elderly people. The life expectancy of male children at birth has increased from 55.7 in 1948 to 73.8 in 2000-2002. This is expected to increase to 75.9 by 2015-2017 and 77.8 by 2030-2032. In terms of women children life expectancy at birth has increased from 57.7 in 1948 to 79.5 in 2000-2002 and is expected to reach 81.9 and 84.0 in 2015-2017 and 2030-2032 respectively.

The life expectancy of males over 60 and 70 years of age reached 17.9 and 10.9 respectively in 2000-2002. In 1948 life expectancy at 55 years of age and 65 years and over stood at 19.0 and 21 respectively. The life expectancy of males over 60 and 70 years of age is expected to reach 19.3 and 11.9 respectively in 2015-2017 and 20.6 and 12.9 respectively in 2030-2032.

In terms of women over 60 and 70 years of age, life expectancy reached 22.1 and 14.2 respectively in 2000-2002. In 1948 life expectancy at 55 years of age and 65 years and over stood at 19.9 and 22.2 respectively. The life expectancy of women over 60 and 70 years of age is expected to reach 24.0 and 15.7 respectively in 2015-2017 and 25.7 and 17.1 respectively in 2030-2032

Graph 06: Life Expectancy Projections for Persons who are 60 years and Over



	60 yrs men	60 yrs women	70 yrs for men	70 yrs for women	80 yrs for men	80 yrs women	90 yrs men	90 yrs women
2000 - 2002	17.9	22.1	10.9	14.2	6.1	7.9	3.2	3.9
2005 - 2007	18.3	22.8	11.2	14.7	6.3	8.2	3.3	4
2010 - 2012	18.8	23.4	11.6	15.2	6.5	8.5	3.4	4.1
2015 - 2017	19.3	24	11.9	15.7	6.7	8.8	3.5	4.2
2020 - 2022	19.7	24.5	12.2	16.2	6.9	9.1	3.6	4.3
2025 - 2027	20.2	25.1	12.5	16.6	7.1	9.4	3.7	4.4
2030 - 2032	20.6	25.7	12.9	17.1	7.3	9.6	3.8	4.5

Years for men and women

03.4 Employment Participation

Employment participation in Malta reached 53.7% in 2003, which is far below the EU target of 70% for 2005. Women participation stands at 33.7%.[53] The age distribution of the 55 to 64 age cohort in proportion to total employed persons is 9.3%. The participation of retirees above the age of 65 is 0.9%.[54] Each of these labour segments are significantly low.

It clearly emerges that the labour market is not managing to encourage women employees to retain their employment after the birth of their children, nor to return to work. The same results in terms of incentives to older people not to stop working life prematurely by encouraging them to stay at work after the statutory retirement age.

The current contributory conditions of earnings related pensions do not serve as incentives for either group to remain within the labour market. This restricts the growth of the contribution base just when increased participation is necessary to compensate for decreasing labour supply.

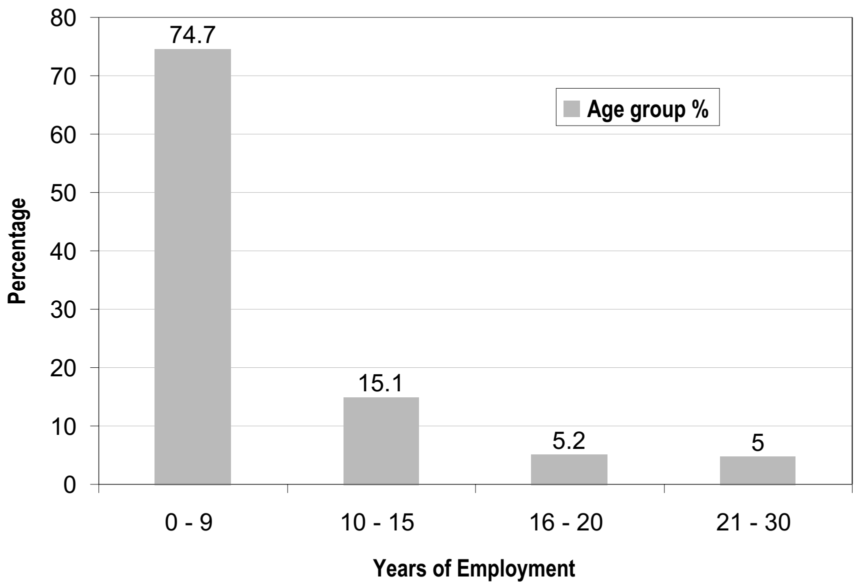
03.5 Changing Gender Roles

The current pensions system is modeled on a traditional family pattern where the man is the main breadwinner and the wife is the full-time home carer who is dependent on her husband for income support. This leads to the effect that amongst retired couples, the woman is dependent on the husband for a pension benefit.

A considerable proportion of women workers exit the labour force at an early age. While the employment rates of young men and women are similar until the age of 25, in the 25 to 34 age bracket they diverge significantly. In December 2003, the rates in the latter bracket were 89.3% for men and 53.3% for women.

Moreover, only 74.7% of women continue to form part of the labour force by the ninth year of employment. It is pertinent to underline that by the 10th to the 15th year of employment, only 15.1% of women remain within the labour force[55]. This is depicted in the graph below.

Graph 07: Females Remaining in the Labour Force According to Years of Employment



It is to be noted that the average exit age of women from the labour force is 26 years whilst their average retirement age is 56.5 years[56].

It is thus argued that women perceive their contributions as wasted – which is in no small part related to their greater participation in the informal economy. This is compounded by the fact that the minimum national insurance contribution payable is 10% of minimum wage; thus, even woman part timers face a disincentive to work in the formal sector given that this contribution is relatively high compared to their earnings. It is, therefore, further argued that most married women do not perceive the earnings related system to be relevant to them and opt for dependence on their spouse's pension, or on the survivor's pension after their husband's death.

03.6 Economic Performance and Wealth

The Maltese economy has performed at an average GDP growth at current market prices of 5.8% (3.1% at 1995 prices) between 1995 and 2003; with growth over the past 2001, 2002 and 2003 being 4.6%, 3.4% and 1.6% (-1.1%, 2.3%, -1.7% at 1995 prices) respectively.[57]

A pensions system that is adequate and sustainable is strongly dependent on the economic performance of the nation and the wealth generated. A weak economy will always struggle to meet the demands of a pensions structure irrespective of the mechanisms put into place to render that structure sustainable to the extent possible.

Securing economic performance and wealth, however, is strongly dependent on the macro and fiscal policies adopted by Government to enable and facilitate the generation of wealth. Consequently, the design of a sustainable and adequate pensions system cannot not be correlated to the design of the macro and fiscal policies directed to boost economic growth.

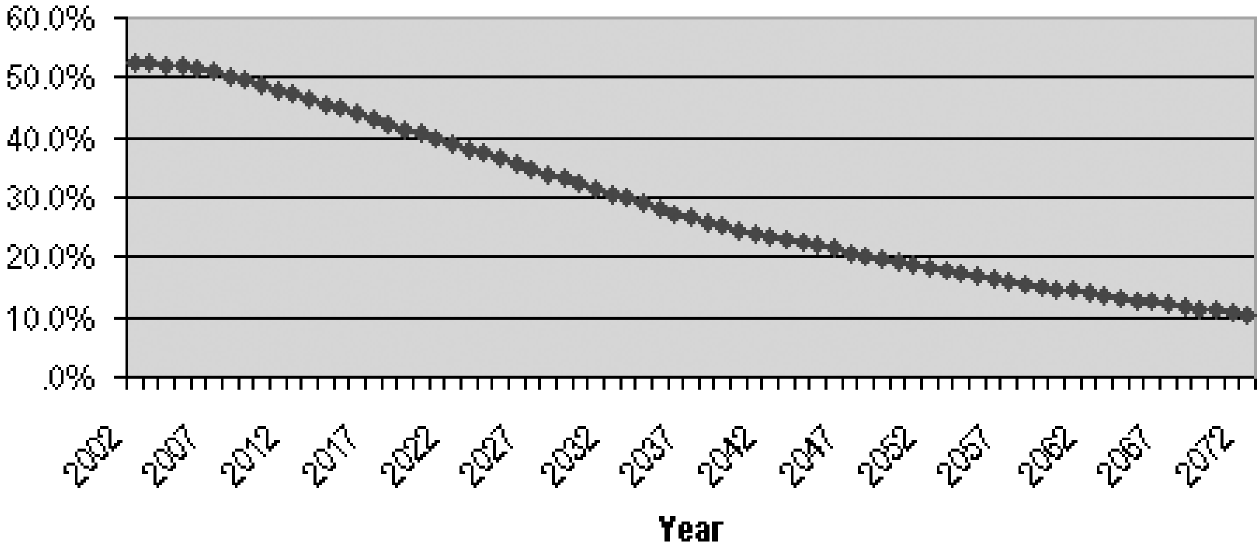
In this regard, this Report argues that Government must complement the introduction of the recommendations proposed in this Report with innovative and creative macro and fiscal policies designed to achieve strong and consistent economic growth. It is pertinent to underline that this aspect is being discussed at the MCESD to achieve consensus amongst the social partners and Government on the measures to be adopted in this regard.

03.7 Adequacy

The average pension relative to the average wage is strongly influenced by the ceiling on contributions and benefits. This ceiling, as shown earlier, is 33% higher than the average wage, and is increased each year by a COLA adjustment that is approximately 80% of annual inflation.

In their PROST simulations, the World Bank conclude that the average pension in relation to the average wage will by 2072 fall considerably. This is depicted in the Graph 08 below.

Graph 08: PROST Simulation of Average Pension Relative to Average Wage, World Bank: March 2004



Note: Source Figure 2, The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004

The World Bank states, and quoting extensively, that:

> *"By the end of the period with positive real wage growth, the ceiling for income subject to contributions will end up about 19% of average wage. Since the pension depends on insurable earnings, the pensions ~~paid~~ will be at best 2/3 of the 19% of average wage, which is about 12% of average wage. While adequacy does not require a benefit equal to 100% of average wage, pensions, which are only 12% of average wage, are generally not considered adequate and may not fulfill the poverty alleviation criterion. Furthermore, while pensions during retirement are indexed to growth in civil servant wages within certain grades, the pensions are further constrained by a maximum, which also grows with COLA. At the end everyone will be receiving the maximum pension."*[58]

03.8 Financial Sustainability

Table 01 below shows the Welfare Gap between 1998 and 2003[59]. The Welfare Gap decreased between 1998 to 2001 by Lm8,829,591. Nevertheless it increased in 2002 on the 2001 balance by Lm5,529,682. In 2003 this increased on the 2002 balance by Lm6,348,711; an increase of Lm3,048,802 on the 1998 balance (a 4.9% increase).

Table 01: Welfare Gap 1998 - 2003

INCOME	1998	1999	2000	2001	2002	2003[60]
Class I Contributions						
1 Employees	36,808,000	40,581,000	47,479,945	53,609,680	54,157,849	125,644,558*
2 Employers	44,188,000	45,089,000	47,479,945	53,609,945	54,157,829	
3 Other	62,000	61,000	143,749	48,421	85,292	
Class II Contributions						
Self Employed	9,400,000	10,471,000	12,956,319	12,124,576	12,388,651	
Direct Contribution by Government in Terms of the SSA	45,197,680	48,071,469	53,958,103	59,672,065	60,352,165	62,782,243
Total Income	**135,655,680**	**144,273,469**	**162,018,061**	**179,064,687**	**181,141,789**	**188,426,801**
EXPENDITURE						
Contributory Benefits						
1 Retirement Pensions	62,805,339	66,098,132	71,692,382	78,466,580	80,886,732	84,131,689
2 Childrens' Allowance	20,111,471	19,034,766	18,430,319	15,851,333	15,850,490	14,858,629
3 Bonus	9,121,947	10,161,381	9,859,511	9,945,137	10,126,270	10,733,462
4 Other	37,348,340	40,936,357	41,710,937	45,038,401	47,757,062	51,973,275
Administration Expenses	2,694,050	2,056,552	2,233,957	2,569,949	2,553,833	2,444,452
Expenses in Connection with Health Recurrent Services						
1 Hospitalisation	54,466,907	55,617,731	63,331,242	67,659,797	69,476,730	75,307,061
2 Elderly & Special Needs	10,641,355	9,543,660	10,211,402	12,237,628	12,724,489	13,560,764
Total Expenditure	**197,189,409**	**203,448,579**	**217,469,750**	**231,768,825**	**239,375,606**	**253,009,332**
WELFARE GAP	**(61,533,729)**	**(59,175,110)**	**(55,451,689)**	**(52,704,138)**	**(58,233,820)**	**(64,582,531)**

**Note: Figure includes Class I and Class II Contributions*

A comparison of income earned through contributions paid by employers and employees (Class I) as well as the self-employed (Class II) against all Contributory Benefits payable subject to the Two-Thirds Pension Scheme, (with benefits including childrens' allowance, bonus, old age pensions, disability pensions, social assistance, medical assistance and supplementary assistance amongst others) shows that income earned is less than benefits paid. As Table 02 below shows, however, the deficit in this regard improved between 1998 and 2001, though it increased by Lm3,919,104 in 2002 over 2001. In 2003 this increased further – Lm2,221,564 on 2002 – though this is still below the 1998 balance. It is pertinent to state that for the purposes of this comparison the State's contribution is not included as according to the World Bank the yardstick to determine a pensions deficit should exclude the State's contribution.[61]

Table 02: Employer and Self-employed Persons / Employee Contributions Against Total Benefits Paid

	1998	1999	2000	2001	2002	2003
Class I Contributions	81,058,000	85,731,000	95,103,639	107,268,046	108,400,970	125,644,558*
Class II Contributions	9,400,000	10,471,000	12,956,316	12,124,576	12,388,651	
Contributory Benefits	(129,387,097)	(136,230,636)	(141,693,149)	(149,301,451)	(154,620,554)	(161,697,055)
Deficit	(38,929,097)	(40,028,636)	(33,633,194)	(29,911,829)	(33,830,933)	(36,052,497)

If the State's Contribution is included the difference between total contributions paid (that is the Class I, Class II and the State Grant) against total benefits paid is as shown in Table 03 below.

Table 03: Total Contributions Against Total Benefits Paid

	1998	1999	2000	2001	2002	2003
Difference	(38,929,097)	(40,028,636)	(33,633,194)	(29,911,829)	(33,830,933)	(36,052,497)
Direct Contribution by Government in terms of the Social Security Act	45,197,680	48,071,469	53,985,103	59,672,065	60,352,165	62,782,243
Surplus	6,268,583	8,042,833	20,351,909	29,760,236	26,521,232	26,729,746

The difference between Employer and Employees contributions paid and Retirement Pensions is shown in Table 04 below.

