# Strengthening the Pension System

# A Strategy for an Adequate and Sustainable Maltese Pension System

**Pensions Strategy Group**

**17th June 2015**

## Executive Summary

The Ministry for the Family and Social Solidarity and the Ministry of Finance in June 2013 set up a Pensions Strategy Group under the chair of the Permanent Secretary of the said Ministry. The Strategy Group was tasked to submit recommendations with regard to the strengthening of the pension system. A notable departure from previous reforms was that the Terms of Reference specified that the Strategy Group should review recommendations for reform presented by associations representing current pensioners.

The Strategy Group was a multi-disciplinary team constituted of technical persons within the government as well as persons external to it. Continuity with the 2004 and 2010 pension reforms was maintained, as members, including the chair, of these working groups were invited on the Strategy Group.

The 2010 Strategic Review which was tabled at the House of Representatives in December 2010 had presented a disquieting picture. The projections, carried out on the World Bank Pensions Reform Options Simulation Tool kit (PROST), and based on the EUROPOP 2008 demographic projections and the Ageing Working Group 2009 macro-economic projections, showed that by 2060 the average pension replacement rate (APRR), that is the average level of adequacy, when compared to the average wage, would fall to 45%; (- 9.6% lower than that enjoyed by pensioners at the time of the review) – which at the time stood at 54.7%. The state of the pension system was seen to be in equilibrium until 2035 but, thereafter deteriorating rapidly as pension spending was anticipated to rise to 15.3% of GDP in 2060, up by 6 percentage points (p.p) from its 2013 level.

To address the state of play in an incremental and flexible manner, the 2010 Strategic Review presented a comprehensive range of recommendations to strengthen the pension system - recommendations spanning demographic and labour market policies; changes to the First Pension and the establishment of a Second Pension and Third Pension pillar respectively.

The core recommendation of the 2010 Strategic Review, was undoubtedly the recommendation proposing the grafting of a longevity/retirement index on the First Pension and in the event that this recommendation was rejected, the undertaking of an in-depth study to assess the possibility of moving onto a Notional Defined Contribution (NDC) pension architecture.

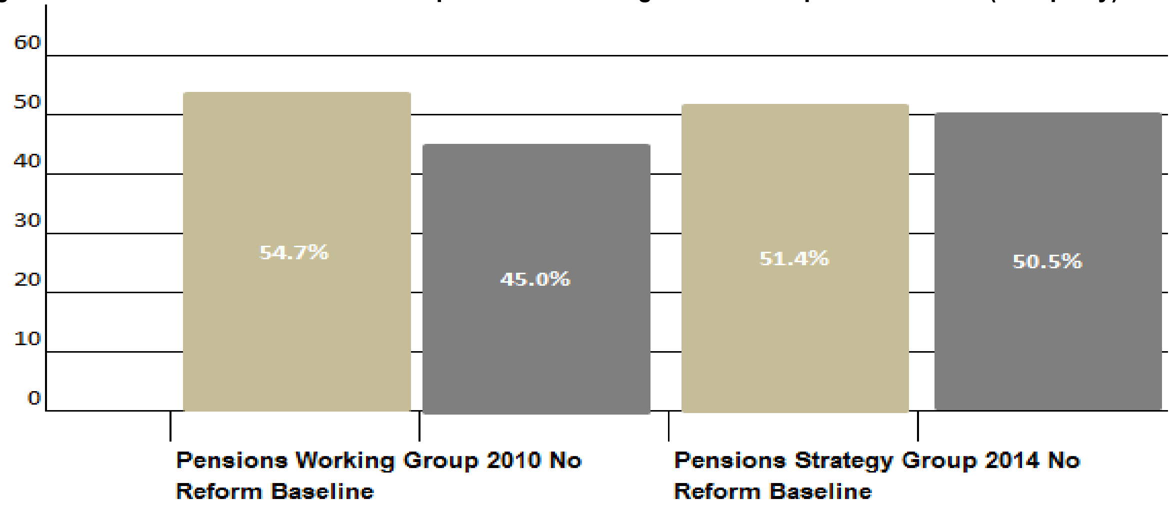
The Strategic Review further proposed that government should by not later than 2020 introduce a mandatory Second Pension on the basis of bi-partisan agreement. Of the 44 recommendations proposed by the 2010 Strategic Review this was the most controversial. Be that as it may, the government of the day did not act on the Review other than setting up the proposed Commission for Financial Literacy and Retirement Income.

The modelling carried out by the Strategy Group, which like that of the previous review uses the PROST model, EUROPOP and Ageing Working Group assumptions, presents on a No Reform Basis, an observable improved situation when compared with that of the 2010 Review.

What has, therefore, changed in this short period? Both the latest releases of the EUROPOP and Ageing Working Group assumptions present a more positive scenario than their previous releases on which the Strategic Review was based. For example, EUROPOP 2013 assumes that by 2060 Malta's population will increase to 476,982 - unlike EUROPOP 2008 which projected that the population would decrease to 408,000. Similarly the Ageing Working Group 2015 macro-economic assumptions assume a participation rate in 2060 for persons 15-64 years of 75.4% as against 70.3% in the previous set of assumptions.

Thus, on the basis of these latest assumptions, in 2060 the pension system on a No Reform Basis should result in an APRR of 51.7%, an improvement of 6.7 p.p.

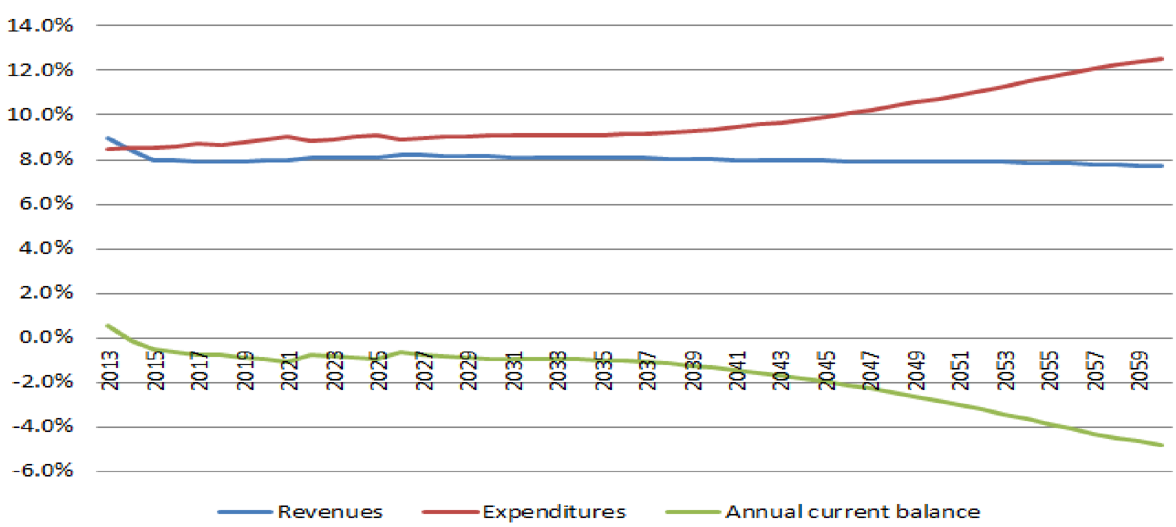
**Figure I: Baseline No Reform Model - Impact on the Average Pension Replacement Rate (Adequacy)**




Whilst this report is reporting a relative improvement to the 2010 Review it is to be underscored that the core financial fundamentals of the pension system with particular regard to the sustainability of the said system do not change and confirm the challenges to the sustainability of the pension system especially post 2040. The projections, which cover contributory pensions for retirement, survivorship and invalidity, are based on data for 2013. In 2013, Government expenditure on these categories of benefits stood at €609.2 million. During the same year, revenues relative to Social Security Contributions amounted to €645.3 million, around a third of which reflect the State Contribution under the obligations of the Social Security Act.

As illustrated in the Figure below, the ratio of total revenue as a proportion of GDP is projected to decline marginally over the projection period from 9% of GDP in 2013 to 7.7% of GDP by 2060. This contrasts with the projected trends for expenditure which is expected to remain broadly stable by around 2040 and then rise to 12.5% of GDP by 2060.  This implies a rise of 4.1 p.p. throughout the entire projection period. Consequently, the system balance is projected to worsen from a small positive balance in 2013 (taking into consideration the State contribution), to a deficit of 4.8% of GDP by 2060.

**Figure II: Baseline No Reform Model – Impact on the Pension System Deficit to GDP**




The unforeseen rise in generosity relative to the 2010 Strategic Review reflects a much faster increase in minimum and maximum pensions (due to larger increases in wages and higher employment rates), would occur at the height of the ageing transition.

These two developments, the rapid increase in spending post-2040 and the unintended significant increase in generosity after that date, shows that much still needs to be done to the pension system architecture to render it sustainable. It needs to be kept in mind that while the current generosity of pensions can be justified on the grounds that typically pensioner households only have one pension income to share between themselves, by 2060, it is believed, that the bulk of pensioner households will enjoy two individual pensions as it is far likely that both male and female members of a family would have accumulated a qualifying contributory history. The previous reform package had taken this in account, when it envisioned a decline in average generosity to 45% in 2060.

In taking forward further reform to the pension system, and building where appropriate on work done over the past decade, the Strategy Group established five underlying principles to guide its work. These are:

(i) The need for a clear definition of the objectives of the pension system.

(ii) An adequate and sustainable pension system sustained by a strong active employment policy.

(iii) The State pension should be a solid foundation, but not the only source of retirement income.

(iv) The pension system to be socially sustainable needs to provide a fair balance between contributions and benefits across generations.

(v) To remain adequate and sustainable, the pension system needs to be able to evolve, particularly to respond to long term developments.

The recommendations presented by the Strategy Group are framed around these principles. In designing the recommendations, within the framework of these principles, the Strategy Group sought to tilt the pension system from an ossified framework where unforeseen future outcomes lead to significantly different outcomes, to one that evolves gradually, smoothly, and incrementally in the face of constant changes in the economic, demographic, social and political environments. It is quite indicative that in just 4 years, changing demographic and economic projections resulted in a revision downwards of expenditure of 3.1% of GDP and an upward revision in the APRR of 6.7 p.p. To maintain trust in the system, Malta requires a system that is not continuously caught off-balance.

In seeking to achieve this, the Strategy Group did not opt for strict automatic mechanisms being drafted onto the pension system. Rather, the Strategy Group builds on Recommendation 62B of the Social Security Act, the tabling at the House of Representatives of a strategic review every five years on the adequacy, sustainability and solidarity of the pension system, which should be complemented by a bi-partisan technical pension commission. The latter would every five years effect changes to the pension architecture on certain parameters with changes affecting successive generations announced 15 years in advance to enable such persons to make appropriate adjustments. This would enable the commission to regularly assess the relationship between the derived benefits and contributions for each generation.

In this respect, the Strategy Group does not recommend fundamental structural changes in the pension system. Together with the World Bank, the Strategy Group studied whether Malta should migrate to an NDC pension architecture. The Strategy Group concluded that the presence of the strong Guaranteed National Minimum Pension (GNMP) renders it unlikely that an NDC architecture would deliver satisfactory results in terms of enhancing pension adequacy and sustainability. It is, thus, seen to be risky to undertake such a complex systemic change for marginal benefits at best.

The Strategy Group also rejects the introduction of an automatic indexation mechanism that links the retirement age with longevity. The Strategy Group prefers a policy approach that incentivises individuals to opt for later retirement once they reach the statutory retirement age, by offering them the chance to contribute more so that they qualify for a full pension, or if they already qualify for one offers them the chance to get an increased pension by deferring their claim. This decision would not just improve the individual’s pension, but also the pension entitlement of their spouse when they decease. This flexible and positive approach is seen to have a far more pervasive and equitable impact than one that mandates an individual to remain in the labour market on the basis of longevity, irrespective of their state of health, the type of profession, skill or trade they possess, or their individual preferences.

The 2007 reform introduced the concept of the GNMP. The Social Security Act in Section 50A defines the GNMP to be "payable at such a rate being not less than sixty percent of the National Median Income as the Minister may, with the concurrence of the Minister responsible for finance, by order under this article from time to time establish and in any case such Guaranteed National Minimum Pension shall not be less than that established for the preceding year".

At the time this amendment was made to the Social Security Act the Government had as yet to determine which yardstick to adopt to determine and benchmark the 'National Median Income'. In this light, the Strategy Group argues strongly that the parameters governing the value of the GNMP need to be specified clearly and in a way that allows it to evolve gradually upwards while maintaining positive incentives for individuals to contribute to the pension system.

The Strategy Group, thus, recommends that the GNMP should be set at the poverty threshold level available in 2016 (2016 is the proposed point of entry of the gradual phasing in of GNMP for all in line with Electoral Manifesto proposal). Between 2017 and 2026, it should be increased by the **full** COLA plus any difference between the **full** COLA for that year and the change in line with the increase resulting from the indexation formula for other pensions. Then after 2026, it would be increased by the **full** COLA plus any difference between the **full** COLA for that year and the change in the maximum pension (resulting from the 70/30 indexation mechanism).

Thereafter, the subsequent GNMP ceilings will continue to increase cumulatively on the basis of this formula. This will secure that (i) the initial level of the GNMP is set at a level consistent with a poverty alleviating income level; (ii) as a minimum, the GNMP will increase from year to year on the basis of the full COLA; thereby ensuring that its purchasing value of the GNMP is protected over time; (iii) the GNMP reflects growth in wage levels, through the indexation formula, and maintains the relativity with the maximum pension which is indexed in the same way; (iv) will ensure equity amongst pensioners as persons will receive the same level of pension value irrespective of the year they retire.

To ensure that the level of the GNMP remains adequate and sustainable, the Strategy Group believes that the appropriateness of its level be evaluated every five years as part of the five-year strategic review mandated by the Social Security Act.

The Strategy Group further recommends that the proposed GNMP mechanism is not only directed to persons who are born after 1962 as per the current legislation, but that it is introduced for all pensioners. The application of the GNMP to all pensioners, in the opinion of the Strategy Group, should not take place in one fell swoop. The adoption of such an approach is costly and will, in the immediate, short and medium term, place the pension system under considerable pressure given the significant fiscal cost it will involve.

The Strategy Group is of the considered opinion that the application of the GNMP to all pensioners should be introduced incrementally. The Strategy Group reviewed a number of options of how the GNMP could be introduced in a phased manner. The Strategy Group's preferred option is that the proposed GNMP is introduced in a manner that it initially benefits those pensioners who are most vulnerable and thereafter it cascades down accordingly: pensioners who as at 1st January 2016 are 76 years of age and over, who are seen to be exposed to significant poverty issues and substantial health and long term care costs. From 2017 onwards the qualifying age would go down year on year until it reaches the cohort of persons who would be aged 65 years in 2027. Of significant note is that this policy should help Malta lower relative poverty considerably, as the elderly constitute about a quarter of all those at-risk-of-poverty in Malta.

The GNMP does not specify a married rate and pensioner couples with just one income will be at-risk-of-poverty. To counter this, the Strategy Group recommends that a top-up is added to the Supplementary Allowance to ensure that married pensioners on the GNMP will not be exposed to being at risk of poverty. The Strategy Group further recommends that the principle applied to the GNMP should also be extended to the Old Age Pension.

Most will agree that Malta's employment record since EU accession has been a success story. Whereas in 2000, the employment rate of persons aged 15 to 59 was 8 p.p. less than that in the EU, by 2013 this gap had dropped to just about one and a half p.p. Malta's employment rate among males in this age group exceeds by far that in Europe. At the same time, the gender gap has steadily been closing such that since 2012 women aged 15 to 39 in Malta have a higher employment rate than those in the EU. Yet challenges remain. The following are identified that have a direct and pervasive impact on the adequacy and sustainability of the pension system.

The fertility rate has collapsed. The average age at first birth has increased from 25.8 years in 2000 to 30.6 years in 2014 (all mothers 18 years of age and older at time of first birth). Similarly the average age at time of first birth of mothers who gave birth to at least two children has also increased from 26.6 years in 2000 to 32.4 years in 2014.

In terms of interrupted career patterns, with the start of the ageing transition, Maltese women can be expected to take more time out of the labour market for child rearing and caring duties, as well as for cultural and social conditions. The result is that a woman who takes time out of the labour market to care for her family, is likely to receive a lower pension income due to a shorter contribution record, or because she is relegated to the sphere of part-time or informal work.

Participation in lifelong learning in both formal and informal competencies and skills has increased given the investment made in the past decade. Be that as it may, lifelong learning, in a state of play of fast increasing change is a strategic policy instrument not only for youths and adults but also within the context of active ageing as it becomes more and more a pre-condition for the economic integration of elderly persons.

In this light the Strategy Group recommends a series of reforms to the pension system with the goal of leveraging the pension system to strengthen the core supporting policies of fertility (demographic); interrupted career patterns (gender); and lifelong learning (retention in the labour market post retirement age). It suggests the introduction of credit contributions to incentivise persons to remain in the labour market. Recognising that Malta's further economic and social development is intrinsically tied with the competency, skills and knowledge of its human capital and that persons with further and higher education have a higher gross value added, the Strategy Group recommends a framework of crediting of contributions in this regard.

Additionally whilst Malta should continue to invest in indigenous human capital to ensure that there is a labour supply to meet competencies, skills and knowledge in future growth areas as well as targeting competencies, skills and knowledge gaps where these exist, the Strategy Group recommends that Malta must complement such investment with an Economic Migration Policy. Additionally, action should be taken to regularise the status of current immigrants so that these are in a position to positively contribute to Malta's economy. This will not only productively muster the competencies and skills that such persons possess but will eliminate the current abuse where such persons are illegally engaged by local firms at a pittance and with no employment rights.

Traditional work practices are changing. Increasingly persons are no longer seeking a 40 hour week single employer relationship but rather a multiple employer relationship that results in a 40 hour week. The Social Security Act is anachronistic with regard to atypical employment practices and the Strategy Group proposes that the necessary reforms are introduced in this regard.

The Strategy Group supports the design of the personal retirement schemes as tabled in the House of Representatives. The decision to adopt the initial level of pension contribution allowance is based on the forecasts made by the 2010 Pensions Working Group which projected that the APRR will decline from 54.7% to 45% in 2060, with the voluntary pension generating a replacement rate of 9.7% to keep average generosity unchanged.

Both the 2004 and 2010 Pensions Working Groups respectively recommended that the appropriate competent authorities should introduce a regulatory framework for equity release schemes. The Strategy Group agrees with the recommendations presented in this regard. Despite the resistance to consider this option, the fact is that there are people who, today, enter into arrangements with private providers of residential homes for the elderly in exchange of their property. They do this, and will continue to do so, because most elderly families are asset rich but cash poor.

To kick-start the process with regard to the formalisation of the home equity market, the Strategy Group proposes that Government should conduct a study to determine the size of the informal equity market, and carry out a study of the possible take-up of more formal arrangements. The Group further recommends that the Government should consider studying the possibility of setting up a Home Equity Bank, financed either through European Union funds or borrowing from multilateral institutions, such as the European Investment Fund. An alternative approach would be to get funding from the National Development Bank mentioned in the Government's Electoral Manifesto.

As financial market instruments have become more sophisticated, people are more likely to make errors when choosing and using financial products, and can suffer considerable losses as a result. Additionally, most persons do not truly understand the pension social contract and overestimate the pension income they will receive on retirement. Thus, education on financial literacy and retirement income is needed to equip persons with competencies and knowledge, so that predictable mistakes when planning for retirement are minimised. In this regard the Strategy Group urges Government to re-convene the Commission on Financial Literacy and Retirement Income with a mandate to (i) inculcate a culture of saving for retirement; (ii) strengthen financial literacy and knowledge on retirement income; and (iii) disseminate within the polity information on how the State pension works.

The representatives of current pensioners' organisation argued that the Maximum Pensionable Income parameter established for the Switchers' Group in the 2007 reform is discriminatory with regard to other cohorts of pensioners. The Strategy Group unequivocally disagree with this position. The Switchers Group unlike the other two Groups (Exempt and Transitional) face the full brunt of the 2007 reform. Inter-generational solidarity must be based on inter-generational equity. The position presented by the current pensioners' organisation not only has a significant impact on spending as a percentage of GDP, but it also constitutes a benefit for which current pensioners did not contribute and which would be borne by future pensioners. It is, indeed, the latter who are facing a pension system where the relationship between contributions and benefits is considerably tightened and who are facing risk as a result of demographic aging and economic uncertainty that are far more significant than that faced by the current generation of pensioners.

At present, for some pensioners their benefit is aligned to an annual assessment of existing collective agreements whilst the pension income of all other pensioners is increased by the COLA. The Strategy Group believes this is socially unjust as it provides no protection to workers who are not covered by a Collective Agreement, who tend to be those on the lowest pension. In this regard it believes that a far more socially equitable solution is that of replacing the current assessment process by an indexation mechanism based on a formula which sees pensions for current pensioners and persons in the Transitional Group increase annually by a % (percentage) of a ratio of 50% Wage Growth : 50% Inflation Growth or the full COLA whichever is the highest.

Recognising, in particular, the role of women in the labour market, the Strategy Group recommends that the surviving spouse gets the deceased spouse's full pension as opposed to the 5/6$^{th}$ survivors pension provided that the surviving spouse has or would have a right to a pension in her (his) right.

Finally, whilst various recommendations were proposed by representatives of current pensioners' organisation over the past years to find a solution to the service pension issue, the Strategy Group is of the considered opinion that this constitutes a 'sui generis' issue. The issue is a direct consequence of the introduction of the Social Security Act in 1979. The principal stumbling block, however, has and continues to be the question of the fiscal implications involved.

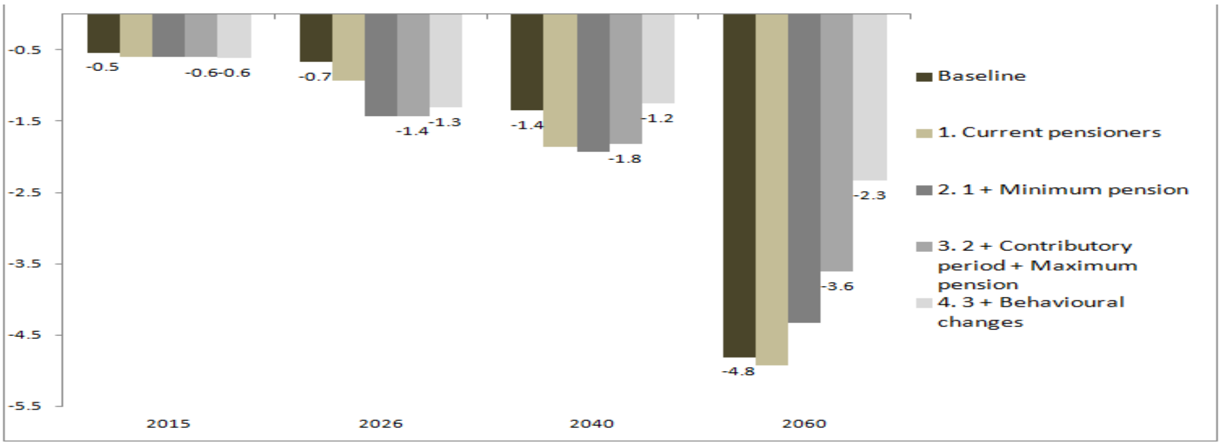
Additionally, the current pensioners' organisations are in dispute in the court of law, both in Malta and in the European Union. For this purpose, the Strategy Group supports the recommendations of previous reform groups that resolution of this action requires direct negotiations between the parties or in the court of law. Until then, the Strategy Group recommends that the government should continue with its current policy with regard to phasing out of the service pension by commutating the service pension by €250 annually through fiscal budgetary measures.

The impact of the key structural reforms to the pension system architecture recommended by the Strategy Group can be grouped into 4 sets of inter-linked measures. The first consists of those measures directly relating to current pensioners: namely changes to indexation, maximum pensionable income and survivors' benefits. As can be seen from Figures III and IV, these reforms rise spending and lead to a slight worsening of the deficit, but this effect starts dying off after 2040.

The reforms to the minimum pension also rise spending over the next decade or so, but thereafter the reform would lead to an improvement in the system balance. The proposed changes to the contributory period and the maximum pension indexation would also impact spending and the system deficit positively, but only after 2040. This strategy reflects the fact that up to 2040, Malta's projected pension spending is in line with that in the rest of the EU, and the required recalibration of the pension system is clearly required in line of the unforeseen improvement in generosity of the system post-2040.

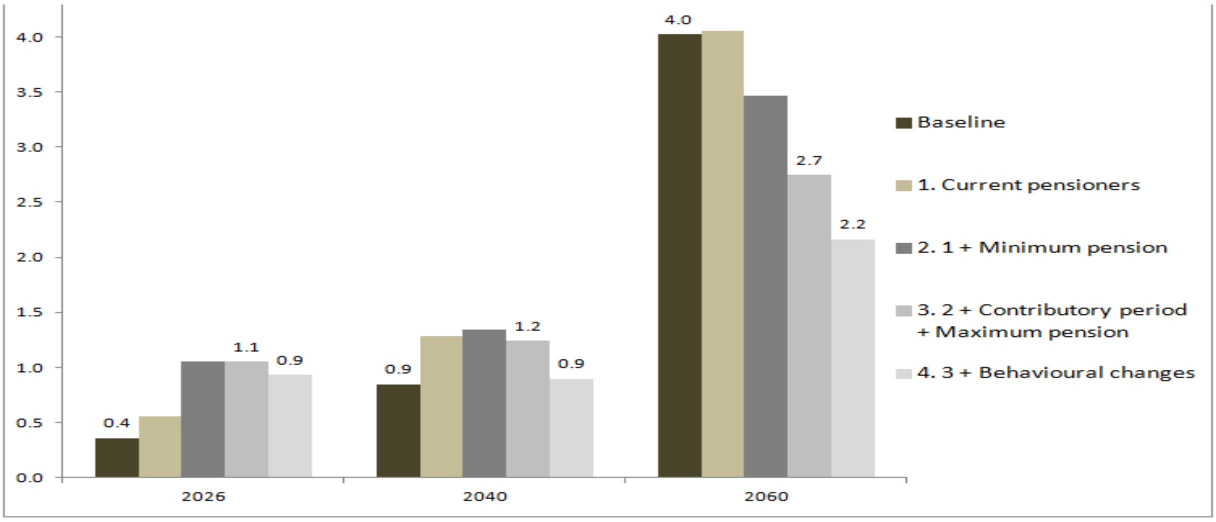
The first sets of reforms assume no behavioural change on the part of contributors. With the aid of World Bank experts, the Strategy Group, however, simulated the possible impact that these reforms could have on labour market behaviour, particularly on early retirement. The results are quite promising. While with no behavioural changes, the system deficit would be improved from 4.8% of GDP in 2060 to 3.6% as a result of the proposed reforms; if labour participation responds as expected, the improvement would be to 2.3% of GDP in 2060. The main impact of the behavioural changes would be to raise revenue, rather than lower expenditure.

**Figure III: Impact of reforms on the pension system balance:**



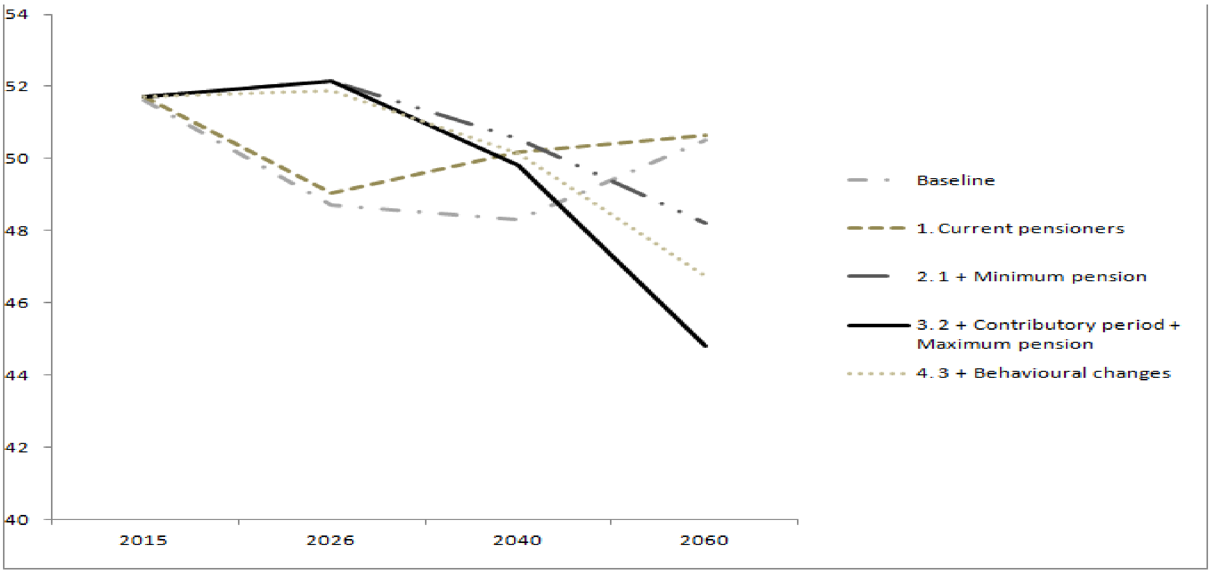

The impact of each individual reform is presented in Chapter 5 of the report.

**Figure IV: Impact of the reforms on the increase in pension spending compared to 2015 (% of GDP)**



As can be seen in Figure V, with no behavioural changes, the average generosity of the pension system – after the proposed reforms – would decline gradually to 45%, the same level projected in the 2007 pension reform. On the other hand, if labour participation reacts to the changes, the decline is more muted – 4.9 p.p. compared to the 9 p.p. anticipated in the 2007 reform.

**Figure V: Impact of these reforms on the Average Pension Replacement Rate (% of average wage)**




It is also important to note that whilst the replacement rate is forecast to decline, the level of the average pension, taking into account the projected increase in living costs, will still grow significantly over time. In fact, up to the mid-2040s the reforms are set to enhance the value of the average pension compared to the current rules, as can be seen in Figure VI. By 2060, the level of the average pension will be some 7% lower than under current rules, but its level will still be 77% higher in real terms than it is now.

**Figure VI: Impact of these reforms on the Average Pension in 2016 constant prices**

The recommendations presented by the Strategy Group with particular regard to those presented in Section 04.2 of the report titled '**Reforms to the Pension System directed to ensure a Socially Sustainable System that provides for a Fair Balance between Contributions and Benefits across Contributions'** are designed as a composite whole.

Any single recommendation taken on its own will not result in the desired impacts to the strengthening of adequacy and sustainability of the pension system that the Strategy Group has sought to address. The Strategy Group underlines that policymakers should avoid the temptation to cherry pick. Rather, the Strategy Group urges the recommendations to be embraced in their totality.

The following are the recommendations proposed by the Pensions Strategy Group:

## Addressing Changing Needs and Issues relating to Society and the Labour Market

### Recommendation 01: Crediting Contributions for Child Rearing, Family Growth, and Gender Equality

The Pensions Strategy Group is of the considered opinion that the child rearing credits framework is recalibrated to meet three objectives: (a) counter the discriminatory impact of the traditional social model on career breaks experienced by females for child bearing and rearing; (b) encourage mothers to be more active in the labour market; and (c) leverage the pension system to positively impact fertility. The Pensions Strategy Group, therefore, recommends that the child rearing credit is calibrated as follows:

| Child | Transitional | Switchers | Severely Disabled Child (with a Disabled Child Allowance) |
|---|---|---|---|
| | | | |
| **Child's Age Limit** | 6 years | 6 years | 10 years |
| | | | |
| **Credit for First Child** | 3 | 5 | |
| **Credit for Second Child** | 2 | 4 | |
| **Credit for Third Child** | 1 | 3 | |
| | | | |
| **Credit for a Disabled Child** | 4 | 8 | |
| | | | |
| **Qualifying period of fully paid contributions to benefit from credit contributions for child rearing** | | 1st January 2016 increases from 10 to 12 years | |

The mandatory qualifying period to qualify for the pension, and to start to benefit from the credits scheme under Section 16 (a)(d) of the Social Security Act should increase from 10 years to 12 years as follows:

- No change for persons born from 1962 and 1965 to keep with the principle that persons should be informed 15 years in advance vis-à-vis changes that effect pension rules.
- To 11 years for persons born between 1966 and 1967.
- To 12 years for persons born on and after1968
- Required pperiod may be reviewed as part of the 5-year strategic review with a view that it continues to bear a direct relation to the contributory period required for a full pension.

Article 16(2)(d) of the Social Security Act which states that "such credits shall only be awarded insofar as, prior to the pension age, such father or mother, as the case may be, resumes gainful occupation for a minimum period equivalent to that period for which such number of credits would have been awarded" should be removed so that such credits are awarded regardless of length of employment. These recommendations will also apply with regard to adopted children.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### Recommendation 02: Crediting Contributions for Human Capital Development and Life Long Learning

Given the strategic importance to Malta to continue to invest in human capital development as a vehicle for further economic growth and social development, the Pensions Strategy Group recommends that the contributions of persons who hold tertiary qualifications that are recognised by the Malta Qualifications Recognition Information Centre are credited as follows:

| | Transitional | Switchers |
|---|---|---|
| | | |
| **Level 5 and Level 6** | 2 months per year of studies | 3 months per year of studies |
| **Level 7** | 3 months per year of studies | 6 months per year of studies |
| **Level 8.** | 6 months per year of studies | 12 months per year of studies |

The Pension Strategy Group further recommends the introduction of a lifelong learning credit of 1 month for each aggregated year of accredited courses for persons who are 18 years of age and over, including those who follow formal apprenticeships or academic or vocational higher education with an education institution and a training / education programme that is registered with Malta Qualifications Recognition Information Centre, is introduced.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

**Recommendation 03: Accounting for Contributions Paid under the age of 18 by persons born before 1962**

The Pensions Strategy Group recommends that contributions paid under the age of 18, by persons born before 1962, are taken into account in the determination of pension entitlement.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

**Recommendation 04: Removing the Ceiling on the Payment of Contributions Post-65 Years of Age**

The current ceiling of 65 years on the payment of contributions by employers and employees is an obstacle to encouraging and incentivising more active participation of elderly persons and it is recommended that discussions take place within MCESD and MEUSAC, with a view to possibly remove this ceiling and that the individual and the employer will pay NI contributions as long as that individual remains active in the labour market.

**Recommendation 05: Reconciling Atypical Employment with the Contributory Principle**

The Pensions Strategy Group recommends that the pension system is to reflect emerging employment patters and should be reformed to ensure that the full contributory entitlement is paid by both a person and an employer in the event that a person works a 40 hour week irrespective of the number of employers the person is engaged with as a part-time worker.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

**Recommendation 06: Facilitating the Transition of Workers from the Shadow to the Formal Economy**

The transition of workers from the shadow to the formal economy has two strategic imperatives with regard to pension reform. The first is that it increases employment participation rates and, thus, strengthens the sustainability of the pension system. The second is that it reduces the 'social protection deficit' that persons in the shadow economy are exposed to and hence renders them eligible for contributory pension support; and, thus, improve adequacy.

The Pensions Strategy Group recommends that the Government undertakes the design of a holistic strategy to tackle the shadow economy through mix of policy measures directed to address the key drivers that elicit such shadow behaviour at the first instance. It is proposed that the Government establishes, *at the earliest possible*, a multi-disciplinary team to draw up a holistic strategy directed to tackle the shadow economy in Malta.

**Recommendation 07: Introducing an Economic Migration Policy for Malta**

The Pensions Strategy Group whilst positively notes the Government recent announcement that it is designing an immigration policy it emphasises that such a policy should that target high and semi-skilled competencies, skills and knowledge as a measure to strengthen Malta's human capital and labour market challenges arising from population ageing. It is proposed that the Government, *at the earliest possible*, designs and introduces such an economic immigration policy.

The Strategy Group further proposes that action is taken to regularise the status of current immigrants so that these are in a position to positively contribute to Malta's economy. This will not only productively muster the competencies and skills that such persons possess but will eliminate the possible abuse where such persons are illegally engaged at a pittance and with no employment rights.

**Recommendation 08: Incentivising Active Participation of Elderly Persons through the Removal of the Mandatory Retirement Age**

The Pensions Strategy Group understands that there cannot be an abrupt transition from a pension system – and labour market – that is governed by a Statutory Pensions Retirement Age which is also the Mandatory Retirement Age to one that abolishes the Mandatory Retirement Age criterion on age equality based legislation. The Pensions Strategy Group underlines that such a debate cannot be ignored and recommends a process of discussion under the tutelage of the Malta Council for Economic and Social Development with the aim of leading to a possible abolition of the Mandatory Retirement Age.

## Reforms to the Pension System directed to ensure a Socially Sustainable System that provides for a Fair Balance between Contributions and Benefits across Generations

### Recommendation 09: Strengthening the Inter-generational Social Contract through a PAYG Notional Defined Contribution Pension System

With the assistance of the World Bank, the Pensions Strategy Group studied the implementation of a Notional Defined Contribution pension system in Malta and concluded that such a complex systemic change was deemed to be inappropriate given the presence of a rather strong Guaranteed National Minimum Pension which makes the system unlikely to deliver satisfactory results in terms of enhancing pension adequacy and sustainability.

### Recommendation 10: Ensuring a Fair Balance between Contributions and Benefits Across Generations (a)

The Pensions Strategy Group considers the introduction of the 5 year strategic review of the pension system as a positive development and that this should be strengthened through the setting up of a special body which every 5 years would establish the parameters of the pension system architecture with a view of announcing changes necessary to maintain balance between contributions and benefits across generations, 15 years in advance and thereby ensuring that persons can make appropriate adjustments.

### Recommendation 11: Ensuring a Fair Balance between Contributions and Benefits Across Generations (b)

The Pensions Strategy Group recommends that for the pension system to remain equitable across generations, the social contract underpinning pension transfers needs:

- To be able to adjust gradually to changing demographic conditions.
- While allowing individuals the flexibility to retire at the respective pension age, the contribution period required to qualify for a full pension needs to be based on a stable ratio between the number of years contributing to that spent drawing the benefit.
- The growth of the maximum pensionable income to reflect changing demographic conditions so as to provide a better deal for future contributors.

### Recommendation 12: Ensuring a Fair Balance between Contributions and Benefits Across Generations

The Pensions Strategy Group underlines that a contribution period that reflects a full career definition would be a truer and fairer mechanism than the contributory period currently in place in the pension system in so far that a balance is maintained with changing needs and issues relating to society and the labour market. The Pensions Strategy Group recommends that any tightening of the relationship between the contribution period and a person's work life should be gradual.

It further proposes that the first tightening in this relationship should be introduced as at 1st January 2016. This presents a minimum of 15-year-in-advance announcement to persons who today are aged 50 years or less (born in 1965 or after). The contributory period for this cohort of persons is being proposed to increase from 40 to 41 years.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### Recommendation 13: Incentivising Late Exits from the Labour Market

The implementation of Article 62A provides an 'exit route' from the labour market despite of the Statutory Pension Retirement Age set respectively for the Transitional Group and the Switchers Group. The Pensions Strategy Group, therefore, recommends the following measures directed to incentivise persons to remain active in the labour market:

- A person will receive the following top-up to his or her pension in the event he or she remains in employment between 62 and 65 years of age without claiming pension:

  | | |
  |---|---|
  | 62 years of age: | 2% top up to the pension value |
  | 63 years of age: | 2% top up to the pension value |
  | 64 years of age: | 4% top up to the pension value |
  | 65 years of age: | 4% top up to the pension value. |

  This will constitute a permanent increase in the person's pension income.

- To give a better incentive to those working, the Group recommends that:

  The number of contributions that need to be paid (that is, not credited) for one to retire earlier than actual retirement age should be established to be at least 7/8s (around 35 years) of the total required (Invalidity Pension credits would be considered as paid for this purpose). This condition shall apply only for those born in 1962 or after and introduced gradually as follows:

  - Those born from 1962 to 1968 – no change (to keep with principle of informing of changes 15 years in advance)
  - Those born in 1969 – 31 years out of 41 years need to be paid
  - Those born in 1970 – 32 years need to be paid
  - Those born in 1971 – 33 years need to be paid
  - Those born in 1972 – 34 years need to be paid
  - Those born in 1973 or after – 35 years need to be paid.

The above is being proposed to be reviewed every 5 years in line with future changes resulting from Recommendation 12.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### Recommendation 14: Incentivising the Deferral of a Retirement Decision

The Pensions Strategy Group recommends that a person may opt for late retirement - that is s/he remains in employment post the Statutory Pension Retirement Age of 65 years of age and during which period s/he defers his or her pension until he / she formally retires - will on eventual retirement receive a far higher pension income for life; the derived right of which will also be enjoyed by the widow/er. A person who defers his or her retirement and pension beyond 65 years will see the pension increase annually in a compound manner for every full year of deferment.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### Recommendation 15: Defining the Guaranteed National Minimum Pension

The Pensions Strategy Group recommends that the Guaranteed National Minimum Pension should be set at poverty threshold which is known as at 1st January 2016 (2016 is the proposed point of entry of the gradual phasing in of the GNMP for all in line with the current Government's Electoral Manifesto proposal). Between 2017 and 2026, the Guaranteed National Minimum Pension increases by the full COLA for that year plus any difference between the full COLA and the income level resulting from the application of an indexation of 50% wages and 50% inflation. Thereafter, the

Guaranteed National Minimum Pension will increase cumulatively on the basis of the full COLA plus any difference between the full COLA for that year and the change in the maximum pension (resulting from the 70/30 indexation mechanism) as is already the case for persons due to retire after 2026. The value of the Guaranteed National Minimum Pension will be further reviewed every 5 years, as part of the strategic review of the pensions system, with the next review due by 2020.

The proposed Guaranteed National Minimum Pension mechanism should be introduced in a phased manner for all pensioners targeting at the first instance the most vulnerable pensioners: pensioners who as at 1st January 2016 are 76 years of age and over. Thereafter, the Guaranteed National Minimum Pension should be extended to further pensioners on the basis of the following implementation schedule:

| Age | Year |
|---|---|
| | |
| **76 and over** | 2016 |
| **75** | 2017 |
| **74** | 2018 |
| **73** | 2019 |
| **72** | 2020 |
| **71** | 2021 |
| **70** | 2022 |
| **69** | 2023 |
| **68** | 2024 |
| **67** | 2025 |
| **66** | 2026 |
| **65** | 2027 |

The Guaranteed National Minimum Pension does not specify a married rate and hence pensioner couples with just one income will be at-risk-of-poverty. To counter this, the Pension Strategy Group recommends that a top-up is added to the Supplementary Allowance to ensure that married pensioners on the Guaranteed National Minimum Pension will not be exposed to being at risk of poverty.

**Recommendation 16: Establishing Relativity of the Old Age Pension with the National Minimum Wage**

The Strategy Group is of the considered opinion that the Old Age Pension is linked to the National Minimum Wage so that any increases to the latter would automatically result in increases to the Old Age Pension. The following is recommended:

| **Single** | **66.7% of the National Minimum Wage** |
|---|---|
| | |
| **Married (both qualify)** | 80% of the National Minimum Wage |
| | |
| **Married (one qualifies)** | 50% of the National Minimum Wage - with the rest of the COLA adjustment to be paid through social assistance payable to the spouse under 60. |

## Recommendation 17: Synchronising the Old Age Pension Retirement Age with Article62(A) of the Social Security Act

The 2007 reform did not increase the retirement age of the Old Age Pension to render it consistent to reforms presented in Article 62(A). This was the result of oversight. The Pensions Strategy Group considers the retirement of 60 years of age for the Old Age Pension as a potential 'formalised' exit route from the labour market and recommends that this is increased to 61 years of age to render it consistent with the contributory retirement age. The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

It is proposed that this measure is introduced incrementally with implementation to initiate in 2016 and scheduled as shown in the Table below.

| | Born |
|---|---|
| | |
| **62 years** | 1954 and 1955 |
| **63 years** | 1956 to 1958 |
| **64 years** | 1959 to 1961 |
| **65 years** | In or after 1962 |

## Reforms outside of the Pension System to ensure that it is not the Only Source of Income

### Recommendation 18: Introducing Incentives for a Voluntary Third Pension

The Pensions Strategy Group supports the recommendations of a Technical Committee to the Minister of Finance with regard to the contribution allowance, the key eligibility criteria, and the amendments to the Social Security Act, the Income Tax, and supporting Legal Notices respectively.

### Recommendation 19: Nudging Persons to Save for Retirement

The Supporting Retirement Pension Scheme that is to be introduced in 2014 may be subject to heuristics which will influence behaviour with regard to long term planning and savings, particularly given that the scheme is completely voluntary. The Pensions Strategy Group recommends that during 2020 Strategic Review, the proposed pension commission (Recommendation 10) should carry out an in-depth review on the performance of the scheme. In the event that the Review shows that voluntary pensions would not have delivered as planned, it should strategically assess the introduction of Mandatory Opt-In Voluntary Opt Out framework, which would see the employer responsible for managing the administration aspects of the scheme and the government responsible for the fiscal incentive is carried out.

### Recommendation 20: Accessing Wealth Accumulated in Property for Retirement Income

The Pensions Strategy Group proposes that the Government should conduct a study to assess the scale of the informal Equity Release market, and carry out a study of the possible take-up of more formal arrangements including the setting up of the Home Equity Bank, either through EU funds or borrowing from multilateral institutions, such as the European Investment Fund or the National Development Bank mentioned in the Government's electoral manifesto. It is proposed that the Government initiates work on this recommendation at the earliest possible.

### Recommendation 21: Inculcating a Culture of Literacy with regard to Financial Savings and Investments and Retirement Income

The Pensions Strategy Group agrees with the direction proposed by the 2010 Strategic Resource in the setting up of a leading structure that would result in the articulation of a financial and retirement income strategy and which would coordinate its implementation. The Pensions Strategy Group recommends the re-constitution of the Commission for Financial Literacy and Retirement Income which should be assigned the following terms of reference:

- Use of educational pathways across the school curriculum, further education, adult and community education and education in the workplace.
- Provision of trusted and independent information to change behaviour and on-going support including but not limited to a targeted designed website, digital markets and social and traditional media.
- Inculcating a new culture by increasing understanding of how consumers act, introducing new strategies such as soft compulsion and addressing gaps in existing advice services.
- Work in partnership with the government, the financial services market, the regulatory authorities and other constituted bodies in establishing new ways to strengthen the connections between all parties that are involved in financial services and retirement income.

It is recommended that this reform measure is implemented by Government at the earliest possible.

