STRATEGIC REFORM OF RETIREMENT, SURVIVOR, AND DISABILITY BENEFITS

A discussion document forming part of the review of comprehensive social security

DEPARTMENT OF SOCIAL DEVELOPMENT

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GLOSSARY OF TERMS

- **Accredited/Approved Funds (AFs)**: Private arrangements that are authorized to manage designated social security benefits. This would include funds permitted to serve the mandatory tier as well as to offer tax privileged arrangements.
- **Basic pension**: This refers to a non-contributory pension payment to persons over the age of 60 and is essentially no different to the SOAP and is used interchangeably in the text.
- **Beneficiaries**: People, whether members or dependents of members, who are in receipt of social security benefits.
- **Contribution Ceiling**: This refers to the maximum mandatory social security contribution level expressed in relation to an income level.
- **Contribution floor**: The income level above which individuals are obliged to make social security contributions. If the contribution floor is X per annum, the social security contribution will only be calculated from the income above X for all members. People earning below the contribution floor would not be included in the contributory social security system.
- **Contribution Threshold**: In this report this refers to any contribution parameter defined as a percentage of the member's gross income.
- **Contributors**: Persons or entities required to make a social security contribution, e.g. "members", "employers" and "government".
- **Defined benefit (DB)**: A retirement arrangement where the benefit formula determines the level of benefits and the link between individual contributions and benefits. Benefits can be either flat rate or earnings-related in nature.
- **Defined contribution (DC)**: A retirement arrangement where benefits are dependent on the value of contributions plus investment returns less the expenses for operating the arrangement.
- **Inter-departmental Task Team on Social Security (IDTT)**: Inter-departmental structure established to co-ordinate inter-governmental consensus on an integrated social security strategy. The IDTT includes government departments and related organs of state with a direct responsibility for any area of social security.
- **National Social Security Fund (NSSF)**: A proposed statutory retirement fund to be established by government for the purpose of managing mandatory retirement risk benefits and basic retirement benefit arrangement.
- **Notional defined contribution (NDC)**: A retirement arrangement similar to a DB fund except that the promised benefits are determined on the same basis as a DC fund.
- **Pay-as-you-go (PAYGO)**: Any system of retirement or risk benefits that are paid from current contributions.

- **Social security contribution**: A member's legally required contribution toward a combination of social security programmes.
- **Social security benefits**: In this paper this is taken to refer to both "retirement benefit" and "risk" benefit arrangements.
- **State Old Age Pension (SOAP)**: The existing means-tested social assistance benefit provided to females and ultimately males over the age of 60. The qualifying age for males is in the process of being incrementally adjusted from an initial 65 to 60.

ABBREVIATIONS

AF	Approved Funds
COIDA	Compensation for Occupational Injuries and Diseases Act
DB	Defined benefit
DC	Defined contribution
DOH	Department of Health
DOL	Department of Labour
DOT	Department of Transport
DSD	Department of Social Development
DSS	Department of Social Security
FSB	Financial Services Board
GEMS	Government Employees Medical Scheme
GEPF	Government Employees Pension Fund
IDTT	Interdepartmental Task Team [on Social Security]
ILO	International Labour Organisation
ISSA	International Social Security Association
MSSR	Master Social Security Registry
NDC	Notional defined contribution
NEDLAC	National Economic Labour and Development Council
NSSF	National Social Security Fund
NT	National Treasury
ODMWA	Occupational Diseases in Mines and Works Act
PAYGO	Pay as you go
PFMA	Public Finance Management Act
RAF	Road Accident Fund
SARS	South African Revenue Services
SASSA	South African Social Security Agency
SOAP	State Old Age Pension
SSB	Social Security Board
SST	Social Security Tribunal
SSTC	Social Security Technical Committee
UIF	Unemployment Insurance Fund

1. INTRODUCTION

1.1 Consideration of the comprehensive reform of the social security system only began from 2000 with the establishment of the Taylor Committee.[1] This was the first process to examine options for an integrated approach for all areas of social security in accordance with a consistent set of principles and guidelines.

1.2 Many of the issues and options examined by the Taylor Committee have moved on considerably, with better picture evolving over what specific policy options should be within the range of consideration by government. The overriding principles, objectives, and solutions, even when not in final form, are far closer to implementation. However, as yet very little in the way of actual implementation has occurred. Particularly in the area of contributory social security.

