

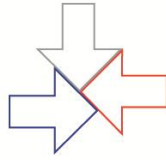
# **The Economic Implications of Pensions**

## **Reactions and Proposals by the Malta Employers' Association**

### **Executive Summary**

**The salient points of MEA's proposals for pension reform are:**

- The second pillar pension should not be introduced in the foreseeable future as it incurs a cost to employers and employees and could have negative economic consequences
- A stronger participation of the labour force is required to strengthen the first pillar pension
- In the medium term, there should be a shift from a purely pay as you go system to a first pillar which is partially funded
- Quality health care should remain free
- Fiscal incentives should be introduced to encourage more people to invest in voluntary third pillar pensions
- There should be consensus between social and political forces on the pensions issue to ensure that any reforms work to improve the welfare of pensioners and in the national interest



## **MALTA EMPLOYERS' ASSOCIATION**

### **The Economic Implications of Pensions**

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##### **1. Current situation**

In the past years there have been many discussions at MCESD regarding pension reform. There has been general consensus among the social partners about the fact that the pay as you go system was unsustainable and the pension system had to be updated to be in line with current and emerging realities.

In 2005 MEA had issued a position paper with proposals for pension reform. The main position adopted by the MEA was based on a number of recommendations which were:

- To raise the retirement age gradually to 65
- To incentivise a higher female participation rate in the labour force
- To have a system whereby pension funds are accounted for separately from health and other benefits
- To shift from a system relying exclusively on PAYG to a partly funded system
- To raise maximum pensionable income
- Introduce fiscal incentives for private pension schemes
- Incentivising a higher activity rate among the retired work force
- N.I. contributions to be increased to a minimum of 40 years to qualify for a full pension with accreditation given for childbearing; life-long learning; looking after elderly parents

A number of these proposals were taken on board when the pension reform was announced in 2008. However, when the reform was announced, it was also mentioned that the system will be reviewed every three years to see whether there was a need for an update.

The Pensions Working Group (PWG) still strongly recommends that a second pillar pension should be introduced. Their main arguments are that:

- the first pillar is still unsustainable in its current state - mainly because of demographic trends
- the second pillar will provide for a better income during retirement. The purchasing power of the first pillar will provide for a basic standard of living
- the second pillar will be based on a personal account

The PWG is aware of the problems of introducing the second pillar, and in the MCESD it has been opposed by both employers and unions as it implies an added cost to both workers and employers. Of common concern is the effect of a fall in disposable income on young persons.

However, the counter argument to that is that employers also have to be conscious of the economic impact of having a growing segment of the population living at subsistence level. This means that, beyond the sustainability argument lies another fundamental concern – that of assuring a decent standard of living to retired persons. This is desirable not just from a social perspective, but also from the perspective of a sustained aggregate demand in the economy which is one of the pre-requisites for growth.

In simplistic terms, the second pillar therefore presents social partners and policy makers with a thorny dilemma – less disposable income and consumption now and better prospects of a decent standard of living in future as against leaving more money to fuel current domestic demand with the risk of having a growing segment of the population living at close to poverty level in future.

The real question is: are these the only scenarios available? Or can there be corrective measures which will not make the mandatory introduction of the second pillar pension so inevitable?

MEA believes that, before committing employers and employees to introduce mandatory second pillar pensions, one needs to build models which also factor in policies which can either delay the onset of the second pillar pension, or which can replace the idea through strengthening the sustainability of the first pillar together with the introduction of voluntary saving schemes through a set of fiscal incentives.

## **2. Strengthening the First Pillar**

### **2.1 Transition from total reliance on PAYG to a Partially Funded Scheme**

PAYG should be reformed to introduce a funded component so that individuals will be paying to sustain their own individual pension. The PAYG component will continue to support existing pensioners and providing a basic standard of living while the funded component will, in the medium to long term, enhance the overall pensions package. It is recommended that the funded component

will be managed by the private sector. The transition to the funded scheme will entail a cost to government, but it can be introduced gradually over a number of years to minimise the fiscal impact.

MEA proposes that the sustainability of the first pillar can be improved through increasing the supply and demand of labour.

The supply of labour can be increased through:

- Higher female participation
- Later exit from the labour force
- Controlled immigration of labour

## **2.2 Higher Female Participation**

MEA has supported the introduction of family friendly measures that encourage higher participation in the labour force, rather than encouraging absence. The provision of subsidised child care, and the extension of school hours are both conducive to higher female participation without incurring a cost to employers and thus resulting in a negative effect on competitiveness. This is preferable to enforcing measures which incentivise absence, such as extension of maternity leave which is paid by employers and career breaks.