## Reforms to Address Challenges Faced by Current Pensioners

### Recommendation 22: Maximum Pensionable Income

The Pensions Strategy Group disagrees that the Maximum Pensionable Income parameter established for the Switchers' Group in the 2007 reform creates an anomaly with regard to the Transition and Exempt Groups. The Switchers Group unlike the other two Groups faced the full brunt of the 2007 reform. The options presented by representatives of the pensioners' organisations will result in a significant financial impact for measures that will be enjoyed only by a very small number of pensions. This will constitute a benefit for which current pensioners did not contribute for and which would be borne by future pensioners, who are operating within a pension system that is far more rigorous and facing significant risk as a result of uncertainty.

### Recommendation 23: Annual Re-Assessment

The Pensions Strategy Group concludes that current pension annual re-assessment is governed by annual Collective Agreement assessment whilst the pension income of all other pensioners is increase the COLA is socially unjust as it provides no protection to workers who are not covered by a Colle Agreement. The Pensions Strategy Group recommends that the current Collective Agreement base assessment for current pensioners and persons within the Exempt and Transitional Group is abolis and replaced by an indexation mechanism based on the following formula:

> Pension increases annually by a % (percentage) of a ratio of [50% Wage Growth : 50% Inflation Growth] or the full COLA whichever is the highest.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### Recommendation 24: Calculation of Pensionable Income for Persons in the Transitional Group

The current calculation is based on the best 3 years of the last 11, 12 and 13 years for employed persons and the best 10 years for self-employed persons within the Transitional Group, depending when born. This is seen to cause a handicap for such persons who may have lost good paying jobs or underwent difficult business cycles in the last 11 to 13 years. The Pensions Strategy Group recommends that by not later than 2018, the pensionable income for the Transitional Group is calculated as follows:

- Best 3 consecutive years in the last 15 years for employed persons born from 1952 to 1961.
- Best 10 consecutive years in the last 15 years for self-employed persons born from 1952 to 1961.

It is recommended that such changes be also effected for persons already on pension before implementation date, but the change becomes effective from start date onwards.

### Recommendation 25: Gender Equality (a)

The Pensions Strategy Group recognises the merit of the recommendation presented by pensioners' organisations that the Survivor's Pension should be replaced by the eligible full pension as the current Survivor's Pension is gender discriminatory and fails to take into account a woman's economic contribution as a family carer during her lifetime. Be that as it may, Strategy Group concludes that the adoption of this proposal in its current form is not affordable and should be rejected.

### Recommendation 26: Gender Equality (b)

The Pensions Strategy Group recommends that the surviving spouse will get the deceased spouse's full pension as opposed to the 5/6$^{th}$ today provided that the surviving spouse has or would have a right to a pension in her own right. In the eventuality that the latter is higher, then she would continue to receive the latter.

### Recommendation 27: Service Pension

The Pensions Strategy Group recommends that the Government should continue with its current policy with regard to phasing out of the service pension for abatement purposes by committing itself to ignore an additional €200 annually from the original amount of the service pension abated from the social security pension through fiscal budgetary measures.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

**Supplementary Papers**



**Figures**

**Tables**

| **Boxes** |
|---|
| |

| | |
|---|---|
| Average Pension Replacement Rate | The value of the average pension relative to the national average wage. |
| Contribution | A payment made to a pension plan by a plan sponsor or member for the purpose of providing a pension to the contributor. The term is used with regards to a First, Second or Third Pension respectively. |
| Defined Benefit PAYG Pension | Refers to the Two-Thirds pension system in Malta which provides on earnings based guaranteed pension income value that is based on two-thirds of a maximum pensionable income ceiling. |
| Mandatory Opt-in Voluntary Opt-out | Directed to capture young people in the labour market automatically and hence countering behaviour limiting issues such as myopia or inertia. By automatically capturing young people early it is believed that people are more likely to remain within the pension scheme given that they structure such investment as part of their long term savings profile before they assume long term expenditures resulting from a decision to raise a family. They can, however, opt out with a defined period from the automatic enrolment. |
| Mandatory Retirement Age | A date when the employer may mandate an employee to retire. This is currently 62 years and will increase to 65 years by 2027. |
| Notional Defined Contribution (NDC) PAYG Pension | A Pay-As-You-Go pension system that aims to mimic the structure of a defined contribution system while maintaining fiscal stability by using an internally consistent rate of return rather than a market based rate of return. |
| Pay As You Go (PAYG) Pension | A pension system, such as that of Malta, where the pension received by a pensioner today is paid through the contributions made by a worker and employer in the labour market today. A PAYG scheme is an unfunded pension scheme, meaning that the scheme accepts responsibility to provide retirement benefits to participants but does not set aside money today to meet future obligations. |
| Statutory Pension Retirement Age | This is the age that a person must retire to qualify for the full pension s/he person is entitled to. This is currently 62 years and will increase to 65 years by 2027. |
| Third Pension | A savings instrument which is long term and 'locks' the savings made by the said person until s/he retires – where-in only a small part of the savings can be taken as a lump sum upon maturity with the remaining large part of the income to be received as a monthly annuity or a programmed annual / monthly drop down income or any other form of income withdrawal as established by the regulatory framework. |

| APRR | Average Pension Replacement Rate |
|---|---|
| ASFR | Age Specific Fertility Rate |
| COLA | Cost of Living Adjustment |
| DSS | Department of Social Security |
| EPD | Economic Policy Division |
| ERS | Equity Release Scheme |
| MFSA | Malta Financial Services Authority |
| Fund | National Insurance Contribution Fund |
| GNMP | Guaranteed National Minimum Pension |
| GDP | Gross Development Product |
| HoR | House of Representatives |
| IP | Invalidity Pension |
| ISA | Individual Savings Account |
| MCESD | Malta Council for Economic and Social Development |
| MFSS | Ministry for the Family and Social Solidarity |
| MPI | Maximum Pensionable Income |
| NI | National Insurance contributory benefits system |
| NMW | National Minimum Wage |
| NRP | National Reform Programme |
| NSO | National Statistics Office |
| PAYG | Pay-As-You-Go |
| PO | Pension Organisations |
| PRS | Personal Retirement Scheme |
| PROST | Pension Reform Simulation Tools Kit (World Bank) |
| PSG or Strategy Group | Pensions Strategy Group |
| 2004 PWG | 2004 Pensions Working Group |
| 2010 PWG | 2010 Pensions Working Group |
| RP | Retirement pension |
| SILC | Survey on Income and Living Conditions |
| SSA | Social Security Act |
| SP | Survivors' Pension |
| SRS | Supporting Retirement Scheme |
| SPRA | Statutory Pension Retirement Age |
| TFR | Total Fertility Rate |
| TTP | Two Thirds Pension |

The Ministry for the Family and Social Solidarity (MFSS) and the Ministry of Finance (MoF), in June 2013 set up a Pensions Strategy Group (PSG / Strategy Group / Group) under the chair of the Permanent Secretary for MFSS[1] with the objective to review the work carried out by the 2010 Pensions Working Group (2010 PWG) and submit recommendations with regard to the strengthening of the pension system. The Strategy Group was also tasked to review recommendations for reform presented by associations representing current pensioners. The full terms of reference of the Strategy Group are presented in **Appendix I**.

The Strategy Group was functionally set up by MFSS to be independent of Government and with the powers to regulate its own proceedings as well as to engage with anyone in or outside Government and to engage expertise, whether internal or external to Government, as appropriate. To meet the deliverables set, the Strategy Group established a number of Sub-Committees. These were:

- **Modelling Working Committee**: This Committee was led by the Economic Policy Division (EPD).
- **Demographics Working Committee**: This Committee was led by the National Statistics Office (NSO).
- **Pensioners' Poverty Committee**: This Committee was led by MFSS.
- **Third Pillar Committee**: This Committee was led by the Ministry of Finance (MoF).
- **Current Pensioner's Committee**: This Committee was led by MFSS. The Committee worked with all representatives of pensioners' associations.

The Strategy Group in its work was primarily guided by the Government's commitment to pension's reform as presented in its Electoral Manifesto – mainly:

- The firm commitment that the statutory retirement age of 65 years will not be increased further but rather that persons will through supporting policies be encouraged to work beyond the statutory pension retirement age (SPRA).
- The firm commitment that no mandatory Second Pension Framework will be introduced.
- A Voluntary Personal Pension Framework is introduced which would be incentivised through fiscal incentives.
- The introduction of a scheme that provides persons with the opportunity to pay for missing contributions and thus regularise their pension position.
- To continue with the gradual implementation of the measure directed to allow service pensioners to enjoy the right to the two-thirds pension and to their service pension.
- To address the anomalies present in the pension system.
- To initiate the process that results, over a period of years, in the introduction of the Guaranteed Minimum Pension to current pensioners.

The Strategy Group also took account of and continued to build on the Government policies or recommendations that directly or indirectly affect pension reform. Of particular importance are the following:

[1] The constitution of the Pensions Strategy Group is presented in Appendix II

(i) The National Strategic Policy for Active Ageing: Malta 2014-2020.

The National Strategic Policy encourages older individuals to remain in the labour market – which requires welfare policies that support an ageing labour force. Such policies are to include the removal of fiscal and social disincentives to stay in employment, adaptation of workplaces to older workers' needs and general difficulties to work shifts and changing the work environment to meet the needs of older employees.[2]

Specific policies identified by the National Strategic Policy are required, including catering for the possibility of gradual or flexible retirement, allowing older workers better access to vocational training and professional education to upgrade their skills, transforming employers' negative mentality about older workers and promoting mixed-age working teams. The National Strategic Policy establishes the importance of flexible levels of employment, with parallel adjustment in social security support, including the reduction of incentives for early retirement and options for continued employment beyond retirement age.[3]

(ii) The National Employment Policy

The National Employment Policy presents a number of recommendations with regard to initiatives to promote female employment encompassing gender pay, workplace practices, gender roles and traditions, and balancing work and family responsibilities amongst others.[4]

The Policy identifies Malta's ageing population impact on both labour market demand and supply as one of the major challenges for Malta. It underlines that an increased active participation of the elderly in the labour market requires policy design with regard to continuing vocational education and training; healthy working conditions; age management; employment services for older workers; ageism and age discrimination; employment friendly tax / benefits; transfer of experience and better reconciliation of work and family commitments.[5]

The Policy also underlines the importance of training and educating migrants in Malta, who, too often, are employed through the black market, and formally integrating these persons in the labour market – a measure which from a macro-economic perspective, is seen to counter the declining working age population as well as reduce the ageing factor.[6]

(iii) National Strategic Policy for Poverty Reduction and Social Inclusion[7]

The strategic policy underlines the Government's on-going commitment to reduce poverty and social exclusion by promoting the well-being and improving the quality of life for all. The strategic policy underscores three overarching challenges that underpin Malta's success in effectively addressing poverty and social exclusion – (a) increasing national sustainable development; (b) promoting empowerment and social solidarity; and (c) consolidating social services.

The strategy, whilst recognising that no person is spared from the possibility of falling into risk of poverty and social exclusion focuses on four population groups: (a) children; (b) elderly; (c) unemployed; and (d) working poor. Additionally, the strategic policy identifies six key dimensions that alleviate poverty and social exclusion. These are (a) income and social benefits; (b) employment; (c) education; (d) health and environment; (e) social services; and (f) culture.

With specific regard to pensions, the strategy proposes the following measures: (a) the introduction of a payment in arrears scheme for people who would have not made adequate social security payments towards a pension; (b) the gradual introduction of a national minimum pension for all pensioners similar to that guaranteed for pensioners born in 1962 and over; and (c) the consideration of introducing the equal distribution of contributory pensions between married partners.

[2] Pg 25, The National Strategic Policy for Active Ageing: Malta 2014-2020, Parliamentary Secretariat for Rights of Persons with Disability and Active Ageing, Ministry for Family and Social Solidarity, Malta, 2013
[3] Ibid
[4] Pp 75-84, National Employment Policy, Ministry for Education and Employment, Malta, May 2014
[5] Pp 89-94, Ibid
[6] Pg 72, Ibid
[7] National Strategic Policy for Poverty Reduction and for Social Inclusion, Ministry for the Family and Social Solidarity

The Strategy Group reviewed the recommendation presented National Reform Programme (NRP) by the European Council in 2014. The recommendation was:

> "To ensure the long-term sustainability of public finances, continue to reform the pension system to curb the projected increase in expenditure, including by measures such as accelerating the increase in the statutory retirement age, increasing the effective retirement age by aligning retirement age or pension benefits to changes in life expectancy and by encouraging private pension savings. Take measures to increase the employment rate of older workers by finalising and implementing a comprehensive active ageing strategy."[8]

In the Government's response to the Council in 2014, the following is of particular note:

> "Government is committed to ensure the long-term sustainability of pensions in Malta by standing ready to introduce, where necessary, further reforms to the first pillar pension whilst exploring the role of supporting pillars, notably the labour market …
>
> … In its work the PSG will review whether reforms relating to first pension design issues can be grafted onto the current Pay As You Go Defined Benefit Pension system or whether a more fundamental reform is required such as a transition to a Notional Defined Contribution first pension … design …
>
> … The gradual increase in retirement age adopted in the 2006 Pension Reform remains valid. It is projected that as a result of the 2006 Reform, the average exit age will increase by 4.8 years over the period 2006-2030
>
> Furthermore, upon the request of the Minister for Finance, the Advisory Group on Third Pillar Pensions submitted to the Minister for Finance its first report on options for incentives for private pensions on the 30th August 2013. …
>
> Upon receiving the report, the Minister for Finance initiated a consultation exercise … with the main financial sector representative organisations … The scheme shall be operative on 1st July 2014."[9]

In the 2015 NRP, the Council in Country Specific Proposal number 2 recommended:

> "To ensure the long-term sustainability of public finances continue the ongoing pension reform, such as by accelerating the already enacted increase in the statutory retirement age and by consecutively linking it to changes in life expectancy."[10]

In the 2015 CSR recommendation the Council is once again emphasising the importance, in its view, of linking the statutory retirement age to a longevity index. The Government's response to the Council's position is consistent with the principles of a number of reforms which the Strategy Group is putting forward.

In the carrying out of its work, the Strategy Group worked closely with the:

(i) Eurostat with regard to the design of the EUROPOP 2013 projections for Malta.

(ii) NSO, EPD and the Department of Social Security (DSS) on determining pensioners' income; articulating options for reform; and assessing outcomes of potential reform measures.

(iii) World Bank with regard to the upgrading of the pension model to the latest version of the PROST modelling tool and the setting up of the No Reform baseline model as at 2014.

(iv) World Bank in designing a modelling framework for a Notional Defined Contribution (NDC) pension system and in carrying out scenarios with regard to the application of this pension system in Malta.

The Strategy Group continued to build on the work carried out since 2004 by different pension reform working groups.

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[8] Pg 10, Malta's National Reform Programme under the Europe 2020 Strategy, Ministry of Finance, Malta, 2014
[9] Pg 11, Ibid
[10] Pg 21, National Reform Programme, Ministry for Finance, April 2015

The Strategy Group thanks all persons that assisted it through the provision of information, discussion of issues and specific studies carried out on its behalf. The Strategy Group specifically thanks the staff of the EPD, NSO, DSS and all persons who participated in the workings of the Sub-Committees. The conclusions of the Report are, however, the views of the Strategy Group.

## 02.1 The Reforms to the Pension System and their Outcomes

A national state pension system, broadly speaking, serves two main functions. The first is to alleviate poverty among elderly people. The second is to provide income stability over the life course. The importance given to each function tends to differ across countries and over time, and reflects history, culture and social arrangements amongst other things. On an individual basis, pensions allow the transfer of consumption from productive middle years to retired years. Moreover they also serve as a means to target resources on people who are poor on a lifetime basis and help improve their living standards during old age.

Besides these primary objectives, policymakers have secondary goals mostly relating to the effect of the pension system on economic behaviour in labour and capital markets, and to create incentives for socially required, but unpaid, activities such as caring and child rearing.

If not conceived as aims, these effects can be seen as constraints. Thus, if a system results in too high tax rates, it adversely affects economic growth, while a system that provides very generous benefits may displace private saving and thus result in smaller capital markets. The main constraint on pension systems, however, is the financial resources allocated for this purpose. From the very beginning, this factor played an important role in shaping pension policy. In most countries when pensions were established, governments established specific taxes or contributions to finance them. These concerns persisted over time and systems in some countries took a relatively long time to move beyond a basic poverty alleviation role or tended to involve private sector employers (rather than the State) in income replacement. The pre-funding of pension promises also tended to be quite common, but gradually this hypothecation of tax revenue or pre-funding shifted towards the Pay-As-You-Go (PAYG) scheme of financing pensions.

The Maltese pension system has tended to follow this path. It was initially conceived as a poverty alleviation scheme for the elderly and gradually evolved into a social insurance scheme. Up to 1979 retirement income provision was through a mixed system, with certain sections of the population also covered by private arrangements. At that point, the decision was made to make the State pension system the sole source of income of retirees. Even then, however, this was meant to be a progressive system with a cap on the Maximum Pensionable Income (MPI).

The way the MPI was managed over time, however, resulted in the system gradually moving towards becoming more of a flat rate system. Moreover its generosity was set to decline dramatically over time, changing the two-thirds pension towards something which would be more aptly called a one-sixth pension by 2060.

At the same time, Malta went through the same demographic transition that affected the rest of the developed world, with a substantial drop in fertility and a significant increase in life expectancy at older ages. This meant that the ratio of contributors to beneficiaries which sustained the financing structure of pensions, gradually, started to deteriorate and is expected to halve by 2060. In the case of Malta, this demographic transition was initially offset through increasing the labour participation of women, which is boosting the contributor base. The relatively low level of the MPI, however, has acted as a counterweight, as an increasing number of workers were paying the highest allowed contribution.

From the mid-1990s to the early 2000s different administrations commissioned studies and established commissions to present recommendations for the reform of the pension system given the increasing recognition of the issues relating to the sustainability and adequacy of the system. Be that as it may the first and only significant overhaul to the system occurred between 2004 and 2007.

The Government at the time, in June 2004 commissioned a Pensions Working Group (2004 PWG) to present recommendations directed to modernise the pension system and to ensure sustainability and adequacy for future generations. The 2004 PWG presented a holistic approach to reform that encompassed:

- Parametric changes to the First Pension with regard to the statutory retirement age; accumulation of contributions, calculation of contributions; indexation of the MPI; valorisation; etc.

- The introduction of a Mandatory Second Pension framework.

- The introduction of a Third Pension framework.

In determining the path way to reform, the Government focused its reform measures to the strengthening of the First Pension framework by means of parametric revisions. The recommendations to design a Mandatory Second and a Third Pension framework respectively were rejected.

The parametric changes where designed to affect various population cohorts differently. The population cohorts were categorised as shown in the Table below.

**Table 01: 2007 Reform - Directed at Three Different Population Cohorts**

| | |
|---|---|
| Exempt<br>55 years and over as at 1st January 2007 | It was believed that persons in this cohort did not have the necessary time to change behaviour and absorb the impact of the changes, and hence no negative changes were made to their pension contract with the State.<br><br>This cohort was affected by positive changes only. Three positive reform measures were introduced. First, the MPI which was frozen since early 1987 at €16,077 was adjusted upwards to €17,475. A subsequent reform allowed the MPI to increase annually by the full Cost of Living Adjustment (COLA) rate.<br><br>Second, the rule that prevented a pensioner to earn more than the national minimum wage and receive his/her full pension income was removed. This change was introduced in order to incentivise elderly persons to remain active in the labour market whilst enjoying the full pension.<br><br>Third, the retirement age for women which stood at 60 years of age was increased to 61 years of age and hence securing gender parity. |
| | |
| Transitional<br>46 years to 54 years as at 1st January 2007 | The impacts of certain measures of reform, mainly the statutory retirement age, the contributory period, and the calculation period were increased by degrees.<br><br>This resulted in persons within this cohort being affected differently. Persons who were closer to 55 years of age at the date of the reform were partially impacted whilst those who were closer to 45 years of age where significantly impacted vis-à-vis the full reforms that were to affect the Switchers Group. |
| | |
| Switchers<br>45 years of age and under as at 1st January 2007 | The persons in this age cohort were fully affected by the totality of the reform measures proposed. This cohort of persons is placed on a new pension contract. |

The Table below presents the main measures introduced in the 2007 reform and how these affected the different population cohorts.

**Table 02: Main Measures Introduced by the 2007 Reform**

| | Switchers | Transitional | Exempt |
|---|---|---|---|
| | | | |
| Statutory Retirement Age | 65 years | 62 years to 64 years | 61 years – no change |
| Yearly Average Number of Contributions | 40 years | 35 years | 30 years – no change |
| Calculation of Pensionable Income | Best 10 years in the last 40 years pre-retirement | Best consecutive 3 years out of last 11 to 13 years | Best consecutive 3 years out of last 10 years – no change |
| Maximum Pensionable Income | €20,940 plus [70% of average wage of previous year + 30% inflation rate of previous year] | €20,940 plus COLA | Introduced a pathway to reach €17,475 from €16,077 on the basis of COLA increases.<br><br>In 2008, through a budgetary measure, it was established that the MPI for the Exempt Group would increase annually by the full COLA adjustment. |
| Guaranteed National Minimum Pension | 60% of National Median Income directed to ensure that the pension provided a more solid foundation for those on low incomes who had a complete contributory record. | | |

Measures were also introduced to leverage the pension system to meet three important policy goals: (i) increasing retention of women in the labour force by incentivising them to re-enter the labour market following maternity; (ii) applying the introduction of credits within the pension system for child rearing as a pro-family policy; and (iii) increasing the active labour participation of persons beyond the SPRA. The reforms are presented in the table below.

**Table 03: Leveraging Reform to the Pension System to meet Society and Labour Market Goals**

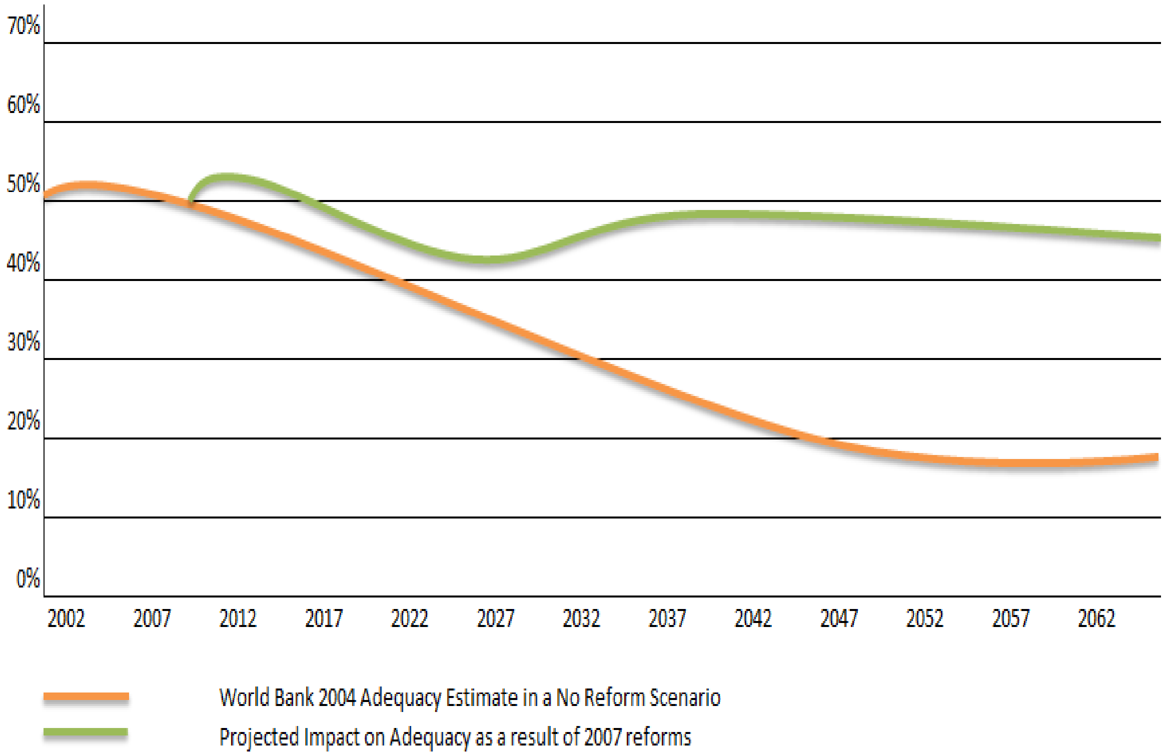
| Policy Goal | Instrument | |
|---|---|---|
| | | |
| Increase fertility and women re-entry into the labour market (i) and Pro-Fertility (ii) | Child Rearing Credits to Contributions | 2 years and 4 years respectively for every child of up to 6 years and 10 years with regard to a disabled children subject that the parent returns to work for equivalent period. |
| | | |
| Increase active participation of persons following statutory retirement (iii) | Earn uncapped income and receive full pension | Removal of pension rule that prevented a pensioner to earn more than the national minimum wage was removed. |

A further important reform was the re-design of the invalidity pension framework – which constitutes part of the National Insurance (NI) contributory benefits package. It was recognised that the then existing invalidity pension had become an 'exit' route for persons who wished to withdraw from the formal active labour market. The reform proposed a revised framework that significantly tightened the mechanisms and criteria relating to the determination of a person as an 'invalid'.

One further important change that stemmed from the 2007 reform was the introduction of a 'trigger' within the Social Security Act (SSA) – Article 65D – which placed an obligation on the government of the day to carry out a Strategic Review on the health of the pension system with particular regard to adequacy, sustainability and solidarity. The first Strategic Review was carried out by the 2010 PWG and was tabled at the House of Representatives (HoR) in December 2010.

The Review concluded that the 2007 reform, to a point, addressed the issue of the adequacy of the pension as the measures introduced de-accelerated its degeneration – stabilising the Average Pension Replacement Rate (APRR) by 2060 to 45% of what would otherwise have been an 18% of the APRR in the event of a no reform scenario. As can be seen from the Figure below, the World Bank 2004 study had estimated that a scenario where no reform was carried out would have seen the value of the average pension in relation to the average wage fall considerably by 2060. Be that as it may, the 2007 reform did not re-establish the adequacy levels for future pensioners to the 54% plus of the average wage enjoyed today by current pensioners at the time of the Review.

**Figure 01: Pre and Post Reforms Impact on Adequacy**




The reforms were projected to result in a different debt profile than that projected by the World Bank for a no reform scenario. Projections of the sustainable impacts of the 2007 reform showed that the pension 'account' would remain in equilibrium till approximately 2032 and thereafter it would sharply decline into deficit – by 2060 reaching a pension deficit to GDP of approximately (5.8%).

The significant increase in the pension's deficit to GDP between 2033 and 2060 is the result of the dramatic changes to the demographics and ageing profile of Malta; and the financial impact of two reform measures: the introduction of the Guaranteed National Minimum Pension (GNMP) and the indexation mechanism to the MPI.


It is pertinent, however, to underline that the sustainability projections, carried out by the PWG in 2010, had one significant departure from that carried out by the World Bank in 2004. The pension system is a tri-partite system where with regard to employees (Class 1) government, employers and employees respectively pay a 10% earnings based contributions capped to the MPI; and with regard to self-employed persons, such persons and government pay a 15% earnings based contribution capped to the MPI. The projections by the 2010 PWG incorporated the State's contribution. The World Bank in its 2004 projections had excluded the State's contribution.

The 2010 PWG concluded that further calibration was required to the pension system and to the supporting policy framework. Of particular note were recommendations with regard to:

- Policy measures directed to increase the fertility rate, increase active participation in the labour market and the adoption of a targeted immigration and residency policy.

- Mitigating the significant degeneration in the sustainability of the pension system by grafting onto the pension system a longevity-retirement index which would have seen the statutory pension retirement age increase from 65 years of age to 68 years of age by 2054. Projections showed that the implementation of such a measure would result in an increase of 1% to GDP for every one year increase in the retirement age – reducing the pension's deficit to GDP by 2060 from the projected (5.8%) to approximately (3%).

- The undertaking of the appropriate study to see whether Malta should shift its Defined Benefits PAYG pension system to a NDC system.

- In the event that the decision reached would be that Malta does not shift onto a NDC system than the Government should introduce a Mandatory Second Pension Framework as a means to diversify from the demographic risk.

The report recommended that the Government with immediate effect should introduce a Third Pension Framework as well as voluntary mechanisms for saving for retirement such as a child pension saving accounts; home equity pension schemes, etc. The Government carried out a consultation process on the report, and a final post consultation report was submitted to the Malta Council for Economic and Social Development (MCESD) in May 2012.

The reform of the pension system, however, was thereafter stalled.[11] Of the recommendations presented by the 2010 PWG only the following were implemented. The Strategic Review:

- Identified that the Child Rearing Credit introduced in the 2007 reform negatively affected parents classified within the Transitional Group – that is persons who were 46 to 54 years of age as at 1st January 2007, and recommended that parents in this age group are provided with a 1 year pension credit for each child born of up to 6 years of age; or 2 years for a disabled child of up to 10 years of age. This recommendation was implemented as a budget measure in 2014.

- Concluded that the pension rule that a surviving female spouse would benefit from a widow's pension subject to the condition that she would forfeit part or all of the pension should she seek employment and that income from employment is greater in value than the yearly average of the National Minimum Wage was seen to constitute gender discrimination and that it acted as a barrier for a surviving female spouse to enter the labour market.

  The Review recommended that a widow should be able to earn income from gainful activity that exceeds the yearly average of the National Minimum Wage without forfeiting her right to a widow's pension whilst she is under the SPRA in order to incentivise her to remain active in or to re-enter the labour market. This recommendation was implemented as a budget measure in 2014.

- That the reform of the pension system will not result in true and meaningful change unless this is complemented by the inculcation of a culture of self-responsibility for retirement achieved through instilling an understanding of the importance of saving for retirement.

  The Review recommended that the government should establish a permanent Commission on Financial Literacy and Retirement Income directed to inculcate such a culture of saving for retirement and to strengthen financial literacy within society. This recommendation was implemented in July 2012 and the Commission was set up with the terms of reference to:

  - Create a financially educated population.
  - Raise awareness of the need to plan for retirement.
  - Provide education on financial management and planning.
  - Design and embark upon education, information and knowledge campaigns to assist people to make informed financial choices and decisions for their retirement.
  - Build and foster a network for financial literacy provision.
  - Collect research on retirement planning behaviour and attitudes.
  - Recommend to Government, strategies to inculcate a culture of savings for retirement.

  The Commission was tasked to complete by the end of 2012 (i) a survey to assess the level of financial literacy in Malta and which assessment should act as a baseline study; and (ii) a National Strategy for Financial Literacy and Retirement Income. Regrettably, the Commission did not complete these tasks. Following the change in government in 2013, this Commission was not reconstituted.

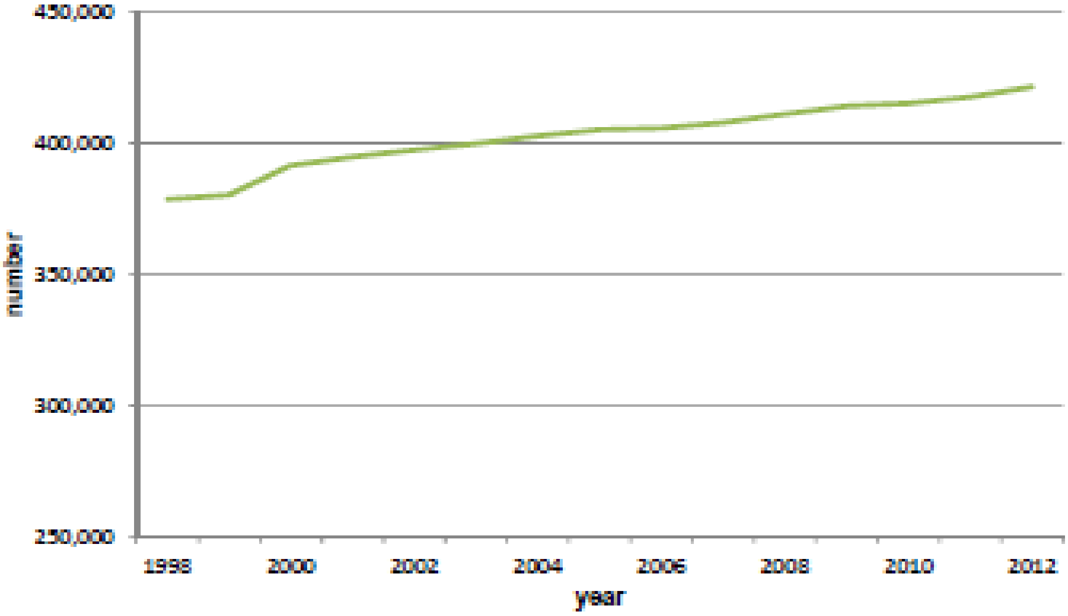
[11] This contrasted significantly with events in the rest of the European Union where the sovereign debt crisis continued to accelerate the reform process leading to higher and less gradual increases in retirement ages and significant reductions in generosity. In most European countries, the importance given by the state to the income smoothing function of pensions diminished, with part of this function being shifted to individual saving plans. A lot more importance was placed on making sure that the pension system gives the right incentives to work and is able to adjust to changing demography. At the same time, there was increased focus on improving the effectiveness of the poverty alleviation function of pensions.

## 02.2 Demographic and Labour Market Challenges to the Pension System[12]

The Strategy Group reviewed Malta's population for the period 1998 to 2012. This period reflects the time frame from when the debate on the need for pension reform started in Malta in earnest to the undertaking of actual reforms.

The Strategy Group looked at the behaviour of fertility, life expectancy, and migration, during this period - the main determinants that propelled the extent and speed of the ageing of Malta's population. Malta's population grew during the period under review as shown in the Figure below.

**Figure 03: Malta's Population between 1998 and 2012[13]**



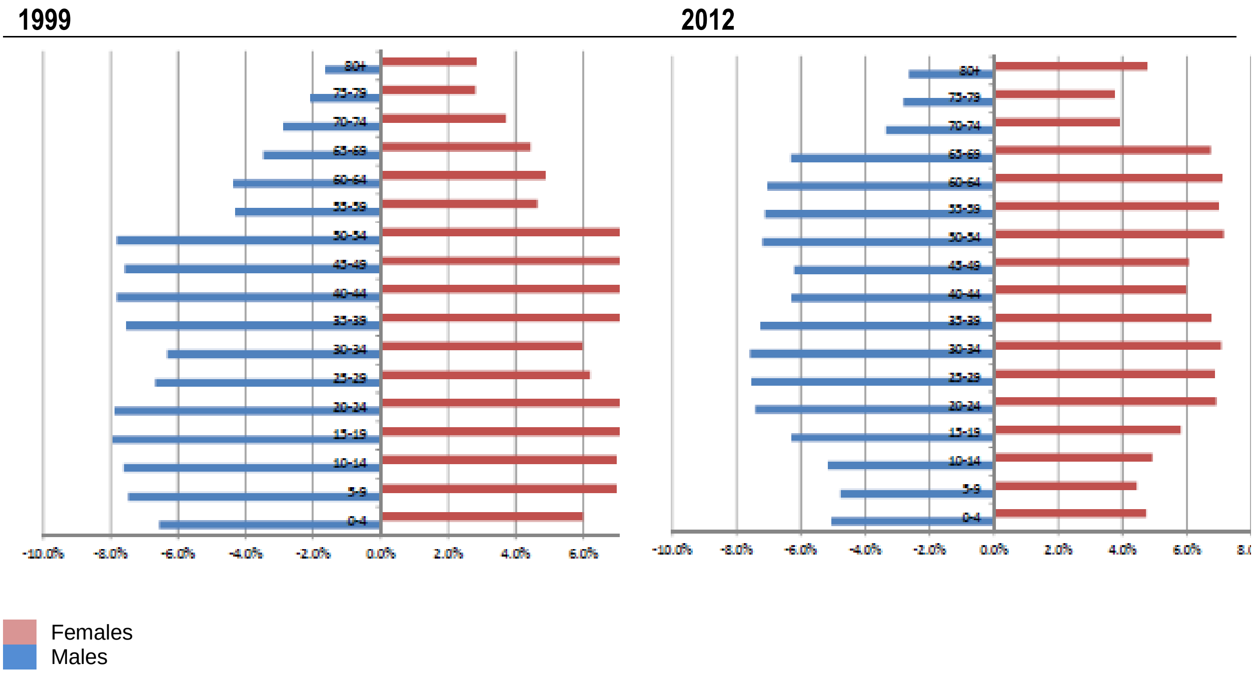

The population structure of Malta between 1999 and 2012 experienced significant changes. This is demonstrated in the Figures below. In 1999 Malta was already demonstrating signs of an ageing population.

The lower base of the population pyramid, which, theoretically, should constitute the largest population cohort, was already smaller than the 15-19 years cohort. By 2012, the impact of ageing on Malta's population becomes more evident.

The upper base of the pyramid, the 60 years and over cohorts, has increased significantly. Indeed, the 60 to 69 years of age cohorts are representative of the population in the age structures between 20 and 59 years of age. The lower base, the 19 years of age and under, shrunk considerably when compared to 1999.

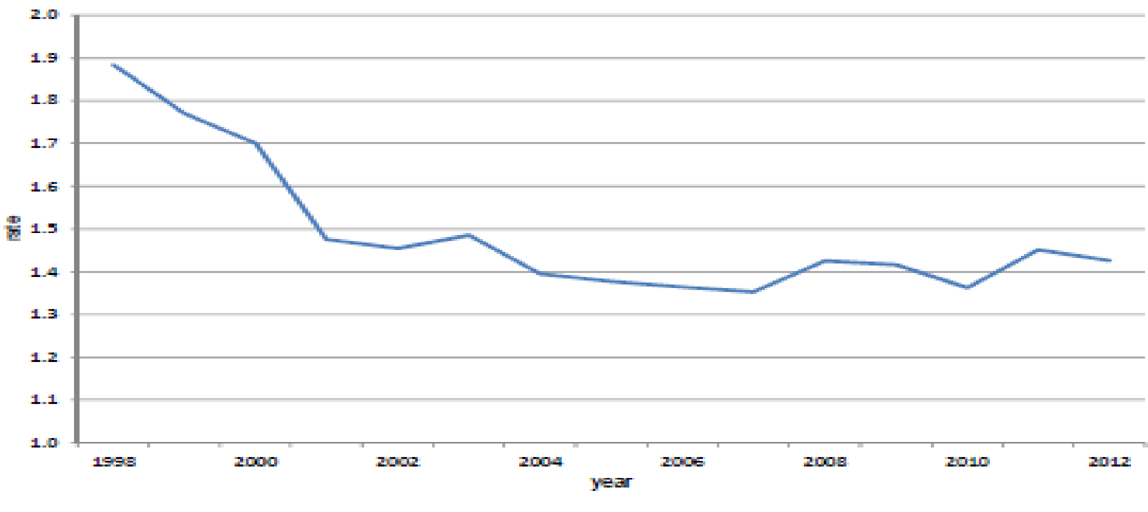
[12] A detailed analysis of the demographic and labour challenges is presented Appendix III titled a 'Review of the State of Play of the Demographic and Labour Market and Supporting Policies Characteristics'.
[13] Ad hoc report prepared by the National Statistics Office for the Pensions Strategy Group. February 2014

**Figure 04: Changes in Malta's Population Structure between 1999 and 2012**[14]




As can be seen from the Figure below, Malta's Total Fertility Rate (TFR) experienced a significant decline between 1998 and 2002. Thereafter it experienced a marginal decrease before it rebounded slightly in 2010 before falling once again in 2012. Malta has now for over a decade experienced a fertility rate that hovers around 1.4. This is of considerable concern as a fertility rate of 1.4 means that Malta's population has collapsed in the absence of strong inward migration. For Malta's population to stabilise the TFR must be, at least, 2.1.

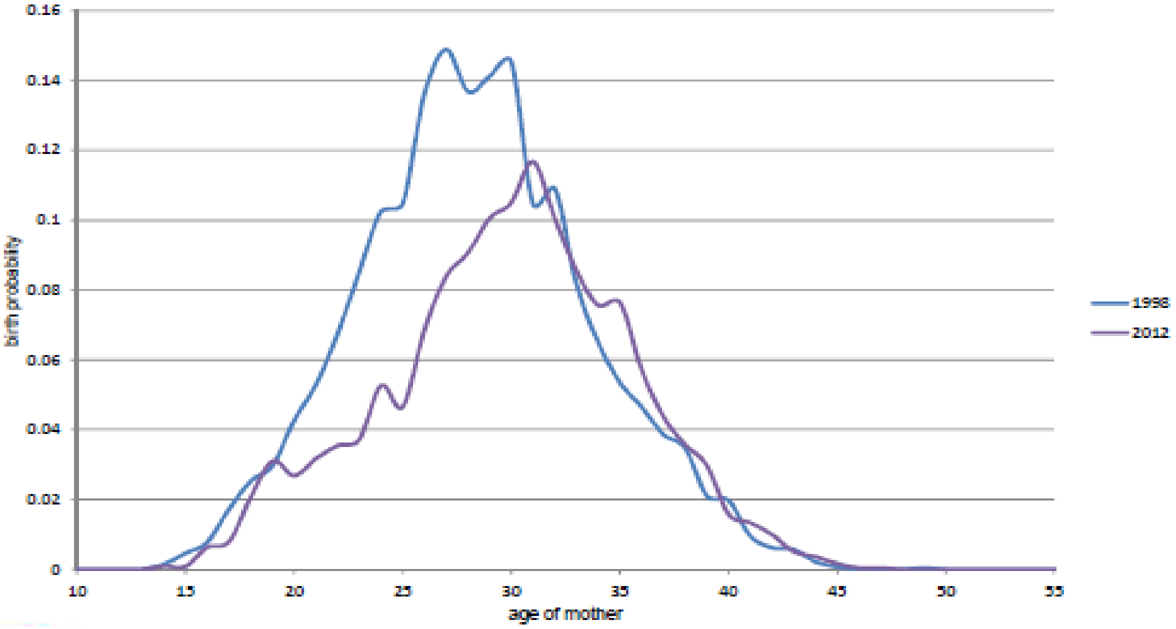
**Figure 05: Total Fertility Rate for Malta**[15]




[14] Ibid
[15] Ibid

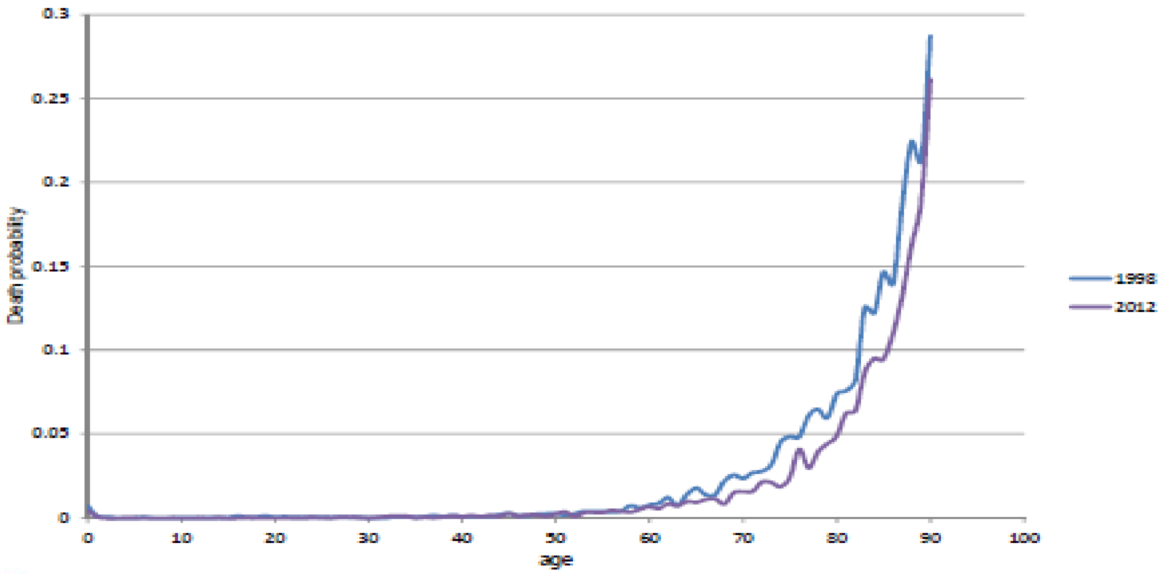
The Figure below shows that the Age Specific Fertility Rate (ASFR) for mothers who have their first child. As can be seen, as women are becoming more active in the labour market they are deferring their decision to start a family to later in life: 30 years of age. This is one significant reason for the decline of Malta's TFR.

**Figure 06: Age Specific Fertility Rate for Malta**[16]




As can be seen from the Figure below, over the 14 year period under review there has been a considerable shift downwards in the death probability rate for persons who are 65 years of age and over - in essence, showing that the unisex life expectancy rate increased.

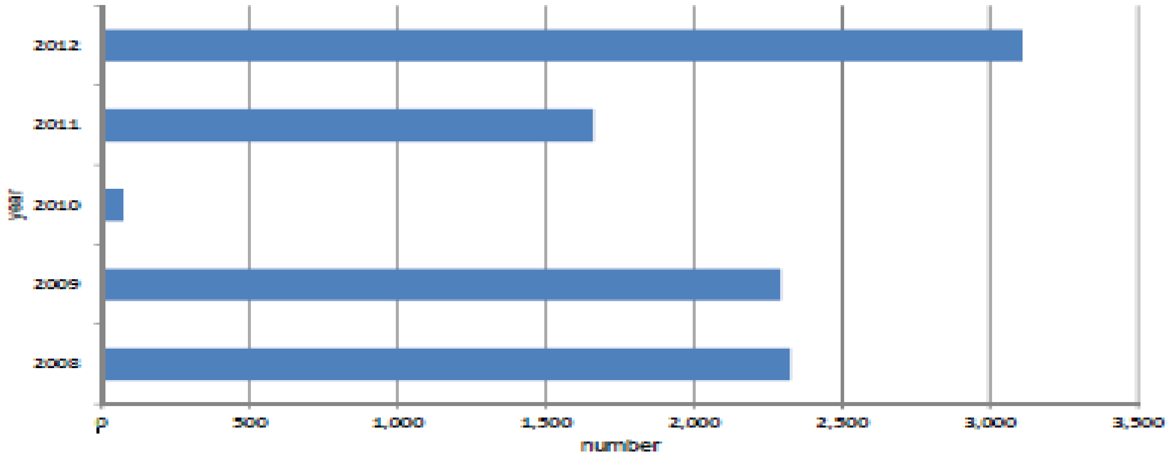
**Figure 07: Death Probability for Malta**[17]




[16] Ad hoc report prepared by the National Statistics Office for the Pensions Strategy Group. February 2014
[17] Ibid

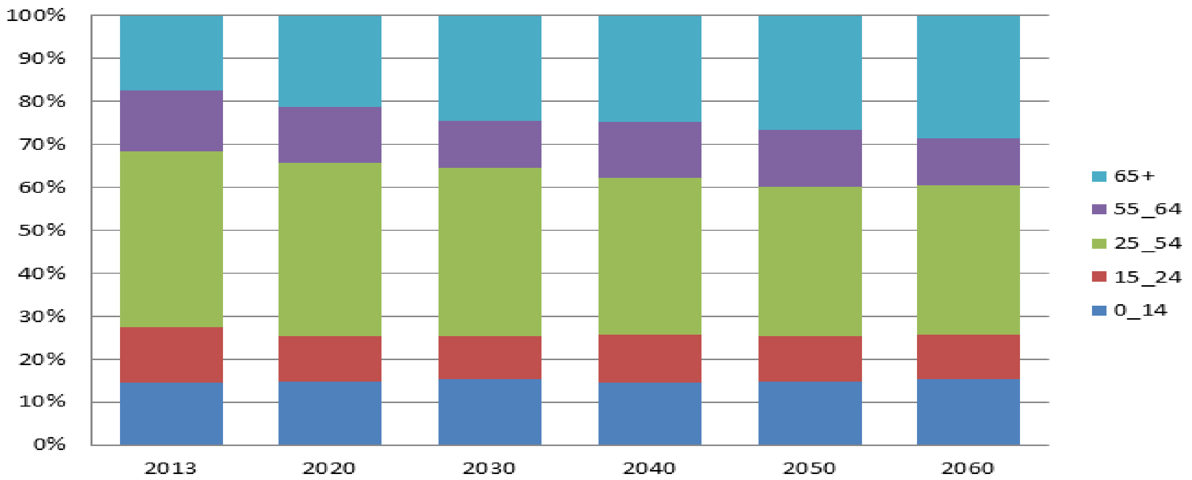
Figure 08 below shows that net migration in Malta for the period 2008-2012 was approximately over 9,000 persons. This, in part, explains the increase that took place in the Maltese population as shown earlier in Figure 03. Immigration flows, other than returning Maltese persons, are, in ascending order, persons from the EU, asylum applicants, and Third Country persons excluding asylum applicants.