Table 04: Employer and Self-employed Persons / Employee Benefits Against Retirement Pensions Benefits

	1998	1999	2000	2001	2002	2003
Class I Contributions	81,058,000	85,731,000	95,103,639	107,268,046	108,400,970	125,644,558*
Class II Contributions	9,400,000	10,471,000	12,956,316	12,124,576	12,388,651	
Retirement Pensions	62,805,339	66,098,132	71,692,382	78,466,580	80,886,732	84,131,689
Surplus	27,652,661	30,103,868	36,367,573	40,926,042	39,902,889	41,512,869

Table 04 above shows that the cost of retirement pensions as at 2003, even without the State's Contribution, against income earned from Class I and Class II contributions is a positive Lm41.5 million. It is pertinent to state that this surplus would be lower if other contributory benefits are included. Nevertheless, it can be concluded that contributions generated from employers, employees and self-employed persons together with the State Contribution are directed to finance non-contributory benefits as well as health recurrent services. The total income generated from contributions does not, today, suffice to meet this expenditure – thereby creating the current welfare gap.

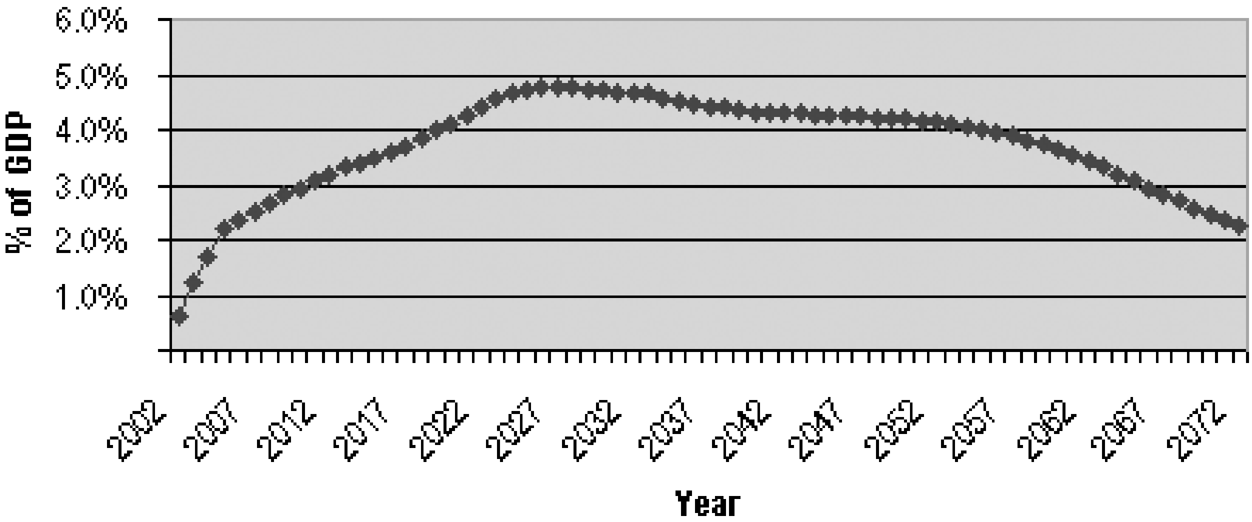
**Note: figures include Class I and Class II contributions.*

The deficit as depicted in Table 02 – that is total contributory income earned excluding the State Contributions against total benefits paid excluding the financing of health recurrent services – as at 2002 stands at 2% of GDP at current market prices.[62]

As the Graph 09 below shows, the World Bank estimates, in the PROST models it simulated, that the deficits will:

> *"... accelerate to 3.5% of GDP by 2015 and to 4.7% by 2030 before leveling off in the future. By 2011, the full 10% government contribution will be insufficient to cover the deficit in pensions, leaving nothing left for the other social benefits"*[63]

Graph 09: PROST Simulation of Pension Deficits as % of GDP, World Bank: March 2004



**Note: Reference World Bank Report, March 2004*

Why, therefore, is the pensions systems expected to undertake such a turn around? The World Bank concludes that a large part of the answer stems from the demographic shifts discussed earlier. Quoting extensively from the World Bank March 2004 Report:

> *"Currently if the working age population is assumed to be all those above age 15 and retirees above the retirement age, there should be 3.9 workers per old age retiree. At the demographic peak, there will be no more than 1.3 workers per retiree. However, looking at the pensions system, the change is more drastic. Currently, there are about 5.8 workers per 2/3 pensioner, more than the demographics would suggest. This is largely because many of those retiring under the old occupational schemes are receiving only top-up pensions and not the full 2/3 pension, a function of the immaturity of the system. In the future, the projections suggest that there will be 1.0 worker per 2/3 pensioner. Furthermore, the system finances more than just 2/3 pensioners. When all the invalids, widows, survivors and top up pensioners are considered, there are only 2.6 workers per pension today and in the future there are projected to be only 0.9 workers per pensioner."*[64]

The World Bank March 2004 report continues to say, and again quoting extensively, that:

> *"Given these demographics it is not difficult to figure out why the pensions system will be running a deficit. In pay as you go systems, revenues come from contributors paying a percentage of average wage. Expenditures come from the pensioners who are paid a pension, which can also be expressed as a percentage of average wage. If there are currently 5.8 workers per 2/3 pensioner, the system could afford to pay 2/3 pensioners 116% of average wage if there were no other pensioners to pay or the contribution rate of 20% (employer and employee) multiplied by 5.8. Given the other pensioners, the system could afford to pay 52% of average wage per pensioner, with the invalidity pensioners and survivors of course receiving less that 2/3 on average, while the 2/3 pensioner of course receives 2/3. In the future, the system could pay only 20% of average wage to the 2/3 pensioner or if all benefits are considered, only 18% of average wage per pensioner. So clearly in a scenario where the system must provide individual pensions equal to 2/3 of their salaries as well as to provide other benefits, the system will run deficits, and relatively large deficits, with the revenues in the future able to cover only 27% of expenditures compared to 92% today."*[65]

03.9 Education and Life-Long Learning

Knowledge and advanced skills will be critical contributors to Malta's economic growth, standard and quality of life as learning outcomes are transformed into goods and services, greater institutional capacity, a better civil society and an improved investment climate.[66] Ensuring good quality continuous life-long learning is an essential and integral element of Malta's strive to become a knowledge based economy.

Moreover, technical and scientific progress is moving at an exponential pace. Whilst this is positive it also demands increasing knowledge and flexibility from people. Thus, the capacity to adapt to change, disseminate and maximise the rapid technological advances is dependent on the ability to inculcate a culture of life-long learning.

It is therefore important that all institutions respond properly to the economic requirements of the Nation. Likewise, it is important that they also respond to the increasing demands of both the young and adults for more and better opportunities of post secondary, vocational and tertiary education. The short 'shelf life' of knowledge, skills and occupations results in the growing importance of continuing education and of regularly updating individual capacities and qualifications.[67]

Thus, educational institutions would not only continue to require substantial public investment to meet both the qualitative and quantitative demands, but they must also change from the current traditional model of finite education to one that promotes life-long learning and continuous professional development.

Moreover, the concept of life-long learning becomes essential towards ensuring that people not only retain skills currency but develop new skills to render effectiveness and value in their employability as they may be mandated by an increase in the statutory retirement age or, by means of incentives, to remain within the workforce.

03.10 Savings

The personal sector wealth held in resident deposits (including bearer deposits) with all banking institutions as at September 2003 stands at Lm2.15 billion. This constitutes 59.7% of the deposits held by banking institutions which amount to Lm3.59 billion. Table 05 shows that savings in real terms have enjoyed a steady growth since 1985 – reaching the Lm0.5 billion mark in 1989, the Lm1 billion mark in 1994, the Lm1.5 billion mark in 1997 and Lm2 billion mark in 2001.

Savings per capita have also increased. Whilst this stood at Lm958 per person in 1985, the Lm2,000, Lm4,000 and Lm5,000 per person thresholds were reached in 1992, 1998 and 2001 respectively.

Table 05: Deposits of Households Resident in Malta with All Banking Institutions[68]

Year	Total Deposits (end of year position) Lm000s	Total Population	Per capita deposits (000s)
1985	362,832	340,907	1.06
1986	359,609	343,514	1.05
1987	396,878	345,636	1.15
1988	452,890	349,014	1.30
1989	523,196	352,430	1.48
1990	609,524	355,910	1.71
1991	681,830	359,543	1.90
1992	766,751	362,977	2.11
1993	877,873	366,431	2.40
1994	1,029,646	369,451	2.79
1995	1,170,640	371,173	3.15
1996	1,322,162	373,958	3.54
1997	1,466,011	376,513	3.89
1998	1,615,056	378,518	4.27
1999	1,704,669	380,201	4.48
2000	1,786,776	382,525	4.67
2001	1,955,817	385,077	5.08
2002	2,121,567	386,938	5.48
2003	2,180,340	388,867	5.61

In the absence of a classification that shows how the above savings are distributed amongst earnings categories it is not possible to conclude whether these savings are equally distributed across the population. The assumption that ownership of these savings, however, is unequally distributed is most likely. If such an assumption is correct, it so follows that the majority of the population would only have saved a modest amount to contribute to their standard of living during retirement.

Whilst savings per capita increased, the savings ratio (based on consumption, disposable income and savings) as shown in Table 06, however, has decreased substantially over the same period of time. The Savings Ratio stood at 8.87 in 1985. This peaks in 1994 when it stood at 16.85%. In 1999 this fell down to 9.22%. In 2000 the Savings Ratio experienced a marked decrease to 4.35% falling to its lowest ever in 2002 at 1.30%. The conclusion is that people are saving less in relation to consumption and disposable income. If the current trends continue this would mean that people would have saved far too little during their working life to boost their pension income during retirement.

Table 06: Savings Ratio[69]

Year	Consumers' expenditure Lm thousands	Savings Lm thousands	Household Disposable Income Lm thousands	Savings Ratio%
1985	333,239	32,440	365,655	8.87
1986	343,369	37,930	381,237	9.95
1987	351,187	62,530	413,621	15.12
1988	387,567	55,870	443,524	12.60
1989	425,515	59,620	485,164	12.29
1990	460,845	73,270	534,120	13.72
1991	494,504	89,660	584,160	15.35
1992	531,530	98,270	629,620	15.61
1993	561,498	105,430	666,930	15.81
1994	608,288	123,280	731,570	16.85
1995	700,425	85,280	785,710	10.85
1996	764,901	82,670	847,580	9.75
1997	803,493	70,720	874,210	8.09
1998	846,002	90,720	936,730	9.68
1999	915,014	92,980	1,008,000	9.22
2000	994,273	45,300	1,042,000	4.35
2001	1,041,866	21,600	1,066,200	2.03
2002	1,079,361	14,200	1,096,000	1.30

House loans, which can be considered as a form of savings, have, as shown in Table 07, increased sharply over the same period. Whilst the per capita investment in house loans increased steadily between 1985 and 1999 it has enjoyed marked growth since 2000. Thus, whilst people are consuming more, it can be concluded that part of this consumption is directed towards investing in acquiring houses as personal and long term assets.

Table 07: House Loans to Resident Households with All Banking Institutions[70]

Year	Total Resident Lending for House Purchase Lm 000s	Population	Per Capita House Loans (000s)
1985	37,692	340,907	0.11
1986	42,047	343,514	0.12
1987	46,488	345,636	0.13
1988	54,352	349,014	0.16
1989	64,440	352,430	0.18
1990	77,328	355,910	0.22
1991	84,427	359,543	0.23
1992	94,287	362,977	0.26
1993	98,885	366,431	0.27
1994	120,031	369,451	0.32
1995	132,559	371,173	0.36
1996	151,166	373,958	0.40
1997	173,690	376,513	0.46
1998	195,054	378,518	0.52
1999	224,089	380,201	0.59
2000	257,943	382,525	0.67
2001	306,722	385,077	0.80
2002	367,124	386,938	0.95
2003	442,245	388,867	1.14

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63 2.06 (i) The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004
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CHAPTER 04

Recommendations for the Reform of the Pensions System to render pensions adequate and sustainable

04

SUMMARY

Presents principles and recommendations in relation to:

01. Securing adequacy: that is, enabling people to maintain a decent standard of living and preventing social exclusion through the promotion of solidarity amongst generations.

02. Achieving financial sustainability: through the extension of working lives: sound public finances.

03. Responding to changes in working norms such as atypical and mobile workers; and the evolution of the social and economic roles of men and women.

04.1 Value System 01: Preventing Social Exclusion

The level of pension guarantee within a pensions system is determined by the shared responsibility of all the stakeholders involved and by the extent to which the pensions system is designed to guarantee a decent standard of living.

Policy instruments to achieve pension guarantees vary. Denmark and the Netherlands, for example, provide for a universal non-means tested flat rate pension linked to earnings to all persons who have been residents at working age. The new Swedish pensions system, on the other hand, includes a guaranteed pension that is only means tested against income from the statutory earnings related pensions scheme. Others offer top-up payments to raise earnings-related pensions entitlement to a specified minimum level.

The PWG believes that the new pensions system for Malta should balance the provision of a safety-net directed to prevent social exclusion in old age whilst allowing for flexibility to entice people to improve their economic wealth as well as to save outside of the State pensions system in order o enhance their quality of life once retirement is reached. In essence this signifies that the underpinning strategic thrust of the PAYG pension (or the First Pillar) should be that of guaranteeing a minimum decent standard of living to prevent social exclusion, with a Second Pillar to be introduced to allow for the improvement of the pension benefit entitlement.

The EU averages of the 50 to 64 and the 65 and over age cohorts found to be at the risk-of poverty (excluding the new ten member states) stand at 14% and 20% respectively; and Malta's position falls within these averages. This clearly demonstrates that the correlation between old age and poverty is not a myth. In essence, these relatively high risk-of-poverty ratios re-inforce the necessity of emphasising that the scope of the First Pillar Pension must be directed towards social inclusion and poverty prevention.

Decision of Principle: 03

There should be a minimum pension guarantee that acts as a safety-net against social exclusion.

The determination of the quantum of the minimum pension, however, cannot be a one off exercise. A mechanism needs to be introduced to ensure that the value of the minimum pension guarantee holds over time. A fair mechanism, thus, needs to be put in place to automatically assure against the erosion of the purchasing value of the minimum pension.

Decision of Principle: 04

A fair mechanism needs to be put in place to automatically assure the value of the minimum pension guarantee against inflation.

The debate that should ensue is that of determining the elements that are to be applied in the design of the instrument to meet this principle. A key element should be a mechanism that allows the State to 'top-up' the benefit in the event that the contribution base is not sufficient to meet the minimum pension guarantee.

It is, however, pertinent to underline that the 'top-up' mechanism should be subject to certain conditions of the contributory aspects of the pensions system. Thus, a 'top-up' should not be triggered as a matter of course. The 'top-up' should be directed to address gaps in an individual's work life that arise due to legitimate reasons: unemployment, ill-health, disability, etc.

Whilst Government should continues to uphold the fundamental premise that its policies must be moulded within a social conscience milieu, it cannot allow for persons to abuse and misuse the social safety nets it puts into place. There must, therefore, be no room for free riders - who ultimately live off the contributions paid by the majority of honest and hard working persons.

