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PENSIONS
ADEQUATE & SUSTAINABLE



WHITE PAPER - NOVEMBER 2004



“Our citizens, and future generations
in particular, deserve no less”

Foreword

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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

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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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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