**Figure 08: Net Migration: 2008-2012**[18]




The EUROPOP 2013 exercise, concluded earlier in 2014, projects the composition of the Maltese population to be as shown in the Figure below.

**Figure 09: Composition of the Maltese Population**




The composition of the population is projected to alter considerably over the period 2013-2060. This is the result of projected developments of trends in fertility rates, life expectancy and migration. The overall size of the population is expected to be larger and older. As shown in Figure 09, while the share of the age group 0-14 is projected to be broadly stable, rising slightly towards the outer years, the proportion of the share of persons of working age 15-64 is projected to decrease from around 68% in 2013 to 56% in 2060. Those aged 65+ and over are projected to become a much larger proportion of the population, rising from 17.5% in 2013 to 28.5% in 2060.

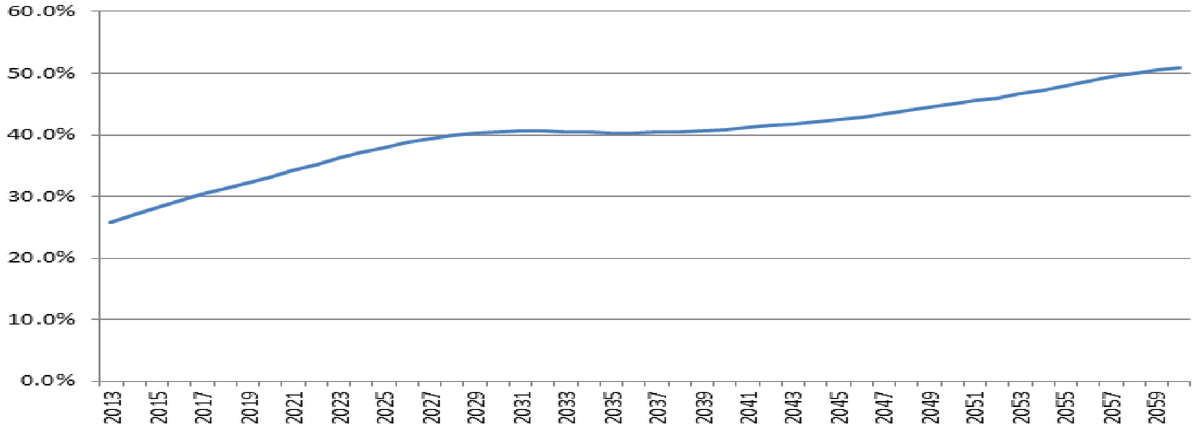
[18] Ibid

**Table 04: Changes in the Population Maltese**

| | 2013 | 2020 | 2030 | 2040 | 2050 | 2060 |
|---|---|---|---|---|---|---|
| | | | | | | |
| **Total Fertility Rate (%)** | 1.44 | 1.56 | 1.67 | 1.73 | 1.76 | 1.78 |
| **1.78Total Net Migration** | 1,617 | 1,565 | 1,468 | 1,422 | 1,336 | 1,146 |
| **Life Expectancy at 65 years (Males)** | 18.1 | 18.8 | 19.7 | 20.7 | 21.6 | 22.4 |
| **Life Expectancy at 65 years (Females)** | 21.3 | 22.0 | 23.0 | 24.0 | 24.9 | 25.7 |

In fact, as illustrated in the Table above, life expectancy at 65 is expected to increase by around 4.3 years in the case of males and 4.4 years for females over the projection period. As a result of these developments, the old-age dependency ratio is expected to worsen over the projection period, from 25.8% in 2013 to 50.9% by 2060. This implies that while in 2013 there are approximately 4 persons of working age for every person age 65 or over, by 2060 there will be 2 persons of working age. Trends in the Old Age Dependency Ratio are shown in the Figure below.

**Figure 10: Old Age Dependency Ratio**




**Supplementary Paper No 1** titled a '**Review of the State of Play of the Demographic and Labour Market and Supporting Policies Characteristics**' presents a detailed analysis of the labour market and supporting policies characteristics. A synthesis of the key characteristics of the labour market is presented in the Table below.

**Table 05: Synthesis of Labour Market and Supporting Policies Characteristics**

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | |
| **Total Employment Rate (Age 20-64)** | 57.3% | 57.4% | 57.9% | 58.6% | 59.2% | 59.0% | 60.1% | 61.6% | 63.1% | 64.8% |
| **Full time Employment ('000s)** | | 134.7 | 138.0 | 139.3 | 141.1 | 142.8 | 1457.7 | 146.3 | 146.8 | 151.5 |
| **Full time with Reduced Hours ('000s)** | | 1.4 | 1.6 | 2.7 | 3.5 | 3.1 | 3.6 | 4.5 | 4.7 | 4.8 |
| **Part time ('000s)** | | 13.3 | 13.9 | 15.5 | 15.1 | 15.2 | 16.0 | 17.2 | 21.0 | 23.0 |
| **Female Employment Rate** | 34.3% | 35.1% | 35.3% | 37.5% | 39.4% | 39.8% | 41.5% | 43.4% | 46.8% | 49.8% |
| **Female in Employment with 1 child** | | 40.9% | 40.9% | 43.0% | 45.4% | 47.4% | 47.5% | 47.7% | 52.7% | 58.0% |
| **No. of Females on Reduced Hours** | | 1,260 | 1,724 | 2,424 | 2,845 | 2,562 | 2,849 | 3,658 | 3,863 | 4,374 |
| **Tele-working in Government** | | | | | 117 | 225 | 414 | | | |
| **Unemployment Rate** | | 7.1% | 6.8% | 6.4% | 6.0% | 7.0% | 6.8% | 6.7% | 6.5% | 6.7% |
| **Total Working Life: Male (years)** | 38.5 | 38.2 | 38.1 | 38.1 | 37.9 | 38.1 | 38.6 | 39.1 | 38.9 | |
| **Total Working Life: Female (years)** | 17.1 | 18.2 | 18.4 | 19.6 | 20.4 | 20.8 | 21.6 | 22.3 | 23.7 | |
| **No. of Part-time: Female** | | 8,547 | 8,691 | 10,259 | 10,455 | 9,916 | 10,898 | 17,216 | 13,299 | 12,933 |
| **Employment of Males over 65 years** | | 3.8% | 3.8% | 3.2% | 3.1% | 5.0% | 6.8% | 7.1% | 7.2% | 7.7% |
| **Employment of Females over 65 years** | | : | : | : | : | : | : | : | : | 1.2% |
| **Male 54 to 75 years LLL** | | 2.4% | 2.0% | 1.9% | 2.6% | 2.7% | 2.2% | 2.4% | 2.0% | 3.0% |
| **Female 54 to 75 years LLL** | | 1.5% | 1.7% | 1.7% | 2.6% | 3.1% | 2.6% | 3.1% | 2.9% | 3.7% |

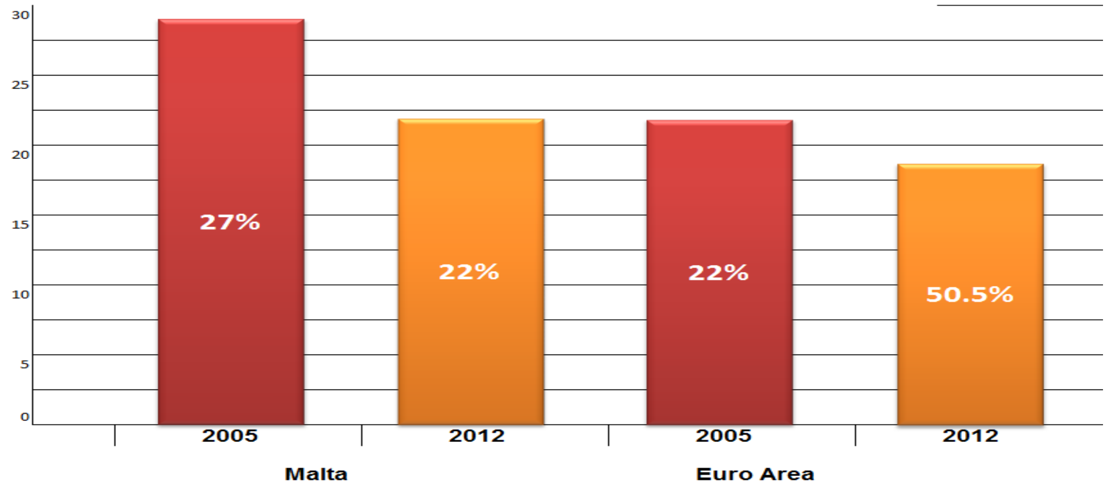
The Strategy Group concludes that positive results have been garnered during the past decade with regard to increasing labour participation through direct as well as supporting policies. The Strategy Group recognises that this augers well for the strengthening of the pension system. Be that as it may, Malta still does not optimise fully its human capital within the labour market with regard to total working life employment, females in employment and elderly in employment amongst others. In this regard challenges remain. These challenges can, in part, be addressed through the leveraging of the pension system to support such complementary strategic goals.

## 02.3 Assessment of the Pension System in Malta

### 02.3.1 General Assessment of the Pension System

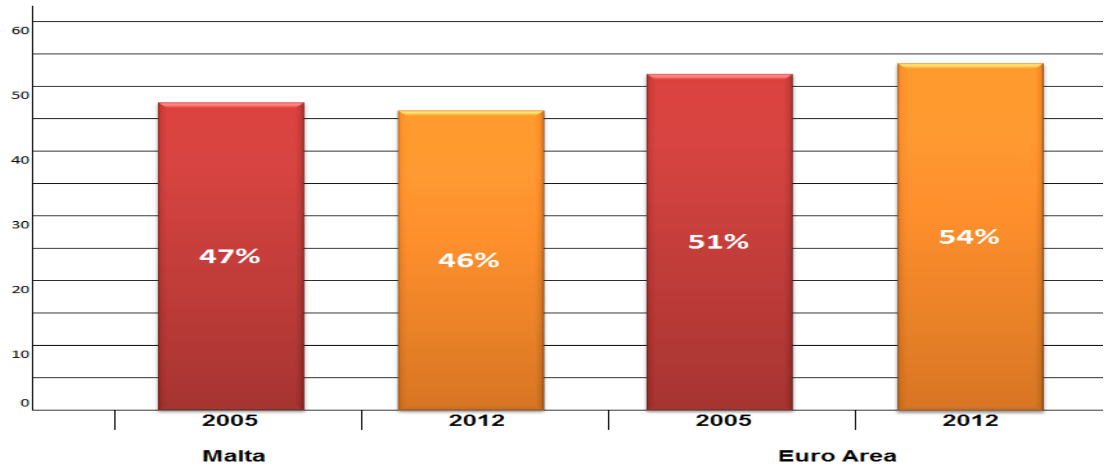
The % of 65+ year olds in relative poverty and / or social seclusion fell by five p.p., in Malta, between 2005 and 2012. This, however, is significantly higher by five p.p. than the state of play in the Euro area in this regard.

**Figure 11: % of 65+ year olds in relative Poverty and / or Social Seclusion**[19]




Additionally, the median pension as a percentage of the median wage fell by one p.p. between 2005 and 2012. During the same period, the median pension as a % of the median wage in the Euro area was not only higher than Malta but increased by three p.p.

**Figure 12: Median Pension as a Percentage of the Median Wage**[20]

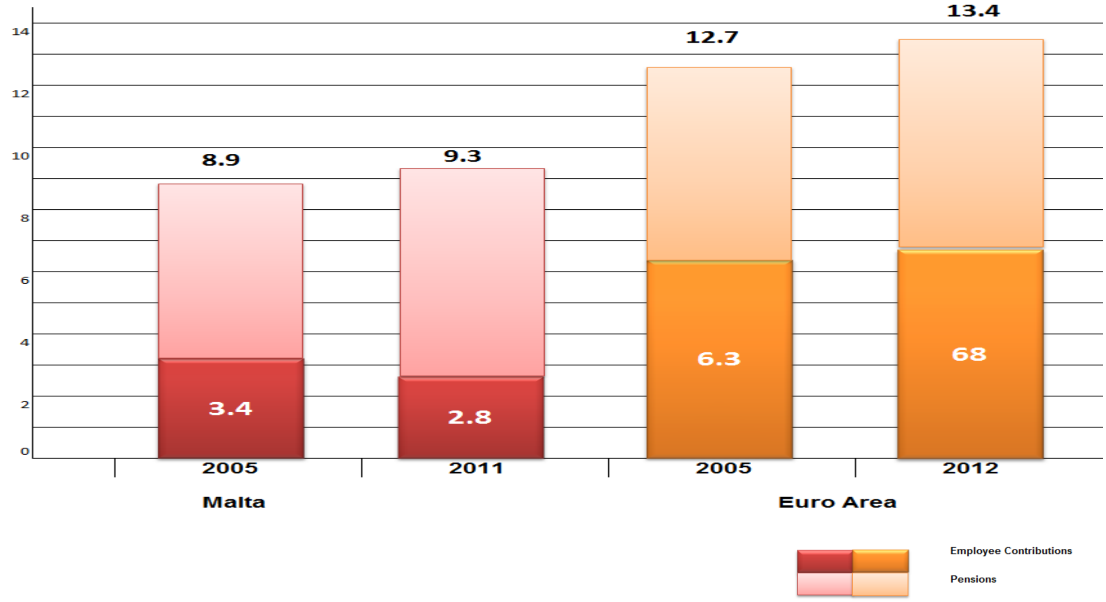



The sustainability of the pension system is dependent on the number of persons contributing vis-à-vis the number of beneficiaries in receipt of a pension. A stronger rate of labour market participation results in a more sustainable pension system. As can be seen from the Figure below, whilst the spend as a percentage of GDP in Malta increased by 0.4% between 2005 and 2011 the percentage of contributions paid by employees during the same period fell by 0.6%. This is in contrast to what

[19] Presentation prepared by Pensions Strategy Group
[20] Ibid

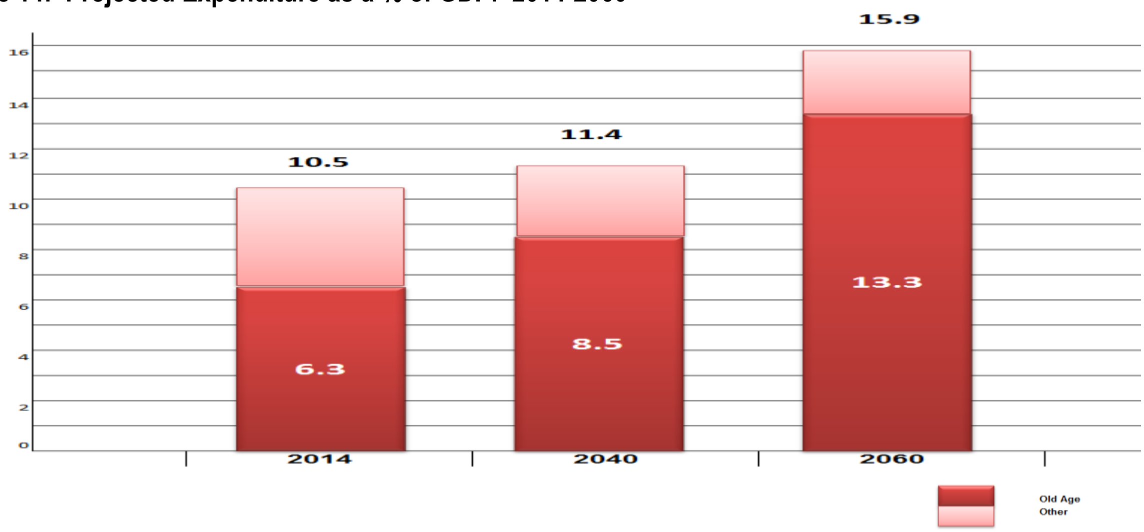
occurred in the Euro area during the same period. Whilst the pension spend as a percentage of GDP increased by 0.7%, during the same period, employee contributions increased by 0.5% - albeit at a lower rate than the increase in GDP spend.

**Figure 13: % of GDP Expenditure on Pensions and Paid in Contributions by Employees[21]**




In a no change scenario, the expenditure of pension as a % of GDP is expected to increase. Today, the pension spend is 10.5% GDP of which 6.3% is directed towards the retirement pension (RP) or old age pension. By 2060 (AGR 12) the pension spend as a % of GDP is projected to increase to 15.9% of GDP – an increase of 5.4%. The proportion of RP and old age pension expenditure over the said period will increase to 13.3% - an increase of 7%.

**Figure 14: Projected Expenditure as a % of GDP: 2014-2060[22]**




### 02.3.2 Assessment of the Pension System: 2012 / 2013

The pension system, under the NI contributory system covers three forms of pensions: retirement; survivors; and invalidity pensions. The RP - also known as the Two Thirds Pension (TTP) - is,

[21] Ibid
[22] Ibid

therefore, only one of the benefits provided under the NI contributory system. The RP, nevertheless, is the largest in terms of beneficiaries and with regard to the overall cost incurred by the system.

The number of contributors as at the end of 2012 stood at 167,921. This is an increase on the 2009 figures, the baseline of the 2010 Strategy Review, where the number of contributors stood at 159,000. The increase between 2009 and 2012 is of 8,921 contributors; or 5.6%.

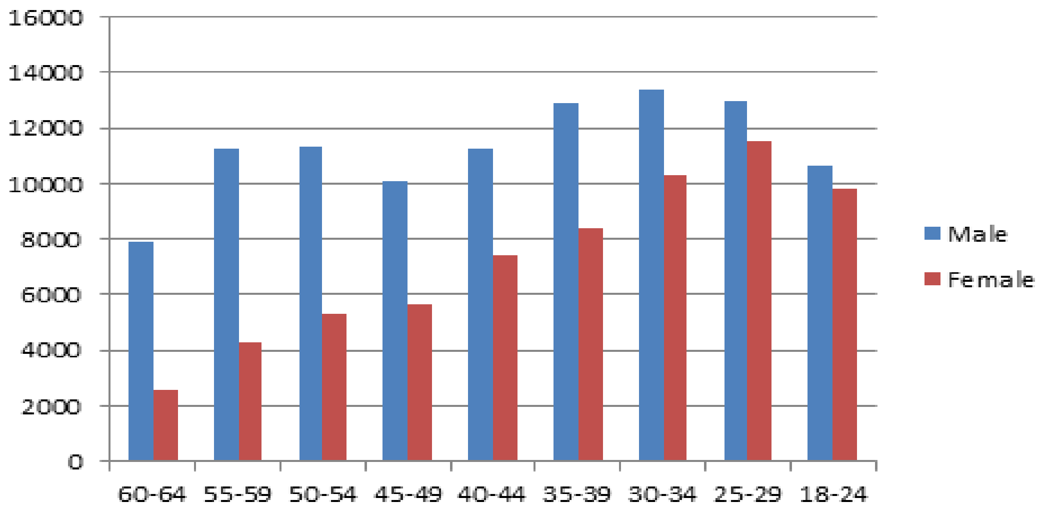
The gender mix over this period also changed considerably. In 2009 men stood at 74% and women at 26% of the contributors' population. In 2012 this shifted to 61.3% men and 38.7% women. This is consistent with the trends in the labour market where in the past years women workers constituted the overwhelming majority of entrants.

The Figure below presents the number of contributors in the pension system in 2012 by age and gender. As is expected, the number of women contributors in the age cohort 40 to 44 years and above remained relatively low in light of the caring role played by women in the Maltese society.

The contributors in the 18 to 24 years cohort is relatively lower than that in the 25-29 years age cohort. This is explained by high increases experienced in the past decade with regard to students following higher and further education. Of particular note is that the number of women contributors in these respective cohorts is marginally lower than that of male contributors.

The number of men contributors in the 45-49 years age cohort dips by over 10% when compared to the 50 to 54 years cohort (11,344) and the 40 to 44 years cohort (11,251) respectively. This may reflect the high migration that took place during the early to mid-sixties when a considerable number of Maltese emigrated to Australia, Canada, United States and the United Kingdom – a period that coincided with considerable economic uncertainty and the rundown of the military services in Malta.

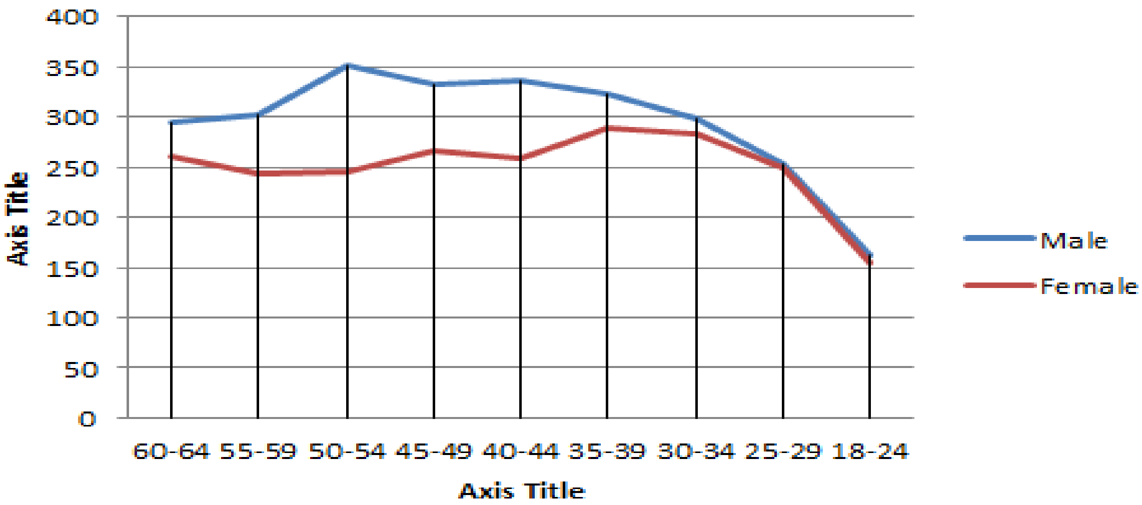
**Figure 15: Number of Contributors in the Pension System: 2012**[23]




The Figure below shows that the difference in the basic wage between men and women contributors narrows down considerably in the age cohort of persons who are 35 to 39 years. The wage differential between men and women contributors practically disappears for those in the 34 years of age and less age cohort. There is, therefore, a very low gender gap in this cohort of contributors. This is not the case with regard to men and women contributors who are aged 40 years and over. The most significant age gap is found in the 50 to 54 years of age cohort of contributors.

[23] Ad hoc report prepared by the Department of Social Security for the Pensions Strategy Group, 18th July 2014

**Figure 16: Contributors in the Pension System by Wage, Age and Gender: 2012**[24]

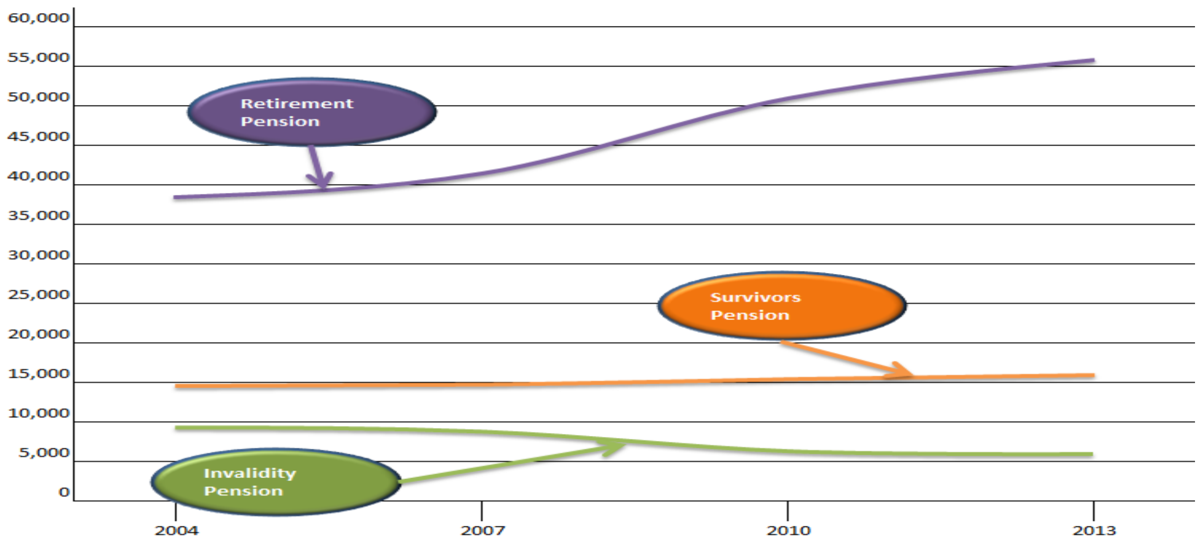



The Figure below presents, for the period under review, the number of pensions in receipt of a contributory retirement pension increased from 37,166 to 56,220 persons over a ten year period[25] – an increase of 19,054 persons or an increase of 51.3% on 2004. This increase stems from the fact that during this period the 'baby boomers' started to retire.

The proportion of men to women with regard to the RP remained unchanged between 2004 and 2013: 25.6%.[26] This trend, more or less, is expected to remain unchanged in the coming years given that the number of women who are in the late 40s and over traditionally worked for short periods, if at all, and assumed full time family responsibilities on marriage and child birth.

The number of persons on a survivor pension (SP), 99.0% of who are women, also experienced an – 2,059 persons for the period under review or an increase of 14.5% on 2014. This number is expected to evolve over time in reflection of developments in the life expectancy of women as well as trends in their respective contributory period.

**Figure 17: Behaviour Pattern of Retirement, Survivors and Invalidity Pensions: 2004 - 2013**[27]

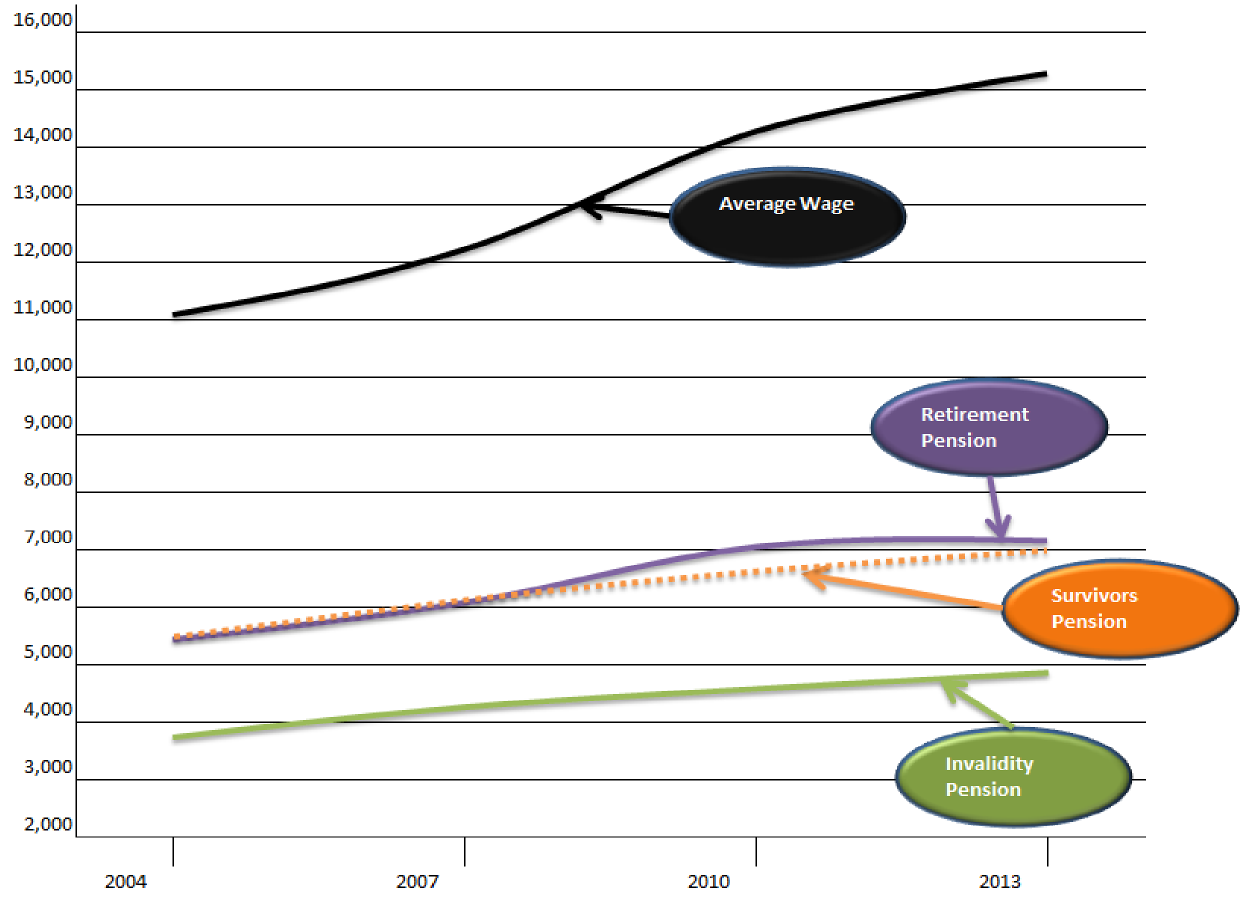



[24] Ibid
[25] Ad hoc report prepared by the Department of Social Security for the Pensions Strategy Group, 25th June 2014
[26] Ibid
[27] Ibid

The number of persons on an invalidity pensions (IP) fell considerably over the period under review: from 9,573 persons to 5,156 persons[28] – a decrease of 4,417 persons or a decrease of 46.1% over 2004. This clearly demonstrates that the reforms introduced in the late 2000 to minimise early exit from the labour market through the abuse of the IP resulted in positive success.

As can be seen from the Figure below, the average wage increased by 37.2% on 2004 or €4,312 between 2004 and 2013 - from €11,082 to €15,394. The RP increased from €5,418 to €7,288 over the said period – an increase of 34.5% on 2004 or €1,870 between 2004 and 2013. Of note is the fact that the average SP income is quasi equal to the average retirement pension income.

**Figure 18: Behaviour of Mean Annual Pension Income: Retirement, Survivors and Invalidity Pensions [29]**




The Table below presents the APRR in proportion to the average wage for the period reviewed. The APRR for the RP is nearly equal to that of the SP – in 2013 the former being higher by 2 p.p. only. The APRR of all three pensions fell during the period under review. The APRR fell by 1.4 p.p. or 2.9% on 2004 with regard to the RP; 3.8 p.p. or 7.7% on 2004 with regard to the SP; and 1.6 p.p. or 4.7% on 2004 with regard to the IP.

[28] Ibid
[29] Ibid

**Table 06: Average Pension Replacement Rate in Proportion to Average Wage[30]**

| Pension | Average Pension Income | | | | Average Wage | | APRR | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Retirement | **2004** | **2007** | **2010** | **2013** | | **€** | **2004** | **20 7** | **2010** | **2013** |
| | **€** | € | € | € | | | **%** | % | % | % |
| | **5,418** | 6,027 | 7,107 | 7,288 | **2004** | 10,820 | **48.9** | 49.3 | 49.5 | 47.5 |
| | | | | | **2007** | 12,230 | | | | |
| Survivors | **2004** | **2007** | **2010** | **2013** | | | **2004** | **2007** | **201** | **2013** |
| | **€** | € | € | € | **2010** | 14,368 | **%** | % | % | % |
| | **5,462** | 6,026 | 6,681 | 7,011 | **2013** | 15,394 | **49.3** | 49.3 | 46.5 | 45.5 |
| Invalidity | **2004** | **2007** | **2010** | **2013** | | | **004** | **2007** | **2010** | **2013** |
| | **€** | € | € | € | | | **%** | % | % | % |
| | **3,754** | 4,200 | 4,544 | 4,972 | | | **33.9** | 34.3 | 31.6 | 32.3 |

The average number of new RP beneficiaries between 2004 and 2013 was 4,854. As was expected, the number of new beneficiaries related to RP is on an increasing trend; though this drops in 2013.

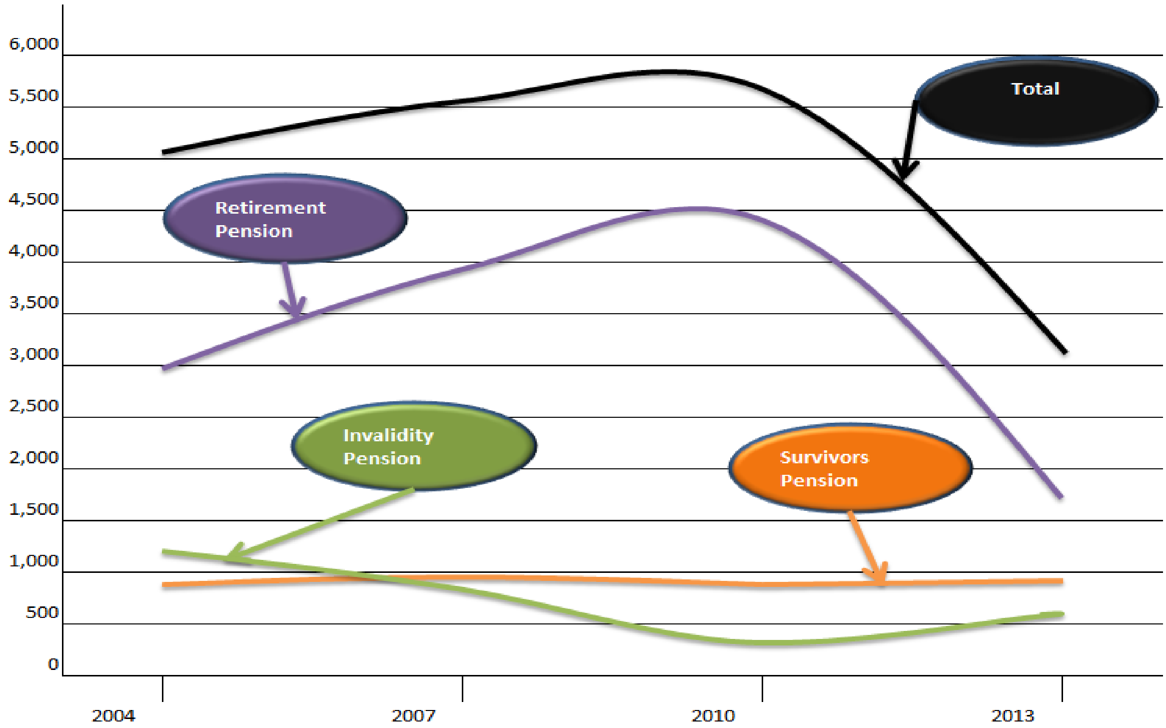
In 2013, the first increase in the SPRA of persons in the Transitional Group (between the age of 46 and 54 years as at 1st January 2007) kicked in as the retirement age for both men and women increased from 61 years to 62 years of age.

The 2007 reform, to account for manual jobs introduced the concept that a worker in the Transitional Group could retire if s/he worked up to 61 years of age and had a contributory history of 35 years, and a worker in the Switchers Group could retire if s/he worked up to 61 years of age and had a contributory history of 40 years. In 2013, a total 1,707 legitimately retired at the age of 61 years.

The number of persons who exited the labour market by qualifying for an IP decreased significantly between 2004 and 2010 following the afore mentioned reforms. It is of concern to note, however, that between 2010 and 2013 the number of beneficiaries in receipt of an IP increased from 391 in 2010 to 524 in 2013 – an increase of 133 beneficiaries or 34.1% on 2010.

[30] Ibid

**Figure 19: New Retirees on the Retirement, Survivors and Invalidity Pensions between 2004 and 2013**[31]




The Table below presents the state of account of the 'National Insurance Contribution Fund' – that is, *had the total contributory revenue been ring fenced to meet the objectives of NI Contribution system only*.

**Table 07: State of Account of 'National Insurance Contribution Fund'**[32]

| | | 2004 | 2007 | 2010 | 2013 |
|---|---|---|---|---|---|
| | | | | | |
| | | €000,000 | €000,000 | €000,000 | €000,000 |
| | | | | | |
| **1** | Social Security Contributions | 295 | 320 | 365 | 432 |
| **2** | Direct contribution SSA 1987 | 147 | 160 | 183 | 214 |
| **3 = 1+2** | **Total Revenue** | **442** | **480** | **547** | **645** |
| | | | | | |
| **4** | Invalidity | 36 | 37 | 29 | 25 |
| **5** | Retirement | 201 | 262 | 368 | 410 |
| **6** | Bonus | 26 | 29 | 47 | 59 |
| **7** | Widows | 77 | 90 | 102 | 114 |
| **8** | Short Term | 10 | 10 | 11 | 12 |
| **9** | **Total Contributory Benefits** | **351** | **429** | **529** | **620** |
| | | | | | |
| **10 = 3-9** | **Current Balance** | **91** | **52** | **18** | **25** |
| **11 = 10/3** | **Relative surplus** | **20.6%** | **10.%** | **3.3%** | **3.9%** |

This is a 'fictitious' fund given that, since the NI Contribution system was introduced in 1979, all incoming contributory revenue is placed in the Consolidated Fund as against a special ring fenced *'National Insurance Contribution Fund'*. It is, however, to be noted that the State contribution with respect to the SSA is being included under total revenue.

[31] Ad hoc report prepared by the Department of Social Security for the Pensions Strategy Group, 25th June 2014
[32] Ibid

As can been seen from the Table above, the ‘Fund’ was in surplus up to 2010, even though the accumulated funds decreased in an accelerated manner during the period under review. The ‘Fund’s’ balance fell significantly between 2004 and 2007, and then again between 2007 and 2010 – from €91m in 2004 to €52m in 2007 to €18m in 2010. This negative impact on the Fund is the result of the fact that the ‘baby boomers’ started to retire during this period.

The balance of the ‘Fund’ in 2013, however, experienced a relative increase from €18m in 2010 to €25m in 2013 – an increase of €7m or 38.9% on 2010. The surplus benefit of the ‘Fund’ also increased from 3.3% to 3.9%.

The increase in the surplus balance of the ‘Fund’ is the result of 2007 reform measures directed to increase the MPI for the Transitional and Switchers Groups respectively. With regard to the Switchers Group, the MPI increased between 2010 and 2013 in three equal tranches from €17,475 in 2010 to €20,940. As from 2014, the MPI for the Switchers Group started to increase year on year on the basis of an indexation consisting of 70% Wages : 30% Inflation. The MPI between 2013 and 2014 increased from €20,940 to €21,412 - an increase of €472 or 2.3% on 2013.

The behaviour of the revenue side of the ‘Fund’ between 2010 and 2013 indicates that this is consistent with the projections made in the 2010 Strategic Review, which anticipated that the ‘Fund’ would likely be in equilibrium up to 2035 where-in, thereafter, the *‘National Insurance Contribution Fund”* was expected to go into deficit.

## 02.4 The Demographic and Macro-Economic Modelling Assumptions for the 2014 Baseline No Reform Model

The Baseline No-Reform Model (BNRM) was calibrated to reflect the latest EUROPOP demographic projections (EUROPOP 2013) and macro-economic assumptions (EPC Ageing Working Group (AWG) 2015). A full analysis of the EUROPOP 2013 and AWG 2015 assumptions respectively and how these compare to the BNRM carried out by the 2004 PWG and the 2010 PWG respectively is presented in **Appendix II**. A synthesis of the main assumptions is presented hereunder:

**Table 08: Synthesis of 2014 Baseline No Reform Model Assumptions compared to 2004 PWG and 2010 PWG**

| | 2004 PWG | 2010 PWG | 2014 PSG |
|---|---|---|---|
| **Base Year** | 2050 | 2060 | 2060 |
| **Population** | 388,000 | 408,000 | 476,682 |
| **Fertility Rate** | 2.1 | 1.48 | 1.78 |
| **Life Expectancy Gains** | M \| F<br>5.1 \| 4.2 | M \| F<br>8.3 \| 7.5 | M \| F<br>6.4 \| 6.3 |
| **Net Migration** | Constant 650 per year | 960 in 2007 falling to 880 in 2060 | 1,617 in 2013 falling to 1,146 in 2060 |
| **Participation Rates: 15-64** | 63.1 | 64.5 | 75.4 |
| **Employment Rates: 15-64** | 64.1 | 64.4 | 70.3 |
| **GDP** | 3.5% average constant 2005-2025; 2.5 average constant | 1.75% average constant | 1.7% average constant |

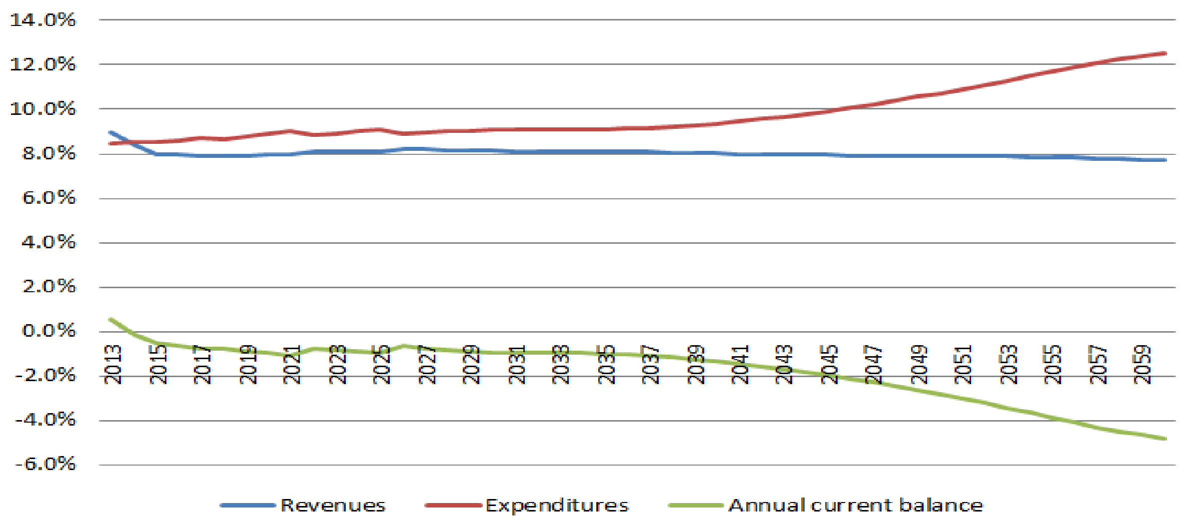
| | | | |
|---|---|---|---|
| | 2026 and 2050 | | |
| | | | |
| **Labour Productivity Rate** | 3.25% | 1.75% | 1.5% |
| | | | |
| **Treatment of Government's Share of NI Contribution** | Excluded | Included | Included |

The Figure below shows the impact of the BNRM as recalibrated on the latest assumptions: the EUROPOP 2013 assumptions with regard to demography and the AWG 2015 assumption with regard to the macro-economic assumptions. As shown above, the EUROPOP 2013 assumptions are more optimistic than the EUROPOP 2008 assumptions, with particular regards to population growth and migration.

The projections cover contributory pensions for old age, survivorship and invalidity, and are based on data for 2013. In 2013, Government expenditure on these categories of benefits stood at €609.2 million. During the same year, revenues relative to NI contributions amounted to €645.3 million, around a third of which reflect the State contribution under the obligations of the SSA.

As illustrated in the Figure below, the ratio of total revenue as a proportion of GDP is projected to decline marginally over the projection period from 9% of GDP in 2013 to 7.7% of GDP by 2060. This contrasts with the projected trends for expenditure which is expected to remain broadly stable by around 2040 and then rise to 12.5% of GDP by 2060. This implies a rise of 4.1 p.p. throughout the entire projection period. Consequently, the system balance is projected to worsen from a small positive balance in 2013 (taking into consideration the state contribution), to a deficit of 4.8% of GDP by 2060.

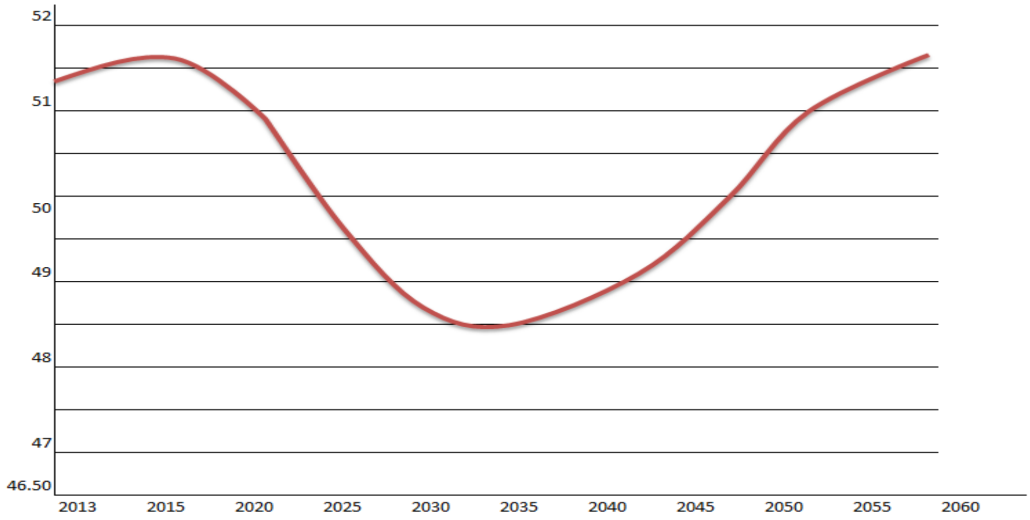
**Figure 20: Baseline No Reform Model – Impact on the Pension System Deficit to GDP**




The 2014 BNRM follows a similar pattern to that projected and applied in the 2010 Strategic Review. Given that the assumptions on which the BNRM projections are based are more positive, the adequacy level with regards to the APRR improves on the 2010 projection. Whilst the APRR under the 2010 projection bottoms out at approximately 42% in 2027 and peaks at 45% of the APRR, under the 2014 BNRM the APPR bottoms out at 48.5% of the APPR in 2034 / 2035 and peaks at 51.7% of the APPR in 2060.