Decision of Principle: 05

The new pensions system must be supported by a strong compliance regime to safeguard honest and hard working persons as well as to deter abuse, fraud and mis-use.

04.2 Value System 02: Enabling People to Maintain Standards of Living

The purpose of pensions systems should not be limited to ensure that older people do not live in poverty – but that they should also provide for arrangements that allow people to maintain, to a reasonable degree, the standard of living they achieved during their working lives.[71]

The underlying issue is whether the State can be the sole guarantor to not only ensure a pensions structure that prevents social exclusion but one that also maintains the individual's level of standard of living. The current pensions structure assumes that the State can be the sole guarantor of this standards of living. In essence, the current pensions model discourages and penalises the principle of "self-help".

The pension studies carried out in Malta since 1997, as shown in Chapter 02, all conclude that there is a need to orientate the current philosophy from one where the State provides the complete pensions spectrum to one where the individual recognises the unavoidable limitations of the State and assumes greater responsibility to provide for his or her own needs on retirement – thereby ensuring the sustainability of the pensions system.

The primary mechanism to increase one's pension income should be through the introduction of a Second Pillar Pensions Scheme (SPPS). The introduction of the SPPS is a natural evolution of the pensions structure, as has been demonstrated in Europe and elsewhere, to ensure and guarantee adequacy by allowing for the provision of additional pensions cover to enable people to maintain a reasonable degree of their pre-retirement standards of living. In fact this is not a new concept to Malta. Prior to the introduction of the Two-Thirds pensions scheme in 1979 there was already a growing large section of the population covered both by a First Pillar (National Insurance) and a Second Pillar (Occupational Pension).

Decision of Principle: 06
The new pensions system should include a Second Pillar Pensions Scheme (SPPS) to increase one's pension income to enhance the standard of living.

It is natural that the standard of living of certain categories of people is such that would require further supplements in their pensions income in order to retain the value of their pre-retirement standards of living. In this regard, the new pensions system should also provide for a Third Pillar Pensions Scheme (TPPS). The TPPS shall be a voluntary option to complement the pensions income.

Decision of Principle: 07
The new pensions system should also provide for a Third Pillar Pensions Scheme (TPPS) which shall be a voluntary option directed to complement the pensions income.

Whilst the SPPS and the TPPS need to be treated separately because of the different issues they present, an issue that is common to both Pillars refers to the regulatory regime that needs to be in place in order to ensure the good governance of the system.

Discussions on private pension insurance schemes in Malta have been shrouded with an aura of uncertainty stemming from the international accounts of abuse of private pension insurance schemes by employers leaving the contributors in dire straits. In truth, the dangers of private pension insurance schemes tend to be more the outcome of mis-management or mis-selling of funds as against ones of fraud. This strengthens the argument in favour of a strong regulatory framework for the management of the SPPS and the TPPS – with governance to be as comprehensive as possible.

The options open to Government in this regard are two-fold. First, Government, given the specific nature and sensitivity of the issue of pensions could establish an 'ad hoc' Pensions Authority that would act as the guardian over the SPPS and the TPPS; with the role of the Pensions Authority being embedded in a pensions legislation. Alternatively, Government could utilise existing institutions and legislation to undertake the governance role in this regard.

The PWG is of the considered opinion that a very strong regulatory regime under the responsibility of an institutional entity that is independent from Government is a far more effective guardian than entrenching such a role within central Government. Independence is a necessity, if not for any other reason, for the very basic fact that Government itself must be regulated in terms of the SPPS it establishes for its employees.

It is pertinent to underline that the OECD Recommendation on Core Principles of Occupational Pension Regulation establishes this principle:

> *"An adequate regulatory framework for private pensions (that) should be enforced in a comprehensive, dynamic and flexible way & in order to ensure the protection of pensions plan members and beneficiaries, the soundness of pension plans and funds and the stability of the economy as a whole… The development of advanced-funded pensions system should go hand-in-hand with a strengthening of the financial market infrastructure and regulatory framework…".*[72]

In this regard, it is believed that the regulatory role over the SPPS and the TPPS schemes should reside with the Malta Financial Services Authority (MFSA) which, since its institution, has garnered strong credibility for good governance of the financial market. "Moreover, the SPPS and the TPPS should be regulated by the Special Funds (Regulation) Act, 2002.

The Special Funds (Regulation) Act, 2002 and the accompanying directives and guidelines provide for a very strong and tight regulatory regime designed with considerable thought and care factoring in the experiences and lessons of other overseas jurisdictions in the management of the SPPS and the TPPS. **Appendix VIII** provides a short review of this Act.

Moreover, it should be noted that the MFSA has built considerable competence and capacity in this regard resulting both from the drawing up of the comprehensive and water tight guidelines supporting the afore-mentioned Act, as well as from the appropriate capacity building undertaken in this area. The MFSA should prove, as it has clearly demonstrated in other areas in the financial services domain, to be a competent guardian over the management of the SPPS and the TPPS.

Decision of Principle: 08

The regulation of the SPPS and the TPPS should be entrusted to the MFSA operating under the Special Funds (Regulation) Act 2002.

04.2.1 The Second Pillar Pensions Scheme

The design of the SPPS can be moulded either on a mandatory or a voluntary basis. The mandatory model, by designation, ensures that an individual will save in a pensions fund or insurance scheme and thereby guarantees that the individual will safeguard his or her standard of living upon retirement. The voluntary scheme is very much dependent on education and information campaigns that induce people to understand the long-term benefits of such an investment. A voluntary scheme may be susceptible to people's spending and saving patterns, a rationale that the future will take care of itself, as well as to the information made available to them. A voluntary scheme will also depend on the level of incentives, such as taxation incentives, made available to entice people to partake in a scheme.

The design of a framework for a SPPS requires consideration of a number of institutional issues. These are discussed hereunder.

(a) The Constitutional Make Up of the Second Pillar Pensions Scheme

The first consideration relates to the constitutional make up of the SPPS. Should the SPPS be constituted in terms of a Pensions Fund that is centralised and managed by the State or should it be on the basis of occupational schemes that are established by individual employers The former may be construed by employee organisations to be a more secure institutional arrangement that protects the workers' contributions from potential fraud and mis-management.

It is pertinent to underline that from the discussions held with the respective Chairmen of MCESD and the NCWR it results that there exists locally a strong school of thought that favours a SPPS that is managed completely by Government under the supervision of a Board of Trustees that includes the social partners. Whilst this model may seem attractive at first glance, and is applied in some overseas jurisdictions, it does have limitations.

The management of funds – and a pension fund would be similar to any other form of investment fund – is a specialised skill that requires actuarial knowledge. The State does not have these skills as it has amply demonstrated so far. Building these skills may be difficult and this could mean that the management of the SPPS may be placed under a regime that is second best. Moreover, a SPPS placed under the authority of Government will not fall under the regulatory regime of the Special Funds (Regulation) 2002.

The argument that the private sector is not to be trusted in a matter as sensitive as a SPPS is one that may not necessarily hold. The core issue is not the private sector per se, but rather the regulatory regime that is applied to ensure that the private sector, or for that matter Government as an employer, operate within strong and appropriate norms that inspire confidence and guarantee credibility in the management of the SPPS.

To apply an analogy, most individuals find no difficulty to trust their life time savings, surely as important as a pension, with a private bank for investment purposes. The trust applied is no doubt motivated by the knowledge that a private Bank behaves correctly and that it is effectively and tightly regulated, thereby ensuring that it is not only perceived to do so but actually does behave correctly. There is no reason to surmise why the same trust and belief cannot be accrued to the private sector management of the SPPS and the TPPS within the ambit of a tight regulatory framework.

In the event that the occupational schemes model is adopted, rather than the centralised State managed SPPS discussed above, a number of issues would need to be discussed. Should the SPPS be (a) a common system applicable to all; or (b) subject to collective bargaining between the employers and the Trade Unions; or (c) ties the employee to the pension scheme selected by the employer or (d) should individuals be given the freedom to select the SPPS of their choice?

Occupational schemes set up through a collective agreement regime could vary from one company to the other which may lead to a considerable disparity of pension schemes that will render administration and regulation difficult. On the other hand a uniform SPPS would provide the contributor with no choice in the savings plan that the person would wish to adopt other than the elements mandated by the regime introduced – unless of course the person complements the SPPS with a TPPS investment. Moreover a rigid regime could also limit competition amongst the SPPS providers as there would be very little to differentiate between schemes provided by different insurance firms and limiting benefits arising to contributors due to competition.

Introducing an element of choice in the design of the SPPS will provide a contributor with flexibility within the confines of the SPPS without the need to opt to a TPPS investment and thus incur the additional administration cost related to the Third Pillar regime.

It is thus proposed that the SPPS should constitute of two tiers:

- A first tier that will be common across all Second Pillar schemes and that will ensure that investors in the SPPS will be covered by means of a common framework that will enhance the First Pillar pension in order to provide for a decent standard of living following retirement. This tier will be financed through contributions made by both the employee and the employer.
- A second tier that will be flexible and voluntary and that will provide room for choice that will allow the individual to invest more, within the SPPS itself, on a range of schemes which could include widows' pension, invalidity pensions, etc in the event that the individual would wish to increase the resultant benefit above that set by the tier referred to above. This tier will be financed solely by the employee and will not be subject to tax incentives that may be introduced for the SPPS.

Decision of Principle: 09
The SPPS should be established in terms of a common yet flexible scheme basis.

A common yet flexible scheme that ties an employee to a SPPS occupational fund established by an employer has a number of limitations. First, the fund generated will reflect the size of the organisation which employs the employee. A small organisation will result in a small fund that will by its nature restrict the quantum of the return on the fund. In part this constrain can be mitigated by allowing different firms and employers to join together to establish a common fund. Second, a strict occupational scheme will necessitate an employee to exit one firm's pensions fund and enter into the new employer's pensions fund when the employee is changing employment. This will place an administrative cost burden on the employee as portability costs will be incurred.

A far better mechanism is that of allowing the employee to choose the pensions fund he or she wishes to subscribe to. Given that the first tier of the SPPS will be common across organisations such a mechanism will be easy to operate and will provide the employee with a choice in the SPPS provider. The employer will not be negatively impacted as the cost of his or her share of the contribution will not change.

A common SPPS should not restrict employers and organisations from creating supplementary pension funds over and above the proposed SPPS in order to render the organisation or work place more attractive for the hiring and the retention of employees.

Decision of Principle: 10
An employee should have the right to choose the provider of the SPPS.

The SPPS is to apply to a self-employed person as well. The principles of the SPPS for a self-employed person will be no different to that established for an employee. The self-employed person would be able to choose the nature of the scheme he or she wishes to subscribe to – that is, either by choosing the pension provider, or joining up with other self-employed or self-employed associations.

Decision of Principle: 11
The SPPS will also apply to the self-employed.

(b) Applying Strict Criteria for the Providers of the Second Pillar Pensions Scheme

The question of whether the establishment of a free market in terms of the private sector firms providing SPPS is a viable model for Malta due to economies of scale is definitely a matter that needs to be looked into. A number of issues require discussion in this regard.

First, a school of thought argues that given the size of Malta and the need to minimise the cost of administration of SPPS, a model that sees Government as the trustee with the fund awarded by means of competitive tender to a single private firm would provide for the best way forward. A danger resides with this model. The issuance of such a tender would be pan-EU member States. The possibility that a large international insurance provider undercuts the private sector insurance local market is a possibility that cannot be ignored.

Second, addressing the economies of scale issue by prohibiting a free, but a tightly regulated market, distorts the free market and denudes the opportunity for competition that a free market renders possible. It is pertinent to underline, that the OECD recommends that:

"Regulation should promote a level playing field between the different operators and take account of the usefulness of a functional approach. The fair competition should benefit to the consumers and allow for the development of adequate private pensions markets."[73]

A model that is tightly regulated where private sector insurance firms will need to qualify against stringent criteria established by the regulator to attain official accreditation from the said regulator to act as SPPS managers is considered to be superior to one that removes competition altogether.

In this regard criteria for the selection of private sector insurance firms to provide the SPPS would include measures such as the requirement to:

(i) have full time-actuarial experts;
(ii) appoint an auditor, independent of the pensions' entity administrator (i.e the selected private sector insurance firm), and the plan sponsor (i.e. the employer) to carry out periodic audits;
(iii) be subject to review by the regulator on-the adequacy of the schemes provided in terms of risks and benefits;
(iv) be subject to review by the regulator-with regards to the fee structure and plans performance;
(v) be subject to review by the regulator with regards to the rights of access to, and disclosure of information by the contributor about the pension plan, claims processes, etc;
(vi) be subject to review by the regulator on the rights of redress provided to the contributor;
(vii) be subject to review by the regulator with regards to the criteria adopted for advertising to minimise dangers of misinformation or inducement of potential members to make a choice based on incorrect information; and
(viii) meet marketing regulations to maintain costs arising from marketing expenses to an absolute minimum and thereby reduce or control the potential significant impact of marketing on the cost of administration of the fund.

Furthermore, the regulations should assure that access to the SPPS should be non discriminatory to avoid exclusions based such as age, salary, period of service (from when the SPPS is introduced), terms of employment, part-time employment and civil status. Moreover, the regulations should also ensure that the rights resulting from the above criteria are protected.

Decision of Principle: 12

Entry into the SPPS provision by private sector insurance firms must be subject to strict entry and performance criteria that must be met at all times.

(c) Establishing the Nature of the Second Pillar Pensions Scheme

Should the SPPS be a defined benefit or a defined contribution scheme? In a defined benefit scheme, the level of benefits is determined by the scheme rules. Pensions are generally linked to the length of time an employee is in the scheme and his or her salary at a set point in time or averaged over a set period. Final salary schemes provide a portion (for example 1/100th a year of membership of the scheme) of final salary at retirement. Other common variants are based on life time average earnings over a said period.

In a defined contribution scheme set periodic contributions are invested. The resulting pension depends on the amount paid into the scheme, the investment return over time, and the annuity rates at retirement.

Research shows that average contribution rates tend to be higher in defined benefits schemes.[74] It is however, pertinent to underline, that research shows that most countries and organisations are moving away from the ‘Defined Benefits’ model to the ‘Defined Contributions’ model as the ‘Defined Benefits’ model has proved difficult to sustain.

(d) Safeguarding the Beneficiaries of the Second Pillar Pensions Scheme

SPPS’ members rightly expect that the pension promised will actually be delivered. Dangers reside in the possibility that the SPPS may be wound up, as employers, for example, become insolvent. This in turn raises the issue of the level of protection that is to be provided to beneficiary during his or her life-time.

Policy instruments in this regard would need to be introduced both to ensure the strong foundations of the regulatory set-up as well as to safeguard the beneficiary during his or her life time.

First, as already pointed out, it is important that the “pension fund must be legally separated from the sponsor (or at least such separation must be irrevocably guaranteed through appropriate mechanisms)”.[75]

The afore mentioned Special Funds (Regulation) 2002 Act already provides for such a strict separation to ensure that pension assets are distinct and different from the sponsors’ own assets through the requirement that sponsors appoint Retirement Scheme and Retirement Fund administrators as appropriate. The administrator is vested with the power to administer the pension fund and is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interests of plan members and beneficiaries.