Employers should also be more flexible in the design of work organisation to cater as much as possible to the needs of their employees to strike a balance between work and family life through practical flexible work practices. Teleworking, reduced hours and other forms of atypical employment offer various options for work flexibility from which female employees may benefit.

Although Malta still lags behind in female participation, this is definitely increasing among the younger cohorts due to cultural changes and a higher level of education among younger women.

## **2.3 Higher participation of Retired Persons**

The reform in the social security legislation to allow for retired persons to continue working without forfeiting their pensions has incentivised thousands of pensioners to continue working beyond retirement. The application of flexicurity measures to the elderly segment of the labour force is being effective in their retention at the workplace. On the other hand, it is unfortunate that early retirement opt outs are still commonly available. Layoffs resulting from privatisation of public entities, abusive boarding out for supposedly medical reasons and early retirement schemes to settle redundancies in the private sector all contribute to an early exit age which weakens the sustainability of the first pillar.

## **2.4 Controlled Immigration – increase in foreign workers in Malta**

Another method of increasing the labour supply is through a controlled influx of foreign labour, Already, there are more than 12000 foreign workers in Malta (approx. 7.5% of the labour force) and many of these contribute to the economy and the social security system. This could alleviate, to an extent, the pressures arising from the demographic shifts on the pension system.

## **2.5 Labour demand**

Policies to increase labour supply are ineffective or counterproductive unless the economy is sufficiently competitive to generate productive employment. Attempting to solve the welfare gap by adding burdens on employers – for example through second pillar contributions – without giving due consideration to the impact on costs and competitiveness may drive people out of jobs in the private sector. Ultimately, the key to sustainability lies in economic growth, and economic growth depends on competitiveness, and in increasing the value of the output of our human resource.

## **3. Incentivising the Third Pillar**

Introducing the third pillar might strike a desirable balance to encourage people to save to top up the first pillar pension. The third pillar should encourage private savings and Malta already has a sound regulatory structure – through the financial services industry – to offer a range of products to people wanting to build a ‘nest’ for their retirement. Although this carries an inevitable risk to investors, the experience in other countries teaches us that the second pillar also carries a similar risk. Government has to implement the necessary legal and administrative safeguards to minimise such risk.

MEA also advocates implementing fiscal incentives to stimulate a higher take up of third pillar packages, and also continuous media campaigns to encourage savings. People need to understand and act on the knowledge that the first pillar on its own simply cannot guarantee a ‘decent’ standard of living during retirement. This would be a better route than introducing a mandatory second pillar.

There is still a strong argument in favour of the second pillar pension in that it shifts the pension system from its current dependence on the pay as you go. However, this objective will still be achieved through the introduction of a voluntary third pillar. The third pillar will also allow for more flexibility in the manner in which individuals and households manage their assets, as its voluntary nature will determine whether they save at all, or whether they would prefer to invest in financial or real assets (i.e. property). Another advantage is that it minimises the administrative costs which are

part and parcel of managing second pillar schemes, and avoids the complexities of pension mobility which could become an administrative nightmare, particularly for SMEs and micro businesses.

The role of the first pillar will more or less be to serve as a safety net in those cases where there are no savings. The fact that in Malta all health care is free (assuming it remains so) strengthens the basic safety net of the first pillar. The first pillar may also be subject to review. Just as the social security ceiling and maximum pensions have been revised in recent years, similar corrective actions may be introduced in future to adjust it to changing situations. It could be the case that simply raising social security contributions gradually, together with other measures proposed in this report, may waver the need to introduce a second pillar element, and might also be less cumbersome to administer for employers.

#### **4. Free Quality Health Care**

The issue of pension reform and sustainability is closely linked to the retention of provision of free quality healthcare. Free healthcare enhances the quality of life of pensioners and offers reassurance about a basic need to this segment of the population.

#### **Conclusion**

There is no question that the issue of pension reform merits further discussion and constant review. The decision to have a three year strategic review provides a valuable opportunity to monitor developments and to anticipate any actions that may be required in sufficient time to avoid sudden shocks. Although there are no clear cut arguments for or against introducing mandatory second pillar pensions, current and projected circumstances would point in favour of encouraging a voluntary third pillar and enforcing sufficient control to ensure good governance, whilst adopting measures which will – directly or indirectly – improve the sustainability of the first pillar. For these reasons, MEA believes that mandatory second pillar pensions should not be introduced in the foreseeable future.

The discussion on pensions should be ongoing and consensus should be reached between all political and social forces to ensure their sustainability. This requires a holistic approach which takes into consideration the numerous external variables which are involved.