Thus, under the 2014 BNRM model the APRR as at 2060 improves by 6.1 p.p. and brings it closer to the 54.7% enjoyed by current pensioners as at 2010 when the Strategic Review was carried out.

**Figure 21: Baseline No Reform Model: Impact on Adequacy**

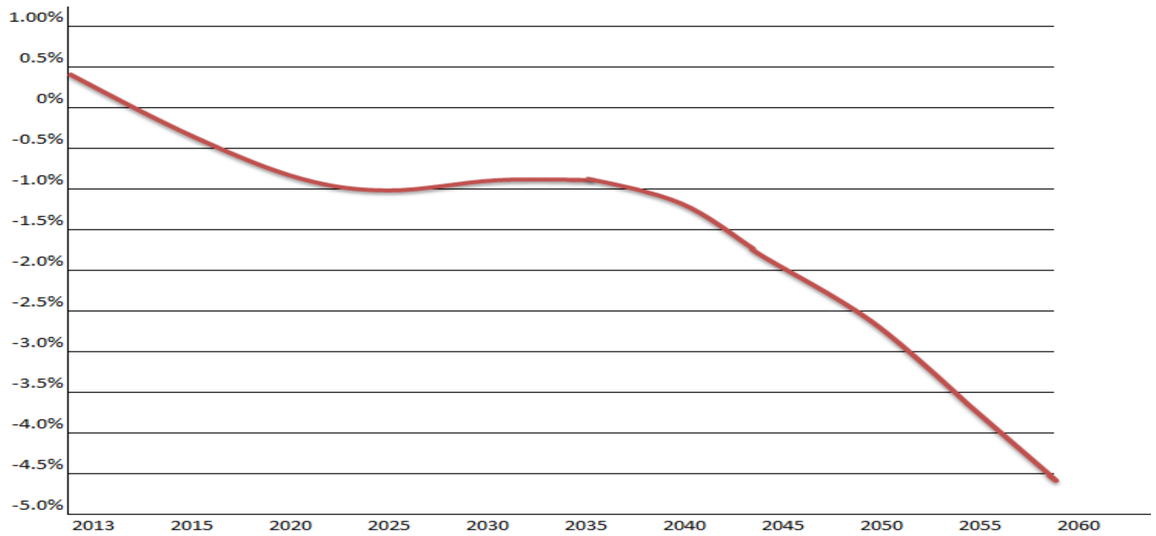



As can be seen from the figure above, on the basis of these latest assumptions, in 2060 pension spending is now forecasted to increase to just 12.2% of GDP by 2060; marking an increase of 3.7 p.p. from the 2013 level. This compares with the 15.3% of GDP spending projection for 2060 made in the 2010 PWG review. Whilst appreciably an improvement on the 2010 Review forecasts the core financial fundamentals of the pension system do not change.

Pension spending stays practically constant between 2020 and 2040, and subsequently rises at a very rapid and worrying pace. The deficit of the pension system at 4.8% of GDP will be quite large in 2060. On the other hand, the new projections suggest that contrarily to what was foreseen in the 2010 Review, the generosity of the system will dip only temporarily till 2035 and then it will rise gradually to exceed its current level.

This rise in generosity, which reflects a much faster increase in the minimum and maximum pensions (due to larger increases in wages and higher employment rates) would occur at the height of the ageing transition. These two developments, the rapid increase in spending post-2040 and the unintended significant increase in generosity after that date, shows that much still needs to be done to the pension architecture to render it sustainable.

**Figure 22: Baseline No Reform Model: Impact of the Pension System Deficit Relative to the GDP**



It needs to be kept in mind that while the current generosity of pensions can be justified on the grounds that typically pensioner households only have one pension income to share between themselves, by 2060 the bulk of pensioner households will enjoy two individual pensions. The previous reform package had taken this in account, when it envisioned a decline in average generosity to 45% in 2060.

The Table below shows that the demographic and macro-economic assumptions which form the basis of the modelling for the 2014 BNRM carried out by the Strategy Group are significantly different from those adopted by the 2004 PWG and the 2010 PWG which were based on World Bank and AWG 2009 / EUROPOP 2008 assumptions respectively.  This accounts for the differences in the results of the modelling carried out under the three different reform groups.

**Table 09: Different Starting Points of the Baseline No Reform Model**

| | PWG 2004<br>World Bank Assumptions<br><br>Reform Model<br><br>Projection Period: 2005 – 2050 | | PWG 2010<br>AWG 2009 Assumptions<br><br>No Reform Model<br><br>Projection Period: 2010 – 2060 | | PSG 2014<br>AWG 2014 Assumptions<br><br>No Reform Model<br><br>Projection Period: 2013 - 2060 | |
|---|---|---|---|---|---|---|
| First Pension | **Adequacy** | **Sustainability** | **Adequacy** | **Sustainability** | **Adequacy** | **Sustainability** |
| | **2050** | | **2060** | | **2060** | |
| | **29.4%** | (2.6%) | **45%** | (5.8%) | **51.7%** | (4.8%) |
| Second Pension | **Adequacy** | | | | | |
| | **9.2%** | | | | | |
| Third Pension | | | | | **Adequacy** | |
| | | | | | **9.2%** | |

## 02.5 Sensitivity Analysis on 2014 Baseline No Reform Model Projections

Long term projections, such as those taken with regard to pensions – which are necessary as they need to cover the life journey of an active labour participant from the moment he or she enters the labour market to the moment he or she leaves it – are not forecasts.  50 years, half a century, is far too long a period of time to assume that projections made today will truly materialise as planned. Furthermore, given the continued Euro Zone financial and economic crisis, there is also considerable uncertainty concerning medium, let alone long term economic developments.

Although the Strategy Group has considerable knowledge of the behaviour of workers and pension beneficiaries for the next 20 years, substantial uncertainty exists, for example, on productivity developments, unemployment, migration flows, and the magnitude of the associated fiscal costs.

For this purpose the Strategy Group carried out a sensitivity analysis on pension system drivers to understand the extent to which projection results are influenced by the underlying assumptions.  The following scenarios are modelled to simulate the behaviour of the pension system under different behaviour assumptions with regard to the key drivers that affect the performance of the pension system.

A description of the sensitivity tests follows alongside a summarising Table.

**Population related sensitivity tests:**

- High life expectancy - A scenario with an increase of life expectancy at birth of two years by 2060 compared with the baseline projection.
- Lower migration - A scenario with 20% less migration compared with the baseline projection.

**Labour force related:**

- Higher employment rate - A scenario with the employment rate being 2 p.p. higher compared with the baseline projection for the age-group 20-64. The increase is introduced linearly over the period 2016-2025 and remains 2 p.p. higher thereafter. The higher employment rate is assumed to be achieved by lowering the rate of structural unemployment (the NAWRU).
- Higher employment rate of older workers - A scenario with the employment rate of older workers (55-74) being 10 p.p. higher compared with the baseline projection. The increase is introduced linearly over the period 2016-2025 and remains 10 p.p. higher thereafter. The higher employment rate of this group of workers is assumed to be achieved through a reduction of the inactive population.

**Productivity related:**

- Higher / lower labour productivity - A scenario with labour productivity growth being assumed to converge, to a productivity growth rate which is 0.25 p.p. higher/lower than in the baseline scenario. The increase is introduced linearly during the period 2016- 2025, and remains 0.25 p.p. above/below the baseline thereafter.
- Lower TFP (risk scenario) - TFP growth would converge to 0.8%, with convergence to the target rate in 2035 from the latest outturn year, i.e. 2013, and the period of fast convergence limited to 5 years, that is until 2040.

**Table 10: Pension System Indicators under different Sensitivity Scenarios (Deviations from the Baseline)**

| | 2013 | 2020 | 2030 | 2040 | 2050 | 2060 |
|---|---|---|---|---|---|---|
| | | | | | | |
| **Baseline** | | | | | | |
| **Total Revenue** | 9.0% | 7.9% | 8.1% | 8.0% | 7.9% | 7.7% |
| **Total Expenditure** | 8.5% | 8.9% | 9.1% | 9.4% | 10.7% | 12.5% |
| **Balance** | 0.5% | -1.0% | -0.9% | -1.4% | -2.8% | -4.8% |
| **ARR for OAP** | 51.4% | 50.9% | 48.4% | 48.3% | 49.9% | 50.5% |
| **Higher life expectancy** | | | | | | |
| **Total Revenue** | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Total Expenditure** | 0.0% | 0.0% | 0.1% | 0.2% | 0.4% | 0.6% |
| **Balance** | 0.0% | 0.0% | -0.1% | -0.2% | -0.4% | -0.6% |

| | | | | | | |
|---|---|---|---|---|---|---|
| ARR for OAP | 0.0% | 0.0% | 0.0% | -0.1% | -0.2% | -0.1% |
| Higher lab. Productivity | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.1% | -0.1% | -0.1% |
| Total Expenditure | 0.0% | 0.0% | -0.1% | -0.1% | -0.2% | -0.2% |
| Balance | 0.0% | 0.0% | 0.1% | 0.3% | 0.1% | 0.1% |
| ARR for OAP | 0.0% | -0.1% | -0.7% | 0.0% | -1.0% | -1.0% |
| Lower lab. Productivity | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.1% | 0.1% |
| Total Expenditure | 0.0% | 0.0% | 0.1% | 0.2% | 0.2% | 0.3% |
| Balance | 0.0% | 0.0% | -0.1% | -0.2% | -0.2% | -0.2% |
| ARR for OAP | 0.0% | 0.1% | 0.7% | 1.0% | 1.0% | 1.0% |
| Higher emp. rate | | | | | | |
| Total Revenue | 0.0% | 0.1% | 0.1% | 0.1% | 0.1% | 0.1% |
| Total Expenditure | 0.0% | -0.1% | -0.2% | -0.1% | -0.1% | -0.1% |
| Balance | 0.0% | 0.2% | 0.3% | 0.3% | 0.2% | 0.2% |
| ARR for OAP | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Higher emp. of older workers | | | | | | |
| Total Revenue | 0.0% | -0.1% | -0.2% | -0.2% | -0.2% | -0.2% |
| Total Expenditure | 0.0% | -0.2% | -0.4% | -0.4% | -0.4% | -0.4% |
| Balance | 0.0% | 0.1% | 0.2% | 0.2% | 0.2% | 0.2% |
| ARR for OAP | 0.0% | 0.0% | 0.1% | 0.1% | 0.0% | 0.0% |
| Lower migration | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.0% | 0.1% | 0.2% | 0.4% | 0.6% |
| Balance | 0.0% | -0.1% | -0.1% | -0.3% | -0.4% | -0.6% |
| ARR for OAP | 0.0% | 0.0% | -0.1% | 0.0% | 0.0% | 0.0% |
| Lower TFP | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.1% | 0.1% |
| Total Expenditure | 0.0% | 0.0% | 0.1% | 0.2% | 0.2% | 0.3% |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Balance** | 0.0% | 0.0% | -0.1% | -0.1% | -0.2% | -0.2% |
| **ARR for OAP** | 0.0% | 0.0% | 0.4% | 0.9% | 1.1% | 1.2% |

Following the review of recent developments and current and future adequacy and sustainability issues with regard to the pension system, this Chapter focuses on first principles and presents the underlying philosophy that the Strategy Group believes should drive the next stage of reform of the pension system.

The Strategy Group contends that the forthcoming stage for reform is to be underpinned by five leading principles. These are:

(i) The need for a clear definition of the objectives of the pension system.

(ii) An adequate and sustainable pension system sustained by a strong active employment policy.

(iii) The State pension should be a solid foundation, but not the only source of retirement income.

(iv) The pension system to be socially sustainable needs to provide a fair balance between contributions and benefits across generations.

(v) To remain adequate and sustainable, the pension system needs to be able to evolve, particularly to respond to long term developments.

In developing these principles, the Strategy Group has sought to learn from the experience of other countries that have reformed their pension systems over the last decades. A **Supplementary Paper No 2** titled '**Pension Policy Design: A Review of Recent Reforms**' setting out the main pension policy design issues discussed and implemented in recent years in other jurisdictions is appended to this report. The main conclusions of this Supplementary Paper are presented in the Box below.

**Box 01: Pension policy design: a review of recent reforms**

Over the last two decades there was a move towards reducing the scope of State pensions. This was mainly due to concerns on the financial impact of ageing. In many countries, however, the changes were also driven by other motives, most notably a desire to individualise pension claims. These changes were not just meant to make economic incentives in pension systems stronger, but also reflected a need to make systems more reflective of societal changes.

While countries faced relatively similar demographic challenges, policy responses differed significantly. Most policymakers maintained the PAYG defined benefit nature of their pension arrangements, and made only parametric changes. A small number of countries, however, embarked on systemic reforms, that meant to make their schemes Defined Contribution (DC).

The main difference between parametric and systemic reforms lies not in the financial impact on pensioners or contributors but in the sharing of risk between current and future generations. DC pensions do not allow much intra- and inter-generational redistribution. In this respect, they tend to reproduce the same income inequality in old age that exists during working age. DC pensions also force adjustment to economic and demographic changes on a single generation. For instance, if life expectancy grows significantly for one generation, that generation bears the entire cost in terms of lower annual pensions.

Besides, those countries that went all the way down the DC route (for example, Italy and Sweden), there were several countries that introduced automatic adjustments in their Defined Benefit (DB) system. The idea of these reformers was that pension systems need to adjust quickly to demographic and economic changes. The pension reform experience over the last two decades suggests that there are five major pension design issues that policymakers need to tackle.

The first is how best to optimise poverty alleviation effectiveness. While initially very little attention was given to the poverty alleviation function of pensions, policymakers now appear much more aware of the need to ensure that after reforms benefits remain adequate. There are two general approaches: some countries (like the UK, Netherlands and New Zealand) opt for particular schemes targeting just poverty alleviation; while others conduct this function within their earnings-related scheme, usually by means of guarantees. The key issues seem to be the trade-off between having a generous system and one with the right incentives to work and save (Sweden for instance offers a graduated minimum pension); and the need to ensure that indexation does not push the elderly into poverty in their later years.

The second question is what role does the State have in smoothing income over the life-course. It appears that most reformers have been more willing to abandon this role than that of poverty alleviation. Possibly this reflects the realisation that those on middle-to-high incomes are more able to accommodate pension reforms and provide for themselves. Many countries have lowered the generosity of their scheme to those on higher incomes, by shifting to career-average computation, modifying the MPI by less than the income on which contributions are paid, cutting accrual rates for higher incomes and indexing less generously higher pensions. Coupled with this, the State, possibly, since it increasingly incentivises private retirement saving, has become more involved in the regulation of private pensions, seeking to lower charges and ensuring a better value for savers.

The third question concerns achieving a right balance between contributions and benefits. There was initially a strong movement towards actuarially fair systems, with reforms such as the establishment of NDC schemes. This has gradually weakened as policymakers understood the irreconcilability of actuarially fair pensions and the need to conduct intra- and inter-generational redistribution. Actuarial fairness is very hard to achieve and societies may not be in the best position to offer it, as the ageing transition is best tackled by being as flexible as possible.

Fourthly, many countries have introduced automatic adjustment mechanisms. These are not restricted to links between the pension age and longevity (for example Denmark), but can also be made in other parameters. These include valorisation or the rate at which past wages are taken into account when computing benefits (for example Sweden), the years required to get a full pension (for example France), or the indexation of benefits (for example Portugal and Germany). The mechanisms affecting indexation are the least attractive from an economic incentive (and equity) point-of-view, as individuals cannot realistically react to them. Similarly, assuming that individuals will react to automatic links between pension age and longevity is quite naïve. If early exits are allowed, existing evidence suggests that individuals will retire early even at great financial disadvantage.

Finally, effective reform requires that administrative and technical implementation be given key status. Many reforms failed because they were not well-tailored to economic, social and administrative conditions. Moreover, to prove long-lasting, policymakers need to work hard on political implementation. Some countries (for example UK and US) have found that achieving consensus required setting up technical or bi-partisan commissions that became recognised as experts on the subject. Equally as important is the need to have a good degree of debate, public discussion and engagement. The key lesson is that unless citizens are aware and accept reforms, and change behaviour accordingly, the task of policymakers will not have ended.

There is no doubt that the 2007 pension reform was important as it was the first step to address the many challenges and issues that characterised what had become an ossified system that had remained practically unchanged for nearly three decades. As has become ever more evident looking at the experience of other countries, a pension system, however, needs to evolve gradually to reflect the changing economic, demographic and social environment, rather than shifting abruptly in large overhauls. For the pension system to remain relevant and fulfill its objectives within the constraints set by society, it needs to be able to evolve smoothly.

One of the main challenges for policymakers involved in the reform of a pension system is how to balance short-to-medium term challenges with those of a more long term nature. Most frequently short-to-medium challenges are resolved with short-term fixes, while long term issues are not thought through adequately.

A more common problem is that many times policymakers adopt very radical changes for the medium to long term while buying political support by giving a better deal for the short to medium term. Such a strategy, while naturally politically attractive, in the long term is self-defeating. The main issues facing national pension systems are relatively clear and require socially sustainable solutions.

Pension systems were set up as inter-generational social contracts which were meant to provide a fair and equitable transfer of resources across generations.

The more one deviates from this principle, the more unlikely it is that these systems will stand the test of time. To remain viable, a pension system needs to be a robust arrangement that can, however, evolve gradually to fit the needs of the society it is meant to serve as it changes over the continuum of time.

### 03.1. Principle 1: There needs to be a Clear Definition of the Objectives of the Maltese Pension System

In this light, the first principle that underpins this next stage of reform is that as a society, Malta needs to be clearer as to what the objectives of the pension system should be. These objectives need to be set not just for the long term but also have to address the needs of current and soon-to-be pensioners. The scope of the national pension system, thus, needs to be clearly defined. This, however, needs to be complemented by a clear definition of the need to define the extent to which the system will enable individuals to smooth their income over their life course.

There is, currently, a spectrum of relatively disconnected anti-poverty measures; spanning from the contributory minimum pension to non-contributory benefits. There is also a wide array of in-kind benefits and services provided by State, in most cases on a universal basis. Rather than maintaining this disjointed approach, the government should strive to establish an integrated approach where the State defines a minimum income standard that it wants certain strata of the population to have access to. The guarantee would be offered on a household basis and would provide a graduated benefit, depending on the benefits, income and in-kind benefits, and services earned within the household. Different types of income would benefit from different taper rates, with income earned on the basis of work or of previous contributions commanding a better rate. This would help to provide incentives for people to be as self-reliant as possible.

Poverty alleviation should as much as possible be kept separate from social insurance. It is to be noted that in most countries minimum income guarantees are financed out of general taxation – so as to differentiate these guarantees clearly from benefits earned on the basis of contributions paid. This differentiation renders it easier for society to understand the cost of poverty alleviation and focus resources on targeted benefits rather than simply increasing benefits for everyone.

With regard to income smoothing, which the Strategy Group believes should remain inspired by social insurance principles, the main issue is that the State needs to be much clearer about the degree of income smoothing that it is willing to offer. It was clear from its inception that the pension system was not meant to provide a constant replacement rate to all. The State has always limited this role to those on medium incomes. It makes sense to retain this principle, and if anything to roll back partially the extension of the income smoothing function made in the 2007 reform.

Aside for the qualification that those on low incomes would get a graduated minimum pension dependent on their income and that those on high incomes would be subject to a maximum pensionable ceiling linked to longevity, the system needs to be kept as simple as possible. Individuals need to be able to understand what they will get out of the system so that they can make the correct employment and saving decisions.

### 03.2 Principle 2: An Adequate and Sustainable Pension System needs a Strong Active Employment Policy

Few would contest that Malta's employment record since the EU accession has not been a success story. Whereas in 2000, the employment rate of persons aged 15 to 59 in Malta was eight p.p. less than that in the EU, by 2013 this gap had dropped to just about one and a half p.p. Malta's employment rate among males in this age group exceeds that in the EU. At the same time, the gender gap has steadily been closing such that since 2012 women aged 15 to 39 in Malta have a higher employment rate than those in the EU. Back in 2000 the employment rate of this category was a sixth less than that in the EU.

This bodes well for the sustainability of the pension system. The main challenge of the ageing transition is how to build an economy that can still generate growth despite a declining share of the working age population. Raising the employment rate, and especially ensuring that women are able to continue participating in the labour market, is clearly a crucial element in addressing the ageing transition. Be that as it may, and without seeking to sound negative, Malta has done the relatively 'easy' part of the catching up process.

The bulk of the increase in female participation has up to now been in part-time employment. For instance, the share of part-time employment among women aged 15 to 39 increased from just 10% in 2000 to 23% in 2013. It is pertinent to underline that whilst recognising the importance of the flexibility provided by part-time work, currently the social security system does not provide significant pension protection to part-time workers. Moreover their contribution to the financing of the system is far smaller than that of full-time workers: for example, the pension system recognises only the part-time employment yielding the highest salary even though a person may hold two or more part-time employment jobs.

Besides this issue, one needs to consider that unless care facilities increase substantially, both childcare services and elderly long-term care or independent living facilities, the trend increase in female employment may be put at risk. Whilst, the present administration has introduced free childcare it is to be noted that at present, women aged between 40 and 64 provide most of the unpaid care provided in Malta (a third of these women report they are inactive to be able to provide care, as against just 8% in the EU). This will become more difficult if the female employment rate is to increase among this age group.

One other challenge that Malta needs to tackle is participation among those aged 55 to 59. While this has increased from 45% in 2000 to 54% in 2013, it falls quite short of the increase seen in the rest of the EU, from 50% to 65%. Similar gaps exist for the age bracket 60 to 64. While an important cause of this gap is the presence of early exit routes, such as disability benefits, long-term unemployment or reliance on non-contributory benefits, there is an issue with skills available and employability. Eurostat data, in fact, indicate that skilled Maltese workers tend to remain longer in employment. Employment of males and females amongst the 65 years of age and over is, however, insignificant.

Over half of Maltese employers report having difficulties filling up vacancies requiring high skills, as against a third of EU employers. Moreover while Malta's economy has out-performed significantly that of neighbouring countries, labour productivity has declined significantly since 2008. Raising the employment rate is an important contributor to sustainability, but it needs to be complemented by an up-skilling of the workforce. This would enable labour productivity to improve and help generate more national output from each additional worker. It would also help to boost the participation rate among older workers, though in this case one would also need to ensure that incentives to work are strengthened.

In the absence of such a strategy, the Maltese economy's reliance on foreign workers could continue to increase. Since EU accession, their share has grown from 1.7% in 2004 to 7% in 2012, and they are increasingly concentrated in the fastest growing sectors of the economy. With the ageing transition hitting neighbouring higher income economies, attracting skilled foreign workers will become harder. Besides continuing to improve the employment rate, enhancing the skills base of local workers, Malta has a need to develop a more holistic targeted migration policy.

An active employment policy will not only make the system more sustainable. It will also enhance the adequacy of the system and reduce reliance on the minimum pension guarantee, particularly if like in the 2007 pension reform there is a further strengthening of the link between contributions made during one's career and the resulting pension entitlements.

### 03.3 Principle 3: The State Pension should be a Solid Foundation, but not the Only Source of Retirement Income

The introduction of the TTP scheme in 1979 marked the end of any role for privately organised collective retirement income schemes in Malta. Existing schemes were closed and members given lump sums. Moreover the tax regime provided no incentives for those opting for financial products that gave regular streams of income in retirement, while benefiting products offering lump sum payments. At the same time, there was no incentive in the social security system for someone to continue working beyond the statutory retirement age, while there were a number of ways how to exit the labour market and still accumulate pension rights.

All this created a climate where dependence on the State pension became the norm. The rules governing the indexation of the MPI before the 2007 pension reform, however, meant that this norm would result in many individuals facing substantial falls in income upon reaching pension age. The 2007 pension reform brought about significant changes to try to address this as shown previously in this report.

On the other hand, the Strategy Group is of the considered opinion that the Government in adopting the 2007 reform did not accept the recommendations presented by the PWG 2004 to push enough the need, especially for those with incomes near the MPI, to complement the State pension with private long term savings for retirement. Even among those in the top 20% of the income distribution, participation in voluntary pension provision and life insurance remains very low (at two-fifths).

The introduction of fiscal incentives as originally proposed would have helped to increase participation in financial products purposely designed for savings for retirement, and more importantly provide an incentive for individuals to purchase products that give them a stream of retirement income rather than a lump sum. For this policy to be successful there needs to be a concerted drive to improve the financial literacy of the population in order to facilitate a move towards less liquid forms of saving and to products suited for retirement purposes. At the same time, more also needs to be done so that individuals are given the means to capitalise on their existing real assets particularly private which forms a very high proportion of household wealth in Malta.

It is pertinent to underline that higher long term saving will not necessarily be the best option for all individuals to have better and more diversified retirement income. For many people, the key component will be to lengthen careers in line with the projected improvement in healthy life expectancy. The 2007 reform marked just the first step in this direction. More needs to be done to reward working beyond retirement age.

### 03.4 Principle 4: To be Socially Sustainable, the System needs to provide a Fair Balance between Contributions and Benefits across Generations

The foundation of the inter-generational contract underlying the provision of pensions in Malta’s pension system is that workers contribute today towards the pensions of those who contributed in the past, on the promise that in future this will be done in their favour by future workers. For this contract to remain socially sustainable, the system needs to provide a fair balance between the ability of generations to contribute and their need for benefits. Given that the payment period for benefits is lengthening significantly due to continued increases in life expectancy, for the conditions governing to remain fair, the social contract needs to evolve.

In some countries, governments have sought to address this challenge by opting to make a pledge defining the contribution rate charged by the social security system to workers and then adjusting the pension benefits to maintain the system in balance. This philosophy, however, carries the risk that pension benefits could become increasingly inadequate, particularly as a stable amount of contributions would need to finance an ever increasing retirement period.

Other countries have instead tried to address the issue by enacting increases in retirement ages, assuming that a change in the legal statutory age will be enough to ensure that the balance between contributions and benefits will remain fair across time. This, on the other hand, fails to take into account that even today there is a significant gap between the age at which people stop contributing and the retirement age. In Malta, for instance the mean age for drawing an old age pension was 59 years, even though the retirement age is 61 (RP) / 60 years (Old Age Pension - (OAP)), while in the EU it was 59 years even though the retirement age tends to be 65.

A more equitable approach would be to try to render the pension system more flexible and allow a degree of individual choice, while refraining from placing all the pressure for adjustment on a generation when it is less likely to be able to shoulder it, that is those persons who are close to or in retirement. A pension system needs to provide the correct incentives for individuals to be self-reliant and make positive adjustments to economic behaviour. Rather than cutting benefits at / or during retirement, as many overly complex new systems do, the focus should be to establish what society's preferred balance between contributions and benefits is, and then devise transparent ways to ensure that this balance is kept over time.

For instance, one option would be to decide upon the ratio between the number of years society is willing to pay a pension, and the number of years it expects an individual to contribute towards this benefit, and seek to maintain this unchanged over time. This new social contract would require decisions on three parameters. These are:

- The age at which benefits could first be accessed.
- The minimum level of generosity allowed.
- A formula that determines the entitlement created by each year of contribution, taking into consideration the period for which entitlements will be drawn.

Thus, rather than focusing on a relatively blunt parameter, like the retirement age, the Strategy Group is of the considered opinion that it makes more sense to address the ageing transition by creating an inter-generationally fair link between the period spent in receipt of benefits and that spent earning them.

Lower income individuals, not only tend to have shorter life expectancy, but also find it harder to remain employable at older ages. They also tend to start contributing earlier towards their pension. Providing incentives for higher income individuals to retire later is fairer than rising retirement age for all in line with average life expectancy. By setting up an adequate safety net, the disincentive to keep the number of contribution years unchanged in the face of lengthening retirement would fall squarely on those on higher incomes. These individuals tend to be more likely to be benefitting from the bulk of longevity improvements and can more easily stay in employment.

### 03.5 Principle 5: To remain Adequate and Sustainable, the Pension System needs to be able to Evolve, particularly to Respond to Long Term Developments

National pension systems, historically and across jurisdictions, have tended to be bulky and unwieldy systems wedded to a conception of society that has passed away decades ago. The Maltese system, like others, is built on the assumption of a full-employment economy where the male is the main breadwinner, has a fairly stable career and level of wages. Upon retirement, the State pension is the main household income, and upon the death of the male spouse, the wife survives on the derived rights from her spouse's previous contributions.

Society has changed substantially away from this model. In most households, both men and women work – so during retirement there will not be as much dependence on one State pension. Careers have become much less stable, while women tend to be mostly in part-time work. To remain employable, after a much lengthier period spent in academic period, individuals will need to retrain themselves and move jobs.

The economy is increasingly relying on different forms of labour arrangements – such as flexible working, the use of highly skilled immigrants and job-sharing. On top of this, Malta's demography has changed dramatically, with fertility falling below replacement, the country becoming a net importer (rather than exporter) of migrants, while those surviving well beyond pension age, 80, have tripled over the last three decades. Moreover, the relatively inflexibility of the social security system itself created some perverse incentives over time, in particular related to access to non-contributory benefits and benefits that allow one to retire earlier than pension age.

While not tinkering too much, with the pension system, it is integral to maintain public trust in its underlying social contract; unless the system is allowed to evolve gradually; its risks becoming increasingly irrelevant and unable to fulfil its objectives.

The 2007 pension reform signified the first big change in the system in nearly 30 years, with one key innovation being the introduction of the legislative requirement of regular strategic reviews. Some countries have tried to embed automatic adjustment mechanisms or rules to help their systems evolve. This, however, has tended to result in considerable complexity and decreased understanding of the system amongst the public. In other countries, there have been significant climb downs as the population resisted changes or politicians felt that current conditions warranted some discretion.

The undertaking of regular reviews, therefore, can provide the flexibility needed, help improve the understanding of the system, while enabling the system to respond to long term developments. The scope of these reviews may need to be better focused and set out more clearly in the legislation, while a permanent standing commission reporting to HoR could help generate the cross-party consensus needed in this area.

The pension system needs to be able to respond to long term economic, social and demographic changes. The best way forward is to achieve consensus on a number of key principles that would allow the system to be responsive to different challenges, rather than fixating on a specific set of parametric reforms to address projected issues that will inevitably turn out to have been misjudged. The system needs to be made resilient to different scenarios, as there will never be one set of parameters that will enable the achievement of the system's objectives for all time. A gradually evolving system driven by clear principles is the best legacy the Strategy Group can leave.

This Chapter presents the reforms proposed by the Strategy Group. The discussion and recommendations presented are organised as follows:

(i) Reforms to the pension system that address changing needs and issues relating to society and the labour market.

(ii) Reforms to the pension system directed to ensure a socially sustainable system that provides a fair balance between contributions and benefits across generations.

(iii) Reforms outside of the pension system to ensure that the pension is not the only source of retirement income.

(iv) Reforms to address pension challenges raised by current pensioners.

## 04.1 Addressing Changing Needs and Issues relating to Society and the Labour Market

As shown in this report, the robustness of the pension system is dependent on core supporting policies with regard to the strengthening of Malta's demographic base; securing, to the extent possible the highest level of active participation by all cohorts in society; and accounting for the demands of an evolving society.

Most of the measures presented in this part of the report are reforms proposed to the pension system with a goal of leveraging the system to strengthen core supporting policies.

### 04.1.1 Crediting Contributions for Child Rearing, Family Growth, and Gender Equality

There is universal acceptance that with regard to gender equality the labour market patterns of men and women are different. Traditionally, these gender differences were not incorporated directly into the pension system design.

The 2007 reform recognised that the pension system penalised a mother worker with regard to her ability to accumulate a contributory history that would entitle her to qualify for a pension. This stems from the fact that it is, invariably within Malta’s society, the female spouse who exits the labour market to rear the child following birth for an appropriate period before she returns back to employment. A significant number of women, indeed, leave the labour market permanently or for a long period until the child grows up and is in a position to fend for his or herself. A considerable number of women with children, therefore, do not work or work fewer hours with the consequence that, historically, it is women who reach retirement age with insufficient or low pension contribution.

The 2007 reform, as shown earlier, sought to mitigate this issue by extending the use of credits within the pension system to fill gaps in the contributory history of the parent exiting the labour force for child rearing purposes. The provision of credits for child rearing introduced by the 2007 reform is conditional. The parent has to re-enter the labour market and work for a length of time equivalent to the time taken out to rear the child subject to a maximum of 2 years for every child (4 years in the event of a disabled child). Although the reform measure was gender neutral, given the cultural context of Malta, it was reasonably assumed that this measure would be primarily directed toward women.

Be that as it may, the 2007 reform did not take into account that by changing the pension system architecture through the tightening of the linkage between contributions and benefits it neutralised the benefits accruing from the child rearing policy reform which it itself introduced. The new pension architecture following the 2007 reform became more tightly based on the individual accumulation of pension rights and a closer link between contributions and benefits (which increased from 30 years to 35 years for the Transitional Group; and to 40 years for the Switchers Group).

The increase in the contributory history that had now to be accumulated made it far more difficult for a woman to receive the full pension. Whereas prior to the 2007 reform a woman had to acquire a contributory history of 30 years to secure her right to receive the full benefit, following the reform, a woman who, for example, benefited from the child rearing credit for two children, had to acquire a 36 year accumulation history to secure that same right.

The 2010 PWG concludes that the 2007 reform was flawed and a recalibration is required if the child rearing credit is to achieve the objective that the reform itself had set for it: the recognition that a woman's work pattern is different from that of a male spouse due to interruptions for child rearing which negatively affect her contributory accumulation history.

In its recommendations, the 2010 PWG proposed an increase in the credit entitlement for child rearing. The increase in credit entitlement was tied to the number of children reared – inter-relating this measure with family planning. The Strategy Group agrees with this approach. It is important to note that the average age at time of first birth in Malta is continuously increasing, leaving thus fewer years, and less reproductive quality years available for any subsequent birth - the latter due to the natural decline in fecundity, leading to lower levels of completed fertility. The tempo effect indicating timing of fertility is a salient factor - impacting the level of the TFR in the last decade, coupled with the decline in the quantum component.[33] This is demonstrated in the Table below.

The average age at first birth has increased from 25.8 years in 2000 to 30.6 years in 2012 (all mothers 18 years of age and older at time of first birth). Similarly the average age at time of first birth of mothers who gave birth to at least two children has also increased from 26.6 years in 2000 to 32.4 years in 2014.[34]

**Table 11: Timing of Fertility in Malta: Mothers 18+ Years of Age[35]**

| Year | Average Age at 1st Birth | Average Age at 2nd Birth | Spacing of births |
|---|---|---|---|
| | All Mothers | Mothers + child | |
| | | | |
| **2000** | 25.826 | 26.690 | 0.864 |
| **2001** | 25.798 | 27.670 | 1.872 |
| **2002** | 25.988 | 28.210 | 2.222 |
| **2003** | 26.131 | 28.690 | 2.559 |
| **2004** | 26.361 | 28.940 | 2.579 |
| **2005** | 26.537 | 29.120 | 2.583 |
| **2006** | 26.737 | 30.090 | 3.353 |
| **2007** | 29.874 | 31.977 | 2.103 |
| **2008** | 30.003 | 32.170 | 2.167 |
| **2009** | 30.052 | 32.123 | 2.071 |
| **2010** | 30.140 | 32.296 | 2.156 |
| **2011** | 30.629 | 32.347 | 1.718 |
| **2012** | 30.603 | 32.658 | 2.055 |
| **2013** | 30.620 | 32.418 | 1.798 |

Research shows that mothers who opt for two children only, have their reproductive considerations linked to a low desired number of children. They reckon that there will be enough quality reproductive years ahead for realisation of one more child (spacing is longest), while mothers who opt for higher

[33] Pg 7, Miljanic Brinkworth, M., Fertility decline and timing of births in Malta, Ministry for Social Policy, 2008, Malta
[34] Ad hoc report by National Statistics Office, September 2014
[35] Ibid

parities, reduce this gap between first and second child considerably, only to take longer for realisation of the third child.[36]

**Table 12: Spacing Between Children[37]**

| Mothers of | First and second birth | Second and third birth | Third and fourth birth | Fourth and fifth birth | Fifth and sixth birth | Sixth and seventh birth |
|---|---|---|---|---|---|---|
| | | | | | | |
| **One child** | | | | | | |
| **Two Children** | 4.56 | | | | | |
| **Three Children** | 4.35 | 3.57 | | | | |
| **Four Children** | 3.64 | 3.17 | 2.97 | | | |
| **Five Children** | 2.57 | 2.71 | 2.33 | 2.34 | | |
| **Six Children** | 1.78 | 1.85 | 2.27 | 2.18 | 1.94 | |
| **Seven Children** | 1.36 | 3.47 | 1.49 | 1.92 | 3.12 | 1.86 |
| **Total Average** | 4.47 | 3.48 | 2.79 | 2.29 | 2.24 | 1.86 |

The age and spacing between the first and second child, therefore, have a significant impact on the progression towards a third child. The above findings show that the decision to have the first child is increasingly being taken later in life and the decision to have a second child is taken within an average period of 4.5 years following the 1st child.

With the above in mind, the Strategy Group is of the considered opinion that the child rearing credits framework introduced in the 2007 reforms is recalibrated to achieve three objectives. The first is to compensate for the discrimination the traditional social model places on the woman as a result that giving birth and rearing a child interrupts her career. The second is to encourage a mother to become even more actively engaged in the labour market - an objective which is now strongly supported by the availability of free child care support and the increasing presence of pre and after school facilities. The third is to leverage the pension system to positively impact the tempo and quantum effects of fertility.

The Strategy Group, thus, recommends that the child rearing framework is recalibrated as follows:

- For the Switchers' Group:

| Child | Age of Child | Credit |
|---|---|---|
| | | |
| **First** | Up to 6 years | 5 years |
| **Second** | | 4 years |
| **Third** | | 3 years |

- For the Transitional Group.

| Child | Age of Child | Credit |
|---|---|---|
| | | |
| **First** | Up to 6 years | 3 years |
| **Second** | | 2 years |
| **Third** | | 1 years |

The SSA in Article 16 (d) provides a more extensive child rearing credited contributions for children with serious disabilities who are in receipt of a Disabled Child Allowance: a 4 year child rearing credit for a child aged up to 10 years. It is proposed that the credit for a child with serious disabilities is increased to 8 years.

[36] Pg 9, Miljanic Brinkworth, M., Fertility decline and timing of births in Malta, Ministry for Social Policy, 2008, Malta
[37] Ad hoc report by National Statistics Office, September 2014

For a person under the present system to qualify for the child rearing contribution, the parent must have paid full contributions for a period of 10 years. As is shown in this report and supporting Supplementary Papers, a women's role in the labour market has changed significantly. In 2004 when the White Paper titled 'Pensions: Adequate and Sustainable' was launched and the child rearing credit proposed the female labour market participation rate stood at approximately 32%. Ten years later, 2014, this now stands at nearly 50%. The expected behaviour of women in the labour market today is that they will remain in the labour market for a far longer period than previous generations.

Given the above, the Strategy Group is of the considered opinion that the mandatory qualifying period to qualify for the pension, and to start to benefit from the credits scheme under Section 16 (a)(d) of the SSA should increase from 10 years to 12 years as follows:

- No change for persons born from 1962 and 1965 to keep with the principle that persons should be informed 15 years in advance vis-à-vis changes that effect pension rules.
- To 11 years for persons born between 1966 and 1967.
- To 12 years for persons born on and after1968.

The Strategy Group further concludes that the condition introduced in Article 16(2)(d) which states that "such credits shall only be awarded insofar as, prior to the pension age, such father or mother, as the case may be, resumes gainful occupation for a minimum period equivalent to that period, for which such number of credits would have been awarded" is removed. This condition on 'care' credits, in this case child rearing, negates what should otherwise be a significant step forward in the promotion of gender equality within the pension system. The Strategy Group adds that such child rearing credits will also apply with regards to adopted children.

**Recommendation 01: Crediting Contributions for Child Rearing, Family Growth, and Gender Equality**

The Pensions Strategy Group is of the considered opinion that the child rearing credits framework is recalibrated to meet three objectives: (a) counter the discriminatory impact of the traditional social model on career breaks experienced by females for child bearing and rearing; (b) encourage mothers to be more active in the labour market; and (c) leverage the pension system to positively impact fertility. The Pensions Strategy Group, therefore, recommends that the child rearing credit is calibrated as follows:

| Child | Transitional | Switchers | Severely Disabled Child (with a Disabled Child Allowance) |
|---|---|---|---|
| | | | |
| **Child's Age Limit** | 6 years | 6 years | 10 years |
| | | | |
| **Credit for First Child** | 3 | 5 | |
| **Credit for Second Child** | 2 | 4 | |
| **Credit for Third Child** | 1 | 3 | |
| | | | |
| **Credit for a Disabled Child** | 4 | 8 | |
| | | | |
| **Qualifying period of fully paid contributions to benefit from credit contributions for child rearing** | | 1st January 2016 increases from 10 to 12 years | |

The mandatory qualifying period to qualify for the pension, and to start to benefit from the credits scheme under Section 16 (a)(d) of the Social Security Act should increase from 10 years to 12 years as follows:

- No change for persons born from 1962 and 1965 to keep with the principle that persons should be informed 15 years in advance vis-à-vis changes that effect pension rules.

- To 11 years for persons born between 1966 and 1967.

- To 12 years for persons born on and after1968

- Required period may be reviewed as part of the 5-year strategic review with a view that it continues to bear a direct relation to the contributory period required for a full pension.

Article 16(2)(d) of the Social Security Act which states that "such credits shall only be awarded insofar as, prior to the pension age, such father or mother, as the case may be, resumes gainful occupation for a minimum period equivalent to that period for which such number of credits would have been awarded" should be removed so that such credits are awarded regardless of length of employment. These recommendations will also apply with regard to adopted children.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.1.2 Crediting Contributions for Human Capital Development and Life Long Learning

Over the past half century or so, Malta has successfully diversified its economy from one dependent on tourism, low cost manufacturing, and heavy industry, to one dependent on tourism, value added services and manufacturing, and knowledge and creative industry sectors. Malta's ageing population renders it imperative that the country's economic growth is primarily achieved by expanding productivity. The expansion of productivity is achieved not only through technology, innovation and efficiency improvement but also through the competency, skills and knowledge levels of the human capital pool available to the country.

Malta's further economic and social development is, thus, intrinsically tied with the competency, skills and knowledge of its human capital – which demands upgrading and deepening of such competency, skills and knowledge. Past administrations, as well as the present one, invested and continue to invest significantly to further increase Malta's human capital talent pool. Indeed, the Government is working on creating a basis to extend the apprenticeship, under-graduate, post-graduate and post-doctoral human capital resource pool.

Given the strategic importance to Malta to continue to invest in human capital development as a vehicle for further economic growth and social development, the Strategy Group recommends that the contributions of persons who follow tertiary education are credited as shown in the Table below, subject to the condition that they hold qualifications that are recognised by the Malta Qualifications Recognition Information Centre (MQORIC).

| | Transitional | Switchers |
|---|---|---|
| | | |
| **Level 5 and Level 6** | 2 months per year of studies | 3 months per year of studies |
| **Level 7** | 3 months per year of studies | 6 months per year of studies |
| **Level 8.** | 6 months per year of studies | 12 months per year of studies |

Lifelong learning is a strategic policy instrument for an ever increasing dynamic world as well as active ageing. Indeed, lifelong learning becomes more and more a pre-condition for the continued economic integration of persons - including elderly persons. It is recognised that (i) a high educational attainment leads to improved labour market integration; and (ii) high educated employees tend to stay longer in the workforce given that having, for example, better working conditions result in an expansion of working lives.[38]

As shown in the **Supplementary Paper No 1** titled a '**Review of the State of Play of the Demographic and Labour Market and Supporting Policies Characteristics**' despite the investment made in recent years, it is clear that many educational needs of older people are not being met. Participation in structured learning declines with age, but the prospect of longer average careers and the fast pace of the modern, information-based society, mean that training and re-training are an important tool to avoid the obsolescence of skills and indirectly prevent premature retirement.

The need to strengthen the framework for lifelong learning for persons who are 18 years of age and over to ensure that they gain new and upgrade competencies, skills and knowledge in a fast changing world is deemed to be of strategic importance. This results from the fact that persons who exit from the labour market will be in receipt of a lower income based pension than that received by persons who remain in the work force beyond 61 years or the SPRA.

The Strategy Group argues that the pension system can be leveraged to promulgate lifelong learning by means of providing a 1 lifelong learning credit of 1 month for each aggregated year of accredited courses for persons who are 18 years of age and over, including those who follow formal apprenticeships or academic or vocational higher education with an education institution and a training / education programme that is registered with Malta Qualifications Recognition Information Centre, is introduced.

**Recommendation 02: Crediting Contributions for Human Capital Development and Life Long Learning**

Given the strategic importance to Malta to continue to invest in human capital development as a vehicle for further economic growth and social development, the Pensions Strategy Group recommends that the contributions of persons who hold tertiary qualifications that are recognised by the Malta Qualifications Recognition Information Centre are credited as follows:

| | Transitional | Switchers |
|---|---|---|
| | | |
| **Level 5 and Level 6** | 2 months per year of studies | 3 months per year of studies |
| **Level 7** | 3 months per year of studies | 6 months per year of studies |
| **Level 8.** | 6 months per year of studies | 12 months per year of studies |

The Pension Strategy Group further recommends the introduction of a lifelong learning credit of 1 month for each aggregated year of accredited courses for persons who are 18 years of age and over, including those who follow formal apprenticeships or academic or vocational higher education with an education institution and a training / education programme that is registered with Malta Qualifications Recognition Information Centre, is introduced.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.1.3 Accounting for Contributions Paid under the Age of 18 by Persons before 1962

The pension system today is such that although a person may legally enter the labour market at the age of 16 years that person can only legally start to contribute for his or her TTP pension at the age of 18 years. In the interim that person and the employer pay a contribution rate that does not exceed the national minimum wage of €6.62 per week to the Consolidated Fund. This, however, is not considered for pension purposes.