A second under-pinning measure is to establish pension funds as autonomous assets that are ‘ring-fenced’ in an ironclad manner that would prevent both the State or a private firm as employers from accessing these funds for matters that are not strictly related to pensions.

Decision of Principle: 13

The SPPS contributions paid by the employer must be strictly separated from the said employer; with the pension fund established as an autonomous 'ring-fenced' asset.

A third under-pinning measure relates to the regulatory framework that will be applied in the constitution of the SPPS asset in terms of how the investment portfolio is organised. In this regard, the MFSA, as the regulatory authority, would be tasked to design investment management standards based primarily on the prudent-person pensions principle in order to, firstly, ensure the safety and security of these assets and secondly, to create an environment in which asset management can obtain the best returns at an acceptable level of risk.

It is further argued that the prudent-person principle should be complemented with a number of quantitative limitations related to diversification. For example, the portfolio will be structured in a manner that establishes thresholds to be invested in, say, a single firm, foreign assets, real estate, etc. Moreover, the regulations should set restrictions to limit the SPPS' provider's ability to invest in its own assets or subsidiaries.

Decision of Principle: 14

The SPPS should be managed on the prudent-person principle together with (a) the inclusion of specified limitations to determine the diversification parameters of the investment portfolio, and (b) restrictions to limit the private sector insurance firm managing the portfolio to invest in its own assets or subsidiaries.

Various models can be applied in terms of instruments directed to safeguard the beneficiary during his or her life time. For example, a measure that will provide SPPS members with greater security against the possible pension implications of insolvency is the introduction of an insurance scheme for such an eventuality – with different models offering different degrees of benefit replacement and guarantee. Another model could consist of the creation of a privileged pension credit in the same way as an employee's salary is privileged in the ranking of debts owed by an employer. In this regard, the Companies Act would need to be amended as appropriate.

A further model, and by far the more effective mechanism, is the constitution of a Pensions Compensation Fund. Pensions Compensation Funds are generally established to:

01. Protect the SPPS when firms become insolvent by ensuring that the members will continue to receive most of the benefits which they were expecting. Different levels of compensations could be established for members of the Scheme.

02. Compensate members of the SPPS in cases of fraud and misappropriation.

Pensions Compensation Funds are generally run by independent Boards – which will be responsible for: paying pension compensation; paying fraud compensation; setting and overseeing the investment strategy of the said Compensation Fund. The Board would ordinarily be required to provide an annual report and accounts describing the activities of the Board in that financial year, which is then presented to Parliament. The issue of funding and management of such a Compensation Fund would have to be examined if and when this alternative model is adopted.

Decision of Principle: 15

Measures to provide for financial protection to SPPS contributors and pensioners against fraud, mis-use, insolvency, etc, must be introduced, and should be designed in a manner that places the least burden on stakeholders.

(e) Assuring Portability and Safeguarding Against Opt-Out from the Second Pillar Pensions Scheme

Individuals should be able to change the provider of their SPPS. Such, portability should not only be timely but should entail no hidden costs. Thus, portability should be devoid of charges or fees such as excessive transaction charges or excessive back end fees unless these fall within criteria set by the regulator.

The introduction of a portable SPPS would be governed by EU Directive 2003/41/EC, which removes the obstacles of cross border management as an employee changes employment from Malta to an EU Member State. Thus portability will take affect not only between employers in Malta but also within the European Union.

It is argued that contributors to a SPPS should not have the option of liquidating their account balance in the fund. In the event that the choice for liquidisation is made available, the danger resides that beneficiaries may opt for 'cash in hand today' which in turn will leave them in a difficult state of play upon retirement as the provision to be rendered upon retirement for a 'decent' standard of living would have been considerably diluted.

A direct consequence of a policy approach that allows for liquidating is the creation of a social problem as a cohort of pensioners could end up with only the First Pillar pension contribution – which is directed primarily towards the prevention of social exclusion.

Decision of Principle: 16

Funds under the SPPS should be portable and a person should not have the option to liquidate the fund.

(f) Rewarding Savings and Investment in the Second Pillar Pensions Scheme

SPPS should be incentivised. One would argue that this would be necessary if the SPPS is to be constituted on a voluntary basis. Should the argument also hold in the event that the Second Pillar is introduced on a mandatory basis? The PWG is of the considered opinion that a mandatory SPPS should also be subject to tax incentives primarily to partially offset the impact on disposable income arising from annual savings that would be invested in the SPPS.

What form should such tax incentive take? For example, should there be tax deductions of contributions to Second Pillar schemes? Should there be exemption of the schemes' investment income during the accumulation period? Should 'benefits' received on the maturity of the pension scheme be exempt from income tax?

Decision of Principle: 17

The annual contributions into a SPPS should not be taxed on an annual basis. A maximum tax, established at a fixed percentage rate, should be paid upon the maturity of the Scheme.

(g) Managing Benefits Upon the Maturity of a Second Pillar Pensions Scheme

When an individual retires, in a SPPS there are three ways by which the person can take the retirement benefits:

(i) as a lump sum payment – which may be dissipated as a one-off expenditure leaving the pensioner destitute;

(ii) programmed withdrawals over the retirement period - which involves longevity risks if the pensioner lives longer than expected; and

(iii) annuity from an insurance company - a contract sold by life insurance companies which guarantees income from the point of purchase until death.

Annuities play a key role in the assurance of retirement income in a SPPS as they:

- provide insurance against the risk of outliving assets, which is possible given the large numbers involved;
- remove inflation risk through indexed annuities (if suitable price indexed bonds are available); and
- minimise investment risk.

The trade-off is the losses in terms of missed opportunities to invest freely; where the argument may be made that a mandatory SPPS limits the right of choice of the individual.

It is argued that annuities, if fairly priced, allow maximisation of income over a pensioner's life time compared with other ways of releasing assets. Annuities can also provide a smooth income consistent with what is typically assumed to be a desired pattern of consumption.

There are various types of annuities available with different characteristics – for example: with profits annuities; inflation indexed annuities; wage index annuities; etc. In order to counter the possible risks related to annuities the regulatory framework will establish the parameters of investment mix between secure investment and risk investment and thereby minimise the exposure of investment loss. Thus the, regulation of annuities is essential and mandatory to ensure the integrity of the system. It is being assumed that given today's awareness of the demographic trends and epidemiological developments the determination of the mortality rates by insurers should be reasonably reflective.

It is pertinent to underline that the regulation of annuities is already provided for under the legal framework for the regulation of insurance business in Malta, in line with the relevant EU Directives. The regulation of annuities specifically within the overall pensions system may, however, need to be addressed and amendments would be required in this regard.

Decision of Principle: 18

The SPPS should upon maturity allow for the option to convert a maximum established part of the individual matured pension fund into a lump sum and with the bulk placed as an annuity to provide for a steady annual pension income over the lifetime of the pensioner.

(h) Securing Social Good

The SPPS should be introduced on a mandatory basis.

The rationale behind this position is the individual's cognisance of the real need to invest today to safeguard one's future upon retirement.

A worrying trend that is emerging is the perception that the future is far too distant and will, in any event, take care of itself. Whilst education may result in raising a degree of awareness that investment in a voluntary SPPS is a necessity, the possibility that large segments of the population will fail to understand the importance of the relevance of such investment cannot be excluded. In such an event, those segments of the population that during their life time would have failed to invest in the SPPS to secure for a decent standard of living during retirement may face a crisis as they realise that the standard of living enjoyed whilst in employment no longer remains sustainable.

What may constitute a personal tragedy to a family arising from a failure to plan for the future will become a national social crisis if this becomes the tragedy of large segments of the population. Thus, a mandatory SPPS is directed and motivated solely by the need to secure social good for ~~the~~ people by ensuring that they will, upon retirement, receive a pension that is not only adequate, but that allows for the maintenance of a decent standard of living.

Decision of Principle: 19

The SPPS should be introduced on a mandatory basis.

(i) Implementing the Second Pillar Pensions Scheme

The transition towards a pensions -system that is multi-pillared with a mandatory SPPS should be gradual and carried out over a reasonable period of time. The first phase towards the establishment of the proposed multi-pillared pensions system should be that of introducing the SPPS, initially, on a voluntary basis. The needs for a transition period in the establishment of a mandatory SPPS are various.

The establishment of a SPPS in Malta will be a novel development to a large group of persons who joined the workforce past 1979. Every measure will have to be taken to ensure that the regulatory and governance framework for the SPPS already in place today and those proposed in this Report are the appropriate ones for its proper functioning. A period of voluntary application of the SPPS will provide contributors with the appropriate time to gain confidence in the SPPS and the regulatory regime established to govern it. It is argued, that the transition to a mandatory SPPS would be far more appropriate once national trust in this new framework is built over the period of its voluntary application.

Furthermore, the SPPS framework will be funded by contributions made by both employers and employees. A transitionary period to a mandatory SPPS will provide both employers and employees time to adjust towards the application of a mandatory SPPS.

The introduction of a SPPS will have the following impacts:

(i) **Employees:** A mandatory savings contribution will impact disposable income – as income is channeled from savings or consumption today to savings and investment for retirement.

A way to partially mitigate this impact on disposable income is for the MFSA and Government to work with private insurance firms to introduce a scheme that will allow holders of life endowment and similar policies to convert such policies into a SPPS. The conversion scheme would transform such policies from their current conditions and benefits to the Second Pillar regime.

People who opt for such a scheme will inject their SPPS with the capital already accrued within the insurance policy, and in terms of the savings contribution to be paid to the SPPS they will continue to pay the previous insurance policy fee and where so necessary, the difference between the fee and the established Second Pillar savings contribution.

This policy measure would impact 79,315 holders of life endowment and profits related policies.[76]

Decision of Principle: 20

MFSA and Government will work with private sector financial firms to encourage them to introduce a scheme that allows owners of life endownment and profits related policies to convert such policies into the SPPS.

(ii) **Employers:** A mandatory contribution will impact the cost of labour; though the increased cost of contribution will be tax deductable given that contributions are a Profit and Loss item.

A transition period will provide Government as well as social partners to explain, educate and build a culture for the importance to save and invest today in order to ensure that a person accumulates sufficient funds to be able to have a decent standard of living following retirement.

Decision of Principle: 21

The SPPS should be introduced in a transitional manner< with the SPPS to be first introduced on a voluntary basis as from 1st January 2006.

The last, yet important, issue in relation to the introduction of the SPPS relates to (a) the determination of age that will establish the age cohorts that will start mandatorily contributing to the SPPS; and (b) the contributions that are to be paid to the SPPS by both the employer – which includes Government as an employer – and the employee.

The determination of the age limit is very much correlated to the return on investment over time to the contributor - in that the investment in the SPPS will provide sufficient income to render it viable to allow a person to attain a decent standard level of living upon retirement.

The Second Pillar, unlike the First Pillar which is determined by the demographic replacement rate, is mainly determined by the market rate. It so follows, therefore, that the longer the period for the introduction of a mandatory Second Pillar, the greater is the risk for people who do not voluntarily take up a SPPS to have a lower return on a lower quantum of investment made; and thereby diluting the provisions required to secure a decent standard of living.

The actuarial studies, undertaken by the World Bank on the pension model it simulated, show that:

(i) the Second Pillar should be introduced for those persons who are 45 years of age and below;

(ii) initially establishing the contributions to the SPPS by the employee and the employer to be 2% each, with the contribution to be based on the basic wage; and

(iii) gradually increasing the contribution to reach 5% each by 2020.

The transition from a voluntary to a mandatory SPPS should take place only following the undertaking of intensive studies directed to determine the:

(i) impact on the cost of production and labour as well as the multiplier effect on the economy due to a potential decrease in disposable income;

(ii) cut-off age for the introduction of the mandatory contribution;

(iii) quantum of the Second Pillar savings contribution to be paid by an employee and the employeer in the case of an employed person; and by the self-employed;

(iv) the indexation to be applied to the SPPS;

(v) the capping to be placed on the SPPS savings contribution in proportion to the wage or income earned; and

(vi) definition of whether the SPPS should be introduced as a defined benefits or defined contribution scheme.

It is thus proposed that the Government, through the MFSA, should appoint an international firm of actuaries to carry out the appropriate studies.

Decision of Principle: 22

The determination of the parameters of a mandatory SPPS should be taken on the basis of intensive actuarial studies.

As shown in Chapter 03 the benefits accrued under the current PAYG pension will start to deteriorate around 2010 – falling from 50% of the average wage to 40% by 2020 and 30% by 2035. The interpretation of these actuarial results leads to one conclusion: the transition period from a voluntary to a mandatory SPPS cannot be indefinitely postponed. The longer the transition period the greater the risk and danger that a larger cohort will become transition casualties as a mandatory SPPS will not provide this cohort with the necessary time required for contributions to the SPPS to accrue the market rate of return on the investments made to secure a decent standard of living.

In order to provide the optimum period for the SPPS to render the necessary rate of return on the investments in a SPPS by those cohorts of persons who will be seriously effected if no reform is made to the current pensions system, indications are that a mandatory SPPS should be introduced by 2010.

It is thus proposed that the Government should take all the necessary action to establish the appropriate mechanisms to enable the introduction of the mandatory SPPS by 2010. Nevertheless, the actual introduction of the mandatory SPPS should only take place following an assessment in 2009 to determine whether the prevailing conditions at that point in time are such that necessitate the mandatory introduction of the Second Pillar in 2010.

Decision of Principle: 23

Indications are that a mandatory SPPS should be in place by 2010. Government should take all necessary action to establish the appropriate mechanisms to enable the introduction of the SPPS by 2010. Nevertheless, the Government should in 2009 undertake an assessment to determine whether the prevailing conditions at that point in time are such that necessitate the mandatory introduction of the Second Pillar by 2010.

04.2.2 Third Pillar Pensions Scheme

The TPPS comprises voluntary private pensions schemes that complement one's pension income. It is recognised that an individual will be far more motivated to participate in a TPPS if Government introduces tax incentive schemes that will render it sufficiently attractive for individuals to participate in such a scheme. The issues, therefore, relate to the taxation incentive regime that Government will introduce. Thus, should contributions paid and dividends earned under a TPPS be tax-exempt Should the accumulated fund be entirely tax-exempt

Decision of Principle: 24

The annual contribution to the TPPS should be non-taxed up to a capped limit. The income derived on the maturity of the TPPS will be subject to income tax based on the individual's PAYE rate.

04.3 Value System 03: Promoting Solidarity Amongst Generations

Pensioners today are benefiting from the net of social solidarity that has been networked over the last fifty years, and many today are in fact receiving a Two-Thirds pension, following changes made in 1979, despite the fact that were one to apply the actuarial logic it would clearly emerge that not enough contributions have been put into the system to allow a person to receive such a rewarding benefit.