1.3 This report focuses primarily on one area of comprehensive social security, which is the non-contributory and contributory portion of retirement, survivor, and disability protection. The purpose is to identify as clearly as possible an implementable position for government to consider. This report supplements the government position paper released on comprehensive social security reform[2], and seeks to elaborate on various options as part of a substantive consultation process.

1.4 Social security reform involves a long-term investment in social stability focusing on the well-being of the family. Without such reform many families will continue to experience preventable hardship resulting from unavoidable life crises. Achieving social security aims and objectives rests entirely on the quality and sustainability of the institutions, both public and private, supporting the delivery of benefits.

1.5 For this reason careful attention needs to be given to the restructuring and governance of state institutions, and the improved regulation of private institutions. However, as with all structural change, careful consideration must to be given to existing institutional investments with systemic change confined to instances where clear social advantages will materialize.

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[1] Taylor Committee, March 2002.

[2] RSA, 2009.

2. BACKGROUND

2.1 There have been a number of processes focusing on retirement reform over the past fifteen years including:

- The Retirement Consultative Forum of 1997;
- The Taylor Committee of Inquiry 2002;
- National Treasury consultation document of 2004;
- National Treasury consultation document of 2007; and
- Department of Social Development (DSD) consultation document of 2007.

2.2 In 2007 government initiated various processes to begin the process of investigating comprehensive social security reform and to finalize recommendations in this regard. This included the establishment of an inter-departmental task team (IDTT) dealing with comprehensive social security which reports to the various Ministers with social security mandates.

2.3 The ministries responsible for social security include:

- Social Development;
- National Treasury;
- Labour;
- Public Service Administration;
- Health;
- Transport; and
- Presidency.

2.4 The IDTT operates as a standing process to review all social security proposals with a view to ensuring their integration into a comprehensive system of social security. The recommendations and points of departure emanating from this process, subsequent to government review and approval, are contained in the government position paper released for consultation.[3] This report therefore serves as an elaboration of positions and options raised in parts of that report to assist in deepening the public engagement process.

[3] RSA, 2009.

3. AIMS AND OBJECTIVES OF A SOCIAL SECURITY SYSTEM

Overview

3.1 The aims and objectives outlined in the government report[4] provide an important basis for prioritizing social security interventions. For that reason they are repeated in this report as they help frame subsequent deliberations.

Purpose of aims and objective

3.2 The aims and objectives need to be directed at the social security system as a whole, rather than certain parts of it. The system includes government departments; statutory institutions; regulated private institutions; regulatory authorities; and judicial and semi-judicial arrangements.

3.3 The **potential aims** of the social security system are:

- *Aim 1*: To integrate the social security system such that no individual or family:
  a) Is forced to live below a reasonable level of income sufficiency;
  b) Falls below a reasonable level of income sufficiency;
  c) Suffers severe reversals of life circumstances due to circumstances beyond their control; and
- *Aim 2*: To promote the integration of all people and families into a well-functioning society.

Box 3.1: Defining Income Sufficiency

Income sufficiency is referred to instead of poverty, as poverty is not a very accurate term. Income sufficiency is a broader measure that takes account of a household's ability to engage positively in society. The notion of poverty captures only the ability of a person or household to survive and is therefore not a good target for the achievement of long-term policy goals. However, the term income sufficiency is itself not always clear, and is open to interpretation. This is therefore something that needs to be discussed in a public debate.

Source: Department of Social Development, 2008, p.3.

3.4 Six *strategic objectives*, consistent with the above aims, are:

- *Objective 1*: Income insufficiency should be eliminated and prevented, no matter the cause.

[4] See RSA, 2009.

- *Objective 2*: Contributory social security should be structured to be as inclusive as possible.
- *Objective 3*: Subsidies of any form should be transparent and focused on the achievement of social security objectives.
- *Objective 4*: Social security arrangements should apply equally to citizens and permanent residents, with the fair treatment of temporary residents.
- *Objective 5*: Public and private social security arrangements should, without exception, be subject to adequate oversight, regulation and governance.
- *Objective 6*: The social security system should, as far as possible, encourage employment creation and formal sector participation.

3.5 The aims consequently reflect two distinct elements: protections for people without adequate income; and protections for those who may have adequate income but who could suffer an avoidable reversal of fortune.