[38] Hytti, Helka and Ilkka Nio (2004): Monitoring the employment strategy and the duration of active working life; Working paper 38/2004, KELA – The Social Insurance Institution Finland; Helsinki

Given the traditional social environment discussed earlier, the number of women in the Exempt and Transitional groups who were in employment was relatively low. Most held relatively low paid jobs in the teaching, nursing, secretarial, retail, and manufacturing sectors and most entered the labour market between 16 to 18 years of age. The number of women who progressed to further and higher education was small and limited to professions such as teaching and nursing.

In the in 1980s the largest numbers of children born were to women aged 20 to 24 years of age. The contributory period to qualify for a pension for women was 10 years. The large majority of women in the Exempt and Transitional groups who exited the labour market to raise a family did not re-enter the labour market following the birth of their first child. Additionally, up to 1980 women who worked with the government and got married had to resign their job. The result is that a large number of female workers in the pre-1962 age category are likely to have failed to accumulate the minimum level of contributions they required to be eligible for the contributory pension or marginally exceeded the minimum level resulting in a low pension income.

**Table 14: Number of 13 Year Olds Active in the Labour Market**

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | |
| **Males** | 847 | 754 | 639 | 706 | 768 | 534 | 408 | 386 | 378 | 335 |
| | | | | | | | | | | |
| **Females** | 475 | 446 | 478 | 495 | 509 | 317 | 301 | 295 | 238 | 236 |
| | | | | | | | | | | |
| **Total** | 1,322 | 1,200 | 1,117 | 1,201 | 1,277 | 851 | 709 | 681 | 616 | 571 |

The Pensions Strategy Group is of the considered opinion that the current system where contributions paid are only accounted for the TTP once the person is 18 years and over should remain. This ensures consistency with other policies such as those directed to reduce early school leaving and to increase the number of students who continue to further or higher education.

Be that as it may, the Group is, however, of the considered opinion that with regard to the pre-1962 age cohort, particularly with regard to women, the consideration of contributions paid at the ages of 16 and 17 years could make the difference between whether a person is or is not entitled to a contributory pension. Thus, the Group recommends that contributions paid under the age of 18, by persons born before 1962, should be taken into account in the determination of pension entitlement.

**Recommendation 03: Accounting for Contributions Paid under the age of 18 by persons born before 1962**

The Pensions Strategy Group recommends that contributions paid under the age of 18, by persons born before 1962, are taken into account in the determination of pension entitlement.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.1.4 Removing the Ceiling on the Payment of Contributions Post-65 Years of Age

NI contributions are paid by the employer and the employee up to the age of 65 years. This is a consequence of the fact that the SSA as currently legislated caps the payment of the NI contributions at 65 years of age. This means that that neither the employee nor the employer pay any further NI contributions in the event that a person continues in employment beyond the age of 65 years.

The impact of this policy restriction is pervasive. A person who reaches the SPRA of 65 years of age who is provided with the opportunity to continue in employment will not be in a position to improve his or her contributory history to obtain a better pension as he or she is receiving no contribution at the first instance. Thus, the ceiling creates an obstacle to encouraging and incentivising more active participation of elderly persons – assuming that such an opportunity for continued employment is provided by the employer.

The Group recommends that discussions should take place within MCESD and MEUSAC on this important issue.

**Recommendation 04: Removing the Ceiling on the Payment of Contributions Post-65 Years of Age**

The current ceiling of 65 years on the payment of contributions by employers and employees is obstacle to encouraging and incentivising more active participation of elderly persons and it recommended that discussions take place within MCESD and MEUSAC, with a view to possibly remo this ceiling and that the individual and the employer will pay NI contributions as long as that individ remains active in the labour market.

### 04.1.5 Reconciling Atypical Employment with the Contributory Principle

As discussed previously, the pension system is strongly geared to the "male-breadwinner model" based on a "standard employment contract" for men; an arrangement essentially characterised by permanent full-time work in the service of one employer.

This type of arrangement is no longer the sole model of employment – particularly in the knowledge economy sectors which have led, in recent years, to increasingly flexible occupational lives and career paths. There is an increasing trend where persons with the appropriate competencies, skills and knowledge in such sectors are able to leverage a better return on the investment they made in their education, training and experience gained by undertaking assignment based work – particularly if a particular sector has a competencies, skills and knowledge deficit.

There are, therefore, an increasing number of persons whose employment is no longer based on a 40 hour week full-time with a single employer, but who work on a job-sharing basis where a 40 hour week is worked with more than one employer.

This job sharing concept also applies with regard women who seek compatibility between employment and family life by working on a shared based with different employers as this allows them to achieve a better balance between the two poles.

The pension system does not support atypical employment on the basis of shared employment. A person who is employed part-time (that is not self-employed) in more than one job with different employers (including the different companies but with the same Directors) pays the NI on the part-time job that has the highest pay in terms of the wage paid. In essence, this means that in the event that such a person accrues the 40 hour entitlement through different part-time jobs that person cannot pay the NI contribution s/he would have otherwise paid if those 40 hours were worked with a single employer. This means that whilst the person is earning wages equivalent to a full time job, his / her Social Security contribution are far lower than they would otherwise be, as the contribution is paid only on the highest paying part-time job.

The impact to a person undertaking such atypical employment, therefore, may be significant as his or her pension income is likely to be much lower given the curtailed level of contribution s/he would have paid on the highest wage earned from one part-time job rather than the total income earned through different part-time jobs. Additionally, the current system exempts employers other than the employer paying the highest wage for part-time work contracted from paying their share of Social Security contribution to that person who would have been engaged on such work.

The pension system today does not reflect emerging employment patterns. The PWG 2010 recommended that the system should evolve to reflect today's work practices. The Strategic Review proposed that the pension system should be reformed to ensure that the full contributory entitlement is paid by both a person and employers, in the event that a person works a 40 hour week irrespective of the number of employers such person is contracted with as a part-time worker.

The Strategy Group supports this reform measure and recommends its adoption. In implementing this recommendation, work is required to modify the Inland Revenue System, to allow for the clustering of different part-time jobs to a person. The Strategy Group proposes that this recommendation is introduced as from 1st January 2016.

**Recommendation 05: Reconciling Atypical Employment with the Contributory Principle**

The Pensions Strategy Group recommends that the pension system is to reflect emerging employment patters and should be reformed to ensure that the full contributory entitlement is paid by both a person and an employer in the event that a person works a 40 hour week irrespective of the number of employers the person is engaged with as a part-time worker.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.1.6 Facilitating the Transition of Workers from the Shadow to the Formal Economy

Undeclared work in Malta is visibly present. Research has sought to estimate the contribution to GDP by the shadow economy. Studies suggest Malta's shadow economy to be 25.8% (Schneider) and 27.2% (Murphy) of GDP.[39]

The shadow economy is primarily constituted of unregistered workers, where many of them are likely to be women or non-national workers. Although there are more women today participating in paid employment in Malta than at any other time, the prevailing view is that there is a considerable number of women who remain concentrated in "invisible" areas of informal work such as domestic and cleaning labour, piece-rate work, and assistance in small family enterprises. All of these offer precarious employment status, low, irregular or no remuneration, and little or no access to social security or protection. Non-national workers tend to be both male and female and are predominantly visible in the construction, cleaning, domestic and tourism sectors.

With particular regard to pension reform, the facilitation of the transition of workers from the shadow to the formal economy has two strategic imperatives. The first is that it will allow for the creation of more formal jobs. This will enable Malta to increase employment participation rates and to move closer to the goal of full-employment. In doing so, such a transition from the shadow to the formal economy will thus contribute to the strengthening of the sustainability of the pension system.

The second is that it reduces the 'social protection deficit' arising as a resulting of persons participating in the shadow economy are likely to be exposed to given that they have little or no access to social security protection beyond non-contributory benefit support. The transition into the formal economy will mean that such persons will become eligible for contributory pension support and hence assist in securing adequacy in retirement.

The Strategy Group is of the considered opinion that the concept of 'demand side' incentives, such as the recent budget measure in 2014, which introduced the concept of a gradual tapering off of the unemployment benefit to enable a smooth transition from unemployment to employment, could be applied with regard to smoothening the transition for people from the shadow to the formal economy.

Good practice design of such measures exist in EU MS and can be studied and reviewed to determine the most appropriate incentive demand side instrument or instruments that can be introduced locally – tailored or crafted, of course, to reflect local social and economic realities. This includes incentives directed to move small scale informal work into the formal economy such as the Mini-jobs scheme in Germany; the easing of the transition from the shadow economy to self-employment such as the Start-up Premium scheme also in Germany; and encouraging customers to purchase from the formal economy in spheres where informal work is rife, such as the Service Vouchers scheme in Belgium.

[39] The research suggests that Malta's shadow economy is higher than the EU 27 MS average with Malta Schneider ranks Malta 7th whilst Murphy ranks Malta 8th in terms of the size of the shadow economy vis-à-vis the GDP.

The development of effective methods to transform work carried out in the shadow into the formal economy is not simply about choosing effective individual policy measures.[40] It is also about putting policy measures together in various combinations and sequences that are effective.

The tackling of the shadow economy, therefore, requires a mix of policy measures directed to address the key drivers that elicit such shadow behaviour at the first instance which include, but are not limited to, the minimisation of exploitation where it exists, unlicensed use of illegal immigrant labour; education through the improvement of skills and competencies of workers in the shadow economy, to demand based incentive measures, to facilitate the transition from the shadow to the formal economy.

The Strategy Group, thus, recommends that the Government establishes a multi-disciplinary team to draw up a holistic strategy directed to tackle the shadow economy in Malta. This would complement on-going efforts directed towards combating precarious employment conditions in Malta.

**Recommendation 06: Facilitating the Transition of Workers from the Shadow to the Formal Economy**

The transition of workers from the shadow to the formal economy has two strategic imperatives with regard to pension reform. The first is that it increases employment participation rates and, thus, strengthens the sustainability of the pension system. The second is that it reduces the 'social protection deficit' that persons in the shadow economy are exposed to and hence renders them eligible for contributory pension support; and, thus, improve adequacy.

The Pensions Strategy Group recommends that the Government undertakes the design of a holistic strategy to tackle the shadow economy through mix of policy measures directed to address the key drivers that elicit such shadow behaviour at the first instance. It is proposed that the Government establishes, *at the earliest possible*, a multi-disciplinary team to draw up a holistic strategy directed to tackle the shadow economy in Malta.

### 04.1.7 Introducing an Economic Migration Policy for Malta

Low fertility and increasing life expectancy in Europe and Malta are reversing the age pyramid, leading to a shrinking number of younger people, an ageing work force, and an increasing number and share of older people. In the age group 0-14 years the decline is already taking place today. Over the period under review, the population aged 15-64 years will drop by 14%.[41] In both Europe and Malta the demographic process can be characterised, as a shift from a society with dominant younger cohorts to a society in which the elderly form a solid majority.

Although a mix of policy measures including rising retirement age, higher labour force participation of women are applied to mitigate against such rapid demographic ageing labour participations rates in the absence of 'zero' migration, show that Europe's labour force will decline significantly. None of the 'traditional' labour market responses alone – rise in retirement age, re-skilling and up-skilling, increased participation rate for females and the elderly, transition from the shadow to the formal economy – will on their own or collectively suffice to compensate for the 'gap' in population decline with its consequential impacts on the sustainability of the pension system.

Inward net migration is increasingly seen by the EU as one of the potentially important means to solve the problem of the EU's ageing population and the increased demand for certain types of competencies, skills and knowledge. Indeed, to compensate for this decline in population, inward net migration to the EU plays a major role. The annual net inflows are projected to increase from about 1,043,000 people in 2010 (equivalent to 0.2% of the natural EU population) to 1,332,500 by 2020 and thereafter declining to 945,000 people by 2060.[42] The cumulated net migration over the entire projected period is 60.7 million by 2060.[43] Be that as it may, employment is projected to peak at

[40] Pg 36, Williams, C, C., The informal economy and poverty: evidence and policy review, Joseph Rowntree Foundation, 2014
[41] Pg 27, 2012 Ageing Report, Economic and Budgetary projections for the 27 EU Member States: 2010-2060, European Economy, 2/2012, Directorate-General for Economic and Financial Affairs, European Commission, 2012
[42] Pg 25, Ibid
[43] Pg 25, Ibid

217.6 million in 2022 and go down to 195.6 million in 2060 - a decline of about 15.7 million workers over the period 2010 to 2060.[44]

Populating ageing will impact Malta in, at least, two significant ways with regards to the labour market. The first impact is the actual physical number of workers required to sustain the *current* level of economic activity. It is projected that for Malta in 2025 to maintain employment at its 2010 level vis-à-vis workers who are 45 years of age, an additional 10,800 workers – or 6.85% of the projected employment population - is required.[45]

Second, a Cedefop 2008 study showed that by 2020 the employment market in Malta will experience an increase in the services sector at the expense of the primary sector, utilities, manufacturing and construction sectors respectively where-in the projected change in the occupational structure will occur in elementary occupation, skilled non-manual occupation, and the highly skilled not manual occupation. This means that in the period leading to 2020, the Maltese employment market is forecasted to grow in medium and high skilled valued added employment.[46] Indeed, this is what in fact is happening today. The transition from a "traditional" industry-based economic development to the "knowledge society," requires new skills, competences and know-how, some of which cannot be directly found amongst the local workforce nor directly generated, at least in the short and medium term, by changes to national education and training systems.

Thirdly, some skills and abilities will always be in short supply - even in times of recession. At times, vacancies in certain sectors are particularly hard to fill.

The arising consequences to the Maltese economy can be dire. Economic theory recognises that the size of the population and the skill level of the human capital are key attributes for economic growth. Whilst, innovation, technology and arising efficiencies compensate for a reduction in the size of the population and in the availability of competencies, skills and knowledge level of the human capital, there is a limit to the extent that these can compensate the absence or stem the demand of competencies, skills and knowledge required and the competencies, skills and knowledge scarcity that are likely to arise in particular sectors. The corresponding impact on sectorial economic growth is very likely to be negative.

Immigration brings new workers to the economy that fills labour gaps in the short and medium term. A pro-active economic migration policy that targets high and semi competencies, skills and knowledge represents a logical part of any labour market strategy directed to address shortages and gaps in a country's human capital pool. Non EU countries such as the United States of America, New Zealand and Australia, and most MS, have incorporated economic migration into their overall vision and strategic thinking on how to combat current and future shortages in labour. The degree to which migration is considered a "desirable" strategic instrument to address labour market needs, however, varies.[47]

Indeed, economic migration policy instruments vary. The points systems in New Zealand and Denmark, for example, reward prospective immigrants working in designated occupations. Canada maintains a list of occupations in high demand, and France, Ireland, and the United Kingdom, all introduced a shortage list of some kind between 2006 and 2008.[48]

The 2010 PWG recognised the importance of these developments. It proposed that whilst Malta should continue to invest in indigenous human capital to ensure that there is a labour supply to meet competencies, skills and knowledge in future growth areas as well as targeting competencies, skills and knowledge gaps where these exist, it argued that the country should complement such investment with:

[44] Pg 28, Ibid
[45] Pg 10, Fargues, P., and McCormick, A., Ageing of skills and complementary immigration in the EU, 2010-2015, RSCAS 2013/81, Robert Schuman Centre for Advanced Studies, European University Institute, Migration Policy Centre, 2013
[46] Page 65, Skills Supply and Demand in Europe: Medium-Term Forecast Up to 2020, European Centre for the Development of Vocational Training, European Union, Luxembourg, 2010
[47] Pg 21, Satisfying Labour Demand through Migration, European Migration Network, June 2011
[48] Pg 2, Sumption, M., Filling Labour Shortages through Immigration: An Overview of Shortage Lists and their Implications, Migration Policy Institute, 2011

> "… targeted immigration and residency policy to narrow skills deficits and inadequate labour supply that is or may constrain the economy from growing further and where short run solutions on the labour domestic market are unlikely to give the desired results – and in doing so increasing the contributory base of the First Pension."[49]

The recommendation presented by the 2010 PWG was not adopted by Government. Whilst Malta's entry into the EU enables for the smooth migration of competencies, skills and knowledge from EU MS, Malta's immigration policy towards persons from Third Countries is heavily tilted against the person irrespective of their competencies, skills and knowledge and the potential contribution to Malta's economy.

This reluctance for Malta, up to now, to embrace an immigration policy that targets high and semi-skilled competencies, skills and knowledge is the result of public discourse which differentiates between EU migrants and Third Country migrants as well as the policy responses required to meet the challenges that immigration brings.

The Strategy Group positively notes the recent announcements that the Government is crafting an immigration policy. The Group emphasises, however, that such an immigration policy should target high and semi-skilled competencies, skills and knowledge as a measure to address on the one hand population ageing and on the other hand to meet labour market challenges arising from such population ageing.

In tandem with the above, the Strategy Group is of the considered opinion that action is taken to regularise the status of current immigrants so that these are in a position to positively contribute to Malta's economy. This will not only productively muster the competencies and skills that such persons possess, but will eliminate the current abuse where such persons are illegally engaged by local firms at a pittance and with no employment rights.

**Recommendation 07: Introducing an Economic Migration Policy for Malta**

The Pensions Strategy Group whilst positively notes the Government recent announcement that it is designing an immigration policy it emphasises that such a policy should that target high and semi-skilled competencies, skills and knowledge as a measure to strengthen Malta's human capital and labour market challenges arising from population ageing. It is proposed that the Government, *at the earliest possible*, designs and introduces such an economic immigration policy.

The Strategy Group further proposes that action is taken to regularise the status of current immigrants so that these are in a position to positively contribute to Malta's economy. This will not only productively muster the competencies and skills that such persons possess but will eliminate the possible abuse where such persons are illegally engaged at a pittance and with no employment rights.

### 04.1.08 Incentivising Active Participation of Elderly Persons through the Removal of the Mandatory Retirement Age

The measure introduced as part of the 2007 reform where income earned from employment by retirees was decoupled from pension income for persons between 61 and 64 years of age was successful in its objective in increasing the participation of elderly persons in the labour market. Be that as it may, the number of elderly men and women pensioners engaged in a form of active labour activity compared to other EU MS and OECD countries is low.

Increasing the cohort of pensioners in the labour market is, therefore, a strategic underpinning with regard to the strengthening of the pension system, in relation to both its sustainability and adequacy.

The Strategy Group agrees with the recommendations presented in the National Strategic Policy for Active Ageing with regard to increasing active participation in the labour market. These are presented

[49] Pg 49, Strategic Review on the Adequacy, Sustainability and Social Solidarity of the Pensions Systems, 2010 Pensions Working Group, Final Report, December 2010

in Box 02. The Strategy Group builds on the recommendations presented in the National Strategic Policy, from, however, a strategic pension perspective.

The SPRA of 65 years of age will be reached in 2026 for the Switchers Group. The SPRA of the Transitional Group will increase from 62 years to 64 years over the coming years and will impact older workers differently according to their age.

This increase in the SPRA to 65 years of age was a direct outcome of the 2007 pension reform. In view of increased life expectancy, the 2010 PWG recommended that government grafts a longevity age index to the SPRA. This recommendation was not accepted by both the Government and the Opposition at the time. It was also rejected by constituted bodies representing employees.

The Strategy Group supports Government's policy approach that the SPRA remains unchanged at 65 years of age and that older works are incentivised to remain active in the labour market beyond retirement through the creation of an enabling environment.

As a mechanism to incentivise a person to continue in employment beyond the SPRA, the Strategy Group recommends that the value of the said pension increases for every year that person remains in employment beyond the SPRA. Due to the impact of this measure on the pension system architecture, this recommendation is discussed in Section 04.2 of this report.

Malta's pension system has a Minimum Retirement Age (MRA) – that is the retirement age established in the SSA, at which an employee will retire, unless s/he is otherwise invited to continue to be employed by his / her employer or is offered new employment elsewhere.

The PRA and the MRA are, in the case of Malta, one and the same. To date, the debate has primarily been focused on the SPRA. There is little, if any, profound discussion on whether Malta should, given the rapid ageing demographics, gradually move to a system that is underpinned by an age legislation approach that is based on equality.

**Box 02: Recommendations of the National Strategic Policy for Active Ageing**

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Continuing vocational education and training

- Recognising the value of continuous vocation education and training for ageing and older workers, for increased productivity and economic growth.
- Improving the opportunities for vocational education and training of ageing and older workers according to their needs and employer and workplace requirements.
- Supporting facilitators and instructors in continuous vocational education and training in becoming more sensitive to the unique learning and teaching styles preferred by older and ageing workers.

Healthy Working Conditions

- Promoting occupational health and safety principles that foster the employability of older and ageing workers, up and even subsequent to statutory retirement age.
- Encouraging increasing job rotation and flexibility amongst co-workers in order to support older and ageing employees.
- Supporting employers in adopting practices that decrease potential health risks experienced by older and ageing workers.

Age Management

- Inspiring work organisations to implement working hours, as well as physical and mental work environments, which correspond to the prerequisites and needs of employees of different and increasing ages.
- Recommending that the management of work organisations supports the individualised treatment of people of all ages in all phases of their work life.
- Encouraging work organisations' management to advocate and implement positive attitudes towards ageing employees, so that their respective strengths may be valued and encouraged in the workplace.

Any debate that has occurred on this issue has seen the constituted bodies representing employers favouring the introduction of different post retirement work mechanisms for persons beyond the SPRA, subject that such instruments are introduced on the basis of agreement with the employer.

The position of constituted bodies representing employee is primarily that of ensuring that there is no further increase in the statutory retirement age of 65 years and those retirees are incentivised and *not* compelled to work beyond the SPRA.

It is to be noted that there are countries, particularly English speaking ones that have abolished the MRA on the base of age equality legislation. These include the USA, New Zealand, Canada, and Australia.

The above implies that mandatory retirement in these countries is illegal. The USA provides for some exceptions, basically, airline pilots, fire fighters and law enforcement officers.

This means that it is unlawful for an employer to discharge any individual or to otherwise discriminate against them with respect to their compensation, terms, conditions or privileges of employment because of that individual's age.

Age discrimination legislation has a direct consequence on the increase in and the presence of the number of older workers in the labour market.

At the first instance, it allows individuals to continue in jobs they already have. In the USA, for example, over 20% of the working population aged 70 to 74 years is in some form of active employment.[50]

In the USA, retirement is now seen as a gradual 'process' and no longer a straightforward transition from full-time work to leisure[51]. In some instances older workers can move into partial retirement where they retire from their main employer, collect pension benefits and continue to work in a 'bridge job'.

### Employment Services for Older Workers

- Promoting relevant employment services which recognise both the diversity of older workers, as well as the unique features which age brings to career trajectories.
- Providing training opportunities to guidance workers on employment services for older workers, including preventive guidance to minimise premature labour exit.
- Establishing employment services to address unemployment amongst citizens aged 50 years and over, who are at greater risk of being either under-skilled or over-skilled in respect to available job opportunities.

### Ageism and Age Discrimination

- Promoting awareness on ageism and age discrimination.
- Expanding legal definitions, noting how age discrimination can be both direct and indirect, that age discrimination can also take place by way of victimisation or harassment and that supporting age discrimination is also an unlawful act.
- Encouraging a right to request to continue working beyond statutory retirement age and to a duty on behalf of employers to respond to this request, in a timeframe of not less than 6 months and not more than 12 months before the date of expected retirement.

### Employment Friendly Tax / Benefit Systems

- Initiating financial incentives targeting employers to retain older and ageing workers employed in their organisations.
- Instigating financial inducements for employers to encourage and assist the re-entry of older and ageing workers back into the workforce.
- Implementing financial incentives that benefit older employees to return or stay in the labour force for as long as possible.

### Transfer of Experience

- Conducting a public campaign that highlights how older workers generally make excellent mentors and role models to younger employees.
- Highlighting how the mentoring of younger workers by older colleagues fosters optimal employee retention levels.

[50] OECD (n.d). Statistical extracts: LFS by sex and age – indicators, available at http://stats.oecd.org/Index.aspx?DatasetCode=LFS_SEXAGE_I_R
[51] Pg 52, Wood, A., Robertson, M., Wintersgill, D., A Comparative Review of International Approaches to Mandatory Retirement, Research Report No 674, Department for Work and Pensions, 2010

Research suggests that where the MRA criterion was abolished, employers often chose to adapt their working environment to provide more amenable working conditions for older employees by, for example, providing flexible working, job sharing, working from home, working only at defined suitable times, gradual retirement schemes, and being able to take more unpaid leave.

- Advocating that older workers who engage in mentoring derive a number of benefits such as increased self-esteem and a sense of accomplishment, which are also valuable to the work organisation.

Reconciliation of Work and Care

- Conducting a public campaign that highlights how older workers generally make excellent mentors and role models to younger employees.
- Highlighting how the mentoring of younger workers by older colleagues fosters optimal employee retention levels.
- Advocating that older workers who engage in mentoring derive a number of benefits such as increased self-esteem and a sense of accomplishment, which are also valuable to the work organisation.

Positions against the abolishment of the MRA have traditionally come from employers and their constituted representatives. The arguments presented against reforms related to the abolishment of the MRA include but are not limited to the following[52]:

- Older employees became less able and efficient, particularly in certain sectors such as manufacturing, as they get older, and that it is not financially sensible to retain workers past their normal retirement age.
- Older employees are potentially more expensive to the enterprise as employers may have to pay disproportionately high insurance and benefits such as disability insurance, life insurance, health insurance and that there is doubt on whether there is a sound business case to retain an older worker in non-knowledge based sectors amongst others.
- Employers will invest less in training older employees when they are within reach of their expected retirement age as they see a limited return of investment in this regard.
- Employers see promotions to be cost effective: thus, with regard to older workers promotions would only occur if the employer feels that the enterprise will get back its investment in training, coaching and additional salary.
- Employers try to strike a balance between voluntary redundancies and early retirement for persons nearing retirement when enforcing redundancy.
- Retirement age impacts upon the job opportunities of younger people.

Whilst there is limited international qualitative research on the impact of the abolishment of the MRA on employers, it is reasonable to assume that an element of cost will occur. There is, however, research that suggests that the abolishment of the MRA criterion is more likely to increase the participation rates of older workers when it is:[53]

- Enacted in conjunction with an increase to the SPRA and other policies to support older working.
- Supported by accompanying policies to encourage older working.

[52] Thomas, A., and Pascall-Calitz, J., Default Retirement Age: Employer Qualitative Research, Research Report No 672, carried out by TNS-BMRB on behalf of the Department of Work and Pensions, 2010
[53] Pg 69, Wood, A., Robertson, M., Wintersgill, D., A Comparative Review of International Approaches to Mandatory Retirement, Research Report No 674, Department for Work and Pensions, 2010

A range of research reports (prior to 2009) by the OECD in Canada, Ireland, Japan and France suggest that there is no clear link between the employment levels of older workers and those of younger workers. In other words, at the time of the preparation of this report, there was no clear empirical evidence to support the argument that banning mandatory retirement increases unemployment among younger workers.[54]

It is pertinent to underline that the European Committee of Social Rights of the Council of Europe, in its discussion of the European Social Charter, with regard to Malta in 2012, concluded[55] that "that the situation in Malta is not in conformity with the Charter, as the termination of employment on the sole ground that the person has reached the pensionable age, which is permitted by law, is not justified."[56]

The Strategy Group understands that there cannot be an abrupt transition from a pension system – and a labour market – that is governed by a SPRA which is the same as the MRA, to one that leads to the abolishment of the MRA criterion on the basis of age equality based legislation.

Nevertheless, the Strategy Group is of the considered opinion that this is a debate that cannot be avoided. That Malta's demographics are ageing is a certainty. That ageing will result in a 'greyer' labour force is a near certainty. Deferring the discussion today on what may be considered to be an uncomfortable issue will only result in a state of play where society will be forced to face such issues under potential duress. The demographic data presented in this report and supporting papers, show that the point when such a discussion must be faced by the social and economic actors in the polity, is neither in the medium nor in the long term but rather, in the near future.

The Strategy Group, thus, proposes that a process of discussion under the tutelage of the Malta Council for Economic and Social Development (MCESD) takes place.

**Recommendation 08: Incentivising Active Participation of Elderly Persons through the Removal of the Mandatory Retirement Age**

The Pensions Strategy Group understands that there cannot be an abrupt transition from a pension system – and labour market – that is governed by a Statutory Pensions Retirement Age which is also the Mandatory Retirement Age to one that abolishes the Mandatory Retirement Age criterion on age equality based legislation. The Pensions Strategy Group underlines that such a debate cannot be ignored and recommends a process of discussion under the tutelage of the Malta Council for Economic and Social Development with the aim of leading to a possible abolition of the Mandatory Retirement Age.

[54] Pg 73, Ibid

[55] Pp32-33, European Social Charter (revised): Articles 1, 9, 10, 15, 18, 20, 24 and 25 of the Revised Charter, European Committee of Social Rights, Conclusions 2012 (Malta), Council of Europe, January 2013: Full recommendation:
"As regards termination of employment on the ground that the person has reached the pensionable age, the report states that the Maltese legislation is based on the approach taken by the ECJ on this issue. The Employment and Industrial Relations Act (EIRA) does not in any way preclude recruitment of a person of a pensionable age. EIRA is giving any employer the right to terminate an employee's employment relationship upon the employee's reaching of the national retirement age. The Committee recalls that according to the Appendix to the Charter, for the purposes of Article 24 the term 'termination of employment' means termination of employment at the initiative of the employer. Therefore, situations where a mandatory retirement age is set by statute, as a consequence of which the employment relationship automatically ceases by operation of law, do not fall within the scope of this provision. The Committee further recalls that Article 24 establishes in an exhaustive manner the valid grounds on which an employer can terminate an employment relationship. Two types or grounds are considered valid, namely on the one hand those connected with the capacity or conduct of the employee and on the other hand those based on the operational requirements of the enterprise (economic reasons). The Committee holds that under Article 24 dismissal of the employee at the initiative of the employer on the ground that the former has reached the normal pensionable age (age when an individual becomes entitled to a pension) will be contrary to the Charter, unless the termination is properly justified with reference to one of the valid grounds expressly established by this provision of the Charter.
The Committee thus holds that the situation in Malta is not in conformity with the Charter as the termination of employment on the sole ground that the person has reached the pensionable age, which is permitted by law, is not justified.

[56] Pg 33, European Social Charter (revised): Articles 1, 9, 10, 15, 18, 20, 24 and 25 of the Revised Charter, European Committee of Social Rights, Conclusions 2012 (Malta), Council of Europe, January 2013

## 04.2 Reforms to the Pension System directed to ensure a Socially Sustainable System that provides for a Fair Balance between Contributions and Benefits across Generations

### 04.2.1 Strengthening the Inter-generational Social Contract through a PAYG Notional Defined Contribution Pension System

As part of the 2010 Strategic Review, the 2010 PWG visited Sweden, one of the countries that as pioneered the use of the NDC pension system. The 2010 Strategic Review included a recommendation that the Government assesses the possibility of migrating Malta's State pension system from a PAYG DB structure to a NDC one. The report had suggested that this assessment is carried out before the second Strategic Review in 2015.

The ageing transition has placed the PAYG DB public pension programmes under question, as their successful operation tended to depend on a relatively low ratio of beneficiaries to contributors. In Malta, according to Eurostat's EUROPOP2013 projections, while total population is projected to rise from 422,556 in 2013 to 476,383 in 2060, the proportion of those of working age is set to fall from 68.0% in 2013, to 60.2% by 2030 and to 56.1%in 2060. By contrast, the share of the elderly population (aged 65+ years) is expected to increase steeply from 17.5% in 2013 to 28.5% by 2060.

The ageing transition has led some countries to replace PAYG pension plans with systems of fully funded private or personal DC accounts, but the difficulties of transition to funded systems have limited their implementation. This has led a number of countries to introduce NDC (or Non-financial Defined Contribution) schemes, with the objective of addressing the fiscal instability of traditional plans and mimicking the characteristics of funded DC plans while retaining PAYG finance.

The NDC model can be viewed as a variant of the PAYG DB model with a number of provisions designed to assure a far closer link between contributions and benefits. The NDC model is based on PAYG financing. Funds obtained from payroll contributions are used to finance pension benefits for those currently retired. It differs from a PAYG DB scheme in that with the NDC scheme, an individual notional account is established for each worker.

This NDC account is typically credited (without any funds being actually deposited) for that portion of contributions (including both the employee's and the employer's share) used to pay pension benefits to others during the person's working years. The NDC retirement benefits are then directly linked to the size of these notional accounts at the time of retirement.

Contributions to NDC accounts are notional: that is they cannot be capitalised. If they were capitalised, appreciation from year to year would be based on returns in financial markets; but this is not the case with NDC accounts. The indexing procedure used varies from one country to another, but in all cases it is linked to changes in wages, the wage sum (the total wage base subject to the payroll contributions, a measure based on trends in both wage levels and the number of workers contributing), or GDP growth.

The NDC pension system incorporates an adjustment mechanism aimed at keeping benefits in a range that can be supported by growth in the payroll tax base. Although benefits are adjusted annually for changes in wage growth, they are not, however, adjusted after retirement to reflect changes in mortality projections.

It should be noted that an NDC scheme is financially stable, regardless of demographic and economic developments, and is maintained stable through a fixed contribution rate and fixed rules for calculating benefits. This entails a risk that the value of pensions will vary over time and to reduce this variability, the indexing of systems liability is based on the growth in average income. As the growth in average income normally will deviate from the systems internal rate of return, this income index implies that assets may grow faster than liabilities or vice versa.

When liabilities are greater than assets, the basis for indexation is automatically switched to an approximation of the system's internal rate of return, thus automatically adjusting pension levels as well. Thus, the pension level is automatically re-established, as is growth in average income as the basis of indexation. Only historic transactions are used to calculate liability and assets and the evaluation of assets is performed by the expected turnover duration, which is highly dependent on the age-related income and mortality patterns.

The NDC scheme seeks uniformity of individual returns to contributions by awarding pension benefits that depend both on notional capital accrued at retirement and on life expectancy. The NDC scheme's goal of uniformity of returns requires higher replacement rates for workers with lower wage growth. It also requires that the replacement rate increases with retirement age. Moreover, the NDC scheme precludes any kind of redistribution.

For the continuation of the pension reform process in Malta, in 2013, the Strategy Group conducting an assessment of the proposal of strengthening of the First Pillar through the implementation of a NDC pension scheme. The Strategy Group, with the assistance of the World Bank, looked into the potential impact of introducing an NDC scheme where benefits depend on contributions made and on life expectancy at retirement.

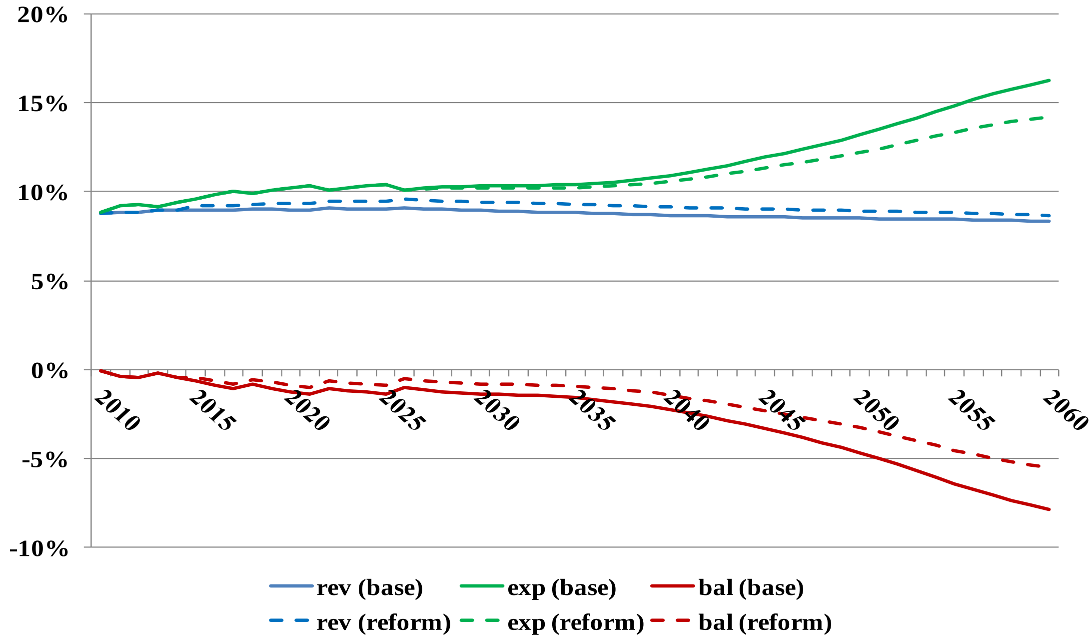
During the World Bank visit, the PROST modelling software was used, given that this software has a sub-module that allows for the modelling of an NDC pension system. This software is also used to model the PAYG DB scheme, and so allows for direct comparisons of the two schemes. For modelling purposes the following was assumed:

- Movement to the NDC pension system was assumed to be mandatory for persons born on and after 1st January 1962.
- Accrued rights by 2015 for post-1962 cohorts are paid out as proportional DB pension upon retirement.
- The contribution ceiling in the NDC pension system remains as determined in the 2007 reform.
- The notional interest rate would equal the insured wage bill growth rate.
- Government would pay contributions equivalent to 30% of the minimum wage for exempted contributors.
- Annuity factors were automatically linked to projected life expectancy.
- The GNMP is indexed to wage growth.
- The NDC pensions are indexed to prices, proportional DB pensions indexed in accordance with the 2007 reform.
- It was assumed that the NDC pension system would result in no change in behavior with respect to retirement pattern (conservative scenario).

This NDC modelling scenario concluded that:

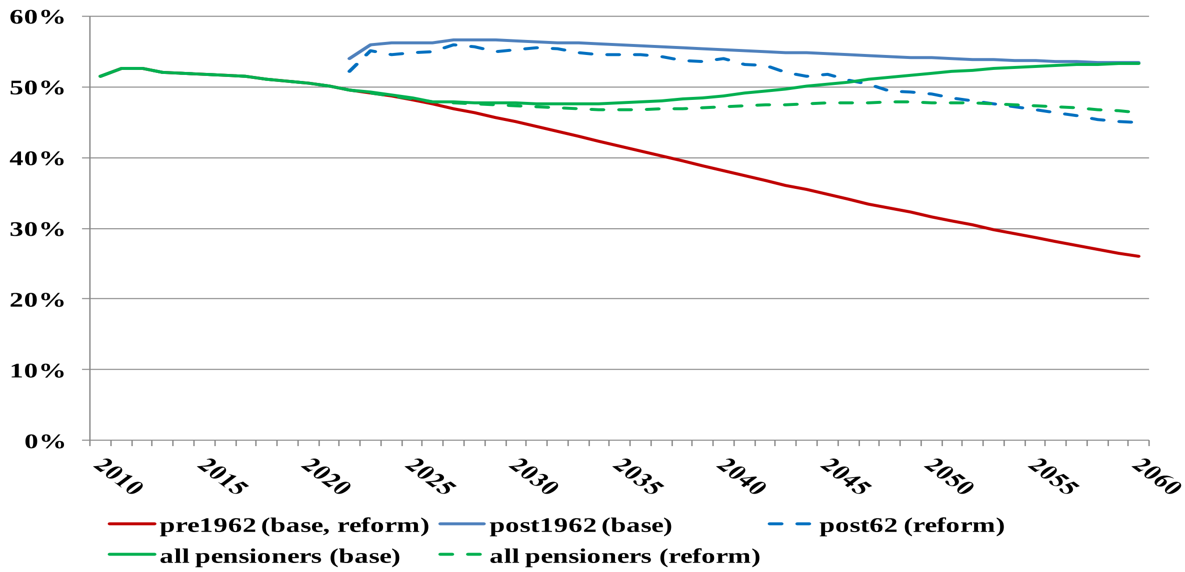
- Financial sustainability with the NDC pension system improves but still remains a concern as indicated in the below chart, with the deficit exceeding 5% of GDP by 2060.

**Figure 23: Pension System Finances - % of GDP**




- Pension adequacy: The average pension would decrease compared with the no-reform scenario, but the overall level should remain adequate in the medium term, though this may become a concern in the longer run. In particular, the fact that the NDC pension would be indexed to prices would result in its relative value eroding over time, and push most pensioners (nearly 90%) on the GNMP

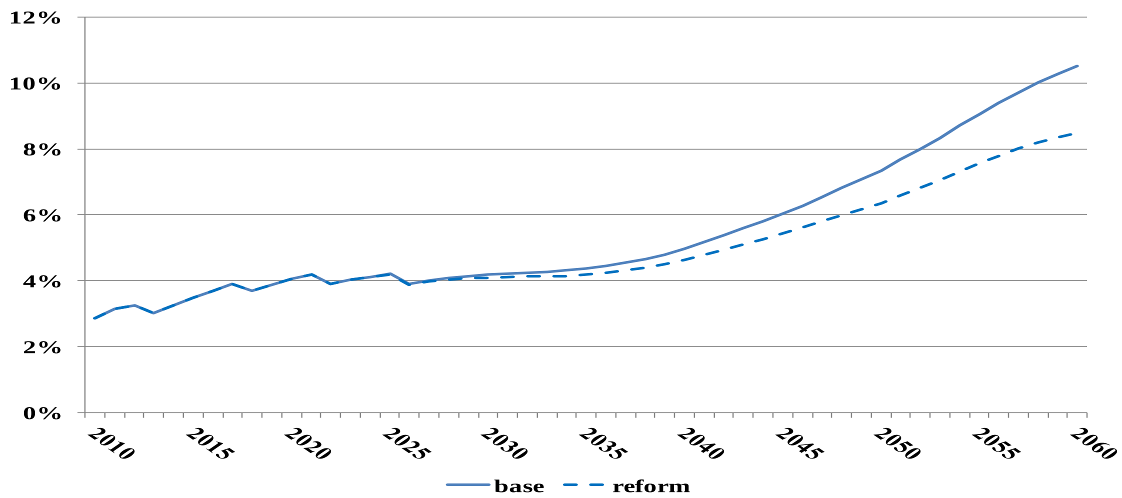
**Figure 24: Average Pension for all Existing Old Age Pensioners - % of Average Wage**




- Equity and incentives: This systemic reform would be difficult to administer and could involve considerable administrative expenses. Moreover in the presence of a relatively generous GNMP and the projected path of the MPI, it could result in most of the administrative work being done just so that most people are eventually paid the GNMP.

- The system also does not seem to offer much in terms of potential cost savings, with little savings before 2040, as can be seen from the Chart below. The GNMP makes the system highly redistributive and by weakening the link between contributions and benefits, it reduces the incentives for those on low to median incomes to continue participating in the labour force. Moreover, the maximum MPI ceiling, and the price indexation of the NDC pension may discourage higher income contributors from participating fully in the system.

**Figure 25: Government Obligations (Contributions and Deficits) - % of GDP**




Therefore, for the case of Malta given the existing legislation on the GNMP and the evolution of the MPI, there may be administratively easier alternatives that could possibly yield better financial results, particularly in the medium term, while providing better incentives for individuals to have longer careers and contribute towards the financial sustainability of the system.

**Recommendation 09: Strengthening the Inter-generational Social Contract through a PAYG Notional Defined Contribution Pension System**

With the assistance of the World Bank, the Pensions Strategy Group studied the implementation of a Notional Defined Contribution pension system in Malta and concluded that such a complex systemic change was deemed to be inappropriate given the presence of a rather strong Guaranteed National Minimum Pension which makes the system unlikely to deliver satisfactory results in terms of enhancing pension adequacy and sustainability.

### 04.2.2 Ensuring a Fair Balance between Contributions and Benefits Across Generations

As shown earlier, the pension system is based on a PAYG inter-generational contract between successive generations. Each generation of workers contributes towards paying the benefits due to the previous generation of workers on the understanding that a future generation will do the same in its regard. This concept of social solidarity is one of the main strengths of the pension system and needs to be maintained.

Demographic changes, however, are bringing about fundamental changes in the terms of this social contract. On the one hand, people are living for longer, and thus drawing pensions for a much longer period of time. This creates additional pressures on current contributors. On the other hand, the size of contributing generations, after decades of steady growth, is projected to start declining. This is expected to add further pressures on future generations of contributors, to make good for their part of the social contract.

These demographic changes mean that the terms of the social contract are being rewritten in a way that threatens adequacy and sustainability. Current generations of men are retiring at 61 and can expect, on average, to receive a pension for 21 years, while women (due to their longer life expectancy) can expect to draw their benefit for close to 26 years. Persons in the Transitional Group to draw a full pension, they are required to have contributed 35 years (40 years in the case of individuals in the Switchers Group).

If these conditions remain unchanged, by 2060, an individual in the Switchers' Group will be able to retire at age 61 with a full pension, after having contributed 40 years, and then expect to draw this pension for more than 26 years. The ratio between the number of years contributing and those drawing a pension would change from one and two-thirds years contributing for every year drawing a pension, to one and one-third years contributing for every year drawing a pension. This would happen at a time when a relatively smaller cohort of contributors will be present to finance this transfer.

The Strategy Group instead believes that the pension system would benefit greatly by adopting some of the adjustments introduced by the French and German governments in their State pension schemes. In the French system, government has legislated that for the inter-generational social contract, to remain equitable in the face of changing circumstances, the ratio between the number of years contributing to those drawing a pension needs to be maintained stable. Individuals are still allowed to retire from a minimum pension age, but if at that time their contributions do not match the required amount they would not be able to draw a full pension.

There are several benefits to this approach. Firstly, it gives flexibility to the individual to choose between a longer period of retirement and an improved benefit. Secondly, it addresses the fact that manual workers, typically, start contributing earlier in their life, but then typically can expect to draw their pension for a shorter period of time than professional workers. Thirdly, in the presence of a strong GNMP, it allows those on low incomes or those unable to work beyond the minimum pension age to retire at an early age without being unduly penalised. Fourthly, it ensures that the contributory principle remains a strong feature of the inter-generational social contract, as successive generations would have contributed relatively the same number of years for each year drawing a pension. Fifthly, it allows for a gradual adjustment in the parameters of the pension system so that the costs of rising to the challenges of the ageing transition are shared across different generations rather than forced on one particular generation of workers.

To allow individuals to make the right choices, the Strategy Group believes that the required contribution period to receive a full pension would be set by a special commission every five years as part of the strategic review process and announced fifteen years in advance. Thus, for instance, the number of years required to receive a full pension for someone due to retire in 2050 would be set in 2035.