The PAYG pension must remain the main mechanism to ensure solidarity amongst generations – that is between the young and the old, the well to do and those on the fringes of society. In this regard, contributions to the PAYG pension, or the First Pillar, should remain mandatory. There should be no opt out from the First Pillar. The First Pillar must continue to enforce the redistribution principle which is at the basis of the social inclusion network to ensure that persons who legitimately may face social exclusion are safeguarded.

Decision of Principle: 25

The First Pillar must remain as the main mechanism to ensure solidarity. Participation in the First Pillar is to continue to be mandatory.

Solidarity within generations can be achieved by ensuring that the First Pillar pension income is annually built up for all pensioners on a uniform annual basis.

This would necessitate ensuring that the First Pillar pension retains its value in terms of erosion due to inflation. A pension that is indexed by wage increases is subject to the vagaries of economic growth and the behaviour of the labour market.

On the other hand, if a pension is linked to the Retail Price Index, the yardstick applied by Government to measure inflation[77], its real value as well as purchasing power will be better secured. The World Bank in its report states that most countries are moving to inflation indexation as this provides better security to retirees in terms of purchasing power during retirement, with their pension entitlement being independent of the behaviour in wage rates.[78]

Decision of Principle: 26

Solidarity within generations requires that the First Pillar post-retirement pension income is annually built up for all pensioners on an annual uniform basis. The annual uniform basis to be applied should be the Retail Price Index.

04.4 Value System 04: Raising Employment Levels

Government has developed a National Action Plan for Employment (NAPE) for 2005 within the European Union employment strategy.

As articulated in Chapter 03 of this document, the broadening of the contribution base is an essential premise that the proposed pensions system must also address for the fiscal sustainability of the pensions system, in tandem with complementary activities undertaken by Government to induce economic growth and to ensure that a trained and adequate labour supply is in place.

As has already been shown, the pensions studies carried out to date are all consistent in highlighting that Malta has a demographic challenge that will impact the financial sustainability of the pensions system. They also strongly highlight the need for the labour force to be enlarged. These studies are also consistent in that the retirement age needs to be increased. They diverge in the detail but not in the principle.

The PWG concludes that a change in the statutory retirement age is a necessity in order to compensate for the impact arising to the demographic replacement rate due to the anticipated shifts in the demographic structure of the Maltese population. In this regard, the PWG is of the considered opinion that the recommendation of the NCWR that the statutory retirement age is increased to 65 years to be a positive measure in this regard.

Decision of Principle: 27

The recommendation of the NCWR to increase the statutory retirement age to 65 years is a positive measure directed to broaden the contribution base as well as to enlarge the pool of labour supply.

Gender is to have no bearing on entitlement to the retirement pension. Therefore, there are to be no differences in the statutory retirement age for men and women.

Decision of Principle: 28

The statutory retirement age of 65 years will be for both men and women.

The issue for discussion in this regard lies with the mechanics to be applied in terms of raising the retirement age. Should this be done with immediate effect for all persons in employment as from 1st January 2006 Should implementation be incremental by means of increasing 1 year every set period starting from 2006 Should implementation be directed to a particular age cohort – for example, for all persons who will be 44 and younger as from 1st January 2006 Should the retirement age be mandatory or should it be treated as a reference value for attaining the nominal pension value with the actual retirement age to be decided by the individual, with the

pension benefits being accordingly adjusted in an actuarially fair manner
Various models can be applied. The model that will have the more positive social impact for both men and women is one where the pension age of 65 years is reached in a phased manner. Thus, the following incremental introduction of an increased mandatory pension age of 65 years is proposed:

(a) in terms of women, the pension age will be 61 years of age with effect from 1st January 2007;
(b) the increase of the pension age for all to the 65 years threshold will start from 1st January 2007, persons holding the following years of age will retire as follows:

Table 08> Scaled introduction of 65 years Statutory Retirement Age

Years of Age as at 1st January 2007	Retirement Age
55 years of age and over	No change
52 years of age to 54 years of age	62 years
49 years of age to 51 years of age	63 years
48 years of age and below	65 years

Despite the raising of the statutory retirement age, it should still be possible for individuals to opt for a shorter career between the age of 61 to 65 years on the basis of proportionate benefits.

Decision of Principle 29

The rising of the statutory retirement age to the proposed 65 years should be gradual with women reaching the 61 year threshold in 1st January 2007. Subsequent to which the statutory retirement age is to increase as shown in Table 08. Individuals should be able to opt for a shorter career between the age of 61 to 65 years on the basis of proportionate benefits.

04.5 Value System 05: Extending Working Lives

The new pensions system should be designed to keep employees within the pool of labour supply even when they retire by introducing mechanisms that will encourage longer working lives.

The discussion now focuses on the policy instruments that should be introduced to achieve this policy goal. The policy instruments are diverse and may range from removal of early retirement schemes at least where the employer is Government, introducing actuarial reductions for early retirement, rewarding with higher pension accrual rates when a person continues to work beyond a certain age, introducing flexible retirement arrangements, and allowing for flexible part-time working arrangements.[79]

It is argued that to the extent possible, the measures adopted should be kept simple, yet at the same time designed to be effective. It is thus proposed that any person who wishes to continue working past the new statutory retirement age can continue to do so with no capping to be placed on the income he or she will earn. In such a case the individual would be eligible for both the First and Second Pillar pension.

The said individual will, however, continue to pay his or her contribution in terms of the First Pillar. There will be no condition placed upon an employer to retain a person beyond the statutory retirement age.

Decision of Principle: 30

A person may opt to continue to work beyond the new statutory retirement age, whilst enjoying the First and Second Pillars pensions, with no capping on the income earned, subject to the payment of the First Pillar contribution.

It is to be noted that a relatively high proportion of Maltese people claim invalidity benefits and exit the labour force, and thus withdraw from economic activity. In 2002, the number of beneficiaries in respect to invalidity pensions stood at 7,560 – a 12.8% increase on 2001, and a 30.8% increase on 1998.[80] The total cost of invalidity pensions as at 2002 stands at slightly over Lm12 million – that is, 15% of the total cost of pensions in respect of retirement pensions which stands at Lm80.9 million.[81]

In essence, therefore, the invalidity pension may have become an exit route not only for those who present a genuine case but also for those who decide to opt out of the labour market. In this regard, it is argued that the invalidity pension schemes in place today are reviewed in order to tighten the criteria under which an individual applies for an invalidity pension. Moreover, the policy instrument should be directed towards rehabilitation as against withdrawal – by adopting the principle of ‘rehabilitation comes before pension’ as well as by offering suitable alternative work.

Decision of Principle: 31

The current invalidity pensions scheme should be reviewed with a view to tighten the eligibility criteria as well as to adopt the principle of ‘rehabilitation or alternative work before pension’.

04.6 Value System 06: Adjusting the Existing Pensions System in a Balanced Way

The principles expressed in this Report are measures that help to redirect both the institutional fabric as well as the ethos of a new pensions system to ensure sustainable adequacy. There is, however, no doubt that changes in the institutional design alone will not suffice.

Whilst Government should continue to uphold the fundamental parameter under the current regime for the provision of a Two-Thirds pension to persons, it is argued that changes in the format and parameters applied in the existing system are required.

The parametrical changes to and departures from the current pensions system that are considered are discussed hereunder.

04.6.1 The Contribution Calculation Base-Line

Both the social security contribution and the Two-Thirds pension entitlement are calculated on the basic wage or salary capped to a statutory limit[82].

The World Bank argues that the existing policy instrument has several shortcomings; namely[83]:

(i) It delegates to employers and employees the opportunity to manipulate the tax base.
(ii) It distorts labour markets as employers will find it cheaper to hire overtime workers instead of hiring new workers.
(iii) The system's replacement rate does not have a one-to-one relationship with the actual income during employment, which may defeat the objective of income replacement.
(iv) It requires higher tax rates, which could convey the wrong information to the market.
(v) It increases administrative costs to employers and the tax authorities in dealing with different bases for the payment and collection of the income and social security taxes respectively.

The World Bank thus recommends that to correct the problems mentioned above a total salary (cash, overtime and in-kind payments) is adopted as the contributions base, similar to income tax.

Whilst the extension of the contributions base from basic salary to total salary may, at the cost of moving away from the principle of equating benefits earned to contributions paid, be justifiable in terms of achieving solidarity amongst generations to further secure fiscal sustainability, it is argued that the application of the total salary base for pension purposes is not an appropriate social instrument as this will generate pressures on those persons who are earning less than the maximum pensions income of Lm6,750.

Decision of Principle: 32

The contributions calculation base-line for the First Pillar pension should be retained on the basic salary.

04.6.2 The Contribution Period for the Accumulation of the First Pillar Pension

The current pensions structure practically allows a person to accrue the Two-Thirds pension after 30 years of employment. Thus a person who joins the labour force after the completion of secondary, upper secondary and tertiary education will meet the 30 years contribution period at 46, 48, and 51/2 years of age respectively.

In essence, this implies that most individuals continue to contribute until they reach the statutory retirement age without accruing any tangible benefits for the period worked beyond the 30-year contribution period. It is, thus, argued that the contribution period should be reviewed to equate it to a life time working period. In this regard, the World Bank recommends that the contribution period for the accumulation of the First Pillar Pension should be increased to a 45 years contribution period.

There is no doubt that the contribution period for the accumulation of the Two-Thirds First Pillar pension should convey a truer and fairer reflection of a persons' work career and should be designed with the necessary disincentives in place to discourage early retirement or abusive access to invalidity pensions. It is thus believed that a 40 year contribution period would be a truer and fairer reflection of a full career definition then the threshold in place under the current regime.

Nevertheless, this parametrical change should be introduced in a scaled manner targeting different age cohorts according to Table 09 in order to smoothen the impact of its introduction with particular regard to those persons who are reaching retirement age. Moreover, in the context of this proposed measure the option to allow individuals to make voluntary payments to bridge any gaps in the contribution record necessary to accumulate a period of 40 years subject to certain conditions should be positively considered.

Table 09: Contributions Period for the Accumulation of the Two-Thirds First Pillar Pension

Years of Age as at 1st January 2007	Accumulation Period
46 years of age and over	No change from current accumulation period
40 years of age to 45 years of age	35 years
39 years of age and below	40 years.

Decision of Principle: 33

The contribution period for the accumulation of the Two-Thirds First Pillar pension should be according to Table 09.

04.6.3 The Time Based Period for the Calculation of the First Pillar Pension

The current time based period for the calculation of the pension is for Class I contributors (employees) on the basis of the average of the best three consecutive years out of the last ten years or for Class II contributors (self-employed) on the basis of the average of the last ten years. The time based difference between the two classes of contributors creates a number of issues. These are:

01. It discriminates between a self-employed and an employed person. Whilst the reasons for such discrimination may have been understandable when introduced, the logic to uphold the argument and graft this discrimination into the new pensions system is not, immediately evident.
02. The requirement to determine the best three years from a person's last ten years of employment may in some cases place pressure on employers to increase an individual's salary in the last years of employment.
03. Experience has brought up cases of individuals who have under-declared their income throughout their working life only to declare a much higher income close to their retirement in order to gain a full pension.

Just as the full contribution condition (proposed to be 40 years) ought to reflect a truer and fairer picture of a person's working life, so also the time based period for the calculation of the First Pillar pension ought to be adjusted to reflect the earnings over the working life and thus to provide a better level playing field for pension calculation.

The time based period for the calculation of pensions for both self-employed and employees should be placed on a consistent yardstick and that in this regard, the yardstick for the calculation of the First Pillar should be a 40 year contributory period.

Here too, it is believed that this parametrical change should be introduced in a scaled manner as shown in Table 10 in order to smoothen the impact of its introduction with particular regards to those persons who are reaching retirement age.

Table 10: Time Based Period Calculation of the First Pillar Pension

Years of Age as at 1st January 2007	Base-line for Calculation of First Pillar
55 years of age and over	No change from the current base-line calculation period
50 years of age to 54 years of age	Average of best 5 years
45 years of age to 49 years of age	Average of best 10 years
44 years of age and below	40 years.

Decision of Principle: 34

There should be no discrimination between self-employed and employed persons on the time base period upon which a First Pillar pension is calculated< and that such calculation should be based on an average of the 40 year contributions accumulation history and introduced as shown in Table 10.

04.6.4 The Maximum First Pillar Pension Entitlement

The maximum entitlement under the existing pension structure is two-thirds of a capped maximum salary limit of Lm6,750. As stated earlier this is 33% higher than the annual basic gross wage.

Whilst the law provides that whenever Government awards a general cost of living increase the post retirement pension income is increased by two-thirds of the cost of living award, the maximum of the base itself has remained unchanged since 1987[84]. **Appendix IX** shows the increases made to the ceiling since its introduction in 1979.

The matter relating to whether the threshold of the maximum pensionable income (MPI) should be revised is one that is directly related to the impact of the increased contributions to be paid by both employers and self-employed on the one hand, and employees on the other. In terms of the former an increased ceiling will impact the cost of business. In terms of the latter an increased ceiling will further impact disposable income. In addressing this issue a number of options were considered. All but the following would impact cost of business and disposable income:

(i) **Retaining the current MPI.** With every passing year the value of the pension income will erode with inflation. Adopting a status quo policy will see the purchasing value of the pension diminishing further within the medium term, becoming negligible over the long term. This option on its own will not safeguard adequacy for future pensioners.

This enforces the need for each and every individual to foster a mentality that does not rely solely on pensions provided by the State. Under any circumstance State pensions need to be supplemented by an individual's savings accumulated throughout his or her working life including in a Second Pillar mechanism.

(ii) **Retaining the current MPI but adjusting it yearly to reflect inflation.** The objective of this policy measure is that of ensuring that the purchasing value of the pension income will not diminish due to inflation given that the MPI will be adjusted annually in relation to inflation from the date of entry of the new pensions system.

Given that this adjustment will be on an annual basis and will be applied cumulatively this measure will ensure that the value of the purchasing income of future pensioners will not be any lower than that received by pensioners today. This option also means that the contributions paid will rise in tandem with the annually adjusted MPI. It is pertinent to underline that the World Bank in its report recommended the adoption of this option.[85]

Decision of Principle: 35

The ceiling of the First Pillar's MPI should be the current MPI adjusted yearly to reflect inflation.

04.6.5 The Revenue Base-Line for the Determination of the First Pillar Pension

The target pension for a full career under the current pensions system is two-thirds of the basic wage. The World Bank states that:

> *"During their working careers, workers pay 10% of their wage for pensions and health and another 15% at least for income taxes. Thus, a two-thirds pension really provides a benefit that is equivalent to 88% of the net salary of the individual."*[86]

The World Bank adds that workers frequently support children, and perhaps, parents; whilst during retirement a person normally supports only himself and his spouse. Thus, a retired person whilst increasing his or her expenditure on health matters would need appreciably less income to be equally comfortable as a worker.[87]

The World Bank concludes that the adoption of a policy instrument that establishes the pension target for a full career as two-thirds of the net wage rather than two-thirds of the gross wage, whilst still upholding the principle of two-thirds pension, will reduce the cost of financing the pensions system without negatively affecting in an appreciable manner the benefits entitlements of the retiree.