3.6 Protecting those without adequate income serves to promote human development to the extent that families are able ultimately to fully and effectively participate in society. Protecting those with income, particularly low-income earners, serves to avoid any unwarranted social reversals. These aims, although related, are mutually exclusive and involve no, or very limited, trade-offs.[5] For this reason both aims can be pursued simultaneously.

[5] Preventing social reversals typically involve mandating participation in various private or socialized arrangements (mandated income smoothing, income preservation, and risk pooling), rather than focusing on income redistribution.

4. SOCIAL SECURITY DESIGN – THE DISTINCTION BETWEEN CONTRIBUTORY AND NON-CONTRIBUTORY SOCIAL SECURITY

Overview

4.1 A comprehensive system of social security seeks to protect society from avoidable risks irrespective of income or socioeconomic status. However, social security interventions need to be sensitive to the particular needs of different socioeconomic groups. Broadly speaking social security interventions can be divided into two categories: *non-contributory* and *contributory*, with the former focused on supporting those with limited income and the latter on those without income.

4.2 *Section 27* of the Constitution indicates that everyone has the right to have access to -

- "*health care services, including reproductive health care*";
- "*sufficient food and water*"; and
- "*social security, including, if they are unable to support themselves and their dependants, appropriate social assistance*."

4.3 The Constitution distinguishes between social assistance and social security, effectively differentiating between non-contributory social security (social assistance and in-kind benefits) and contributory social security (social security). The Constitution therefore accepts implicitly that contributory social security need not as a rule be universal. *However, where incomplete an appropriate non-contributory arrangement should at least be available.*

Non-contributory social security

4.4 Non-contributory social security arrangements (e.g. social assistance) aim at sharing out resources more equally and are normally funded from general taxes. Although they are important in all countries, such arrangements are more important in poorer countries because the process of economic development involves a systemic disruption of communities with a disproportionate impact on those with the lowest income.

4.5 These arrangements have an important a developmental purpose through the protection offered to the poorer sections of society. However, if they are not organized properly, they can also make human development more difficult by discouraging appropriate participation in the economy.

Contributory social security

4.6 Contributory social security arrangements (in other words, funds into which people pay regular amounts over a period of time) are aimed at helping people protect themselves with insurance policies for health, death, and disability. They are mainly aimed at income-earning households. They also involve mandatory income smoothing through forced savings arrangements such as pension funds, which can be public or private.

4.7 Contributory social security tries to share risk and smooth out an individual's income over his or her lifetime. This is typically not possible when arrangements are voluntary, for-profit and unregulated. Putting contributory social security into place does not depend on the national availability of resources, but instead draws on a reasonable proportion of individual and/or family income.

4.8 Although contributory social security arrangements focus on apparently less vulnerable groups (from a socioeconomic perspective) than non-contributory arrangements, both are essential elements of a comprehensive social security system. The former benefit more from redistributive schemes, many of which are non-contributory in nature, while the latter mostly require structural interventions to protect specific categories of vulnerable person unrelated to income (e.g. the old, persons with disabilities, single parents, orphans, etc.).

5. RETIREMENT PROVISION AT PRESENT

Introduction

5.1 A range of retirement arrangements exist which are intertwined with the long-term insurance products and insurers through the provision of group risk benefits, administration and investment management. Other players include employee benefit companies and retirement funds with various methods by which they interact with insurers.

5.2 A substantial array of market participants and arrangements exist all providing differing levels and quality of protection. Although providing variable cover, the existing system has adapted well to the almost non-existent strategic policy vacuum that has persisted for many years. Understanding the way forward consequently requires an acknowledgement of what exists and why.

5.3 The evolution of group retirement and risk (survivor and disability) benefits have emerged primarily via employers as an indirect form of compensation. In the absence of the state as an initiator of social protection, employers are a second-best solution due to their ability to pool employees for the purposes of establishing employer sponsored arrangements and contracting.

5.4 Another form of solidarity occurs through unions which are often able to group employees across employers by industry. Again, although not perfect, this is a second-best solution in the absence of strategic government interventions.

5.5 Private retirement arrangements consequently represent an important base off which to build and should not be negated purely because of the inevitable short-comings. It is well understood that without strategic government intervention the market would not be able to improve the quality of protection available. There is however a need to explicitly highlight what is wrong with the existing system to ensure that policy is properly prioritized.