The commission would arrive at its decision after consulting available longevity projections for each successive generation. For the commission to recommend a deviation in the ratio, it would need to prove that the social costs of doing so would not outweigh the benefits. The commission would also be required to study the impacts of previously announced changes in contribution requirements for preceding generations.

**Recommendation 10: Ensuring a Fair Balance between Contributions and Benefits Across Generations**

The Pensions Strategy Group considers the introduction of the 5 year strategic review of the pension system as a positive development and that this should be strengthened through the setting up of a special body which every 5 years would establish the parameters of the pension system architecture with a view of announcing changes necessary to maintain balance between contributions and benefits across generations, 15 years in advance and thereby ensuring that persons can make appropriate adjustments.

Besides acting on maintaining a clear link between the number of years one contributes and that of the years drawing a benefit, Maltese society needs to also look into the impact of the relative decline in the size of contributing generations. Even if one was to maintain the same ratio between the years contributing and those receiving a pension, the sustainability of the system is endangered by the fact that the ratio of contributors to beneficiaries is falling over time. In this respect, the German government introduced a sustainability factor in its calculation of the pension value. In essence, if the ratio of contributors to beneficiaries declines, the increase in pensions is decreased proportionally. This helps reduce the burden faced by future generation of contributors.

The Strategy Group has studied the implications of adopting a sustainability factor in the calculation of pensions. The Strategy Group concludes that in the Maltese case, it might be inequitable to apply this factor to all pensions. A fairer solution could be to adjust the indexation of the MPI in this respect. This would mean that only the higher pensions would adjust gradually to reflect the worsening demographic ratios, while State pensions for those who need them the most would remain unchanged.

**Recommendation 11: Ensuring a Fair Balance between Contributions and Benefits Across Generations**

The Pensions Strategy Group recommends that for the pension system to remain equitable across generations, the social contract underpinning pension transfers needs:

- To be able to adjust gradually to changing demographic conditions.
- While allowing individuals the flexibility to retire at the respective pension age, the contribution period required to qualify for a full pension needs to be based on a stable ratio between the number of years contributing to that spent drawing the benefit.
- The growth of the maximum pensionable income to reflect changing demographic conditions so as to provide a better deal for future contributors.

The Strategy Group underlines that a contribution period that reflects a full career definition is a truer and fairer mechanism than the contribution period introduced as a result of the 2007 reform. Be that as it may, a balance must be secured between on the one hand the number of years one contributes and that of the years drawing a benefit, and on the other changing needs and issues relating to society and the labour market. With regard to the latter, the Strategy Group has in this report proposed a number of measures that include:

- Increased credits for child rearing, family growth, and gender equality.
- Credits for human capital development.

The implementation of the measure with regards to the tightening of the contribution period with a person's working life should be gradual. The Strategy Group recommends that the first tightening between the contribution period and a person's working life should be introduced with effect from 1st January 2016.

This recommendation will affect those persons who today are aged between 46 and 50 years of age (born between 1965 and 1969). The contributory period for this cohort of persons will increase from 40 to 41 years. This provides the effected cohort of persons with a 15 year advance notice.

**Recommendation 12: Ensuring a Fair Balance between Contributions and Benefits Across Generations**

The Pensions Strategy Group underlines that a contribution period that reflects a full career definition would be a truer and fairer mechanism than the contributory period currently in place in the pension system in so far that a balance is maintained with changing needs and issues relating to society and the labour market. The Pensions Strategy Group recommends that any tightening of the relationship between the contribution period and a person's work life should be gradual.

It further proposes that the first tightening in this relationship should be introduced as at 1st January

2016. This presents a minimum of 15-year-in-advance announcement to persons who today are aged 50 years or less (born in 1965 or after). The contributory period for this cohort of persons is being proposed to increase from 40 to 41 years.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.2.3 Incentivising Late Exits from the Labour Market

The argument has been presented by constituted bodies, primarily those representing employees, that having a single SPRA and which SPRA increases across all categories of employees to be unjust. The primary argument put forward is that proponents of such an approach assume that an older person's professional and health ability to work beyond 65 years of age increases steadily over time – irrespective of the type of employment and the sector of employment such person is involved in.

Research shows that, for both men and women, there is a decisive influence of work conditions and education on life expectancy. A Eurostat study shows that life expectancy increases with educational attainment: higher educated people live longer than lower educated people, both men and women. In general, the life expectancy gaps for men, at any selected age, are much higher between medium and low educational attainment than between high and medium education. For women, at any age, life expectancy gaps between high and medium educational attainment and between medium and low educational attainment are less pronounced.[57]

The Austrian Institute for Economic Research in 2008 identified a high correlation between the work carried out, activity and life expectancy for Austrian workers. Manual workers were found to have a 75.7% probability of reaching 70 years when compared to 84.4% with regard to non-manual workers.[58]

In Malta, life expectation in relation to work is not measured by type of employment (manual, non-manual, and managerial and professional workers) nor by the employment sector (construction, manufacturing, etc.) but by the level of education – the International Standard Classification of Education (ISCED 1997) education level attainment.[59] Eurostat data shows that life expectancy for Levels 0-2 for 2007 and 2008 stood at 79.63 and 79.46 respectively, whilst those for Levels 5 and 6 for the same period stood at 82.09 and 81.76 respectively.[60]

The afore mentioned Eurostat study identified that the life expectancy gaps for persons in Malta as at 2007, between high and low education attainment, stood at 3 years for males and 1 year for females.[61] There is no data that projects the relationship between life expectancy and the education level of Maltese persons over the medium and the long term.[62]

The 2004 PWG in its final 2005 report identified the issue of whether 'manual'[63] and 'non manual' workers should be treated differently, given the arising impacts of the quality and type of work on a person's ability to achieve a healthy life expectancy (HLE) that would enable a manual worker to work productively and without health risks as the SPRA is raised gradually to 65 years of age.

The 2004 PWG assessed the following options in this regard:

[57] Corsini, V., Population and social conditions, 24/2010, eurostat

[58] Böheim, R., Knittler, K. and Mahringer, H., Impact of working life career and night work on life span. Male mortality risk in the 1924–1949 cohorts in Austria, Austrian Institute of Economic Research (WIFO), Monographs, March 2008

[59] Levels 0 to 2 – pre-primary, primary, and lower level education; Levels 3 to 4: upper secondary and post-secondary non tertiary education; and Levels 5 and 6 – first and second stage of tertiary education.

[60] http://appsso.eurostat.ec.europa.eu/nui/submitViewTableAction.do

[61] Ibid

[62] In the UK, the NSO projects that the class longevity (that is ratio between routine / manual and managerial and professional workers) as at 2028 will rise from 2.6 years to 3.1 years for men and from 2.4 to 3.8 for females - www.ons.gov.uk

[63] The 2004 PWG defined a manual worker as a worker who works through the expenditure primarily of physical rather than intellectual labour (often referred to a blue collar worker characterised by three core skill differentiations: skilled craft worker; semi-skilled worker; or unskilled worker

(01) The SPRA for a manual worker is increased to 65 years similar to other workers subject that the period leading to the age of 61 years the worker is re-skilled and re-trained through a process facilitated by government and the private sector with a transition to a more suitable employment.

(02) The manual worker is provided with the option for an early exit to his or her retirement pension once s/he reaches the age of 61 years and has accrued 40 years of contribution (a 35 year contributory history with regard to workers in the Transitional Group). This early exit was subject to certain punitive conditions

(03) A separate SPRA is established for manual workers on the basis of skill differentiators that would have reflected either the then SOC 2000 job classification, or the ISCO-88 ILO Minor Group Classification.

As shown earlier, the Government, in launching the 2007 reforms, opted for Option 02 as the instrument directed to attain a fair balance between the SPRA for manual and non-manual workers.

The third option was rejected because the 2004 PWG concluded that establishing a SPRA for certain and different categories of manual job occupations would be administratively complex to handle and may result in misuse as well as abuse.

Of particular concern was the possibility that holders of job occupations that would not have been categorised under a separate SPRA would lobby through their representatives to be exempted from the 65 year SPRA on the basis that their job or profession required them to carry out "heavy work" which resulted in negative health outcomes such as physical and psychosocial complaints.

In the 2007 reform, the Government adopted a tailored version of the recommendation presented by the 2004 PWG.

The reform allowed for a person to legally exit the labour force at any time if at the age of 61 years s/he would have accumulated a full 40 year contribution history (a full 35 years period in the case of persons in the Transitional Group).

Whilst it rejected the condition that such an early exit from the labour market should be 'penalised'; subject to a reduced temporary pension; it retained the condition that a person who opted out of the labour market would be excluded from the labour market.

This disincentive was based on the rationale that if a person decided to opt out of the labour market then that person should bear a social cost. There was no provision that allowed a person who choose early exit to formally re-enter the labour market.

In 2013 the first instance in the increase of the SPRA of persons within the Transitional Group

Box 03

State Pension Retirement Age or Early Pensions in EU Member States for Occupations in Certain Jobs or Sectors

**Austria**: a retirement age of 60 years of age for persons "having hard working conditions".

**Cyprus**: an old-age pension (Σύνταξη Γήρατος) "one month early for every period of five months of mining work, on condition that they have retired from that occupation, but in no case they can draw pension before the age of 58".

**Estonia**: an old-age pension under "favourable conditions are also paid to workers in occupations that are considered hard or hazardous (e.g. workers in chemical, metal, glass, pulp industry, mining, etc.), may retire 5 or 10 years before the legal retirement age, if they have fulfilled qualification requirements foreseen by the law (from 15 to 25 years of contribution period of which at least half in the given profession)".

**Greece:** a retirement age of "60 years and 9 months of age for men and women (increasing by 6 months every year until the age of 62 is reached in 2016) if 35 working years or 10,500 insurance days of which 7,500 days must have been worked under arduous or unhealthy conditions)".

**Hungary**: an early retirement pension "due to hazardous working conditions (Korkedvezményes öregségi nyugdíj) according to the Act LXXXI of 1997 on Social Insurance Pension before the starting date of the benefit prior to the retirement age, but not later than 31 December 2014".

(between the age of 46 and 54 years as at 1st January 2007) kicked in as the retirement age for both man and women increased from 61 years to 62 years of age. As shown earlier, in 2013 as the mandatory retirement age increased from 61 years of age to 62 years of age, 1,707 persons triggered

The Strategy Group has assessed the recommendation presented by the Strategic Review that the retirement age should be linked to a longevity index. The Strategy Group rejects a mandatory approach in this regard.

There is a large body of empirical evidence that shows that financial incentives embedded in pension systems influence people's retirement behaviour positively. Many OECD countries have undertaken reforms in recent years to make early retirement less attractive and to encourage people to work longer by offering higher pensions to people who retire later.

The Strategy Group subscribes to this school of thought.

**Latvia:** an early retirement pension for "persons, who until 1996 worked under particularly hazardous and arduous conditions may retire from the age of 54 years and 6 months to 59 years and 6 months".

**Poland:** an early pension for persons "born before 01/01/1949 working in unhealthy conditions or performing a specified type of work (official list) - 5 years early (e.g. journalist, glass workers, rail workers), 10 years earlier (miners, persons working with lead, cadmium or asbestos, steel workers, pilots, divers) or 15 years early (wind instrument musicians)".

**Portugal:** a retirement age of "as a rule of 55 years of workers involved in heavy or unhealthy work".

**Spain:** The legal age of retirement "can be reduced for certain groups whose professional activity is arduous, toxic, dangerous or unhealthy".

The Strategy Group underlines that an approach to secure a balance with regard to the retirement age of manual workers and non-manual workers through a pension system that incentivises rather than penalises persons to continue to remain active in the labour market is its preferred approach. It is also a fairer approach as it does away with a 'one size fit' approach that would affect manual and non-manual works alike that would result from the introduction of a longevity indexation mechanism. Be that as it may, the Strategy Group acknowledges that a degree of social cost should be borne by the person who opts for leisure once s/he meets the criteria set in Article 62A and exits the labour market.

The Strategy Group, therefore, recommends the introduction of following measures directed to incentivise persons who would have met the criteria of Article 62A to remain active in the labour market:

- A person will receive the following top-up to his or her pension in the event he or she remains in employment between 62 and 64 years of age:

  | | |
  |---|---|
  | 62 years of age: | 2% top up to the pension value. |
  | 63 years of age: | 2% top up to the pension value. |
  | 64 years of age: | 4% top up to the pension value. |
  | 65 years of age: | 4% top up to the pension value. |

  This will constitute a permanent increase in the person's pension income. The proposed incentive is with intent designed not to be actuarially fair.

- To give a better incentive to those working, the Group recommends that the number of contributions that need to be paid (i.e. not credited) for one to retire earlier than actual retirement age, should be established to be at least 7/8s (35 years) of the total required (Invalidity Pension credits would be considered as paid for this purpose). This condition would apply only for those born in 1962 or after and introduced gradually as follows:

  - Those born from 1962 to 1968 – no change (to keep with principle of informing of changes 15 years in advance)

- Those born in 1969 – 31 years need to be paid.
- Those born in 1970 – 32 years need to be paid.
- Those born in 1971 – 33 years need to be paid.
- Those born in 1972 – 34 years need to be paid.
- Those born in 1973 or after – 35 years need to be paid.

The Strategy Group underlines that the above is reviewed every 5 years in line with future changes resulting from Recommendation 12.

**Recommendation 13: Incentivising Late Exits from the Labour Market**

The implementation of Article 62A provides an 'exit route' from the labour market despite of the Statutory Pension Retirement Age set respectively for the Transitional Group and the Switchers Group. The Pensions Strategy Group, therefore, recommends the following measures directed to incentivise persons to remain active in the labour market:

- A person will receive the following top-up to his or her pension in the event he or she remains in employment between 62 and 65 years of age without claiming pension:

  | | |
  |---|---|
  | 62 years of age: | 2% top up to the pension value |
  | 63 years of age: | 2% top up to the pension value |
  | 64 years of age: | 4% top up to the pension value |
  | 65 years of age: | 4% top up to the pension value. |

  This will constitute a permanent increase in the person's pension income.

- To give a better incentive to those working, the Group recommends that:

  The number of contributions that need to be paid (that is, not credited) for one to retire earlier than actual retirement age should be established to be at least 7/8s (around 35 years) of the total required (Invalidity Pension credits would be considered as paid for this purpose). This condition shall apply only for those born in 1962 or after and introduced gradually as follows:

  - Those born from 1962 to 1968 – no change (to keep with principle of informing of changes 15 years in advance)
  - Those born in 1969 – 31 years out of 41 years need to be paid
  - Those born in 1970 – 32 years need to be paid
  - Those born in 1971 – 33 years need to be paid
  - Those born in 1972 – 34 years need to be paid
  - Those born in 1973 or after – 35 years need to be paid.

The above is being proposed to be reviewed every 5 years in line with future changes resulting from Recommendation 12.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.2.4 Incentivising the Deferral of a Retirement Decision

As stated in the previous sub-section of this report but of critical importance to re-iterate the Group is not in agreement with a reform resulting in the introduction of an indexation mechanism that links the SPRA with longevity as recommended by the 2010 PWG. Many OECD countries have undertaken alternative reforms in recent years to make early retirement less attractive and to encourage working longer by offering higher pensions to people who retire later.

Actions, for example, have been taken by jurisdictions on how to improve the participation rates of workers past the SPRA in terms of encouraging them to remain in the labour market. This is the preferred approach of the Strategy Group with regard to ensuring that people remain active for longer in the labour market.

The Strategy Group is of the considered opinion that a policy approach that incentivises persons to defer their decision to retire once they reach the transitional SPRA or the 65 years of is likely to have a far more pervasive impact than one that mandates a person to remain in the labour market on the basis of longevity, irrespective of the state of health, type of work or otherwise of the said person.

The Strategy Group recommends that a person who opts for late retirement - that is s/he remains in employment post the SPRA of 65 years and defers his or her pension (that is he or she does not claim the pension) during his or her period of continued employment will on eventual retirement, receive a far higher pension income for life. It is further proposed that the derived right to such a higher pension income would also be enjoyed by the widow/er upon the decease of the said pensioner.

Countries apply different deferral rates. In Denmark, in line with the semi-automatic adjustment of the pension age, workers can defer receipt of the public basic pension for up to ten years. The pension is then increased by the ratio of the period of deferral to average life expectancy at the time the pension is claimed.

For example, the projected life expectancy for a 68 year-old will be 17.1 years; the increase of the pension for postponing the claim from 67 to 68 would be 1: 1.7, which is 5.8%. In the UK, late claim of the State pension increases the retirement income at a rate of 1% for every five weeks of delay, resulting in a 10.4% extra for a complete year of deferral.[64] The Table below presents incentive rates applied by other countries with regards to annual incentive increases.

**Table 16: Incentives for Every One year of Pension Deferral**

| Country | Annual Increase |
|---|---|
| | |
| Finland | 7.20% |
| France | 5.00% |
| Switzerland | 5.2% to 6.5% |
| Japan | 8.40% |

The Strategy Group recognises that careful attention is required to determine the appropriate actuarial incentive that is to be accrued to the pension income to incentivise individuals to work beyond the SPRA. The Table below presents an actuarially neutral adjustment rate for late retirement.

**Table 17: Actuarial Neutral Adjustment Rate for Late Retirement**

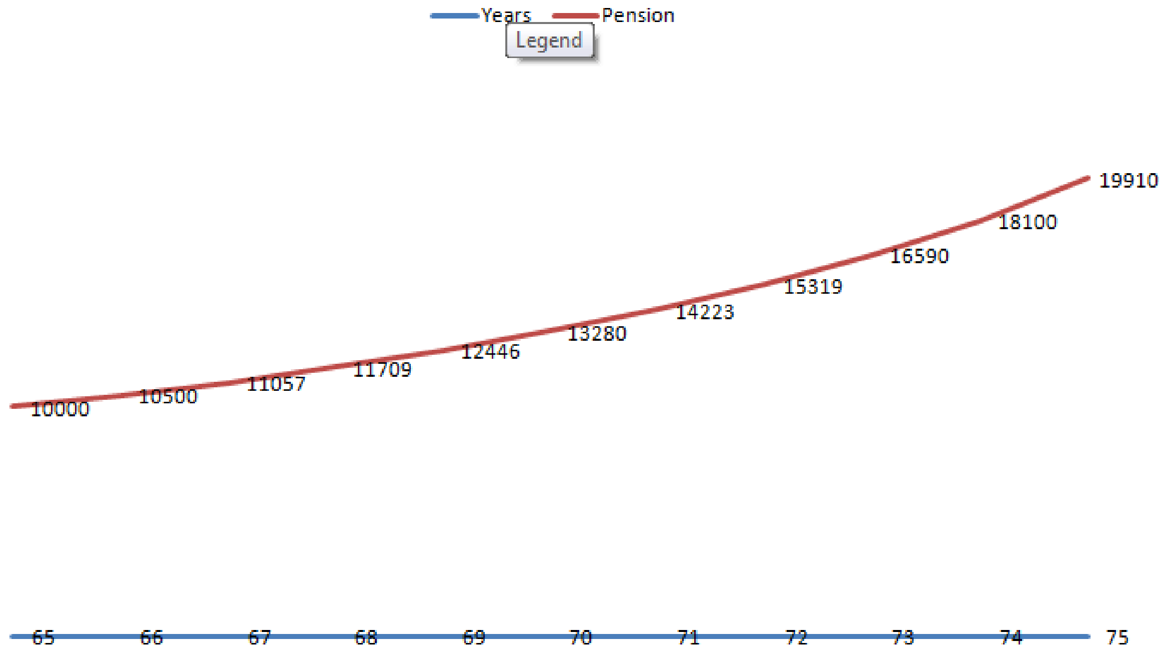
| Years | | Longevity Unisex | Annual Adjustment |
|---|---|---|---|
| | | | |
| 65 | Switchers | 19 | 5.0% |
| 66 | | 18 | 5.3% |
| 67 | | 17 | 5.6% |
| 68 | | 16 | 5.9% |
| 69 | | 15 | 6.3% |
| 70 | | 14 | 6.7% |
| 71 | | 13 | 7.1% |
| 72 | | 12 | 7.7% |
| 73 | | 11 | 8.3% |
| 74 | | 10 | 9.1% |
| 75 | | 9 | 10.0% |

[64] Pg 102, Review of the Irish Pension System: Preliminary Version, OECD, April 2013

A person who defers his or her retirement and pension beyond the SPRA will see the pension increase in a compound manner. The Figure below demonstrates how such Actuarial Neutral Adjustment Rates for Late Retirement, positively impacts a person who opts for a late retirement.

This is demonstrated in the following example: a person who is 65 years of age and can retire with a pension income of €10,000 and who decides to continue working up to 68 years. Should such a person retire at 68 years of age his or pension income would increase to €11,708. In the event that this person decides to defer his or her retirement to 70 years of age, his or her pension income would increase permanently to €13,280.

**Figure 26: Impact of Actuarial Neutral Adjustment for a Person who is in receipt of a €10,000 Pension at the Statutorily Retirement Age and Defers Pension whilst remaining Active in the Labour Market**




**Recommendation 14: Incentivising the Deferral of a Retirement Decision**

The Pensions Strategy Group recommends that a person may opt for late retirement - that is s/he remains in employment post the Statutory Pension Retirement Age of 65 years of age and during which period s/he defers his or her pension until he / she formally retires - will on eventual retirement receive a far higher pension income for life; the derived right of which will also be enjoyed by the widow/er. A person who defers his or her retirement and pension beyond 65 years will see the pension increase annually in a compound manner for every full year of deferment.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.2.5 Defining the Guaranteed National Minimum Pension

The 2007 reform introduced the concept of the GNMP. The SSA in Section 50A defines the GNMP to be "payable at such a rate being not less than sixty percent of the National Median Income as the Minister may, with the concurrence of the Minister responsible for finance, by order under this article from time to time establish and in any case such Guaranteed National Minimum Pension shall not be less than that established for the preceding year".

At the time this amendment was made to the SSA, the Government had as yet to determine which yardstick was to be adopted to determine and benchmark the 'national median income'. Moreover the current legislation besides leaving this level of uncertainty and the determination of the national median income at the discretion of Ministers does not specify the precise time-frame for any updates in its value, which could result in its relative value decreasing dramatically over time.

In this light, the Strategy Group argues strongly that the parameters governing the value of the GNMP needs to be specified clearly and in a way that allows it to evolve gradually upwards while maintaining positive incentives for individuals to contribute to the pension system. This leads the Pension Group to present a number of recommendations.

First, the Group recommends that the GNMP should be introduced for all pensioners with effect from 1st January 2016. The Strategy Group assessed a number of options of how the GNMP should be implemented. A big bang approach that places all pensioners born before 1941 on the GNMP as from 1st January 2016 is far too costly and, thus, not sustainable. The Group concludes that the best option that should be adopted is that where the GNMP is offered gradually, starting from 2016 for all those born in 1941 or before and gradually lower age of access every year so that those born in 1960 and 1961 would qualify for the GNMP in 2026. Those born in 1962 or after already qualify for it from 2027 onwards.

Secondly, the Strategy Group further proposes that the GNMP should be set at the poverty threshold level available in 2016 (2016 is the proposed point of entry of the gradual phasing in of GNMP for all in line with current Government's Electoral Manifesto proposal). Thereafter the GNMP increases by the full COLA for that year plus any difference between the full COLA and the income level resulting from the application of an indexation of 50% wages and 50% inflation. This means that the increase on the GNMP through the application of the full COLA would constitute the minimum increase.

The adoption of this recommendation would secure that (i) the initial level of the GNMP is set at a level consistent with a poverty alleviating income level; (ii) as a minimum, the GNMP will increase from year to year on the basis of the full COLA; thereby ensuring that its purchasing value of the GNMP is protected over time; (iii) the GNMP reflects growth in wage levels, through the indexation formula and maintains the relativity with the maximum pension which is being proposed to be indexed in the same way; (iv) will ensure equity amongst pensioners with relatively lower incomes as persons will receive the same level of pension value irrespective of the year they retire.

Finally, the Strategy Group is cognisant of the fact that over time the relative poverty threshold may grow at a different rate than the proposed indexation. To ensure, therefore, that the GNMP remains, over the continuum of time, adequate and sustainable, the five year strategic review mandated by the SSA will be tasked to present recommendations on whether its level would need to be adjusted.

**Table 18: Incremental Implementation of the New Definition of the GNMP**

| Age | Year |
|---|---|
| | |
| **76 and over** | 2016 |
| **75** | 2017 |
| **74** | 2018 |
| **73** | 2019 |
| **72** | 2020 |
| **71** | 2021 |
| **70** | 2022 |
| **69** | 2023 |
| **68** | 2024 |

| | |
|---|---|
| **67** | 2025 |
| **66** | 2026 |
| **65** | 2027 |

At present the GNMP does not specify a married rate. This reflected the understanding that as time went by, both members of a pensioner household would qualify for a GNMP in their own right. The Strategy Group, however, believes that given the importance of the GNMP in alleviating poverty, since pensioner couples with just one income are still likely to be present in society and may be the most at-risk-of-poverty, it recommends that a top-up is added to the Supplementary Allowance to ensure that married pensioners will not be exposed to being at risk of poverty.

**Recommendation 15: Defining the Guaranteed National Minimum Pension**

The Pensions Strategy Group recommends that the Guaranteed National Minimum Pension should be set at poverty threshold which is known as at 1st January 2016 (2016 is the proposed point of entry of the gradual phasing in of the Guaranteed National Minimum Pension for all in line with the current Government's Electoral Manifesto proposal). Between 2017 and 2026, the GNMP increases by the full COLA for that year plus any difference between the full COLA and the income level resulting from the application of an indexation of 50% wages and 50% inflation. Thereafter, the Guaranteed National Minimum Pension will increase cumulatively on the basis of the full COLA plus any difference between the full COLA for that year and the change in the maximum pension (resulting from the 70/30 indexation mechanism) as is already the case for persons due to retire after 2026. The value of the Guaranteed National Minimum Pension will be further reviewed every 5 years, as part of the strategic review of the pensions system, with the next review due by 2020.

The proposed Guaranteed National Minimum Pension mechanism should be introduced in a phased manner for all pensioners targeting at the first instance the most vulnerable pensioners: pensioners who as at 1st January 2016 are 76 years of age and over. Thereafter, the Guaranteed National Minimum Pension should be extended to further pensioners on the basis of the following implementation schedule:

| Age | Year |
|---|---|
| | |
| **76 and over** | 2016 |
| **75** | 2017 |
| **74** | 2018 |
| **73** | 2019 |
| **72** | 2020 |
| **71** | 2021 |
| **70** | 2022 |
| **69** | 2023 |
| **68** | 2024 |
| **67** | 2025 |

| | |
|---|---|
| **66** | 2026 |
| **65** | 2027 |

The Guaranteed National Minimum Pension does not specify a married rate and hence pensioner couples with just one income will be at-risk-of-poverty. To counter this, the Pension Strategy Group recommends that a top-up is added to the Supplementary Allowance to ensure that married pensioners on the Guaranteed National Minimum Pension will not be exposed to being at risk of poverty.

As a further a measure to combat poverty and social exclusion, the Group is of the considered opinion that the Old Age Pension (OAP) should be directly linked to the National Minimum Wage so that any increases to the latter would automatically result in increases to the Old Age Pension. This would result in an immediate increase to non-contributory old-age pensioners.

**Recommendation 16: Establishing Relativity of the Old Age Pension with the National Minimum Wage**

The Strategy Group is of the considered opinion that the Old Age Pension is linked to the National Minimum Wage so that any increases to the latter would automatically result in increases to the Old Age Pension. The following is recommended:

| **Single** | **66.7% of the National Minimum Wage** |
|---|---|
| | |
| **Married (both qualify)** | 80% of the National Minimum Wage |
| | |
| **Married (one qualifies)** | 50% of the National Minimum Wage - with the rest of the COLA adjustment to be paid through social assistance payable to the spouse under 60. |

### 04.2.6 Synchronising the Old Age Pension Retirement Age with Article62(A) of the Social Security Act

The 2007 reform, as well as the 2010 Strategic Review, gave no consideration to the importance of ensuring that the retirement age should not only be consistent across gender but also across different forms of retirement pensions: non-contributory as well as contributory. Thus, whilst the statutory retirement age, for women, was raised from 60 years to 61 years of age, there was no similar recommendation to lift the retirement age for the OAP from 60 years to 61 years of age.

This was an oversight given that the focus at the time was narrowly directed towards the contributory retirement pension. The number of households who are in receipt of an OAP is relatively considerable: 203 married households, and 3,022 single households.

The Strategy Group considers the retirement age of 60 years of age for the OAP as a potential ‘formalised’ exit route from the labour market. The Strategy Group, therefore, recommends that this is increased to 61 years of age to render it consistent with Article 62 of the SSA.

**Recommendation 17: Synchronising the Old Age Pension Retirement Age with Article62(A) of the Social Security Act**

The 2007 reform did not increase the retirement age of the Old Age Pension to render it consistent to reforms presented in Article 62(A). This was the result of oversight. The Pensions Strategy Group considers the retirement of 60 years of age for the Old Age Pension as a potential 'formalised' exit route from the labour market and recommends that this is increased to 61 years of age to render it consistent with the contributory retirement age. The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

It is proposed that this measure is introduced incrementally with implementation to initiate in 2016 and scheduled as shown in the Table below.

| Age | Born |
|---|---|
| | |
| **62 years** | 1954 and 1955 |
| **63 years** | 1956 to 1958 |
| **64 years** | 1959 to 1961 |
| **65 years** | In or after 1962 |

## 04.3 Reforms outside of the Pension System to ensure that it is not the Only Source of Income

### 04.3.1 Introducing Incentives for a Voluntary Third Pension

The Technical Committee on the Third pension presented a report to the Minister for Finance in January 2014. This was followed by a consultation exercise with the key financial service providers. The recommendations proposed that the introduction of the Third pension should be supported by a fiscal incentive framework directed to reinvigorate the culture of long term savings for retirement. An increase in higher private saving can help address the possible pension adequacy gap that may evolve over the next decade due to the gradual weakening of the generosity of State pension.

**Supplementary Paper No 3** titled **'Supporting Retirement Saving (SRS) Incentives Scheme**' presents a synthesis of the technical report presented to the Minister of Finance. The recommendations presented to the Minister of Finance included the following main features of the scheme:

- The SRS incentives scheme is composed of two components. The first component is the provision of a tax refund on contributions to a personal retirement scheme (PRS) up to a maximum of €1,000 a year. Moreover any investment income or gains made on these qualifying contributions will be exempt from income tax. The second component allows for the setting up of a special deposit account, termed as an Individual Saving Account (ISA), allowing for an annual deposit of a maximum of €1,000. Any interest earned on ISA balances is tax free.

- The Scheme was presented to the HoR in late July 2014 and a budget of €1.5 million allocated. Initial projections indicate that based on the experience of the UK and countries with similar schemes, when demand for such types of savings matures, the cost of tax relief, under the conditions envisaged, could eventually rise to €5 million.

- For a saving product to be deemed and to be eligible for tax incentives, a PRS requires to fulfil the following criteria:

  (i) Schemes need to operate under the Retirement Pensions Act.

  (ii) Benefit payments shall not start earlier than age 50 or later than 70.

(iii) Only up to 30% of assets can be given as a lump sum, the rest through annuity or drawdown in accordance to regulations.

(iv) Schemes will be subject to specified investment restrictions under the Retirement Pensions Act.

(v) Schemes are to have transparent charges and provide regular information to savers. While individuals will be free to contribute more than the maximum amount eligible for tax refunds, scheme operators will need to maintain separate records for qualifying and non-qualifying contributions. At any one point, individuals will have to hold all their qualifying contributions into one PRS.

- At any one point, individuals are allowed to have only one ISA with a licensed banking institution. Accumulated deposits will be allowed to be transferred to an alternative provider once a year. This provision is meant to reduce administrative costs and induce banks to compete on the level of interest they offer. Once an amount is withdrawn from an ISA, it cannot be deposited back, and unutilised deposit allowances will not be transferrable over successive years.

- Taken together, if individuals on middle income levels save the maximum amounts, based on conservative return assumptions, income from these savings would more than compensate for the projected decline in the relative State pension generosity resulting from the 2007 reform. Granting higher allowances than those envisaged under the new Third pension would unduly benefit those on high incomes. Allowances, however, would be reviewed every five years and their relative value would be maintained.

The Third pension is supported by a fiscal incentive scheme that is primary directed towards providing support for those on low to middle incomes to save €1,000 annually for their retirement. Thus, the fiscal incentive scheme is pegged on a single rate of tax of 15% as against providing for tax relief at effective marginal rate of tax. This means that all taxpayers will get the same amount of tax refund for the amount of savings they make. One of the added benefits of applying this rate of tax relief would be to effectively increase the minimum tax threshold by a maximum of €1,000 for low-income individuals opting to save in a PRS. On the other hand, people on high incomes who are already saving will get little material benefit from carrying on with the same saving behaviour as before. As a result, rather than providing for tax relief at the effective marginal rate of tax, the use of a single rate of tax, namely 15% was recommended. The initial maximum tax refund would be of €150 a year.

The decision to adopt this initial level of pension contribution allowance is based on the forecasts made in the 2010 PWG which projected that the APPR of the RP will decline from 54.7% to 45% in 2060. To compensate for a projected drop between pension income enjoyed by pensioners today and that which will be enjoyed by future pensioners, the 2010 PWG proposed a carve-out of NI contributions of approximately 4% of wages. This was deemed to result in a replacement rate of 9.2% by 2050, offsetting the drop in relative State pension generosity. The Central Bank of Malta's survey on Household Finance and Consumption Survey indicates that, on average, the saving rate in Malta is 4% with median annual household savings of €3,000.

The Technical Committee modelled the return from a constant saving of €1,000 for a person aged 25 years. The decision to establish €1,000 as the pension saving value is that this sum is equivalent to 5% of current gross wages – marginally above the average saving rate. A person who is 25 years of age today has a life expectancy of 22 years at age 65 years. The modelling assumed an average inflation rate of 2.5%, a real rate of return at 2.5% and a real wage growth at 1.5%.

On reaching 65 years, the individual's accumulated pension pot would be converted into a fixed-sum annuity or drawdown arrangement (also earning a 2.5% real interest rate). This fixed-sum annuity or drawdown would be equivalent to a replacement rate of 9% (of the contemporary wage in 40-years' time) if one assumes that no lump sum is taken (equivalent to a maximum of 30%). In the event that the full 30% lump sum is taken, then, the replacement rate would fall to 5.6%.

The initial allowance set was calculated on the basis of the anticipated drop in average generosity envisioned in the 2010 PWG review. The new projections suggest that there will not be any decline in generosity for those retiring in 2060. The Group, however, is of the considered opinion that the proposed initial allowance should be maintained so as to increase the adequacy of the system and also reduce reliance on the first pillar.

**Recommendation 18: Introducing Incentives for a Voluntary Third Pension**

The Pensions Strategy Group supports the recommendations of a Technical Committee to the Minister of Finance with regard to the contribution allowance, the key eligibility criteria, and the amendments to the Social Security Act, the Income Tax, and supporting Legal Notices respectively.

#### 04.3.2 Nudging Persons to Save for Retirement

The Third pension scheme proposed by the Technical Committee on the Third Pension as shown in the Section above is a 'voluntary scheme'. Traditional economic theory underlines that a person acts rationally, where-in throughout his or her lifecycle s/he borrows when young, saves in middle age and builds wealth, and spends his or her savings in old age. In truth, a person does not act rationally when s/he comes to plan long term.

Behavioural economics suggests that people cannot rationally plan over their lifetime, so instead display biases and use judgements based on rules of thumb or social and cultural norms. Behavioural economics recognises that people use heuristics, or mental short cuts and biases, to help them make behavioural choices. The Box below looks at the common types of heuristics that influence behaviour.[65]

| Box 04 | Common Types of Heuristics that Influence Behaviour |
|---|---|
| Anchoring | People find it easier to judge issues that are far away or uncertain by referencing something that is familiar. When judging retirement income, people may use a rule of thumb based on their current income or wealth and not on what their future needs might be. Research suggests that the further one is from retirement, the higher is the uncertainty of what the future may hold and, hence, the least likely to have a realistic assessment of what their standard of living will be like in retirement. |
| Inertia | One of the most powerful heuristics is that of habit or inertia – that is the tendency for people to simply do what they have always done, without giving it a lot of conscious thought. Inertia is also one of the key barriers associated with saving privately for later life, where some people know they should save for retirement, but tend not to do anything about it or find reasons for not doing it. Research suggests the younger a person is, the less likely they are to place savings for retirement as a priority. This cohort of persons is the least likely to have a private pension, so this result might be symptomatic of a lack of engagement in pension issues. |
| Availability | People often display bias according to the availability or ease with which they can imagine the possibility or consequences of something happening. Research suggests the persons in the lower age groups are likely to see the pension system as something which will always be there, and which will provide them with the same level of income during retirement as that received by their parents. |
| Loss Aversion | A natural bias people have is a tendency to be loss averse – they feel a current loss more keenly than a longer-term reward. Through observations of people's behaviour, it has been suggested that people display what has been described as a lack of self-control, with people taking a short-term view of planning for later life and over-consuming in the short-term. |

[65] Pp 52-56, MacLeod, P., Fitzpatrick, A., Jones, A., et al. Attitudes to Pensions: The 2012 survey, Research Report, No 813, Department for Work and Pensions, 2012, UK

Given these types of heuristics that influence behaviours, policy designers have sought to overcome such barriers by introducing special tax arrangements or tax incentives to encourage retirement saving. This is what the Third Pension, discussed above, seeks to do.

The OECD 2012 analysis, however, shows that younger persons tend to be less often enrolled in voluntary private personal pensions (which are defined to include occupational retirement pensions as well as private voluntary pensions). In Ireland, as in other OECD countries where voluntary private pensions are prominent, coverage increases with age. The coverage rate in voluntary private pensions generally increases with income, reaching a plateau after the 7th or 8th income deciles. In voluntary systems, however, the coverage among the poorest income groups is quite low, at around 15%, except in the United States where it reaches 29%.[66]

The **Supplementary Paper No 3** titled **'Nudging Persons to Save for Retirement'**, suggests that when people are left by themselves to provide for retirement, empirical evidence shows that some of them will not save enough for retirement. Estimates in Ireland, for example, show that 41.3% of the individuals working in the private sector aged 20 to 69 are covered by a voluntary private pension plan. Of these, 31% are covered by occupational private pension plans, while only 12% are covered by personal pension plans. Similar rates of coverage for occupational pension plans are reported in Canada and the United Kingdom.[67] The coverage of personal voluntary pension plans is very low (below 5%) in countries such as Greece, Luxembourg, Portugal, and Turkey.[68]

The low take-up of voluntary private pensions (excluding occupational retirement pensions) is a direct result of the types of heuristics that influence behaviours for generational planning as is the case with regard to saving for retirement.

It is pertinent to note, however, that Germany, on the other hand, experienced an important increase in coverage thanks to the introduction of *Riester* pensions in 2001 as part of a major pension reform. *Riester* products can be purchased by anyone covered by the social insurance system, and who is subject to full tax liability. Participants qualify for subsidies or tax relief from the government, the level of which depends on the respective contribution rate and number of children. To receive full State subsidy, pension participants must invest at least 4% of their previous year's income in a *Riester* plan.[69]

In order to reduce these barriers and encourage people to save enough for an adequate retirement income, a number of governments have introduced mandatory opt-in voluntary opt-out, or automatic enrolment schemes. Such schemes are directed to capture young people in the labour market automatically and hence countering behaviour limiting issues such as myopia or inertia. By automatically capturing young people early, it is believed that they are more likely to remain within the pension scheme, given that they will structure such investment as part of their long term savings profile, before they assume long term expenditures resulting from, say, a decision to raise a family or other responsibilities.

Automatic enrolment is, therefore, intended to work by turning on its head the inertia that inhibits saving. Automatic enrolment, thus, overcomes people having to make a proactive decision today about their future, as they are automatically saving for a private pension - unless they decide to opt out.

Evidence from countries that have adopted such schemes shows that the application of automatic enrolment has a pervasive impact. In the United States, case studies show that the changing of the design of pension plans (for example the 401(k) plans) and making enrolment the default option, has resulted in increased enrolment and membership of similar schemes among new employees - ranging from around 20-40% to around 90%.[70]

[66] Pg 65, Ibid
[67] Ibid
[68] Pg 188, Pensions at a Glance: 2013, OECD and G20 Indicators, OECD 2013
[69] Pg 119, OECD Pensions Outlook: 2012, OECD
[70] Pg 9, Enabling and encouraging saving: the evidence around pension reform and saving, Department for Works and Pensions, February 2013, UK

New Zealand has experienced a substantial increase in coverage as a result of the introduction of a similar automatic enrolment pension supported by government subsidies. Until the introduction of the "KiwiSaver" pension scheme in 2007, coverage rates had declined to less than 10% of the working-age population. By June 2012, enrollment in the KiwiSaver pension scheme had reached 68%. Italy has been less successful in raising coverage rates after the introduction of automatic enrolment in 2007, with private pension plans covering 13.3% of the working-age population at the end of 2010.[71]

As stated earlier, the Strategy Group has proposed that the Strategic Review, which is entrenched in the SSA, is supported by a permanent pension commission. The current Strategic Review milestone is this year. 2015 is far too early to assess the performance of the SRS scheme given that this is in its infancy. The Strategy Group proposes that in the 2020 Strategic Review, the permanent pension commission should undertake an in-depth review of the performance of the SRS scheme.

In the event that the Review shows that the SRS scheme would not have delivered as planned, the Review should give strategic consideration to recommending a mandatory opt-in voluntary opt out scheme, where the employer is responsible for managing the administration aspects of the scheme, and the government is responsible for the design of the fiscal incentive framework of the scheme.

**Recommendation 19: Nudging Persons to Save for Retirement**

The Supporting Retirement Pension Scheme that is to be introduced in 2014 may be subject to heuristics which will influence behaviour with regard to long term planning and savings, particularly given that the scheme is completely voluntary. The Pensions Strategy Group recommends that during 2020 Strategic Review, the proposed pension commission (Recommendation 10) should carry out an in-depth review on the performance of the scheme. In the event that the Review shows that voluntary pensions would not have delivered as planned, it should strategically assess the introduction of Mandatory Opt-In Voluntary Opt Out framework, which would see the employer responsible for managing the administration aspects of the scheme and the government responsible for the fiscal incentive is carried out.

### 04.3.3 Accessing Wealth Accumulated in Property for Retirement Income

76.4% of persons in Malta[72] own (freehold and ground rent) their home. For the majority of people, buying a home is the single largest investment made in their lifetime. By the time they reach retirement age they would have paid most of the borrowing they used to purchase their home. In owning their home, as they near retirement, persons would have built up considerable amount of equity in their home. The value of the property, thus, constitutes a high proportion of accumulated wealth of most older persons.

The high level of property ownership in Malta means that most persons are asset rich but cash poor. Today, there is no formal home equity market in Malta that is governed and regulated. Yet, there are people who do release value from their property as they retire. Some persons will downsize by selling their home and move into a smaller house. Others enter into arrangements with private providers of residential homes for the elderly in exchange of their property. Yet many others may have homes worth significant equity but limited savings with the State pension acting as the main source of income during retirement.

**Supplementary Paper 04** titled **'Accessing Wealth Accumulated in Property for Retirement Income'** looks at the equity release market within the context of Malta's property market and household savings. The 2004 PWG, in its final report, had recommended that the financial services market should offer a regulated property pension scheme as a Third pension product. It had underlined that property should not be seen as a substitute source of retirement income to a Second and Third Pillar pension respectively – but rather as a complement thereto. It emphasised that further research is carried out regarding the need or otherwise of a tailored regulatory regime for such plans,

[71] Pg 48, OECD Reviews of Pensions Systems: Ireland, OECD, 2014
[72] Census of Population and Housing 2011, Final Report, National Statistics Office, Malta, 2014

and other related areas such as inheritance law and taxation and that supporting educational campaigns should accompany at any time any availability of these types of products.

The 2010 PWG had recommended that the Ministry responsible for Pensions and that the MFSA, should consider studying the introduction of a regulated home equity release market directed to allow a person to boost his or her retirement income without the need to sell his or her property during his and his spouse’s lifetime. Not all members of the PWG 2010 were comfortable with a recommendation for the setting up an Equity Release Scheme (ERS) market in Malta. A minority argued that such an ERS market would result give rise to the following issues:

(i) A danger that a large stock of property may end up concentrated in the hands of a small number of private sector players.

(ii) That whilst the local housing market has traditionally proven to be stable it does not mean that Malta will not suffer declines in the prices of housing or for the matter that it may never suffer a negative equity collapse.

(iii) Increased investment in property which may create further pressures on a sector that is categorised by a high number of vacant property.

It is the view of the Strategy Group that an 'informal' ERS market is actually in place today. It is known that private owners of residential homes enter into agreement with private providers of residential home care where-in the residential home is exchange for a place within the private care institution. There is no legislation in place for ERS today and thus, such ‘consumers’ have no protection.

Furthermore, the fact that there is no formal ERS market, results in a state of play where the 'home' exchange is taking place with a very limited number of private care elderly providers. De facto this is resulting in a concentration of homes with very few private market players.

Malta, therefore, has a lacuna in the market for equity release products on older people's homes' value who are asset rich and income poor. Over the next decade, the number of older people will increase substantially, so using personal wealth more effectively to pay for day to day costs assumes greater importance. Establishing an ERS market is not a panacea. It is recognised that an ERS has risks and good governance through regulation is of significant importance.

Be that as it may, denying elderly people who are asset rich and income poor from a regulated and formalised ERS market is not acceptable particularly if participation in long term saving products remains low.