In evaluating this policy recommendation, the conclusion reached is that this proposal should not be positively considered. This is so for mainly two reasons. First, the adoption of this proposal will further diminish the adequacy of the pension income received. Whilst it is necessary for changes to be undertaken to maintain sustainability it is also necessary to retain a balance in the measures that are to be introduced to achieve such sustainability. It is to be recalled that the World Bank also proposed that the social security contribution should be paid on total employment earnings (salary, overtime, and in-kind payments, etc) whilst recommending that the pension income will be calculated on the net wage.

Second, the proposal is not conducive for our social environment. Unlike most countries, Malta still retains a strong extended family fabric. Pensioners who have children and grandchildren continue to support their extended family to the extent possible. This strong extended family structure must be encouraged to the extent possible.

Decision of Principle: 36

The revenue base line for the determination of the First Pillar should remain two-thirds of the basic wage.

04.6.6 Contributions to be Paid on the First Pillar

The First Pillar is currently funded as follows:

(a) Class I Contributions (Employees): 10% by the State, 10% by the Employer, 10% by the Employee subject to an established minimum and maximum contribution.

(b) Class II Contributions (Self-Employed / Self-Occupied): 15% of the earned / annual income subject to an established minimum and maximum contribution. The contribution payable by the State is equivalent to 50% of this contribution.

The parameters of the First Pillar contribution are a sensitive matter given the impact they may have on the economy and on Malta's competitiveness as well as the impact on a person's standard of living due to one's disposable income.

The World Bank in its actuarial studies concludes that:

(i) The Class I contribution for the First Pillar remains unchanged.[88]

(ii) The Class II contribution, given the distortion that exists between employees and self-employed contributions, should be increased to 20% - and that 50% of the contribution will be deductable from income tax.

Following the undertaking of models on the various categories of self-employed the simulations show that under present circumstances the World Bank's recommendation will have a negative impact.

Decision of Principle: 37

The Class I and the Class II contributions should remain unchanged.

04.7 Value System 07: Rendering the Pensions System Sustainable in a Context of Sound Public Finances

The financial sustainability of the pensions system is to a large extent linked to the sustainability of public finances as a whole. Thus an aggressive drive to attain continuous reduction of public debt, and consequently, of interest on payments, should continue to remain an underpinning priority.

It is, however, pertinent to underline that pensions constitute a large component of total government expenditure. Moreover, as structured today, social security contributions cover not only contributory and other pensions entitlements but also health and non-contributory benefits; hence the welfare gap.

In this regard, it is argued that three structural changes are required in the way the funding of social security is organised.

(a) Financing Health Insurance Partly through the First Pillar Contributions

As announced in the Government 2004 budget, funding for health should be separated from the financing of contributory and non-contributory benefits falling under the social security regime. This first structural change will ring-fence health financing from other social security related expenditure. Moreover, Government has also declared that the health insurance will be partly paid by the PAYG contributions.

Decision of Principle: 38

The 2004 budget declaration that health funding should be separated from social security funding and ring-fenced accordingly, and that part of the social security contribution will finance health services should continue to hold.

(b) Establishing a Ring-fenced Account for Contributory Benefits and Pensions

Financing of contributory benefits and pensions relating to the First Pillar should be governed by means of ring-fencing in one account both the income raised by Government through social security contribution payments – with the exclusion of that share of the contribution channeled towards the health fund – as well as the expenditure relating to both the administration and associated contributory benefits payment.

A ring-fencing mechanism will achieve two underpinning benefits:

(i) It will ensure that contributions paid will finance the benefits and pensions accruing from these contributions.

(ii) It will show at any point in time the true statement of accounts in relation to the surplus or deficit of the financing of contributory benefits.

The question, however, arises whether a ring-fenced account would suffice to meet the total pensions expenditure even should the changes discussed in this Report be introduced. It is perhaps safe to conclude that in the face of the challenges spelt out earlier the revenue that the new pensions system will generate will not always achieve a balanced Account.

Mechanisms, therefore, need to be put into place to ensure a controlled manner by which arising deficits are neutralised. A ring-fenced Account will facilitate the planned introduction of changes that might be necessary in an incremental manner to render a balanced account as management information on the health of this Account would be available in real time. This will avoid a situation where the status of the Account becomes known at too late a stage thereby requiring radical change with the subsequent difficult implications and repercussions.

A potential policy instrument in this regard is the establishment of a reserve item within the proposed Account. This mechanism is used in a number of EU states to "underline their commitment to sound public finances & underscore ħsuch commitmentż by establishing reserve funds, often outside the public budgets, which will allow government to maintain adequate pension levels for the baby boom cohorts, thereby mitigating the need for raising taxes or contributions."[89]

A further consideration involves the maintenance of the current self-appropriation mechanism or a re-design of the said mechanism to ensure that its activation is triggered only under specific conditions.

The adoption of a ring-fenced Account raises the issue of the governance of the said Account.

Decision of Principle: 39

A ring fenced Account for contribution benefits and pensions, with appropriate transparent governance, is established.

(c) Non-Contributory Benefits

Non-contributory benefits, currently funded through security contributions should be financed through the Consolidated Fund.

04.8 Value System 08: Recognising Periodic Gaps in Labour Market Participation

04.8.1 Atypical Employment Nature of Women

The existing pensions system, as stated in Chapter 03, still reflects the traditional family and labour market structures. Men, irrespective of their age and family status, tend to be in full time employment. Many woman, on the other hand move from full time to no work and potentially back to part-time or reduced hours as they acquire family responsibilities.

Inevitably, this, besides diminishing the labour supply, makes it harder for women to build up adequate pensions entitlement due to gaps in their contributions record. Furthermore, the average woman tends to earn less than the average man as in general women tend to be employed in occupations with lower wage and salary levels. In fact the average salary of a woman is Lm4,502 as against Lm5,299 of a man.[90]

The current pensions system is unfair to women because it penalises women for those periods where they are involved in work related to family care, child bearing and child raising. Thus women are hindered from earning a pensions benefit entitlement despite the fact they would have paid the full contribution for the period they were in employment. By design, the current pensions system fails to acknowledge and account for the atypical occupational behaviour of women.

In this regard, therefore, measures need to be designed and introduced to attract women back to the labour market and thus build up their social security contributions record that would enable them to acquire the pension entitlement.

Decision of Principle: 40

The reality of woman's atypical employment and the resultant entitlement handicaps should be recognised and pension policy instruments that reflect this reality are to be introduced.

04.8.2 Parental Responsibilities in Relation to Child Bearing and Raising

The parental responsibilities relating to the bearing and raising of children are a valuable social role that Government should promote. Yet, the current pensions system discriminates against persons who spend time out of employment during the early childcare years.

It is pertinent to add that EU Directive 79/7[91] demands equal treatment of men and women in statutory social security measures. The Directive allows for the introduction of exceptions in pension rights for the bringing up of children. It is to be noted that Germany, Greece, France, Ireland, Italy, Luxemborg, UK and Sweden have all introduced positive pension credit measures to account for child raising responsibilities.

There are several issues associated with the design of a policy instrument that provides child-raising credits to a person's pension contributions. The issues range from how is compensation to be provided; for what duration; whether the individual is to be completely out of the labour force to attain a credit; whether the credit is to be accrued to either parent; and whether this latter decision is made by the parents themselves.

It is thus argued, that a policy instrument that takes into account parental responsibilities in relation to child bearing and child raising periods by providing for the phased crediting of the individual's contributions as well as the payment of voluntary contributions under established conditions should be positively considered.

Decision of Principle: 41

A policy instrument that takes into account parental responsibilities in relation to child bearing and child raising periods by providing for the phased crediting of the individual's contributions as well as the payment of voluntary contributions under established conditions should be positively considered.

The issue, however, cannot be resolved solely at a fiscal level. As long as the traditional division of gender roles is prevalent, and women are seen or placed under social pressure to be exclusively responsible for the management of the home and caring for children, this 'double shift' will militate against women taking up full time or part time employment.

Thus, family friendly measures to enable the balance of work and family life, not least through encouraging the sharing of domestic responsibilities, the provision of child care facilities, and other support oriented instruments, are essential policy elements that need to be reinforced in order to encourage not only increased women market participation but also the retention of the woman worker in the labour market.

Decision of Principle: 42

The introduction of family friendly measures to enable the balance of work and family life and thus ensure not only increased participation but also retention of the women in the labour force should continue to be re-inforced.

04.8.3 Rapidly Changing Employment and Career Patterns

Employment and career patterns are changing rapidly. There is a shifting trend towards definite contract employment and a growing importance of temporary labour, casual employment, part-time employment, etc.

Moreover, it is pertinent to mention that the concept of 'job for life' no longer predominates an individual's working life goal with the need for a career change increasingly becoming the norm. Furthermore changes in economic behaviour arising from the increasing exponential impact of globalisation as well as economic restructuring result in gaps due to unemployment, time out for re-skilling and continuous learning, etc. In essence, therefore, the changing conditions of the world of work due to both internal and external influences are leading to increasing breaks in an individual's work track record: gaps, stages of part-time employment, tele-working, trans-national mobility, switches between different forms of employment, etc.

Intrinsically intertwined with such breaks is, inevitably, fluctuating income. The current pensions system, as designed, will probably result to individual deficits in pension entitlements. The new pensions systems, therefore, must be designed in a manner that accounts for flexibility that is reflective of new norms in employment behaviour.

Measures need to be taken to remove those elements in the system that encourage periods of inactivity, or activity within the informal economy when people need to be attracted to participate in the labour market even on a part-time basis.

Decision of Principle: 43

Measures need to be taken to remove those elements in the system that encourage periods of inactivity or activity within the informal economy when people need to be attracted to participate in the labour market even on a part-time basis.

04.8.4 Life Long Learning

One of Malta's objectives is to participate fruitfully in the competitive knowledge based economy and both Government and private institutions must encourage the development of institutional, technological and organisational change to boost productivity and innovation.

The report of the High Level Group on the Future of Social Policy in an Enlarged European Union concludes that:

> *"This can be achieved only with workers whose qualifications are permanently adapted to the changing demand & (and) that social partnerships (on life long learning) & (introduced) at national level may implement life long learning".*[92]

Whilst companies and government entities have an obligation to foster life long learning amongst their staff to continuously re-inforce the organisations' intellectual capital, triggers to incentivise individuals to embark upon life long learning should also be promoted at a national level.

In this regard, the design of policy instruments that account for 'credits' for the undertaking of unpaid periods for training, reskilling and continuous development should be positively considered.

Decision of Principle: 44

The design of policy instruments that account for 'credits' for the undertaking of unpaid periods for training, reskilling and continuous development should be positively considered.

71 pg 31, Joint Report by the Commission and the Council on Adequate and Sustainable Pensions, ECOFIN 76, SOC 115, 7165/03, 10th March 2003, Brussels

72 pg 3, OECD Recommendation on Core Principles of Occupational Pension Regulation

73 pg 3, OECD Recommendation on Core Principles of Occupational Pension Regulation

74 pg 52, Simplicity, Security and Choice: Working and Saving for Retirement, Secretary of State for Work and Pensions, UK, December 2002

75 pg 4, OECD Recommendation on Core Principles of Occupational Pension Regulation

76 This figures consists of endowment and whole life policies but exclude term and unit linked policies as at 31st December 2003. Ad hoc Report by MFSA, October 2004

77 pg 139, Economic Survey, January – September 2003, Economic Policy Division, Ministry of Finance and Economic Affairs, 24th November 2003

78 4.05 (2), The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004

79 pg 56, Joint Report by the Commission and the Council on Adequate and Sustainable Pensions, ECOFIN 76, SOC 115, 7165/03, 10th March 2003, Brussels

80 pg 44, Social Protection In Malta: A Statistical Analysis of Social Protection Accounting 1998 – 2002, National Statistics Office, Malta, February 2004

81 Pg 45, ibid

82 In 2004 the maximum social security contribution and the Two-Thirds pension are calculated on a capped basic wage or salary of Lm6,748.

83 2.08 (iv), The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004

84 The MPI was set at Lm6,000 in 1979. This was increased as follows> Lm6,300 on 5th January 1981, maximum weekly rate increased from Lm57.7 to Lm 70.5 in January 1982, and the MPI increased to Lm6,750 on 1st January 1987

85 4.08 (i), The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004

86 4.05 (i) (4), ibid

87 ibid

88 pg 6, MCESD, Explanatory Note regarding the World Bank Proposal on the Reform of the System of Pension in Malta

89 Pg 70, Joint Report by the Commission and the Council on Adequate and Sustainable Pensions, ECOFIN 76, SOC 115, 7165/03, 10th March 2003, Brussels

90 Pg 5, Labour Force Survey: December 2003 National Statistics Office, 30th March 2004

91 In the area of occupational pensions, Directive 96/97/EC has modified Directive 86/378/EC to bring it in line with Article 141 as interpreted by the European courts of Justice. It also restricts possible derogations compared to Directive 79/7 as Article 141 of the Treaty requires that women and men must received equal pay for equal work; including occupational pensions

92 pg 48, Report of the High Level Group on the Future of Social Policy in an Enlarged European Union, Directorate General for Employment and Social Affairs, European Commission, May 2004

CHAPTER 05

Implementing the proposed changes to the Pensions System

05

SUMMARY

01. **Presents time frames for the implementation of changes proposed.**

02. **Presents an assessment of the proposed changes on beneficiaries and the cost of the proposed pensions system.**

03. **Presents an abstract of the changes proposed.**

04. **Presents a reconciliation of the changes proposed with the main recommendations of the World Bank.**

05.1 Implementing the Proposed Changes to the Pensions System

The proposed new pensions system is designed to, through the:

01. First Pillar, to provide a decent standard of living commensurate with one's contribution record.

02. Second Pillar, to enhance one's standard of living during retirement age.

03. Third Pillar, to provide one with the opportunity to invest further to meet the expectations of a particular chosen life style.

The proposed pensions system is depicted graphically below.

Graph 10: The Proposed Pensions System

FIRST PILLAR PENSION

- Mandatory
- Post Retirement Pension Income Retail Price Indexed
- Minimum Person Guarantee indexed to a fair mechanism against inflation erosion
- 40 Year Accumulation Contribution Time Based Period (Implemented on a staggered basis)
- Two-thirds of basic wage up to a MPI Ceiling
- Current MPI but indexed to RPI (Lm6,750)
- To consider Credits for a Long Life Learning
- To consider credits for Parental Responsibilities related to Child Bearing and Raising
- Basic Wage Contributions Base
- Capped Contribution and will increase in proportion to MPI
- Retirement Age Based
- Option for Disincentivised Gradual Retirement

Transparent Pensions Account

- Compliance Based
- No changes to PAYG contribution

Provides a Decent Standard of Living

SECOND PILLAR PENSIONS SCHEME

- Mandatory by 2010: but introduced in 2006 on a voluntary basis
- Common Yet Flexible framework
- No Opt Out
- Portable
- Tax Free Contributions
- Capped % Income Tax on maturity of fund
- Part to be paid as Lump Sum on Maturity and main to be placed in Annuity to provide annual pension

Regulatory Safeguards

Enhance the Standard of Living

THIRD PILLAR PENSIONS SCHEME

- Voluntary
- Contribution Non-Taxed subject to a Capped Value
- Income Tax on PAYE rate upon maturity

Complements the Second Pillar Pensions Scheme

Governed by MFSA Subject to Special Funds (Regulations Act)

Health Fund
Contribution from First Pillar to be determined

CONTRIBUTOR

Statutory Retirement Age to be 65 years with implementation staggered by age cohorts Ability to earn uncapped income whilst benefiting from First Pillar and Second Pillar pensions subject to payment of contributions

The PWG proposes the following recommendations for the implementation of the changes to the pensions system.

