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

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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