A potential model that may be considered to counter the issue of property concentration is the creation of a Home Equity Bank. The Home Equity Bank would take the form of a public agency that is underwritten by the State whose primary function would be to enable people to release equity from their homes in return of an income which is payable for life. A Home Equity Bank may result in advantages and disadvantages as shown in the Table below.[73]

[73] Mayhew, L., Smith, S., The UK Equity Bank - Towards Income Security in Old Age, City University London, 2014

| Box 05: Advantages and Disadvantages of a Home Equity Bank | |
|---|---|
| **Advantages** | Disadvantages |
| | |
| Older Person | |
| | |
| Older people who are asset rich and income poor are able to convert part of their assets to income. This will allow them to have a more comfortable retirement and fewer financial worries. | If the income is not directly linked to house prices then users may feel that they did not get a 'fair share' assuming they have given up a percentage of their home. |
| Assuming that the income is inflation protected (either linked to inflation or house prices (though this could lead to a more volatile income)) the improvement will be durable. | |
| The asset income exchange can be priced with only an allowance for administration costs, hence giving higher income than if bought from a commercial provider. | |
| Individuals normally trust government financial institutions more than commercial firms and so should enjoy greater peace of mind. | |
| Unless the whole value of the home is used, users will still benefit from rising house prices. | |
| | |
| **Government** | |
| | |
| **The Equity Bank will help reduce pensioner poverty and improve well-being and help people to remain in their homes for longer and keep them in better order.** | If house prices go up a lot there could be pressure to increase income but not the other way around, in which case Government would be faced with difficult choices (again, only if a percentage of the home is given up). |
| **It will help make a contribution to care costs when and if they are required, and help moderate growth in state funded social care.** | If a person dies early there could be pressure on compensation to heirs (but again not the other way around). The scheme could be designed to avoid large financial loss but this would mean generating less income. |
| **If house prices go up this could be an additional source of profit for Government (but only if a percentage of the home and not a fixed sum is transferred into state ownership).** | Heirs may contest that their elderly relation did not understand what they were doing, which underlines the necessity for good financial advice. |
| | There is an upfront cost and depending on the age offered there could take several years to break even. |
| | |
| **Heirs** | |
| | |
| **Heirs would see a member of family with more income in old age and potentially take some financial pressure from their shoulders.** | Heirs would lose some of their inheritance – this would be particularly distressing if a family member dies early unless there is protection built in for early death. |
| **If family member has to go into care the net cost of the equity release will be lower than expected due to it being more likely that the government will fund more of the care costs due to means testing.** | |

| Private Sector Market | |
|---|---|
| | |
| **If equity release becomes more popular as a result of the introduction of the Equity Bank, commercial providers might receive more business from those outside the qualifying criteria.** | They would be up against a new competitor that can borrow money cheaper, has a different pricing mechanism and has a better 'brand' of trust so sales will be harder. |
| **The Government may decide to franchise the product in which case commercial providers could compete with, as well as against, the Equity Bank.** | |

To kick-start the process, the Strategy Group proposes that Government should conduct a study of how large the informal ERS market is, and carry out a study of the possible take-up of more formal arrangements.

Government would also need to study how to finance the setting up of the Home Equity Bank, either through EU Social funds or borrowing from multilateral institutions, such as the European Investment Fund. An alternative approach would be to get funding from the National Development Bank mentioned in the Government's electoral manifesto. Private providers should be allowed to participate in this market, and there should be an appropriate market regulatory framework.

**Recommendation 20: Accessing Wealth Accumulated in Property for Retirement Income**

The Pensions Strategy Group proposes that the Government should conduct a study to assess the scale of the informal Equity Release market, and carry out a study of the possible take-up of more formal arrangements including the setting up of the Home Equity Bank, either through EU funds or borrowing from multilateral institutions, such as the European Investment Fund or the National Development Bank mentioned in the Government's electoral manifesto. It is proposed that the Government initiates work on this recommendation *at the earliest possible*.

### 04.3.4 Inculcating a Culture of Literacy with regard to Financial Savings and Investments and Retirement Income

In both developing and developed countries, the awareness of the importance of financial education and knowledge of retirement income, has gained significance with particular regard to ensuring that persons become more understanding of the importance of saving for one's retirement. As financial market instruments have become more sophisticated, people are more likely to make errors when choosing and using financial products, and can suffer considerable losses as a result. Thus, financial education is also directed at equipping persons with competencies and knowledge of how predictable mistakes when choosing and using financial products are minimised.

Similar to the default bias of heuristics with regard to long term planning for saving for one's retirement as discussed in the previous section, biases affect consumer choice and decisions in the retail markets. This manifests in a number of ways including:[74]

- Most consumers find financial products complex, unpleasant and time-consuming. Consumers often lack motivation to invest time and effort to make informed decisions and, because of the complexity, cannot easily evaluate some products at all. Financial products have little inherent interest for most people and practical cognitive limitations, for example with numeracy and literacy, make many product concepts and descriptions difficult to understand.

- Many financial decisions require assessing risk and uncertainty. People are generally bad (even terrible) intuitive statisticians and are prone to making systematic errors. The influences on

[74] Pg 16, Eta, K., Hunt, S., et al, Applying behavioural economics at the Financial Conduct Authority, Occasional Paper No.1, Financial Conduct Authority, UK, 2013

assessments of risk and uncertainty in insurance and investment markets may be subtle and opaque even to experts.

- Financial decisions may require making trade-offs between the present and the future. Saving and borrowing decisions, for instance, often give rise to self-control problems and may result in procrastination, for example consumers may over-borrow on a credit card, and then not pay it back when they originally intended to.

- Many financial decisions are emotional. Emotions such as stress, anxiety, fear of losses and regret can drive decisions rather than the costs and benefits of the choices, for example fear might drive the purchase of an expensive insurance policy for a mobile phone that is very unlikely to be needed.

- It can be difficult to learn about financial products: Some financial decisions, such as taking out a mortgage or planning a pension – are made infrequently and with consequences revealed only after a long delay. Other decisions may depend on macro-economic circumstances that consumers may have little chance of learning about. Or, because it may be taboo to talk about financial outcomes, people may have limited opportunity to learn from others.

The 2010 PWG had proposed that the Government should establish a permanent Commission on Financial Literacy and Retirement Income mandated to (i) inculcate a culture of saving for retirement; (ii) to strengthen financial literacy; and (iii) to disseminate within society information on how the State pension works. The previous administration accepted this recommendation and, as shown earlier in the report, in July 2012 set up a Commission on Financial Literacy and Retirement Income.[75]

In the initial phase, the Commission was tasked to complete by the end of 2012 (i) a survey to assess the level of financial literacy in Malta and which should act as a baseline study; and (ii) A National Strategy for Financial Literacy and Retirement Income. Regrettably, the Commission did not conclude these tasks. Furthermore, it was not reconstituted following the change of administration in 2013.

The Strategy Group agrees with the direction proposed by the 2010 PWG in the setting up of a leading structure that would result in the articulation of a financial and retirement income strategy and which would coordinate its implementation. This was the case in the UK, where the Financial Services Authority initiated the process and was the leading force behind the national strategy, or in New Zealand, where the Commission for Financial Literacy and Retirement Income was the driving force and coordinating leader from the very beginning.

The first and immediate tasks of a newly set-up Commission for Financial Literacy and Retirement Income would be to work with the MFSA on the financial literacy survey and on the basis of the outcomes of the survey design a National Strategy. It is proposed that the Terms of Reference of a newly constituted Commission should be following:

- Use of educational pathways across the school curriculum, further education, adult and community education and education in the workplace.

- Provision of trusted and independent information to change behaviour and on-going support including but not limited to a targeted designed website, digital markets and social media, traditional media.

- Inculcating a new culture by increasing understanding of how people act vis-à-vis long term retirement planning, introducing new strategies such as soft compulsion and addressing gaps in existing advice services.

- Work in partnership with the government, the financial services market, the regulatory authorities and other constituted bodies in establishing new ways to strengthen the connections between all parties that are involved in financial services and retirement income.

[75] The full Terms of Reference of the 2012 Commission on Financial Literacy and Retirement Income are in Section 2.1 of the report.

**Recommendation 21: Inculcating a Culture of Literacy with regard to Financial Savings and Investments and Retirement Income**

The Pensions Strategy Group agrees with the direction proposed by the 2010 Strategic Resource in the setting up of a leading structure that would result in the articulation of a financial and retirement income strategy and which would coordinate its implementation. The Pensions Strategy Group recommends the re-constitution of the Commission for Financial Literacy and Retirement Income which should be assigned the following terms of reference:

- Use of educational pathways across the school curriculum, further education, adult and community education and education in the workplace.
- Provision of trusted and independent information to change behaviour and on-going support including but not limited to a targeted designed website, digital markets and social and traditional media.
- Inculcating a new culture by increasing understanding of how consumers act, introducing new strategies such as soft compulsion and addressing gaps in existing advice services.
- Work in partnership with the government, the financial services market, the regulatory authorities and other constituted bodies in establishing new ways to strengthen the connections between all parties that are involved in financial services and retirement income.

It is recommended that this reform measure is implemented by Government at the earliest possible.

## 04.4 Reforms to Address Challenges Faced by Current Pensioners

The pensioners' organisations[76] (PO) that participated in the Sub-Committee for Current Pensioners' Pension Issues identified a number of issues and presented recommendations for consideration. These are discussed hereunder.

### 04.4.1 Maximum Pensionable Income

Most retirees within this cohort of pensioners had their pension calculated on an MPI of €15,750 (Lm6,750) introduced in January 1981. Up to 2004 the MPI remained unchanged – increasing, over a span of 25 years by only €1,747 over the initial MPI of €13,976 (Lm6,000) established when the NI contributory system was introduced. As a consequence of this, the PO argued that the original social contract made by the State that the social security system would provide a pension based on 66% (2/3) of a capped ceiling was not maintained as the value of the MPI – which was originally pegged to the salary of the President of the Republic – depreciated considerably over time and lost a significant part of its purchasing value.

The PO underlined that the creation of three MPIs for different employees introduced by the 2007 reform "changes the goal posts" and "is unfair and results in an even greater number of pensioners being pushed even nearer the poverty line".[77] The PO further emphasised that the 2007 reform discriminated against current pensioners as it capped the MPI for persons born before 31st December 1951 to €17,470 (Exempt Group), persons born between 1st January 1952 to 31st December 1961 to €20,970 (Transitional Group); whilst it introduced an uncapped MPI that increased by an annual index of 70% Wages and 30% Inflation for persons born after 1st January 1962 (Switchers Group).

In an ideal state of play, the PO argued there should be one MPI which should be equal to all cohorts of pensioners – current and future – which should be set at €20,970. The PO understood that such a

[76] The pensioners' organisations were the Alliance of Pensioners, the National Alliance of Pensioners, the National Association of Service Pensioners, the Kummizzjoni Nazzjonali ghall-Anzjani, the General Workers Union, and the Union Haddiema Maghqudin

[77] Discussion paper on the Maximum Pensionable Income (MPI) prepared by the Alliance of Pensioners' Organisations (ALO) for the consideration of the Pensions' Reform Sub-Group (PRSG), October 2013

solution would place pressure on the sustainability of the pension system. The PO, thus, alternatively presented two options for the reform of the MPI of current pensioners that is based on a phased implementation timetable. Either option would affect a total of 5,219 beneficiaries in 2015: 979 females and 4,230 males.

The first option phases the introduction of an increase in the MPI as follows:

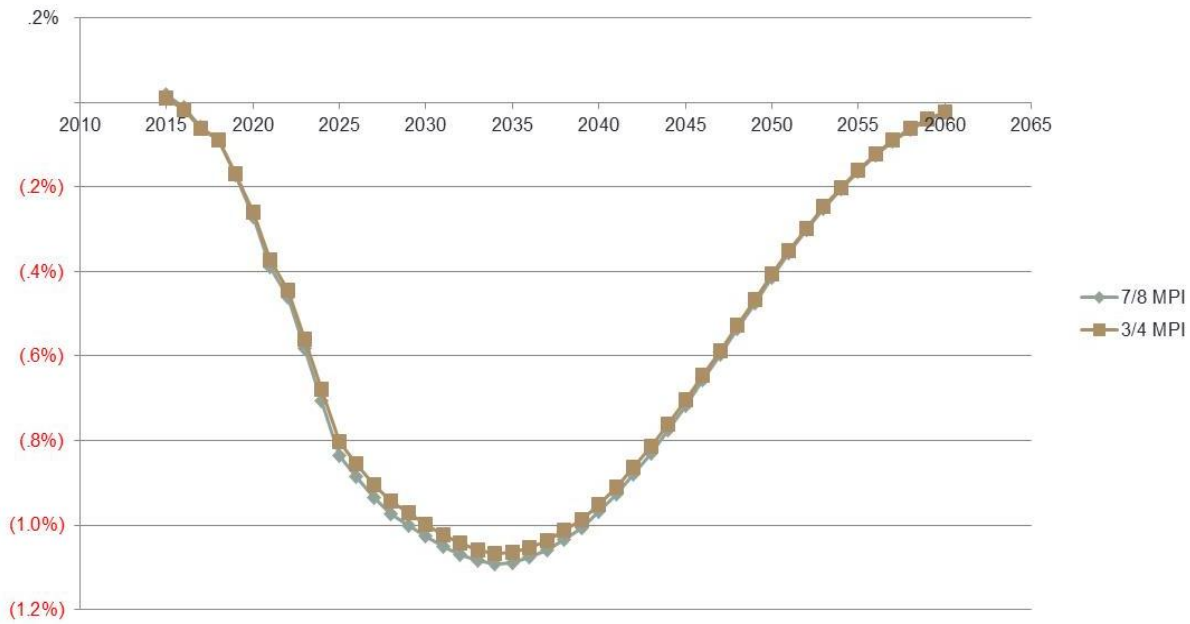
(I) For persons born between 1952 and 1961, the MPI is raised by 7/8 of the difference in the MPI for persons born after 1st January 1962 and the MPI for persons born before 1st January 1962.

(i) For persons born before 1st January 1952, raise the MPI by ¾ of the difference in the MPI for persons born after 1st January 1962 and the MPI for persons born before 1st January 1962.

The estimated increase in expenditure in the pension system in 2014 in the event that this recommendation is implemented is estimated by the Group to be €9.5m or 0.1% of GDP. As can be seen, however, between 2024 and 2045, the financial cost of this measure would constitute over 0.8% to GDP - peaking at 1.1% to GDP in approximately 2035. This is shown in the Figure below.

The second option phases the introduction of an increase in the MPI by raising the 2014 MPI for persons born before 1st January 1962 by approximately €500 a year between 2015 and 2020 and reaching €20,972 in 2020.

**Figure 27: Maximum Pensionable Income Increase: Option 01**




In a 'no change' scenario the MPI would increase by €1,181 between 2014 and 2020. In the event, however, that Option 2 is implemented, the MPI would increase by €3,158. This is 2.6 times more than that under the current regime. The impact of the implementation of Option 2, with regard to the MPI and the maximum TTP is shown in the Table below.

**Table 20: Maximum Pension Income Increase: Option 02**

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Persons born before 1st January 1962 (Current Regime) | | | | | | | |
| **MPI** | 17,812.0 | 17,933.21 | 18,145.18 | 18,569.13 | 18,569.13 | 18,782.10 | 18,993.07 |
| **Max TTP** | 11,874.72 | 11,955.47 | 12,096.79 | 12,379.42 | 12,379.42 | 12,520.73 | 12,662.05 |
| **COLA** | | 2.33 | 4.08 | 4.08 | 4.08 | 4.08 | 4.08 |
| **Per week** | | 229.91 | 232.63 | 235.35 | 238.07 | 240.78 | 243.50 |
| | | | | | | | |
| **OP Proposal** | | | | | | | |
| **MPI** | 17,812.0 | 18,312.08 | 18,812.08 | 19,312.08 | 19,812.08 | 20,312.08 | 20,970.0 |
| **Max TTP** | 11,874.72 | 12,208.05 | 12,541.39 | 12,874.72 | 13,208.05 | 13,541.39 | 13,980.0 |
| **Per week** | 228.36 | 234.77 | 231.18 | 247.59 | 254.00 | 260.41 | 268.85 |

The weekly pension income increases from €229.91 to €243.50 between 2014 and 2020 under the current regime and €234.77 to €268.85 during the same period reviewed under Option 2. The financial impact is significant. The Group estimates that the cumulative increase to the baseline is €30.1m for the period 2015 to 2020 as shown in the Table below.

The Strategy Group does not agree with the arguments made by the PO on the MPI, and rejects both of the recommended options. It does so for two primary reasons. First, the Strategy Group strongly contends that the PO is not correct when it states that the 2007 reform created an anomalous situation between current and future pensions with regard to the MPI. The 2007 reform moved away from a single MPI to three ceilings because it dealt separately with different cohorts of persons with regard to the impact of the 2007 reform measures.

**Table 21: Financial Impact of Option 2 Proposed by the Pensioners' Organisations**

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| | | | | | | |
| Persons born before 1st January 1962 (Current Regime) | | | | | | |
| **Pensioners** | 5,964 | 6,243 | 6,515 | 6,566 | 6,824 | 7,073 |
| **Benefit Rate** | 229.91 | 232.63 | 235.35 | 238.07 | 240.78 | 243.50 |
| **Expenditure** | 71,297,358 | 79,521.859 | 79,728,525 | 81,289,292 | 85,437,802 | 89,564,876 |
| | | | | | | |
| **OP Proposal** | | | | | | |
| **Benefit Rate** | 234.77 | 231.18 | 247.59 | 254.00 | 260.41 | 268.85 |
| **Expenditure** | 72,803,649 | 78,297,555 | 83,875,949 | 86,730,518 | 92,402,443 | 98,887,395 |
| | | | | | | |
| **Increase relative to base line** | 1,506,290 | 2,775,969 | 4,147,424 | 5,441,226 | 6,964,641 | 9,322,519 |
| | | | | | | |
| **Cumulative Expenditure: 2015: 2020** | | | | | | 30,157,797 |

As stated earlier, but important to re-iterate once again, persons who were 55 years of age and over as at 1st January 2007 when the reform was introduced, were exempted from all of the negative measures introduced by the reform. Indeed, this cohort of persons gained positively from two reform measures. The first is, the MPI was increased to €17,475 (Lm7,500) and thereafter pensions would receive the full COLA amount. The second is that persons between 61 and 65 years of age had their pension income decoupled from income earned from employment to allow them to work in the labour market and earn any income together with the full pension.

The Transitional Group and the Switchers Group respectively were negatively affected by the reform – the latter Group facing the full brunt of the reform measures. The MPI and the indexation mechanism measures, with regard to the Switchers Group, were introduced to balance the reform's negative impacts such as the increase in the contributory history to 40 years; the increase in the calculation period to the best 10 years from a 40 year contributory history; and an increase to the retirement age to 65 years.

On the other hand, persons in the Exempt Group, which include current pensioners, enjoyed far less exacting parameters to access a full pension when compared to the Switchers Group: they had to meet a contributory history of 30 years; the calculation period was based on the best 3 consecutive years out of last 10 years; and the retirement age was of 61 years.

The second reason is that in the considered opinion of the Strategy Group, the recommendations presented by the PO to increase the MPI are not socially equitable. The financial impact, as estimated by the Group, of the Options presented with regard to the increase in the MPI of current pensioners, are considerable as shown above: a significant financial impact for measures that will be enjoyed only by a very small number of pensions.

Additionally, the acceptance of either one of the options presented by the PO would constitute a benefit for which current pensioners did not contribute for: the contribution paid whilst in employment was to a maximum of 10% of the MPI at the time and not on the new MPI that the PO are requesting. In essence, therefore, this means that future pensioners, who are operating within a pension system, that is far more rigorous and facing significant risk, as a result of uncertainty than the one which current pensioners are enjoying, would have to 'pay' for this new added benefit sought by current pensioners.

**Recommendation 22: Maximum Pensionable Income**

The Pensions Strategy Group disagrees that the Maximum Pensionable Income parameter established for the Switchers' Group in the 2007 reform creates an anomaly with regard to the Transition and Exempt Groups. The Switchers Group unlike the other two Groups faced the full brunt of the 2007 reform. The options presented by representatives of the pensioners' organisations will result in a significant financial impact for measures that will be enjoyed only by a very small number of pensions. This will constitute a benefit for which current pensioners did not contribute for and which would be borne by future pensioners, who are operating within a pension system that is far more rigorous and facing significant risk as a result of uncertainty.

### 04.4.2 Annual Assessment

The PO in a paper presented on the indexation of the MPI, cited the respective positions of the Directorate-General for Social Affairs and Inclusion within the EC and the Social Protection, on the importance of proper indexation of pensions, in that "standards of living of pensioners drop over time to the rest of the population as the indexation of pensions in payment most often lack behind the evolution of wages / salaries".[78]

The PO further underlined that the MPI of €17,475 for persons born before 31st December 1951 has no mechanism that ensures it retains its value and that the present system is resulting in a MPI that is "being systematically eroded by being merely increased by COLA indexed to inflation at the minimum wage level".[79] The PO emphasised that the inability to "tackle the MPI problems has led to the absurd situation where the maximum social security pension payable exceeds the Guaranteed National Minimum Pension (GNMP) (that, is the minimum pension to ensure a decent standard of life for a couple by just €50 per week."[80]

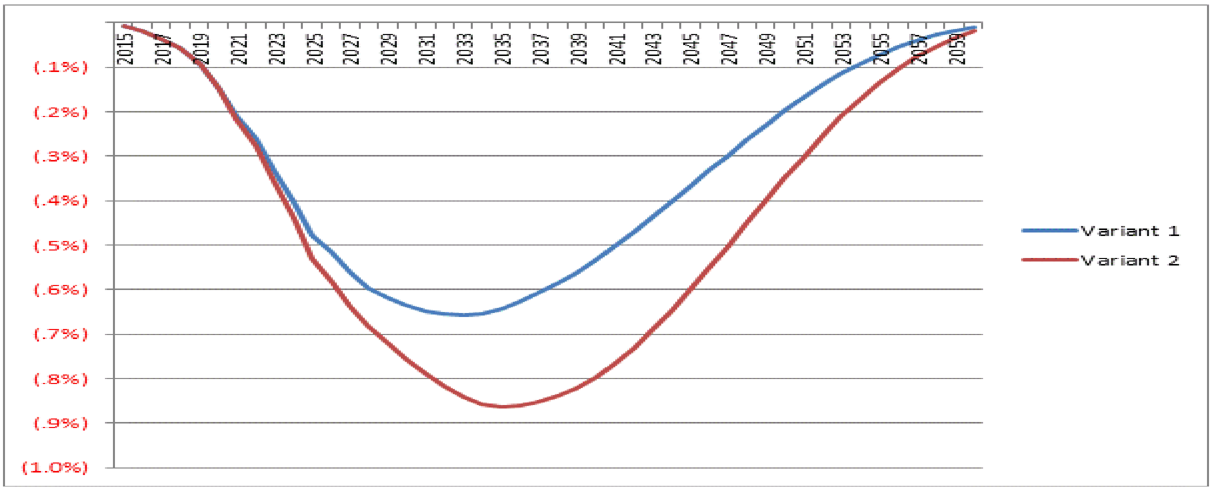
The PO expressed that the state of play is such that many persons who retired with an adequate income, are gradually slipping into poverty given the absence of an adequate pension indexation. The PO stated that the erosion of the purchasing power for all pensioners could be mitigated or prevented, if the inflation rate forms part of the indexation mechanism formula. Moreover, the inflation

[78] Discussion Paper on the Indexation of Pensions prepared by the Alliance of Pensioners' Organisations (APO) for the Consideration of the Pensions Reform Sub-committee (PSRG).
[79] Ibid
[80] Ibid

part of the indexation formula should be based on a "basket of goods and services considered as basic needs of pensioners when they grow older".

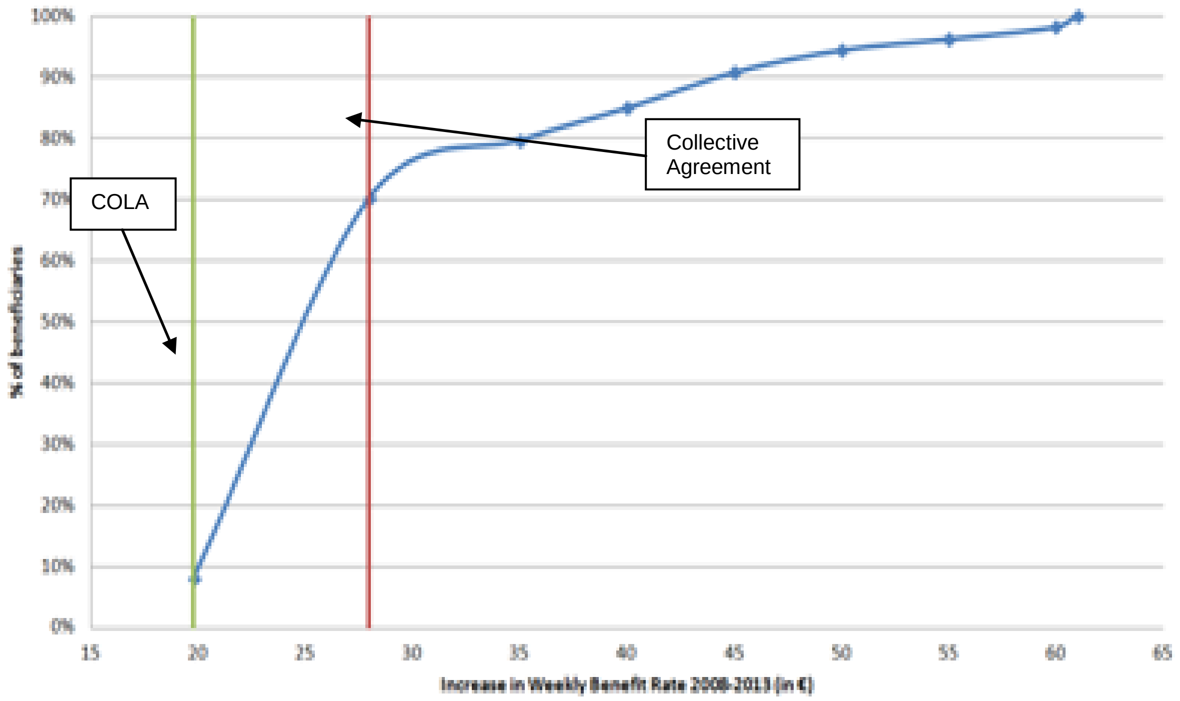
The Strategy Group modelled the proposed indexation mechanism as well as an indexation mechanism based on 100% Inflation. As can be seen from the Figure below, the introduction of an indexation mechanism onto the MPI has a considerable financial impact. As expected, an indexation mechanism based on 100% inflation, has a far lower impact than one that includes wage inflation in its make-up.

**Figure 28: Financial Impact of Introducing an Inflation based and a *Wage : Inflation* based Indexation Mechanism to the Maximum Pensionable Income**




The Strategy Group is of the considered view that the introduction of an inflation : wage indexation mechanism, does have a socially equitable impact for current pensions. Apart from the issues raised by the PO, increases in the pensions of current pensioners today are either (i) by means of annual assessments in the event that pensioners were governed by a Collective Agreement when they were in employment; or (ii) with regard to all other pensions the pension income is increased on the basis of COLA only. This has resulted, in the view of the Group, in a socially unjust situation as no protection is provided to workers who are not covered by a Collective Agreement. The social injustice that exists between these two groups is evident and can clearly be seen from the Figure below.

**Figure 29: Pension Indexation 2008-2013**




The Figure above presents an analysis of indexation for persons who have been in retirement between 2008 and 2014 - a total sample of 36,689 beneficiaries. The focus is on contributory pensions - retirement, invalidity, successors and widows. During the period under review, 8% of the beneficiaries received an increase in benefit rates equal or less than COLA. On the other hand, 70% of beneficiaries had their benefit rate adjusted by a mean increase of approximately €27.98 per week. Furthermore, the effort to calculate Collective Agreement increases, place a high administrative burden on the DSS, due to the manual effort required.

The Strategy Group recommends that an indexation mechanism based on the following formula:

> Pension increases annually by a % (percentage) of a ratio of [50% Wage Growth : 50% Inflation Growth] or the full COLA whichever is the highest;

grafted onto the 2016 MPI for current pensioners that would result in annual automatic adjustments is introduced.

## Recommendation 23: Annual Re-Assessment

The Pensions Strategy Group concludes that current pension annual re-assessment is governed by annual Collective Agreement assessment whilst the pension income of all other pensioners is increase the COLA is socially unjust as it provides no protection to workers who are not covered by a Colle Agreement. The Pensions Strategy Group recommends that the current Collective Agreement base assessment for current pensioners and persons within the Exempt and Transitional Group is abolis and replaced by an indexation mechanism based on the following formula:

> Pension increases annually by a % (percentage) of a ratio of [50% Wage Growth : 50% Inflation Growth] or the full COLA whichever is the highest.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

### 04.4.3 Guaranteed National Minimum Income

The PO underlined that over 19% of pensioners in the 65 years and over were deemed to be at-risk-of-poverty (ARP) and that it agreed with the Electoral Manifesto pledge of the party in government that no person will be paid less than 60% of the median income. The PO emphasised that the introduction of a GNMP for the Switchers' Group only is discriminatory and, hence, not acceptable. Indeed, the APO highlighted that there is a substantial difference between the income received under the National Minimum Pension (NPM) and the GNMP, particularly with regard to a married person who maintains a wife and has a yearly average of contributions of 50 and over. The GNMP provides an income that is 34% higher than the NPM – a difference of €40 per week.[81]

The matter of the GNMP is addressed by this report in Section 04.2.6 of this report titled 'Defining the Guaranteed National Minimum Pension'.

### 04.4.4 Calculation of Pensionable Income for the Transitional Group

In reviewing the 2007 reform, one issue that the Strategy Group considers that should be reviewed is the calculation of the pensionable income for persons in the Transitional Group. The current calculation is based on the best 3 years of the last 11, 12 and 13 years for employed persons and the best 10 years for self-employed persons. This is seen to cause a handicap for persons within this Group who may have lost well-paying jobs or underwent difficult business cycles in the early part of the last 11 to 13 years.

Thus, the Strategy Group recommends that the pensionable income for the Transitional Group is calculated as follows:

- Best 3 consecutive years in the last 15 years for employed persons born from 1952 to 1961.
- Best 10 consecutive years in the last 15 years for self-employed persons born from 1952 to 1961.

**Recommendation 24: Calculation of Pensionable Income for Persons in the Transitional Group**

The current calculation is based on the best 3 years of the last 11, 12 and 13 years for employed persons and the best 10 years for self-employed persons within the Transitional Group, depending when born. This is seen to cause a handicap for such persons who may have lost good paying jobs or underwent difficult business cycles in the last 11 to 13 years. The Pensions Strategy Group recommends that by not later than 2018, the pensionable income for the Transitional Group is calculated as follows:

- Best 3 consecutive years in the last 15 years for employed persons born from 1952 to 1961.
- Best 10 consecutive years in the last 15 years for self-employed persons born from 1952 to 1961.

It is recommended that such changes be also effected for persons already on pension before implementation date, but the change becomes effective from start date onwards.

### 04.4.5 Gender Equality

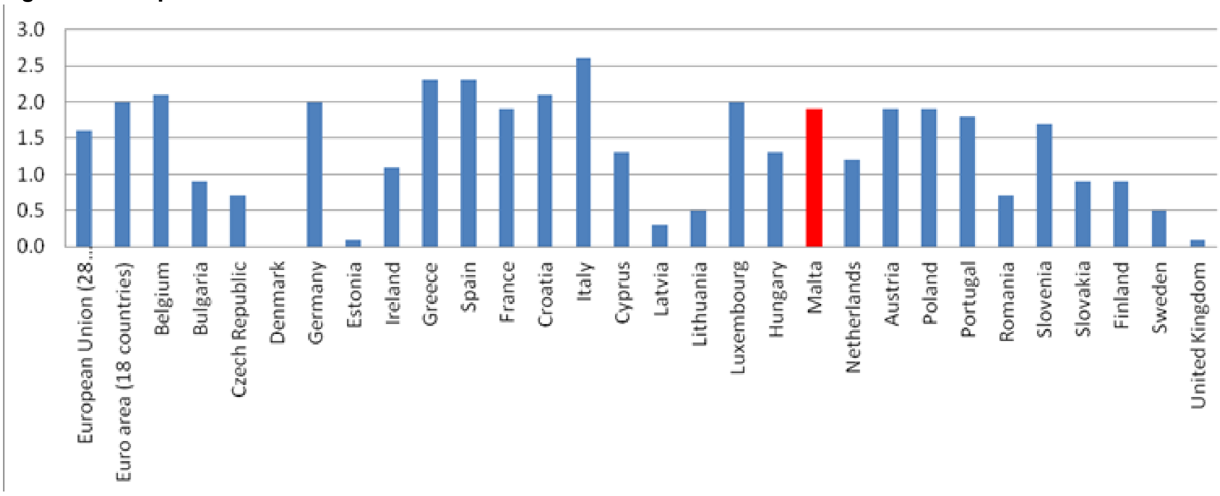
The PO is of the considered opinion that the survivors' pension which sees a wife, however, receive 5/6th of the pension income should her husband pass away is discriminatory. Whilst the wife loses 1/6th of the pension if her husband passes away, the husband continues to receive the full pension in the event that his wife passes away. The survivors' pension, the PO argues, is based on the current

[81] Discussion Paper on a Guaranteed National Minimum Pension, prepared by the Alliance of Pensioners' Organisations for the consideration of the Pensions' Reform Sub-Group

social model where the male is the breadwinner and the female is the family carer. This model does not recognise the economic value of the wife as a family carer and one who, traditionally, has sacrificed her career to support that of her husband.

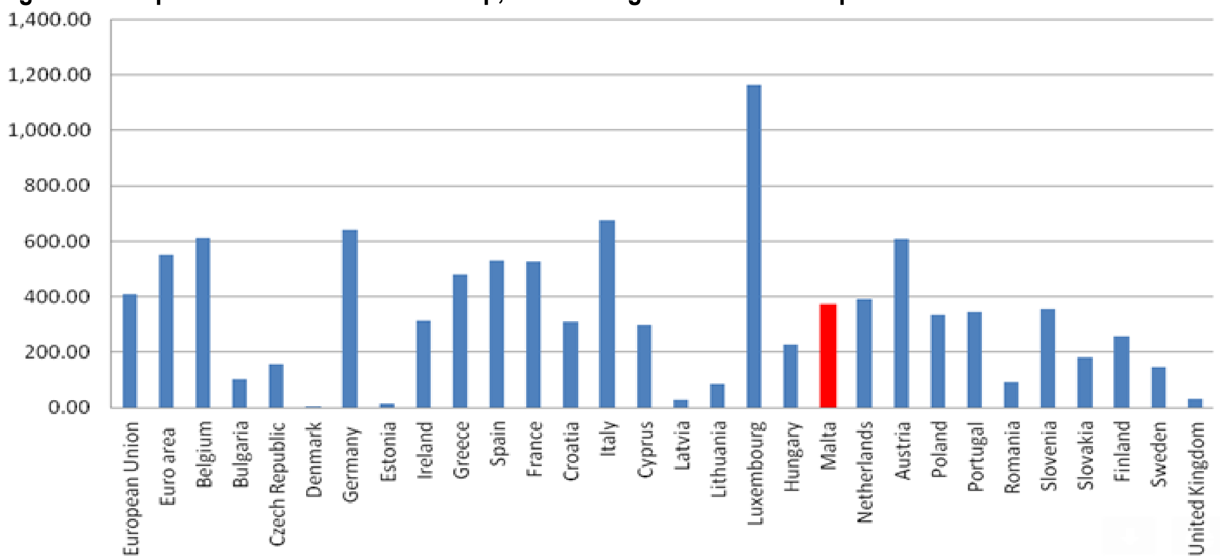
Thus, the PO recommends that a wife should be provided with the full retirement pension upon the death of her spouse. .It is pertinent to underline that the PWG 2010 had concluded that the current format of the survivor partnership is gender discriminatory and, too, had recommended that the female survivor should be provided the full retirement pension upon the death of her spouse. The Strategy Group has analysed the proposal presented by the PO. As can be seen from the Figure below Malta, when compared to other EU MS, is today spending beyond the EU average on survivors' pension.

**Figure 30: Expenditure on the Survivor Pension as a % of GDP[82]**




Although, the Strategy Group is cognizant of the fact that within the EU MS there are more generous survivors' pensions than that present in Malta the purchasing power standard per inhabitant vis-à-vis expenditure on survivorship in Malta ranks 10th amongst the EU 27.

**Figure 31: Expenditure on the Survivorship, Purchasing Power Standard per Inhabitant[83]**




[82] Eurostat Data 2011, Malta 2012

[83] Ibid

There is no doubt that the proposal presented by the PO has merit, and in an ideal world should be adopted. The concern with this recommendation is the cost it will add to the annual pension expenditure. Projections carried out by the Strategy Group show that if this recommendation was to be adopted it would result in an annual increase in the pension expenditure of €13.0m. Its adoption would result in a state of play in 2014 where the expenditure related to survivor pensions – exclusive of bonuses – would increase from €66.8m to €79.7m. This constitutes an annual expenditure of 0.2% of GDP which over time will increase to 0.4% of GDP. The Strategy Group, thus, concludes that the adoption of this proposal as presented by the PO in its current form is not affordable and should be rejected in its current form.

**Recommendation 25: Gender Equality (a)**

The Pensions Strategy Group recognises the merit of the recommendation presented by pensioners' organisations that the Survivor's Pension should be replaced by the eligible full pension as the current Survivor's Pension is gender discriminatory and fails to take into account a woman's economic contribution as a family carer during her lifetime. Be that as it may, Strategy Group concludes that the adoption of this proposal in its current form is not affordable and should be rejected.

The PO presented one further issue. It underlined that an anomaly is in place with regard to the treatment of a 'widow/er' - that is persons who lost their spouse but are of an age that is below the SPRA - and survivors - that is persons who lost their spouse but are in formal retirement.

One of the measures that was recommended by the 2010 PWG and subsequently implemented as a budget measure was the reform related to the decoupling of the widow pension from income earned to incentivise a widow/er to re-enter the labour market without losing her widow/er pension. Upon retirement, that person would have to choose the highest between her contributory pension earned through employment and the widow/er pension (which at this stage would become considered as a successor's pension). The PO is stating that this results in a state of play where the person "loses" one of the pensions from the two the widow/er should be entitled to; the pension s/he worked for and the pension for which s/he has a derived right as the successor to his or her spouse.

The PO further stated that this state of play does not encourage women to be active in the formal market as it would be far more attractive for them to remain in the informal market and invest in a private pension. This would ensure that a woman receives both her (private) pension and her husband's / partner's succession pension should the latter pass away.

The Strategy Group recognises that traditional employment patterns are changing and that the pension system must respond to such changes. The number of women who are active in the labour market is on the increase and will continue to do so. This means that women will have a pension of their own as a result of their employment contributory history. As society continues to change and evolve the purpose of a survivors pension as a 'derived' right will be increasingly questioned.

To account for the fact that a woman who is active in the labour market is contributing to the economy's and her family's well-being, the Strategy Group recommends that the surviving spouse will get the deceased spouse's full pension as opposed to the 5/6th successor's pension to which she is entitled today. This is subject to the condition that the surviving spouse has or would have a right to a pension in her own right. In the eventuality that the latter is higher, then she would continue to receive the latter.

**Recommendation 26: Gender Equality (b)**

The Pensions Strategy Group recommends that the surviving spouse will get the deceased spouse's full pension as opposed to the 5/6$^{th}$ today provided that the surviving spouse has or would have a right to a pension in her own right. In the eventuality that the latter is higher, then she would continue to receive the latter.

### 04.4.6 Service Pension

The PO underlined that the 1979 amendments relating to how occupation pensions are treated for the purposes of deduction from the retirement pension are discriminatory. The PO stated that they have instigated action against the government in Malta, and in the EU, in order to achieve justice on this issue.

All of the POs, with the exception of the National Association of Service Pensioners, proposed that a just solution could be attained if Section 56 of the SSA is repealed and measures are introduced to rectify the state of play. The PO proposes the phasing out of the removal of any occupational pension from the calculation of the retirement pension on the basis of the age of the person: the older a person is the higher would be the disregarded share of the occupational pension that is allocated to him or her. The option presented is phased as follows as from 1st January 2015:

- Total disregard of any occupational pension for pensioners aged 80 years and over;
- Disregard of not less than 80% of any occupational pension for pensioners aged 75 to 79;
- Disregard of not less than 60% of any occupational pension for pensioners aged 70 to 74;
- Disregard of not less than 40% of any occupational pension for pensioners aged 66 to 69; and
- Disregard of not less than 20% of any occupational pension for pensioners aged 65 or below and for all those entitled to an occupational pension who retire on or after 1st January 2015.

The Strategy Group modelled this recommendation. In the carrying out of the modelling, adjustments were made to (i) the service pension to reflect that the first €1,466 of a service pension is reduced from a retirement pension; and (ii) the reduction of the commuted part for pensioners aged 72 years and over.

**Table 22: Implementation of Recommendation Proposing Phased Removal of any Occupational Pension from the Calculation of the Retirement Pension by the Age of the Person**

| Pension Age | Service Pension Ignored | Females | Males | Total | Cost of Measure (€) |
|---|---|---|---|---|---|
| | | | | | |
| **Over 80** | 100% | 500 | 1,797 | 2,297 | 5,964,666 |
| **75-79** | 80% | 352 | 1,616 | 1,968 | 7,165,013 |
| **70-74** | 60% | 380 | 1,397 | 1,777 | 6,157,360 |
| **65-69** | 40% | 441 | 795 | 1,236 | 1,219,673 |
| **62-64** | 20% | 92 | 121 | 213 | 347,182 |
| | | | | | |
| | | 1,765 | 5,726 | 7,491 | 20,853,894 |

The National Association of Service Pensioners, on the other hand, proposed that Article 56 of the SSA is repealed with effect from 1st May 2004 at the latest and that the reform is introduced over a period of three years with a minimum of €1,000 of the service pension disregard annually per pensioner with another equal amount paid out in arrears. The Strategy Group modelled this recommendation. The financial impact is shown in the Table below.

**Table 23: Implementation of Recommendation Proposing Phased Removal of any Occupational Pension from the Calculation of the Retirement Pension over a Three Year Period**

| Year | Beneficiaries | Cost of Measure (€) | Cost of Arrear Payment (€) | Total Cost (€) |
|---|---|---|---|---|
| | | | | |
| **2015** | 7,533 | 4,472,242 | 7,533,000 | 12,005,241 |
| **2016** | 6,746 | 4,036,606 | 6,739,000 | 10,775,606 |
| **2017** | 5,764 | 3,508,216 | 5,764,000 | 9,272,216 |

The Strategy Group does not support either of the recommendations presented by the PO. The Strategy Group is aware that various attempts have been made to rectify the situation of service pensioners. The principal stumbling block, however, has and continues to be the question of the fiscal implications involved. Within this context the Strategy Group concludes that the current policy which seeks to phase out service pension through fiscal budgetary measures should be continued.

Since the introduction of this policy in 2008, different governments have through the National Budget allocated a sum for the annual commutation of the service pension - with the exception of 2009, where no allocation was made. The Strategy Group recommends that the Government should maintain this policy and should consider increasing the annual sum allocated for commutation for each pension to €200.

**Recommendation 27: Service Pension**

The Pensions Strategy Group recommends that the Government should continue with its current policy with regard to phasing out of the service pension for abatement purposes by committing itself to ignore an additional €200 annually from the original amount of the service pension abated from the social security pension through fiscal budgetary measures.

The Pensions Strategy Group proposes that Government implements this recommendation in 2016.

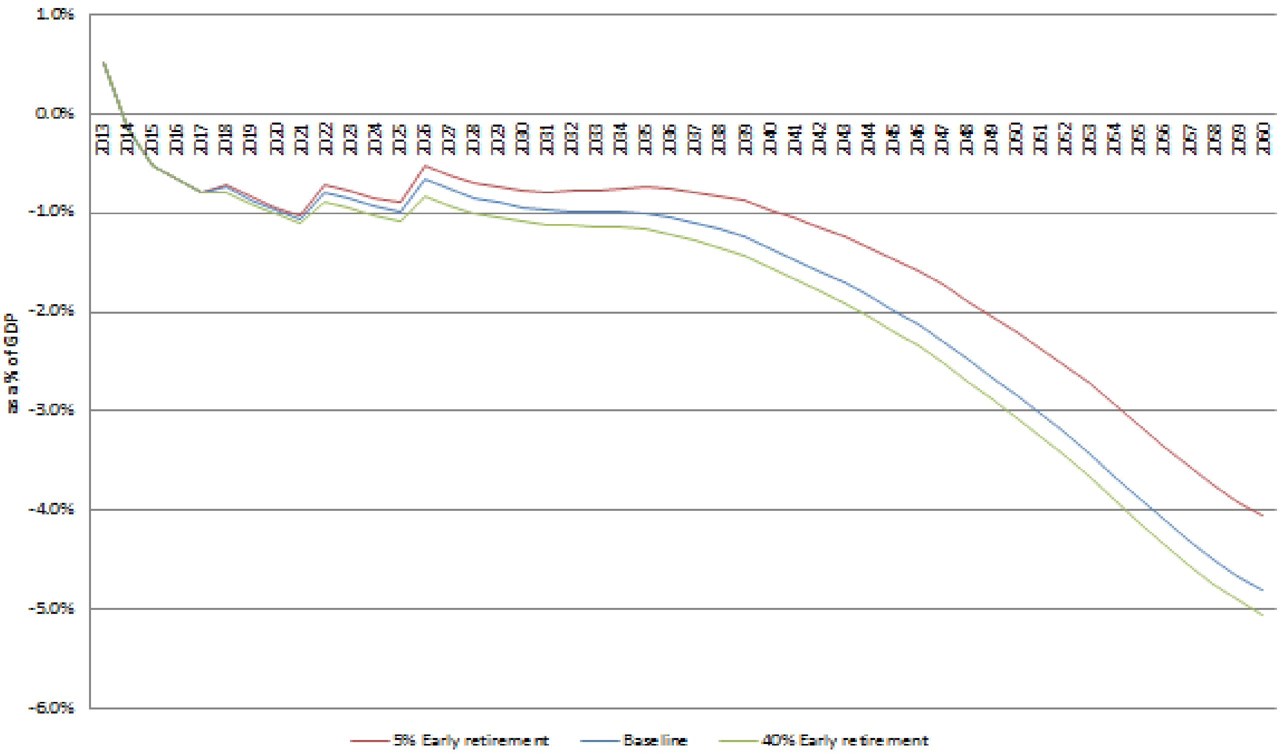
## 05.1 Illustration of the Reform Scenarios

This Chapter outlines the evolution in pension indicators for sustainability and adequacy under different reform scenarios.  A description of the individual scenarios is presented below alongside a table summarising the main outcomes.

### Early Retirement

The baseline model assumes that around 20% of pensioners are opting to retire earlier than the rest of their cohort. The scenarios presented below, outline the impact, should the proportion of pensioners retiring early decrease to 5% or indeed increase to 40%.