Current Pensioners

01. Current pensioners and individuals who will retire prior to the implementation of the proposed changes will not be effected by the recommendations proposed.

Retirement Age

02. The retirement age should be increased to 65 years of age for both men and women. To smoothen the impact of this change it is proposed that this measure is introduced in a scaled manner as follows:
    (a) In terms of women, the pension age will be 61 years of age with effect from 1st January 2007.
    (b) The increase of pension age for all to the 65 years threshold will start from 1st January 2007, persons holding the following years of age will retire as follows:

Years of Age as at 1st January 2007	Retirement Age
55 years of age and over	No change
52 years of age to 54 years of age	62 years
49 years of age to 51 years of age	63 years
48 years of age and below	65 years.

First Pillar Pension

03. The minimum pension guarantee should be annually adjusted to assure its value against inflation erosion. This recommendation should be implemented as from 1st January 2007.

04. The contribution period for the accumulation of the Two-Thirds First Pillar pension should be increased from 30 years to 40 years. This recommendation should be implemented as from 1st January 2007. To smoothen the impact of this change it is further proposed that this measure is introduced in a scaled manner as follows:

Years of Age as at 1st January 2007	Accumulation Period
46 years of age and over	No change from current accumulation period
40 years of age to 45 years of age	35 years.
39 years of age and below	40 years.

05. The base-line for the calculation of the Two-Thirds First Pillar pension should be changed from the best consecutive three years from the last ten years for employees and from the average of the last ten years' net income for self-employed persons to the average of the 40 year contributions accumulation history for both employees and self-employed. This recommendation should be implemented as from 1st January 2007. To smoothen the impact of this change it is proposed that this measure is introduced in a scaled manner as follows:

Years of Age as at 1st January 2007	Base-line for Calculation of First Pillar
55 years of age and over	No change from the base-line calculation period
50 years of age to 54 years of age	Average of best 5 years
45 years of age to 49 years of age	Average of best 10 years
44 years of age and below	40 years.

06. A strong compliance regime is put into place in order to safe guard honest and hard working persons as well as to deter abuse, fraud and mis-use. Action should be taken with immediate effect.

07. The Two-Thirds First Pillar post-retirement pension income is annually built up for all pensioners on an annual uniform basis. The annual uniform basis to be applied should be the Retail Price Index. This recommendation should be implemented as from 1st January 2007.

08. A person may continue to opt to work beyond the new statutory retirement age whilst enjoying the Two-Thirds First Pillar (and Second Pillar) pension with no capping on income earned subject to the payment of the First Pillar contribution. This measure will come into effect in tandem with the recommendations proposed on the retirement age.

09. The current invalidity pensions scheme should be reviewed with a view to tighten the eligibility criteria as well as to adopt the principle of 'rehabilitation or alternative work before pension'. Action should be taken with immediate effect.

10. The ceiling of the First Pillar's Maximum Pensionable Income should be the current Maximum Pensionable Income adjusted yearly to reflect inflation. This recommendation should be implemented as from 1st January 2007.

11. The Class I and Class II contributions should remain unchanged.

12. Part of the Social Security Contribution should finance health services. This should be determined as early as possible in 2005.

13. A ring-fenced account for contribution benefits and pensions, with appropriate transparent governance should be established. This recommendation should be implemented as from 1st January 2007.

14. Non-contributory benefits should be financed through the Consolidated Fund. This recommendation should be implemented as from 1st January 2007.

15. A policy instrument that takes into account parental responsibilities in relation to child bearing and child raising periods by providing for the phased crediting of the individual's contributions as well as the payment of voluntary contributions under established conditions should be introduced. This policy measure should be determined in 2006 and introduced as at 1st January 2007.

16. A policy instrument that removes those elements in the pensions system that encourage periods of inactivity within the informal economy when people need to be attracted to participate in the labour market should be introduced. This policy measure should be determined in 2006 and introduced as at 1st January 2007.

17. A policy instrument that accounts for 'credits' for the undertaking of unpaid periods of training, re-skilling and continuous development should be introduced. This policy measure should be determined in 2006 and introduced as at 1st January 2007.

Second Pillar Pensions Scheme

18. The Second Pillar Pensions Scheme should be mandatory. Nevertheless it should be introduced in a transitional manner with the Second Pillar first introduced on a voluntary basis as from 1st January 2006.

19. MFSA and Government should work with the private sector financial firms to encourage them to introduce a scheme that will allow owners of life endowment and similar policies to convert such policies into the Second Pillar pension. Action should be initiated in 2006 and once agreement is reached a caveat should be set to allow owners of such policies who take up this option to post date subscription to 1st January 2006.

20. The determination of the parameters of the proposed mandatory Second Pillar Pensions Scheme should be taken on the basis of intensive actuarial studies that Government should commission through the MFSA. Government should commission this study through MFSA in tandem with the consultation process.

21. Indications through the modeling carried out are that a mandatory Second Pillar Pensions Scheme should be in place by 2010. Government should take all the necessary action to establish the appropriate mechanisms to enable the introduction of the mandatory Second Pillar Pensions Scheme by 2010. Nevertheless, the Government should in 2009 undertake an assessment to determine whether the prevailing conditions at that point in time are such that necessitate the mandatory introduction of this Pillar by 2010.

Third Pillar Pensions Scheme

22. The new pensions system should also provide for a Third Pillar which shall be a voluntary option directed to complement pensions income. The Third Pillar Pensions Scheme should be introduced as from 1st January 2006.

Regulation of the Second and Third Pillar Pensions Schemes

23. The regulation of the Second and Third Pillar Pensions Schemes should be entrusted to the MFSA operating under the Special Funds (Regulation) Act 2002. Such authority should be provided to the MFSA with immediate effect so that the necessary work for the introduction of a voluntary Second Pillar Pensions Scheme and the Third Pillar Pensions Scheme is completed in 2005.

Periodic Review of the Pensions System

24. The new pensions structure once introduced cannot be considered to be etched in stone – immutable to review and change. The pensions structure must be continuously under review so that parameterisation, calibration and changes are undertaken incrementally and in an evolutionary manner.

    Thus, periodic health checks of the new pensions system to account for emerging needs and changes in the social and economic fabric of our Nation are essential. Such health check reviews and assessments should be carried out every five years.

    The first periodic structured review of the pensions system should be carried out in 2009.

05.2 Impact of the Proposed Changes to the Pensions System

The impact of the proposed changes is assessed on two tiers. The first assesses the impact of the proposed changes on pension benefits to be received by contributors. The second assesses the impact of the proposed changes on the cost of the pensions system.

05.2.1 Impact on Beneficiaries

The Department of Social Security was requested by the PWG to assess the impact of the proposed changes on persons occupying the positions shown below. The models simulate a number of scenarios of persons holding different ages:

- Labourer
- Clerk
- Assistant Principal
- Senior Principal
- Director.

The scenarios modeled are shown in Table 11 (page 65). The basic assumption taken is that the annual rate of inflation will be 2.5%. As can be seen from Table 11 the main impact on the First Pillar Pension will be on those cohorts of persons who will be 44 years of age and below at the time when the changes are introduced.

This is so for two main reasons. First, the proposed recommendations seek a change in the determination base of the pension from 30 years to 40 years, as well as a shift in the accumulation time base from the best consecutive three years of the last 10 years to 40 years.

Second, the proposed recommendations to the pensions system are premised on the cardinal principle that the proposed changes to the First Pillar Pension will be complemented by the Second Pillar Pensions Scheme. Thus, the loss accruing to a reduced First Pillar Pension for this cohort of persons will be compensated by the Second Pillar Pension.

In this regard, the impact of the proposed recommendations on beneficiaries reflects the conceptual thinking that spurred the recommendations: where the Second Pillar Pension becomes a key component in the pensions system for those persons who will be tomorrow's future pensioners.

The results of the models generated would be of concern if the changes proposed impact the 45 years of age and above cohorts – the cohorts that will not be buffered by the introduction of the SPPS given that the Second Pillar Pension would require sufficient time to accrue capital and to generate a positive return on that capital. This concern, however, as can be seen from Table 11 does not materialise.

It is, however, pertinent to underline that the First Pillar Pension is expected to improve for those persons who join the workforce following the introduction of the proposed reforms. As can be seen a person who joins the workforce at the age of 25 years in 2014 will obtain a higher First Pillar Pension. This is the consequence of the recommendations related to the maximum pensionable income ceiling, which will be subject to inflation indexed adjustments.

Wages, however, will also increase and various categories of workers will see their wages surpass the MPI ceiling. A consequence of this is that over time the maximum of the Two-Thirds pension income will be reached by a considerable number of categories of workers.

The recommendation relating to the Minimum Pension Guarantee – that is correlating the increases to the Minimum Pension directly with inflation - will see the rate of adjustment to the current base line to increase at a lower rate than if a flat rate of Lm1.50 annual COLA increase is assumed. Under the proposed mechanism the Maximum Pension Guarantee will by 2023 increase to Lm73.8 as against Lm79.4 under a COLA adjustment mechanism.

Table 11: Impact on Beneficiaries - Scenarios Modeled

AGE GROUPS	GRADE 20 WORKER	CLERK
A person of 55 years of age who will obtain a First Pillar Pension under the Current Pensions System	- Will retire at 61 years of age with a weekly pension of **Lm57.07** - At age of 75 years weekly pension will stand at **Lm80.65**	- Will retire at 61 years of age with a weekly pension of **Lm75.98** - At age of 75 years weekly pension will stand at **Lm107.37**
A person of 52 years of age who will obtain a First Pillar Pension under the proposed changes	- Will retire at 62 years of age with a weekly pension of **Lm63.00** - At age of 75 years weekly pension will stand at **Lm80.65**	- Will retire at 62 years of age with a weekly pension of **Lm83.87** - At age of 75 years weekly pension will stand at **Lm107.37**
A person of 45 years of age who will obtain a First Pillar Pension under the proposed changes	- Will retire at 65 years of age with a weekly pension of **Lm80.65** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm107.36** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension
A person of 44 years of age and below who will obtain a First Pillar Pension under the proposed changes	- Will retire at 65 years of age with a weekly pension of **Lm76.93** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm94.38** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension
A person of 18 years of age who joins the workforce following the introduction of the proposed changes will obtain a First Pillar Pension as follows	- Will retire at 65 years of age with a weekly pension of **Lm98.18** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm172.93** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension

ASSISTANT PRINCIPAL	SENIOR PRINCIPAL OFFICER	DIRECTOR
- Will retire at 61 years of age with a weekly pension of **Lm97.15** - At age of 75 years weekly pension will stand at **Lm137.28**	- Will retire at 61 years of age with a weekly pension of **Lm102.89** - At age of 75 years weekly pension will stand at **Lm145.38**	- Will retire at 61 years of age with a weekly pension of **Lm102.89** - At age of 75 years weekly pension will stand at **Lm145.38**
- Will retire at 62 years of age with a weekly pension of **Lm107.24** - At age of 75 years weekly pension will stand at **Lm137.28**	- Will retire at 62 years of age with a weekly pension of **Lm110.84** - At age of 75 years weekly pension will stand at **Lm141.89**	- Will retire at 62 years of age with a weekly pension of **Lm113.61** - At age of 75 years weekly pension will stand at **Lm141.89**
- Will retire at 65 years of age with a weekly pension of **Lm137.27** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm133.65** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm133.65** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension
- Will retire at 65 years of age with a weekly pension of **Lm101.37** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm101.37** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm101.37** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension
- Will retire at 65 years of age with a weekly pension of **Lm185.43** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm186.43** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension	- Will retire at 65 years of age with a weekly pension of **Lm186.43** - If Second Pillar Pensions Scheme is mandatory introduced for persons of 45 years of age and younger the above pension benefit will be supplemented with a Second Pillar Pension

Table 12: Minimum Pension Guarantee Assessment

		Weekly Rate	Inc By COLA 1.75	Inc by Inflation 2.5	Difference
Basic Year	**2004**	**46.15**	**46.15**	**46.15**	
	2005		47.90	47.3	0.60
	2006		49.65	48.5	1.16
	2007		51.40	49.7	1.70
	2008		53.15	50.9	2.21
	2009		54.90	52.2	2.69
	2010		56.65	53.5	3.13
	2011		58.40	54.9	3.54
	2012		60.15	56.2	3.92
	2013		61.90	57.6	4.26
	2014		63.65	59.1	4.57
	2015		65.40	60.6	4.85
	2016		67.15	62.1	5.08
	2017		68.90	63.6	5.28
	2018		70.65	65.2	5.44
	2019		72.40	66.8	5.56
	2020		74.15	68.5	5.64
	2021		75.90	70.2	5.68
	2022		77.65	72.0	5.67
	2023		79.40	73.8	5.62

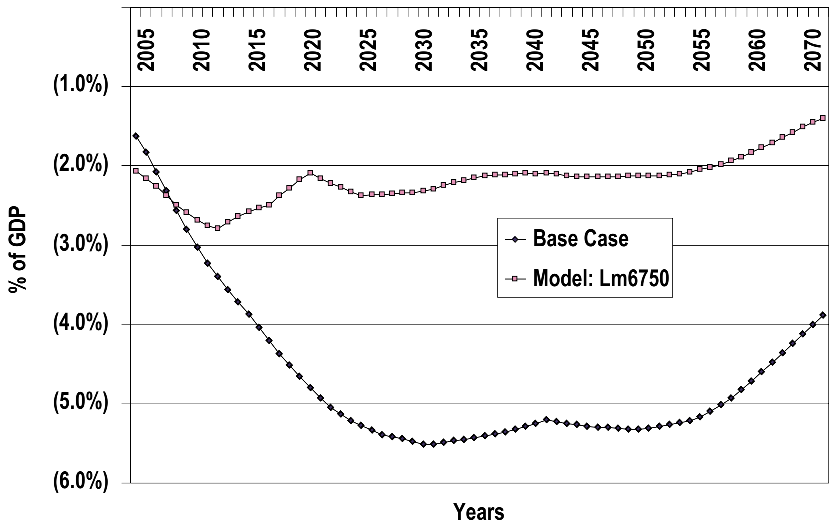
05.2.2 Impact on the Cost of the Pensions System

The World Bank was requested by the PWG to model the recommendations proposed within the context of macro economic related variables. The assumptions provided to the World Bank are presented in **Appendix IV**.

