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:

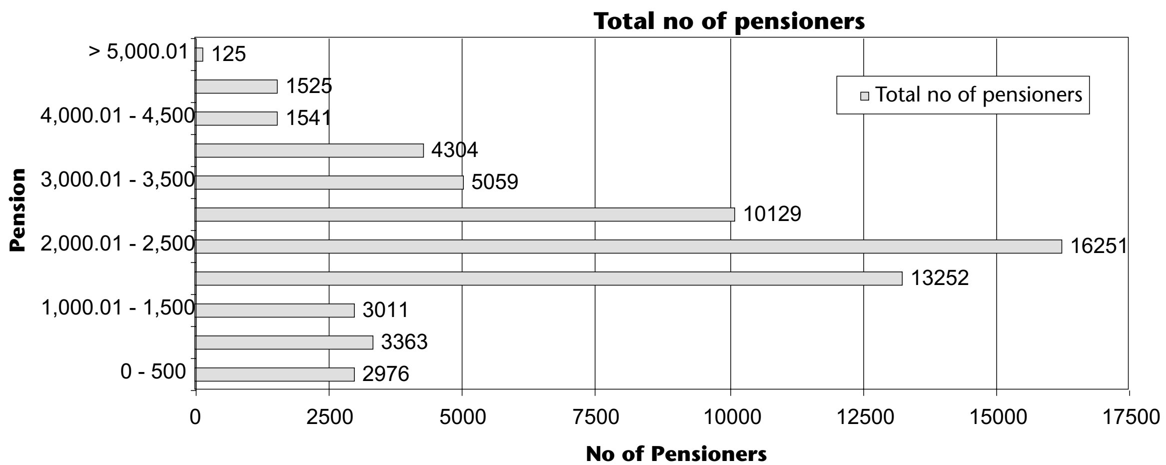
- Persons in full time education or training.
- Non-gainfully occupied married persons whose spouse is alive.
- Persons in receipt of assistance under the non-contributory scheme.
- Non-gainfully occupied persons whose total annual income does not exceed a given ceiling (Lm430 or Lm630 per annum for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