**Figure 32:  Early Retirement:  Developments in the Pension Systems Balance**

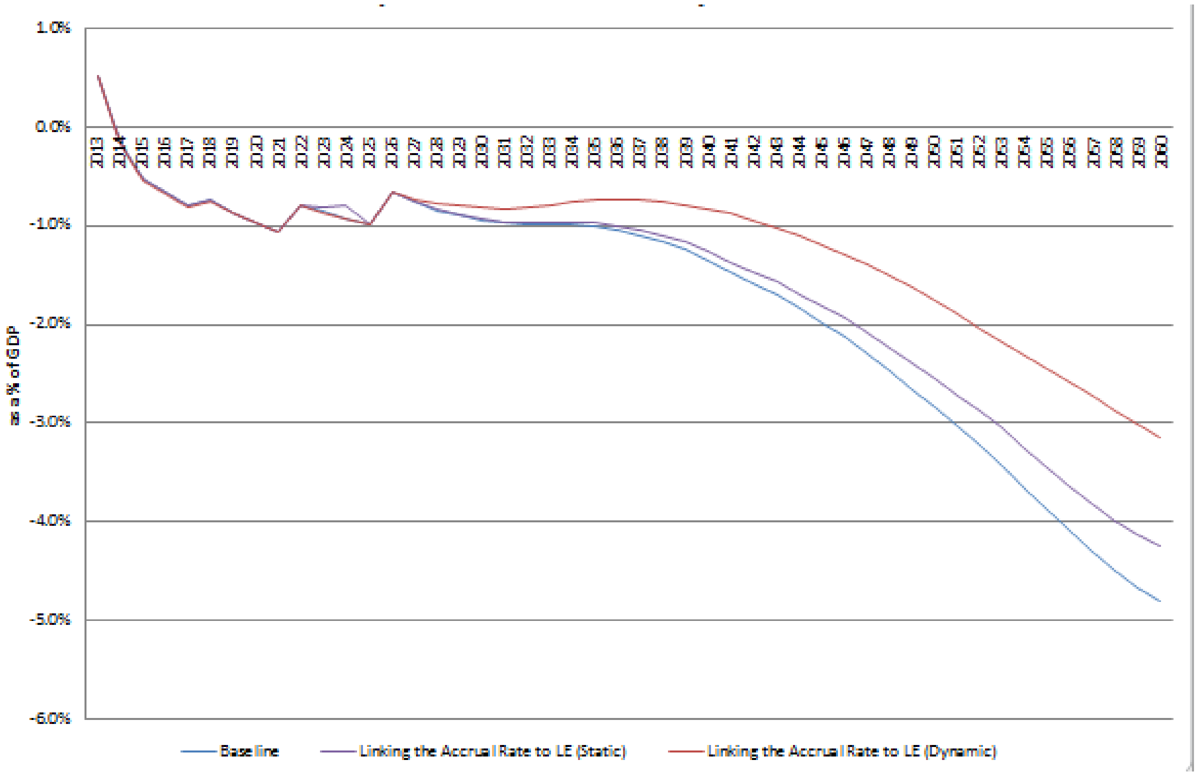



This scenario illustrates how reductions, in the number of persons retiring earlier, could have an important impact on the sustainability of public finances. Reducing the proportion of persons retiring earlier from 20% to 5% could improve the pension system balance by 0.2% of GDP by 2060.

### Linking Accrual Rate to Life Expectancy

The accrual rate reflects the number of years of contributions, necessary for full pension eligibility. The scenarios below present the impact of linking the accrual to future gains in life expectancy for persons born after 1962, starting from 2026. Two scenarios are being presented, illustrating the implications of behavioural changes relative to the decision to retire.

**Figure 33: Linking Accrual Rate to Life Expectancy: Developments in the Pension Systems Balance**

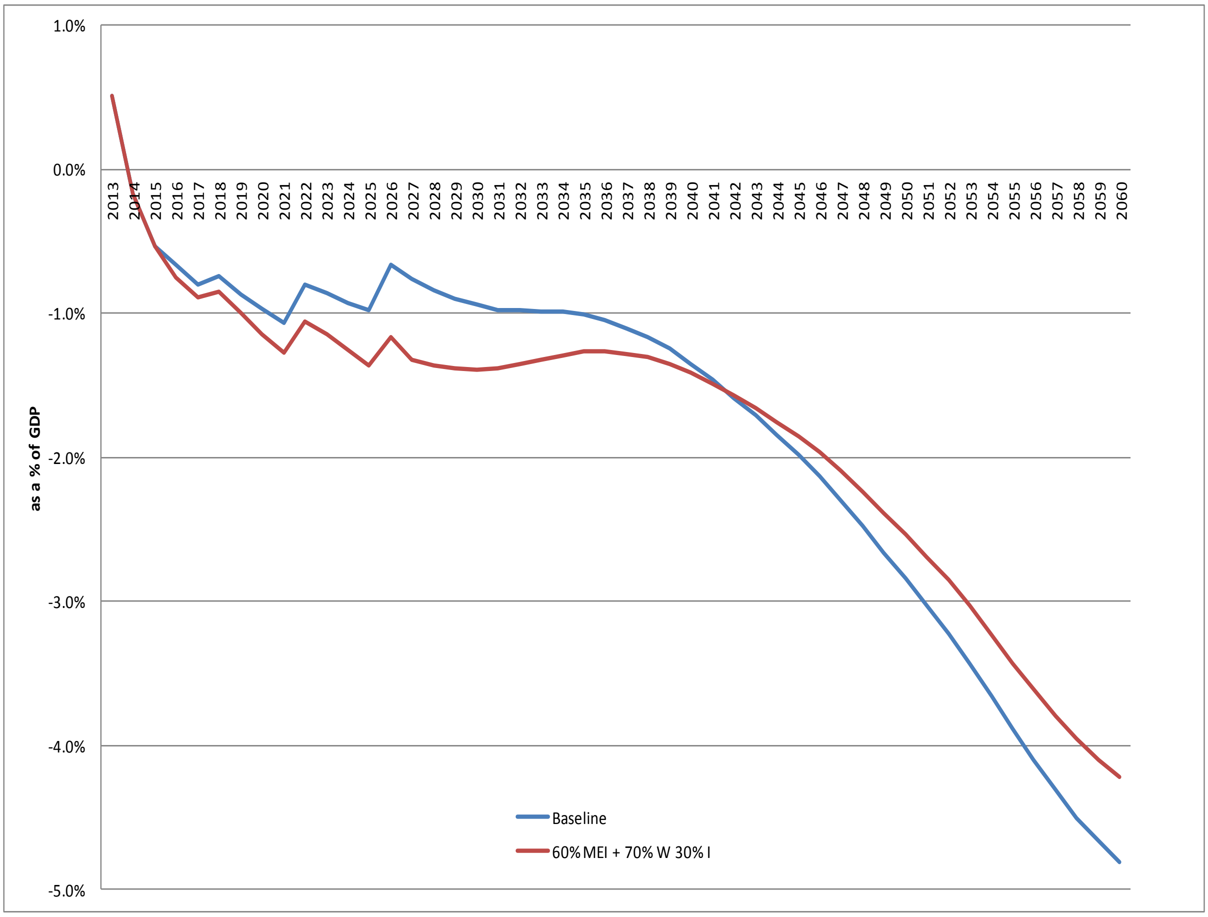



It is shown that linking the accrual rate to life expectancy, results in an improvement in the pension system balance of 0.5 p.p. of GDP, with the strongest gains being noted in the scenario allowing for changes in the retirement behaviour. In fact, under the assumption that the changes in the accrual rate lead to later retirement, the pension system balance improves by 1.7 p.p. of GDP relative to baseline projections.

## GNMP Scenario at 60% of Median Equivalised Income

Scenario models the impact of linking the GNMP to 60% of the median equivalised income in 2016 and indexed 70% to wage growth and 30% to inflation thereafter. The GNMP is introduced gradually, started with the older cohorts until it covers all cohorts of old age pensioners by the middle of the next decade. As illustrated in Figure 34, the pension system balance is expected to worsen up to around 2040 in light of the more generous arrangements for non-switchers and transitory group, with improvements in the overall balance of around 0.6 p.p. of GDP by 2060 relative to baseline projections.

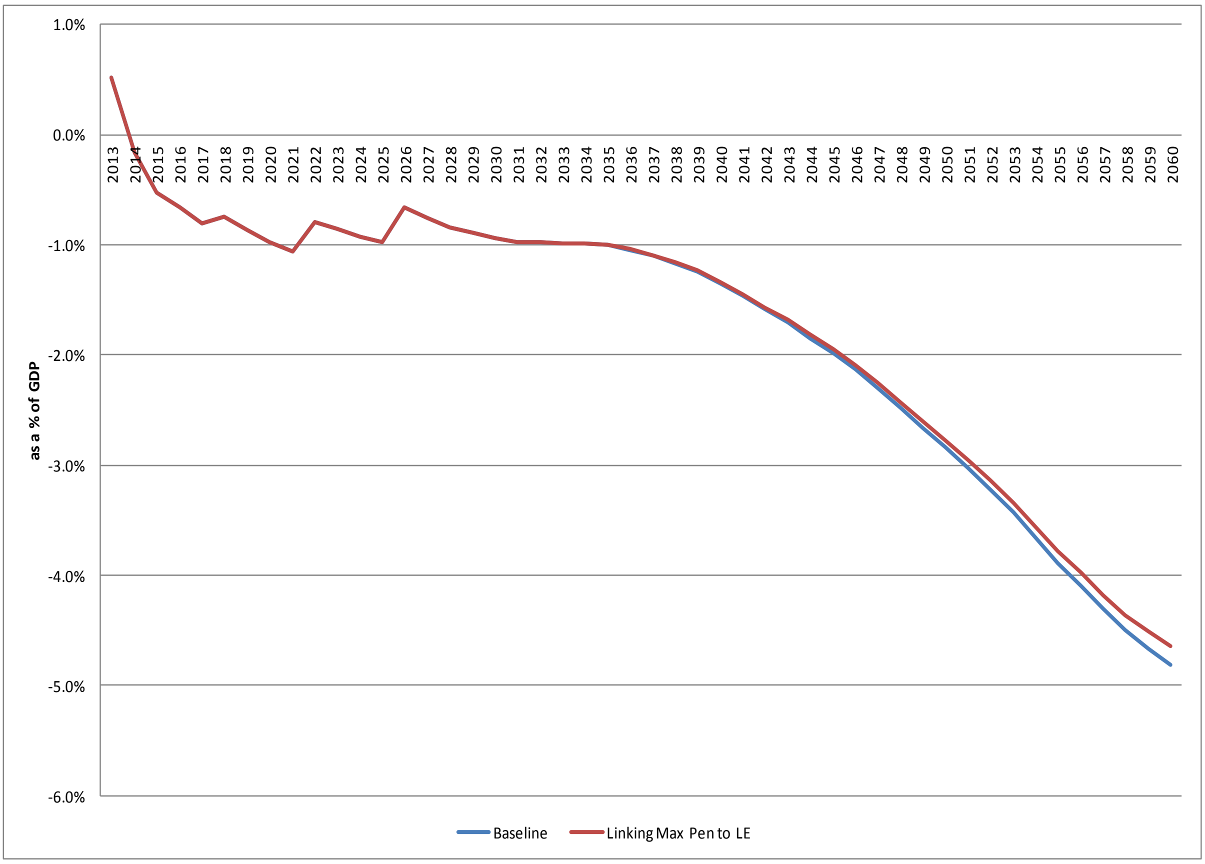
**Figure 34: Guaranteed National Minimum Pension: Developments in the Pension Systems Balance**




## Linking Maximum Pension to Life Expectancy

In the case of persons born on and after 1 January 1962, the 2007 reform introduced an indexation mechanism based on 70% in wage growth and 30% in inflation. This particular scenario, adjusts the indexation trajectory in line with gains in life expectancy starting from 2026 onwards.

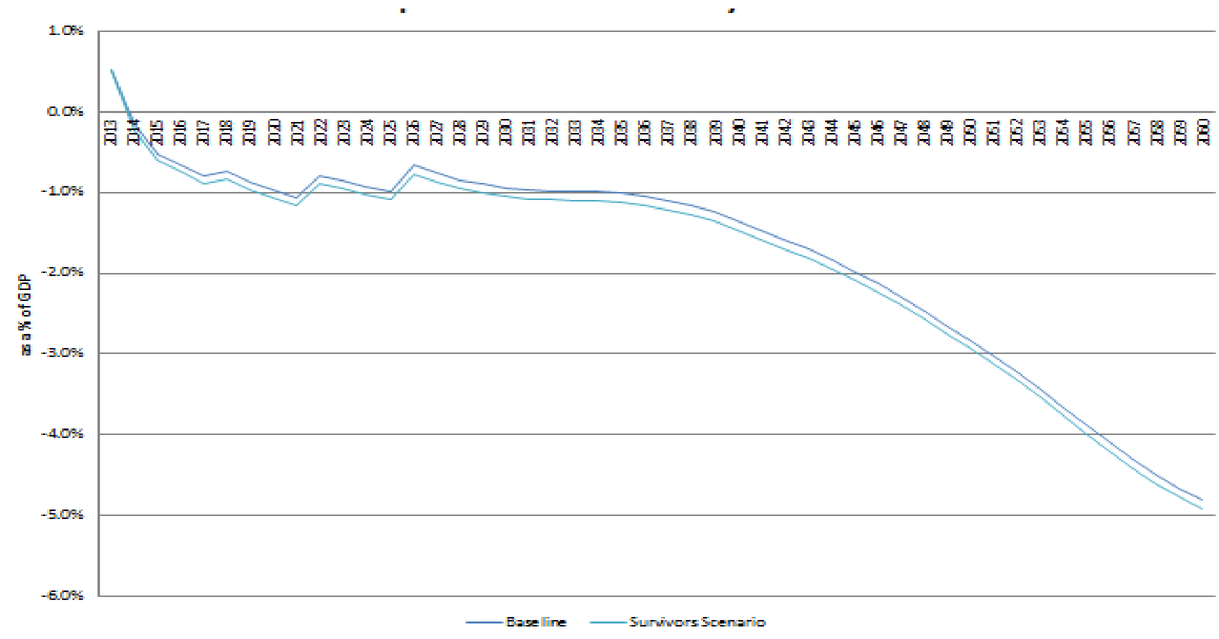
**Figure 35: Life Expectancy: Developments in the Pension Systems Balance**




## Survivors

This scenario models the impact of enabling widows entitled to a pension in their own right, to be eligible to the deceased spouse's full pension as opposed to the current regime where survivors are eligible only up to 5/6ths of deceased spouse's pension.

**Figure 36: Survivors: Developments in the Pension Systems Balance**

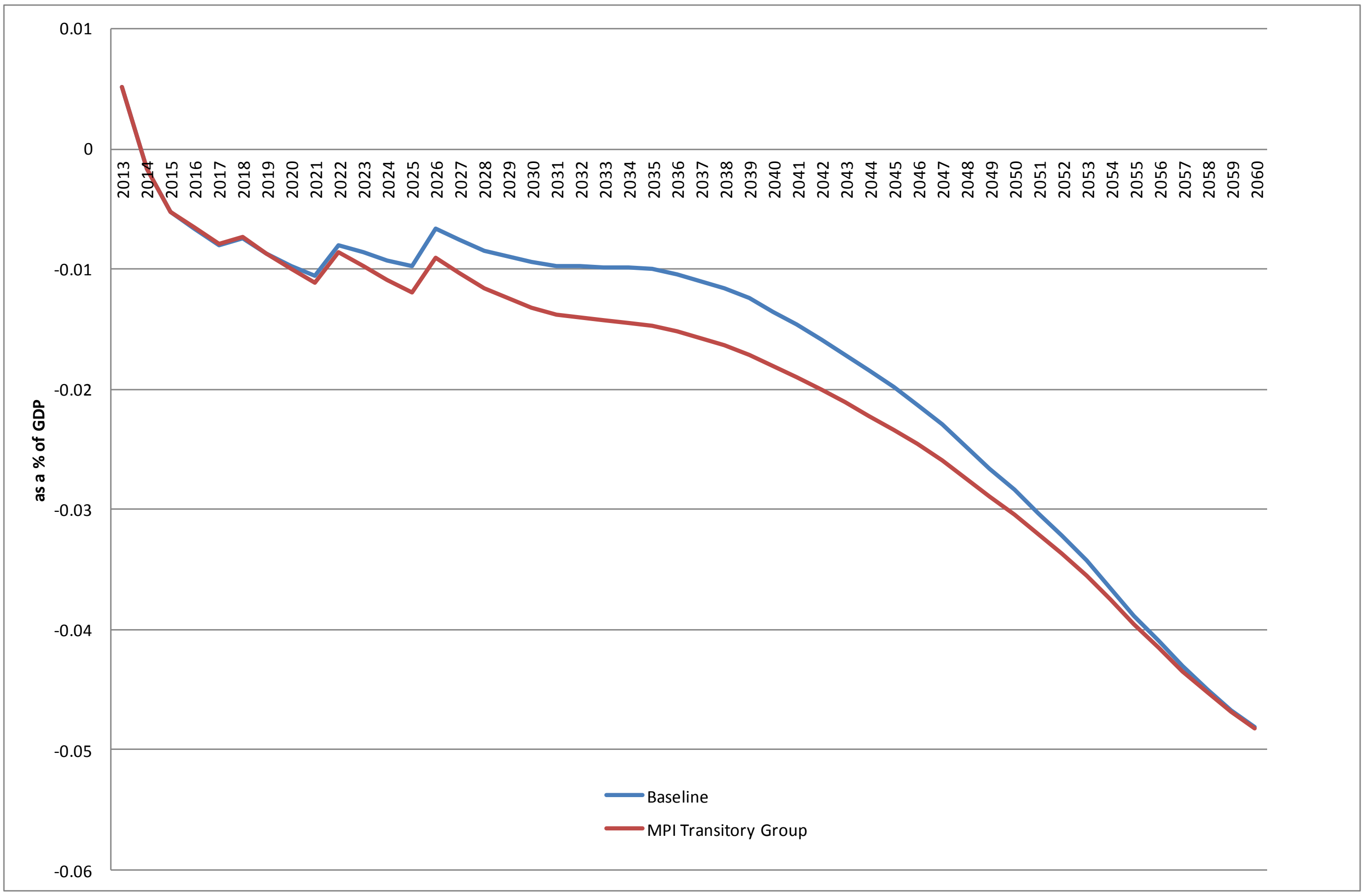


### Indexation for Current Pensioners

The scenario models changes in the pension indexation mechanism for persons born before 1st January 1962. Under the current regime, pensions are indexed by a hybrid of increases granted in collective agreements (for pensioners where their former occupation is covered by a collective agreement) and COLA (for the rest). The scenario models shifting to an indexation based on 70% of wage growth and 30% of inflation rate.

Furthermore, the Maximum Pensionable Income, for the transitory group (persons born between 1 January 1952 and 31 December 1961) is also indexed to 70% of wage growth and 30% of inflation as opposed to current indexation based on COLA. The change in indexation is expected to lead to a worsening in the balance, peaking at around 0.5 p.p. of GDP by 2040, relative to baseline. By 2060, the overall balance is unchanged, relative to the baseline trajectory.

**Figure 37: Indexation for Current Pensioners: Developments in the Pension Systems Balance**




The Table below presents the Pension System Indicators under different reform scenarios (deviations from the baseline).

**Table 24: Pension System Indicators under different reform scenarios (deviations from the baseline)**

| | 2013 | 2020 | 2030 | 2040 | 2050 | 2060 |
|---|---|---|---|---|---|---|
| **Baseline** | | | | | | |
| **Total Revenue** | 9.00% | 7.90% | 8.10% | 8.00% | 7.90% | 7.70% |
| **Total Expenditure** | 8.50% | 8.90% | 9.10% | 9.40% | 10.70% | 12.50% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Balance | 0.50% | -1.00% | -0.90% | -1.40% | -2.80% | -4.80% |
| ARR for OAP | 51.40% | 50.90% | 48.40% | 48.30% | 49.90% | 50.50% |
| **Early Retirement to 5%** | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.0% | -0.1% | -0.2% | -0.1% | -0.1% |
| Balance | 0.0% | 0.1% | 0.1% | 0.2% | 0.1% | 0.2% |
| ARR for OAP | - | - | - | - | - | - |
| **Early Retirement to 40%** | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.1% | 0.1% | 0.2% | 0.3% | 0.3% |
| Balance | 0.0% | 0.0% | -0.2% | -0.1% | -0.3% | -0.2% |
| ARR for OAP | - | - | - | - | - | - |
| **Linking Accrual Rate to Life Expectancy (assuming no behavioural change)** | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.0% | 0.0% | -0.1% | -0.2% | -0.5% |
| Balance | 0.0% | 0.0% | 0.0% | 0.1% | 0.2% | 0.5% |
| ARR for OAP | 0.0% | 0.0% | -0.1% | -0.6% | -1.7% | -2.6% |
| **Linking Accrual Rate to Life Expectancy (assuming changes in retirement patterns)** | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.1% | 0.2% | 0.5% | 0.7% |
| Total Expenditure | 0.0% | 0.0% | -0.1% | -0.3% | -0.6% | -0.9% |
| Balance | 0.0% | 0.0% | 0.1% | 0.6% | 1.0% | 1.7% |
| ARR for OAP | 0.0% | -0.1% | -0.3% | -0.3% | -0.5% | -0.7% |
| **GNMP at 60% of Median Equivalised Income** | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.2% | 0.4% | 0.0% | -0.3% | -0.6% |
| Balance | 0.0% | -0.1% | -0.5% | 0.0% | 0.3% | 0.6% |
| ARR for OAP | 0.0% | 1.2% | 2.6% | 0.4% | -1.5% | -2.4% |
| **Linking Maximum Pension to Life Expectancy** | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | -0.1% |
| Balance | 0.0% | 0.0% | 0.0% | 0.1% | 0.0% | 0.2% |
| ARR for OAP | 0.0% | 0.0% | -0.1% | -0.1% | -0.4% | -0.8% |
| **Survivors Scenario** | | | | | | |
| Total Revenue | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.1% | 0.1% | 0.1% | 0.1% | 0.1% |
| Balance | 0.0% | -0.1% | -0.2% | -0.1% | -0.1% | -0.1% |
| ARR for Survivors | 0.0% | 2.6% | 2.8% | 3.0% | 3.0% | 3.7% |
| **Reform Pension Indexation for Current Pensioners** | | | | | | |
| Total Revenue | 0.0% | 0.1% | 0.0% | 0.0% | 0.0% | 0.0% |
| Total Expenditure | 0.0% | 0.1% | 0.4% | 0.4% | 0.2% | 0.0% |
| Balance | 0.0% | 0.0% | -0.4% | -0.4% | -0.2% | 0.0% |
| ARR for OAP | 0.0% | 0.3% | 2.2% | 2.5% | 0.9% | 0.0% |

## 05.2 Theoretical Replacement Rates

The sub-section outlines the results of a number of scenarios modelling the impact of reform measures, on a set of theoretical replacement rates. Theoretical replacement rates are an exercise intended to outline the developments in the adequacy for a pension system over a forty year period. TRRs are defined as the ratio of an individual's pension, as proportion of the salary in the year preceding employment.

The computations are based on a number of assumptions, notably, the individual starts working at the age of 25 years, in a career spanning 40 years and illustrates the implications for average, low earner (66% of the average wage) and high earner (200% of the average wage) . Wage growth and inflation assumptions are aligned with the assumptions of the EPC Ageing Working Group. This exercise outlines also the effect of the tax rules (income tax and social security contributions) by distinguishing between gross and net replacement rates.

The scenarios modelled are defined in line with the description provided for the reform scenarios presented above. Some additional descriptions are outlined below alongside tables summarising the main results.

### Career Break and Child Credits Scenario

This scenario models the implications for the evolution in TRRs in the case of a person spending 10 years of career break, for child care purposes. The scenario compares the impact of increasing the credits for child care from a total of 6 years to 10 years in connection to the care of two children.

### Linking Accrual Rate to Life Expectancy

The scenarios below present the impact of linking the accrual to future gains in life expectancy for persons born after 1962, starting from 2026. The scenario presumes no behavioural changes relative to the decision to retire. Furthermore, the implication of granting two years of credits relative to investment in human capital, is also illustrated.

### Linking the GNMP to 60% of the Median Equivalised Income

The scenario models the impact on TRRs of linking the GNMP to 60% of the MEI for a minimum wage earner. The MEI is indexed 70% to wage growth and 30% to inflation. In comparison to the other scenarios, Table 5, compares the differences in the Gross and Net Replacement Rates, at the same point in time for the two group of persons affected.

**Table 25: Evolution in TRRs under different Reform Scenarios**

| | 2013 | | 2053 | | Difference | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Gross | Net | Gross | Net | Gross | Net | | | | |
| **Base Case** | 66.0% | 79.2% | 60.8% | 72.8% | -5.2% | -6.4% | | | | |
| **200% AW** | 34.1% | 44.8% | 30.4% | 38.6% | -3.7% | -6.1% | | | | |
| **66% AW** | 67.2% | 78.9% | 70.7% | 82.6% | 3.4% | 3.7% | | | | |
| | | | | | | | | | | |
| | 2013 | | 2053 | | Difference | | 2053 | | Difference | |
| | Gross | Net | Gross | Net | Gross | Net | Gross | Net | Gross | Net |
| | *No Reform* | | | | | | *Reform* | | | |
| **Accrual Rate Scenario** | 66.0% | 79.2% | 60.8% | 72.8% | -5.2% | -6.4% | 54.8% | 66.4% | -11.3% | -12.9% |
| **Human Capital Credits (1st degree plus post grad) on top of Accrual Rate Scenario** | 66.0% | 79.2% | 60.8% | 72.8% | -5.2% | -6.4% | 57.4% | 69.7% | -8.6% | -9.5% |
| **Linking Max Pen to LE** | 66.0% | 79.2% | 60.8% | 72.8% | -5.2% | -6.4% | 55.1% | 66.7% | -11.0% | -12.5% |
| **Career Break + Child Credits** | 66.0% | 79.2% | 54.9% | 66.5% | -11.1% | -12.7% | 60.8% | 72.8% | -5.2% | -6.4% |
| | | | | | | | | | | |
| **For 200% AW Earner** | | | | | | | | | | |
| **Accrual Rate Scenario** | 34.1% | 44.8% | 30.4% | 38.6% | -3.7% | -6.1% | 27.4% | 35.2% | -6.7% | -9.5% |
| **Human Capital Credits (1st degree plus post grad) on top of Accrual Rate Scenario** | 34.1% | 44.8% | 30.4% | 38.6% | -3.7% | -6.1% | 28.7% | 36.7% | -5.4% | -8.0% |
| **Linking Max Pen to LE** | 34.1% | 44.8% | 30.4% | 38.6% | -3.7% | -6.1% | 27.5% | 35.4% | -6.5% | -9.4% |
| **For 66% AW Earner** | | | | | | | | | | |
| **Accrual Rate Scenario** | 67.2% | 78.9% | 70.7% | 82.6% | 3.4% | 3.7% | 63.6% | 74.8% | -3.6% | -4.0% |
| **Human Capital Credits (1st degree plus post grad) on top of Accrual Rate Scenario** | 67.2% | 78.9% | 70.7% | 82.6% | 3.4% | 3.7% | 66.7% | 78.5% | -0.5% | -0.4% |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Linking Max Pen to LE** | 67.2% | 78.9% | 70.7% | 82.6% | 3.4% | 3.7% | - | - | - | - |

**Table 26: Linking the GNMP to a 60% of Maximum Pension for a Minimum Wage Earner**

| | | **2013** | | **2013** | | **Difference** | | **2053** | | **2053** | | **Difference** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Gross | Net | Gross | Net | Gross | Net | Gross | Net | Gross | Net | Gross | Net |
| | | *no reform* | | *reform* | | | | *no reform* | | *reform* | | |
| **Person Born Before 1 Jan 1962** | 67.7% | 75.2% | 82.7% | 91.9% | 15.0% | 16.7% | - | - | - | - | - | - |
| **Person Born on and after 1 Jan 1962** | - | - | - | - | - | - | 90.2% | 100.3% | 74.9% | 83.2% | -15.3% | -17.1% |

### 05.3 Holistic Impact of the Proposed Key Structural Reforms

The impact of the key structural reforms to the pension system architecture, recommended by the Strategy Group, can be grouped into 4 sets of inter-linked measures. The first consists of those measures directly relating to current pensioners: namely changes to indexation, maximum pensionable income and survivors' benefits.

As can be seen from Figures 38 and 39, these reforms rise spending and lead to a slight worsening of the deficit, but this effect starts dying off after 2040. The reforms to the minimum pension also rise spending over the next decade or so, but thereafter the reform would lead to an improvement in the system balance. The proposed changes to the contributory period, and the maximum pension indexation, would also impact spending and the system deficit positively, but only after 2040.

This strategy reflects the fact that up to 2040, Malta's projected pension spending is in line with that in the rest of the EU, and the required recalibration of the pension system is clearly required in line of the unforeseen improvement in generosity of the system post-2040.

The first sets of reforms assume no behavioural change on the part of contributors. However, with the aid of World Bank experts, the Pensions Strategy Group simulated the possible impact that these reforms could have on labour market behaviour, particularly on early retirement. The results are quite promising. While with no behavioural changes, the system deficit would be improved from (4.8%) of GDP in 2060 to 3.6%, as a result of the proposed reforms; if labour participation responds as expected, the improvement would be to 2.3% of GDP in 2060. The main impact of the behavioural changes would be to raise revenue, rather than lower expenditure.

**Figure 38: Impact of reforms on the pension system balance:**

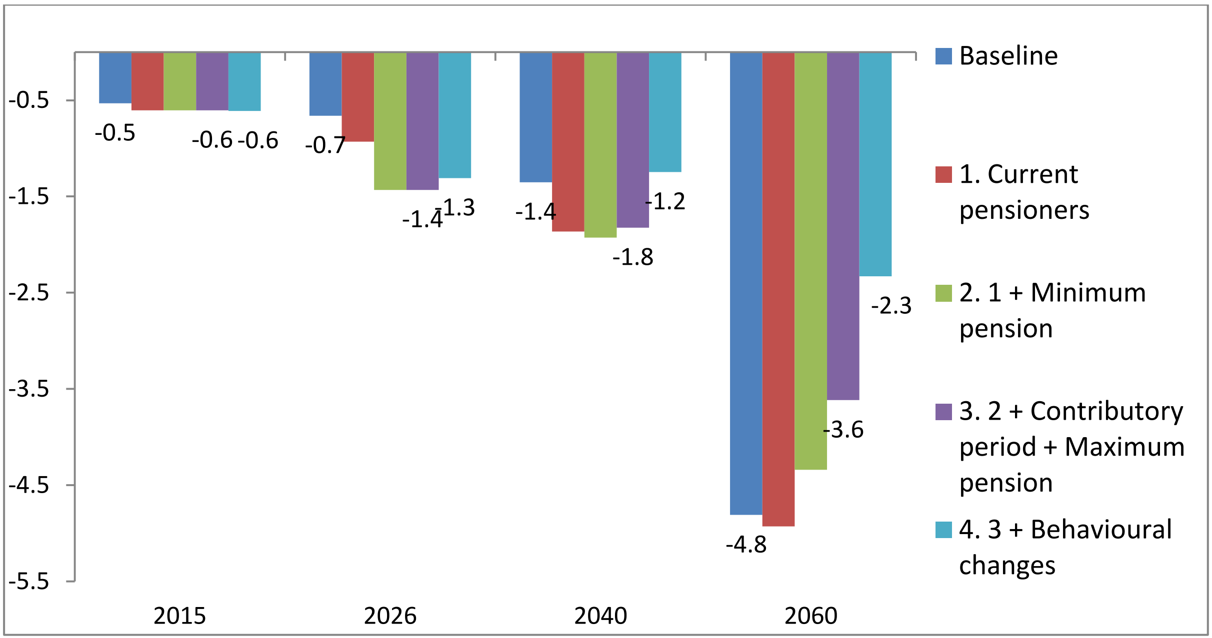
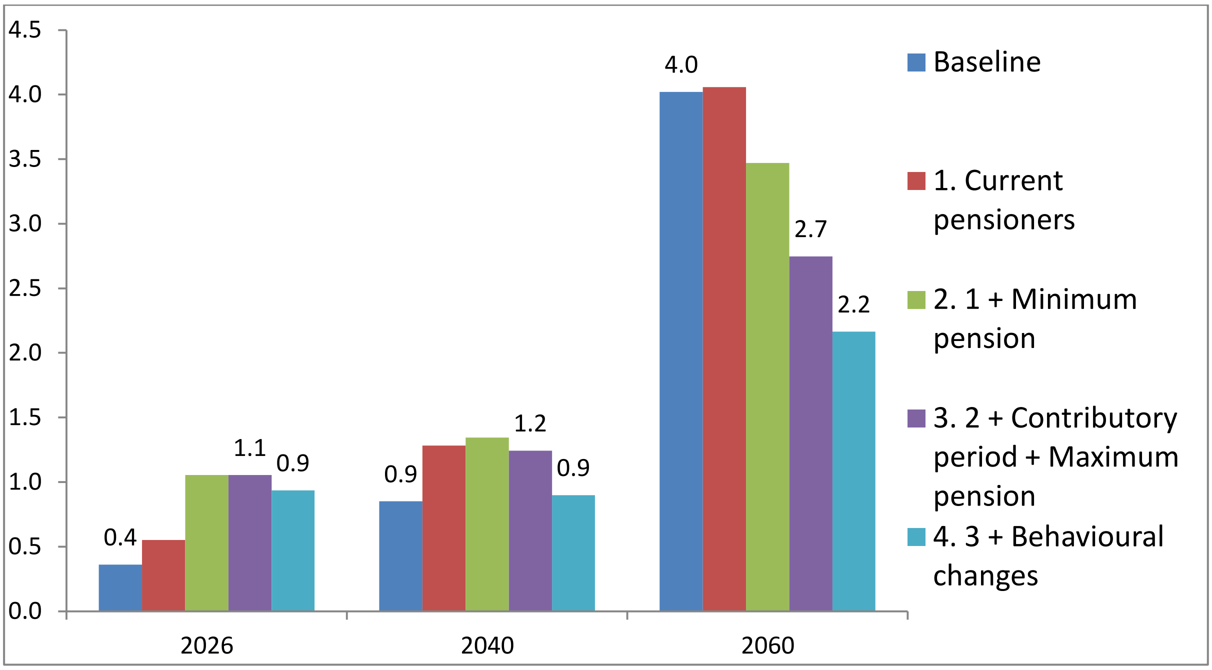
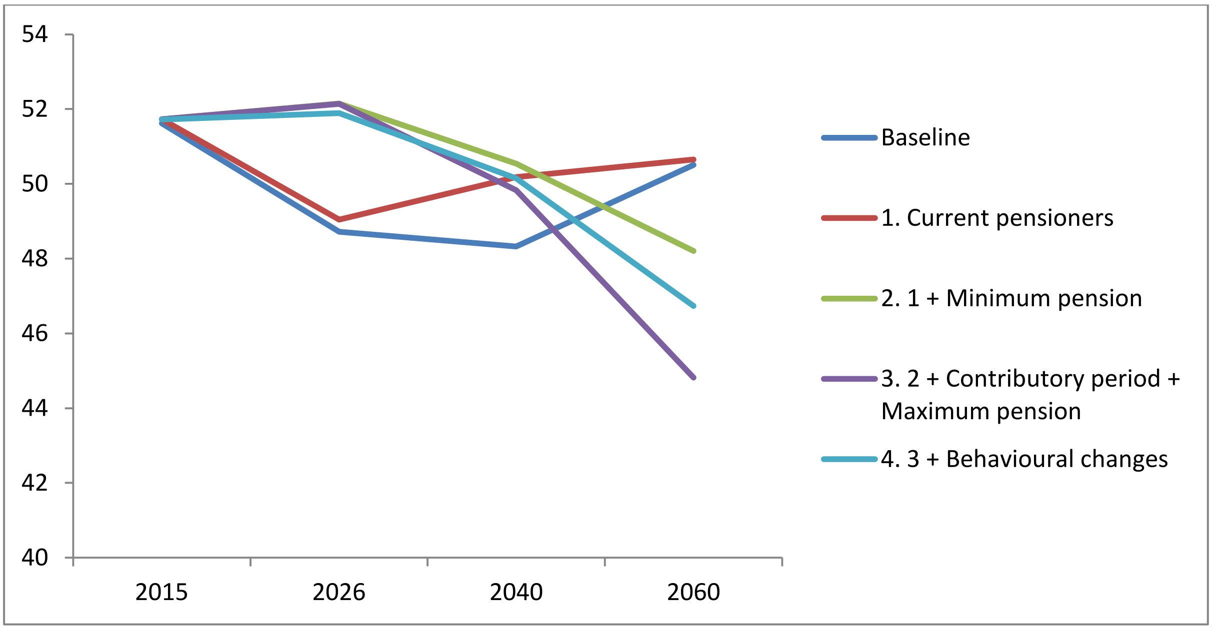


**Figure 39: Impact of the reforms on the increase in pension spending compared to 2015 (% of GDP)**




As can be seen in Figure 39, with no behavioural changes, the average generosity of the pension system – after the proposed reforms – would decline gradually to 45%, the same level projected in the 2007 pension reform. On the other hand, if labour participation reacts to the changes, the decline is more muted – 4.9 p.p. compared to the 9 p.p. anticipated in the 2007 reform.

**Figure 40: Impact of these reforms on the Average Pension Replacement Rate (% of average wage)**




It is also important to note that whilst the replacement rate is forecasted to decline, the level of the average pension, taking into account the projected increase in living costs, will still grow significantly over time. In fact, up to the mid-1940s the reforms are set to enhance the value of the average pension compared to the current rules, as can be seen in Figure 41. By 2060, the level of the average pension will be some 7% lower than under current rules, but its level will still be 77% higher in real terms than it is now.

**Figure 41: Impact of proposed reforms on the Average Pension in 2016 constant prices**


To a large extent the improvement in the level of the average pension between 2016 and the mid-2040s reflects the early introduction of the GNMP. As can be seen from Figure 42, the proposed changes will result in an increase in the weekly contributory minimum pension of €21 on average. This increase will rise to €41 per week by 2026.Similalry, as shown in Figure 43, there will be significant improvements in the non-contributory minimum pension, initially rising by €7 per week, increasing to €20 per week in 2026.

**Figure 42: Impact of the early introduction of the GNMP**

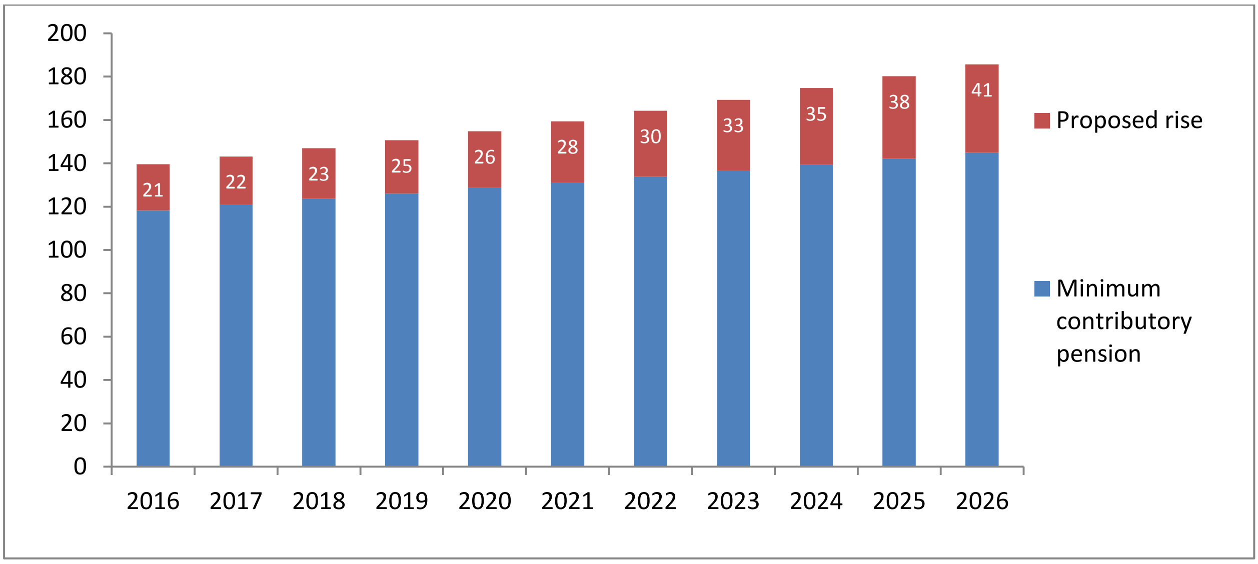
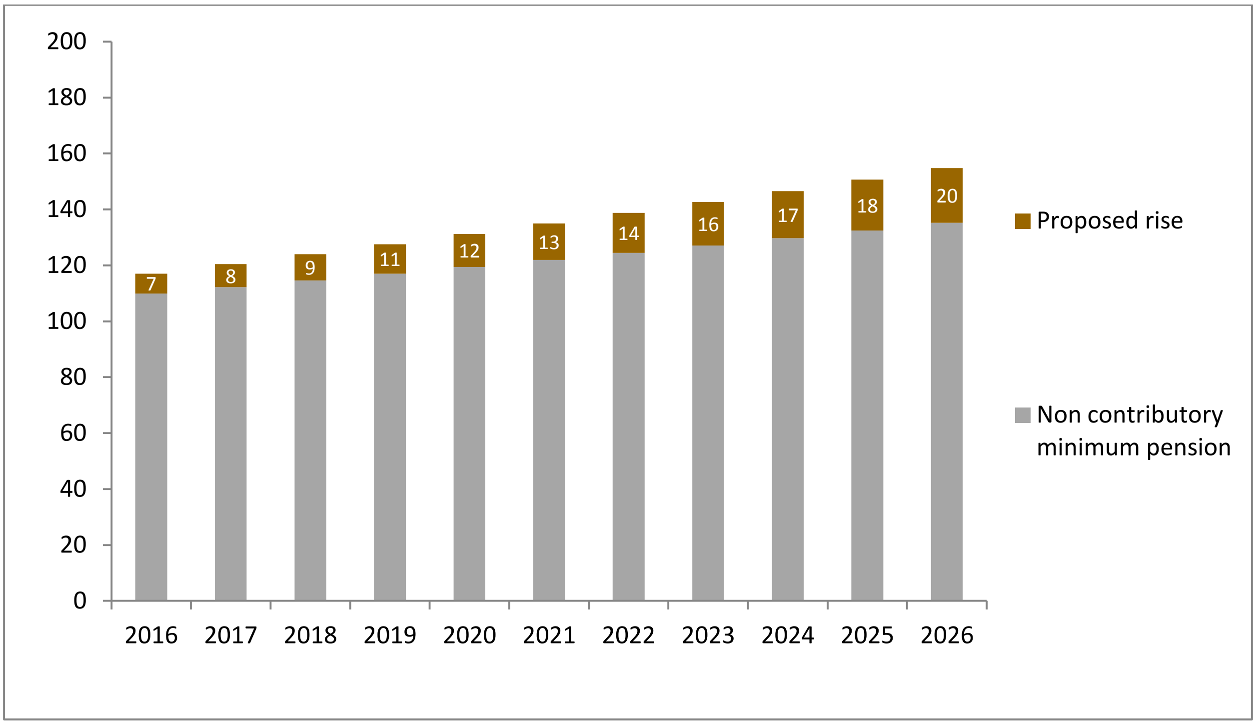


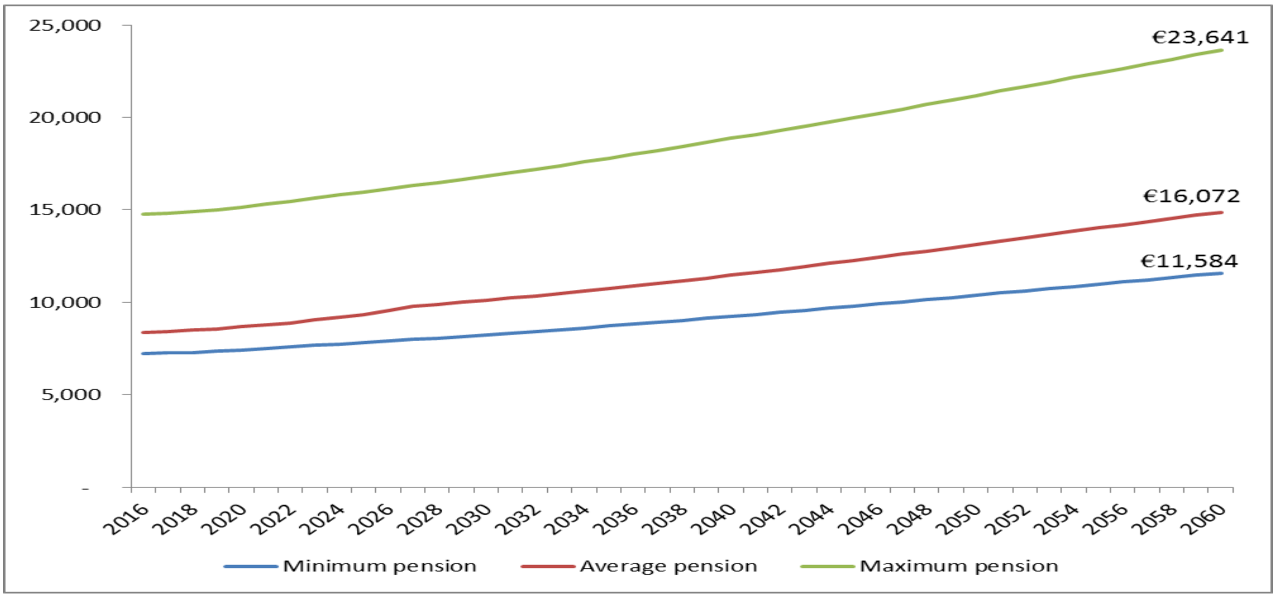
**Figure 43: Impact of the revision in the non-contributory minimum pension**




Besides the improvement in the minimum wage, the reform package also confirms the increase in the maximum pension for those born post-1962. These individuals are entitled to this improvement as they are paying a higher amount of contributions, both in terms of having a longer contributory period and a higher pension age, but also as they pay contributions on an additional amount of income compared to those born in earlier years.

Figure 44 shows how the minimum and maximum pension will evolve over time, after adjusting for projected inflation. Both the minimum and maximum pension will grow by 60% over the period 2016 to 2060 in real terms. The average wage will increase by 77%. This is expected to occur as the improvement in contributory records, especially for women, will be increasing entitlement. As a result fewer individuals will be just entitled to the minimum pension.

**Figure 44: Pension levels after reform in constant 2016 prices**



The recommendations presented by the Pensions Strategy Group, with particular regards to those presented in Section 04.2 of the report titled '**Reforms to the Pension System directed to ensure a Socially Sustainable System that provides for a Fair Balance between Contributions and Benefits across Generations,** are designed as a composite whole. Any single recommendation taken on its own, will not result in the desired impacts to the strengthening of adequacy and sustainability of the pension system that the Group has sought to address. The Strategy Group underlines, that the Government should avoid the temptation to cherry pick. Rather, the Strategy Group urges the Government to embrace the recommendations in their totality.

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