It is pertinent to state that the macro economic assumptions provided to the World Bank are different from those adopted by the World Bank when it presented its results in its March 2004 Report. Thus a 'like' baseline comparison with the World Bank's March 2004 projections is not possible.

The simulations of the proposed changes to the pensions system show that:

(i) Graph 11: PROST Simulation: Sustainability, World Bank: October 2004



A scenario of no change (Base Case) will see the deficit increase extensively within a relatively short period of time: 25 years. This result is largely consistent with the World Bank March 2004 simulation (Graph 09: page 46).

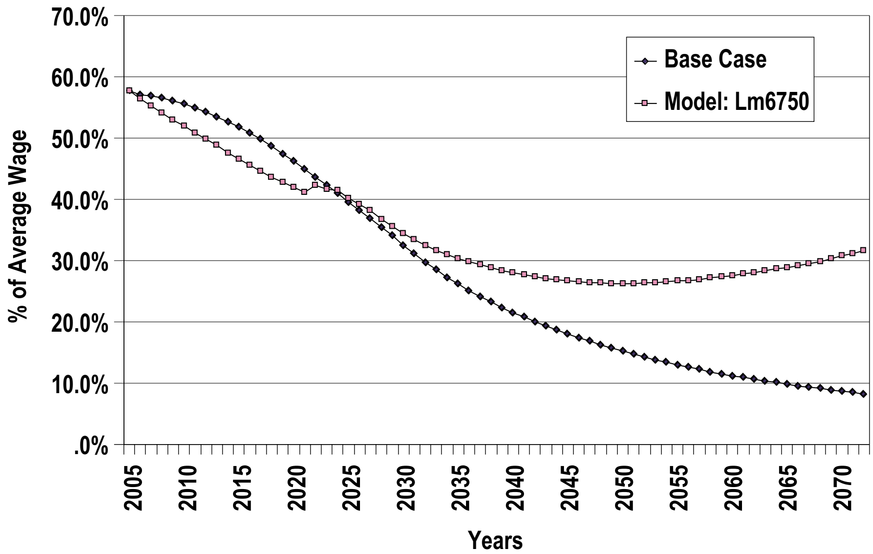
The introduction of the proposed changes will see the deficit increase at a relatively steep rate within the first ten years. This increase stems from the channeling of First Pillar contributions to the Health Fund. It is pertinent to state, though, that this increase in the deficit within this period of time is no worse than if no changes are undertaken to the pensions system.

However, whilst the deficit will continue to grow under the Base Case Scenario, under the proposed reform scenario the deficit will start to improve and will decrease from 3% of GDP to 2% of GDP by 2025.

This improvement arises as the proposed changes (that is, the proposed parameters of the First Pillar Pension and the introduction of a Second Pillar Pensions Scheme) start to impact the pension cohorts towards which they are directed: future generations.

The deficit in proportion to GDP is expected to stabilise over the period of the simulation.

(ii) Graph 12: PROST Simulation: Adequacy, World Bank: October 2004



A scenario of no change (Base Case) as the graph above shows will see the average benefits as a % of average wage fall dramatically over the period of the simulation of the model. This is consistent with the World Bank March 2004 simulation (Graph 08: page 43).

The introduction of the proposed changes will see the benefits as a % of average wage decrease until they stablise at 30% of average wage by 2023 before this starts to improve and gradually increase to 40% of average wage.

The simulations show that the proposed changes manage to stem the erosion of the adequacy of the average pension benefit in relation to the average wage. The proposed changes, however, do not bring the average benefit in proportion to the % of average wage to the relationship it enjoys today.

This result was expected by the PWG. The focus of the changes proposed are directed to establish a multi-pillar pensions system, and within this context introduce incremental changes that are directed to secure to the extent possible a decent standard of adequacy and sustainability in a manner that would smoothen the resulting impact on people's disposable income and the costs to businesses, which in turn could negatively affect the economy.

Radical changes can always be applied – at a cost to both society and the economy at large. The PWG is convinced that such an approach would not be a prudent one. It is for this purpose that it strongly recommends a structured review of the pensions system every five years – in order to allow the government of the day to make appropriate changes to the pensions system in a timely manner by taking into account the circumstances as they would stand at that point in time.

Whilst certain critical elements that underpin a First Pillar Pension are factual: primarily, the aging of the population, the decrease in the population, the continued drop in fertility; the modeling is, ultimately, based on assumptions. Assumptions are ultimately just that – and they are extremely vulnerable when projected over a long term period as is the case with the simulations modeled. The PWG believes that the implementation of radical measures today on the basis of assumed long term macro-economic behaviour is not advisable.

This does not negate the conclusion of this Report that the matter of an adequate and sustainable pensions system is an issue – and for the matter, it is an issue that must be addressed. The PWG, however, believes that a degree of flexibility resides today to enable an approach to the resolution of this issue that is based on staged phases as against a 'big bang' approach that mandates immediate radical changes. This conclusion of the PWG, however, is based on two key premises.

First, a conceptual framework of the pensions system that best serves the country is required. The PWG proposes the multi-pillar pensions system as the framework that is to be adopted in this regard.

Second, the Pensions system must be managed strategically. Thus, continuous and periodic review of the behaviour of the pensions system must be carried out in order to undertake measured and appropriate parametrical revisions to ensure that the goal of securing an adequate and sustainable pensions system is maintained at all times.

In conclusion, the PWG is convinced that in the event that no action is taken within the immediate years, future governments will ultimately have no choice but to adopt and implement radical solutions.

05.3 Abstract of Proposed Principles and Recommendations of the New Pensions System

01. Government should positively consider issuing the Report of the Pensions Working Group as a White Paper to facilitate the national discussion and consultation process required on this important matter.
02. Whilst the process of pensions reform must be holistic in its design and formulation, implementation of measures constituting the new pensions system should, as far as possible, be staggered and phased.
03. There should be a minimum pension guarantee that acts as a safety-net against social exclusion.
04. A fair mechanism needs to be put in place to automatically assure the value of the minimum pension guarantee against inflation.
05. The new pensions system must be supported by a strong compliance regime to safeguard honest and hard working persons as well as to deter abuse, fraud and mis-use.
06. The new pensions system should include a Second Pillar Pensions Scheme (SPPS) to increase one's pension income to enhance the standard of living.
07. The new pensions system should also provide for a Third Pillar Pensions Scheme (TPPS) which shall be a voluntary option directed to complement the pensions income.
08. The regulation of the SPPS and the TPPS should be entrusted to the MFSA operating under the Special Funds (Regulation) Act 2002.
09. The SPPS should be established in terms of a common yet flexible scheme basis.
10. An employee should have the right to choose the provider of the SPPS.
11. The SPPS will also apply to the self-employed.
12. Entry into the SPPS provision by private sector insurance firms must be subject to strict entry and performance criteria that must be met at all times.
13. The SPPS contributions paid by the employer must be strictly separated from the said employer; with the pension fund established as an autonomous 'ring-fenced' asset.
14. The SPPS should be managed on the prudent-person principle together with (a) the inclusion of specified limitations to determine the diversification parameters of the investment portfolio, and (b) restrictions to limit the private sector insurance firm managing the portfolio to invest in its own assets or subsidiaries.
15. Measures to provide for financial protection to SPPS contributors and pensioners against fraud, mis-use, insolvency, etc, must be introduced, and should be designed in a manner that place the least burden on stakeholders.
16. Funds under the SPPS should be portable and a person should not have the option to liquidate the fund.
17. The annual contributions into a SPPS should not be taxed on an annual basis. A maximum tax, established at a fixed percentage rate, should be paid upon the maturity of the Scheme.
18. The SPPS should upon maturity allow for the option to convert a maximum established part of the individual matured pension fund into a lump sum and with the bulk placed as an annuity to provide for a steady annual pension income over the lifetime of the pensioner.
19. The SPPS should be introduced on a mandatory basis.

20. MFSA and Government will work with private sector financial firms to encourage them to introduce a scheme that allows owners of life endowment and profits related policies to convert such policies into the SPPS.
21. The SPPS should be introduced in a transitional manner; with the SPPS to be first introduced on a voluntary basis as from 1st January 2006.
22. The determination of the parameters of a mandatory SPPS should be taken on the basis of intensive actuarial studies.
23. Indications are that a mandatory SPPS should be in place by 2010. Government should take all necessary action to establish the appropriate mechanisms to enable the introduction of the SPPS by 2010. Nevertheless, the Government should in 2009 undertake an assessment to determine whether the prevailing conditions at that point in time are such that necessitate the mandatory introduction of the Second Pillar by 2010.
24. The annual contribution to the TPPS should be non-taxed up to a capped limit. The income derived on the maturity of the TPPS will be subject to income tax based on the individual's PAYE rate.
25. The First Pillar must remain as the main mechanism to ensure solidarity. Participation in the First Pillar is to continue to be mandatory.
26. Solidarity within generations requires that the First Pillar post-retirement pension income is annually built up for all pensioners on an annual uniform basis. The annual uniform basis to be applied should be the Retail Price Index.
27. The recommendation of the NCWR to increase the statutory retirement age to 65 years is a positive measure directed to broaden the contribution base as well as to enlarge the pool of labour supply.
28. The statutory retirement age of 65 years will be for both men and women.
29. The rising of the statutory retirement age to the proposed 65 years should be gradual with women reaching the 61 year threshold in 1st January 2007. Subsequent to which the statutory retirement age is to increase as shown in Table 08. Individuals should be able to opt for a shorter career between the age of 61 to 65 years on the basis of proportionate benefits.
30. A person may opt to continue to work beyond the new statutory retirement age, whilst enjoying the First and Second Pillars pensions, with no capping on the income earned, subject to the payment of the First Pillar contribution.

31. The current invalidity pensions scheme should be reviewed with a view to tighten the eligibility criteria as well as to adopt the principle of 'rehabilitation or alternative work before pension'.
32. The contributions calculation base-line for the First Pillar pension should be retained on the basic salary.
33. The contribution period for the accumulation of the Two-Thirds First Pillar pension should be according to Table 09.
34. There should be no discrimination between self-employed and employed persons on the time base period upon which a First Pillar pension is calculated; and that such calculation should be based on an average of the 40 year contributions accumulation history and introduced as shown in Table 10.
35. The ceiling of the First Pillar's MPI should be the current MPI adjusted yearly to reflect inflation.
36. The revenue base line for the determination of the First Pillar should remain two-thirds of the basic wage.
37. The Class I and the Class II contributions should remain unchanged.
38. The 2004 budget declaration that health funding should be separated from social security funding and ring-fenced accordingly, and that part of the social security contribution will finance health services should continue to hold.
39. A ring fenced Account for contribution benefits and pensions, with appropriate transparent governance, is established.
40. The reality of woman's atypical employment and the resultant entitlement handicaps should be recognised and pension policy instruments that reflect this reality are to be introduced.
41. A policy instrument that takes into account parental responsibilities in relation to child bearing and child raising periods by providing for the phased crediting of the individual's contributions as well as the payment of voluntary contributions under established conditions should be positively considered.
42. The introduction of family friendly measures to enable the balance of work and family life and thus ensure not only increased participation but also the retention of women in the labour force should continue to be re-inforced.
43. Measures need to be taken to remove those elements in the system that encourage periods of inactivity or activity within the informal economy when people need to be attracted to participate in the labour market even on a part-time basis.
44. The design of policy instruments that account for 'credits' for the undertaking of unpaid periods for training, reskilling and continuous development should be positively considered.

05.4 Reconciliation of the Proposed Principles and Recommendations of the New Pensions System with the main Recommendations of the World Bank March 2004 Report

As stated in Chapter 01, the World Bank March 2004 econometric models and recommendations constituted the primary mainstay against which the new pensions system was benchmarked whilst being designed. Table 13 provides a reconciliation of the proposed pensions system with the main recommendations submitted by the World Bank:

Table 13: Reconciliation of Proposed Pensions System with the March 2004 World Bank Recommendations

March 2004 World Bank Recommendations	Accepted
Application of measures to minimise abuse of the Invalidity pension.	✔
Adoption of total wages (cash, overtime and in-kind payments).	
Increase of the contribution of self-employed to 20%, and that 50% of this to be deductible from income taxes.	
The reduction of the minimum contribution for part-time workers to make contributions and benefits commensurate with actual earnings.	✔
The removal of disincentives for workers to continue working beyond the minimum retirement age.	
Retirement age will be raised to 65 and will apply to those above the age of 45.	✔
A further rise in the retirement age beyond age 65 in line with future improvements in life expectancy.	
Indexation for pensions post retirement to inflation rather than the 80% inflation and the 20% wage growth contribution.	✔
The pension is based on full life time career earnings for both the accumulation and the base-line calculation of the pensions period. Full life time career established at 45 years.	Partially accepted
No discrimination between self employed and employed persons on the time base upon which First Pillar is calculated.	✔
The target pension for a full career is two-thirds of net wage rather than two-thirds of gross wage.	
Contribution to Health Fund from PAYG: 1% from State Grant; 2% from Employee.	
Workers older than 45 at the time of the reform will retain their old benefit structure although current pensioners will see indexation system change to one that is inflation related as against wage related.	
Ceiling on contributions and the maximum pension will begin to rise right away.	✔
First Pillar contribution rates will remain unchanged.	✔
Second Pillar.	✔
Second Pillar contributions will amount to 2% each from employers and employees and 3% from self-employed in 2005, rising gradually to 5% each from employers and employees and 7.5% from the self-employed by 2020.	

Rejected	New
X	
X	
	Persons will be allowed to work post retirement age with no cap on income earned whilst enjoying their First and Second Pillar pensions. Nevertheless they will be requested to pay the contribution on the incom earned.
	65 years retirement age will be incrementally reached and will be gender neutral. Statutory retirement age to be raised to 65 years and should be introduced in a scaled manner. Option for gradual opt-out between the 61 and 65 years cohort in a disincentivised manner introduced.
X	
	Full life time career defined as 40 years. Introduced in a scaled manner.
X	
Under Consideration	Requires discussion with the Ministry of Health, the Elderly and Community Services to ensure that recommendations are consistent.
X	Current pensioners will not be affected by proposed changes. Scaled implementation process proposed.
	Ceiling on MPI will rise with inflation. Contributions paid will rise accordingly.
	Different institutional mechanism proposed. There will be a transitional process where-in the Second Pillar is introduced on a voluntary basis.
Under Consideration	Actuarial Study should be undertaken by Government through MFSA to determine the parameters of the Second Pillar.
	Minimum Pension Guarantee indexed to a fair mechanism to buffer against erosion through inflation.
	Recognition of women atypical employment nature and policy instruments to be designed in this regard.
	Need to design gender neutral pension policies to account for parental responsibilities relating to child bearing and raising.
	Need to design life long learning pension policies to support Malta's strive to be a competitive knowledge based economy.
	Establishment of a Pensions Account.