Background

5.6 Due in large part to the minimalist focus of the apartheid to human development, South Africa has never evolved a coherent social security system in a manner consistent with peer countries. As white were historically guaranteed employment, conventional contributory employee benefit arrangements for retirement, survivor, and disability benefits were sufficient to achieve similar levels of protection possible in industrialized country settings.

5.7 Seen together with non-contributory benefit arrangements for retirement and disability differentiated by race, generated a form of earnings-related tier below the contributory systems. Whites and Asians were consequently allocated far better non-contributory social assistance than Blacks and Coloureds. This reflected a perceived difference in living standard for each race group that needed to be protected. Quite clearly the principles upon which this social security system was based were unique internationally and would not survive within a democratic open society.

5.8 The elimination of apartheid however left a partially constructed system without its racially based pillars. Although the social grants system provides basic protection, there is no sound structural base upon which to protect income earners from life crises and the consequences of aging. Income earners, irrespective of race, are not guaranteed employment for life and will consequently experience many difficulties due to unemployment, ill health, disability, and the death of a breadwinner. The voluntary arrangements, which were premised on full employment for Whites, fall far short of the requirements for adequate social security, even within a de-racialised society.

5.9 The incorporation of African workers into the contributory pension system took shape in the early 1980s centering initially around objections to proposed legislation (Preservation of Pension Interests Bill of 1981) which would have required the compulsory preservation of pensions upon withdrawal from a fund for African workers. The objections were sufficiently strong for the legislation to be withdrawn. From that period on, however, Black trades unions (in particular COSATU) developed their own provident funds and managed the investments. These funds are DC in nature and largely pay out lump-sum benefits.[6]

5.10 As with all other areas of policy, government does not have the luxury of a clean slate. By default South Africa has inherited an extreme version of what can be referred to as a "decentralized model" of contributory retirement funding, a term used to describe the approach adopted by Chile from 1982 onward. However, even the controversial Chilean model, which has caused much debate ever since its inception, nevertheless embodies many of the social security elements still missing within South Africa.

5.11 In stark contrast with many developing countries therefore, South Africa seeks to structurally transform its contributory social security system from the vantage point of an extreme decentralized model, with limited social security protections in place. It is unavoidable therefore that any attempt to implement these tiers would involve some substitution from existing provision, and a degree of disruption to existing players. Understanding where we are is consequently extremely important.

Retirement arrangements

5.12 Retirement funds can take a number of forms in South Africa:[7]

- *Pension funds*: These provide annuities (normally in the form of monthly pensions) for employees on retirement. The Income Tax Act (ITA) limits the option of a lump sum benefit to no more than one-third of the annuity payable.

[6] DSD, 2007, p.58.

[7] See DSD, 2007, pp.57-58.

- *Provident funds*: These provide benefits for employees on retirement or solely for the purpose of providing benefits to a deceased member's dependants or for a combination of both. The benefits may be paid by way of a lump sum. No employee contribution is tax deductible.
- *Umbrella funds*: These are either pension or provident funds available to employers. These multiple employer funds are typically sponsored by a financial services company. Essentially employees working for different employers or organizations are able to join a single fund. Umbrella funds operate on a DC basis and are consequently fully funded. These funds have no elected trustees, with trustees usually drawn from the administration company or its ultimate owner.
- *Segregated funds*: This is an arrangement whereby the investments of a particular pension scheme are managed by an insurance company independently of other funds under its control. In such instances the governance structure of the pension fund conforms to the requirements of a closed occupational pension fund, unlike with umbrella funds.
- *Retirement annuity*: This is a personal pension arrangement that can be taken out by an individual with a life assurance company. Both lump sum and monthly contributions can be made. The monies placed in the fund are not accessible until the member reaches an age in excess of 55 years. The performance of the fund is typically market-linked. Such funds are registered with the Financial Services Board and the South African Revenue Service. Such arrangements include linked funds where annuities are tied to specified market instruments, such as unit trusts. Withdrawals prior to age 55 cannot be made, except for disability.
- *Preservation funds*: Where an individual transferring from an employer is unable to transfer their pension to a new fund, an option is to make use of a preservation fund. Such funds allow an individual to 'park' their retirement savings somewhere until such time as they can switch it to a more appropriate vehicle. No tax is paid on withdrawal from the original fund, as the preservation fund has a similar (but different) tax status to ordinary pension funds and retirement annuities. It is possible to make one withdrawal of any amount from these funds prior to retirement, but no top-up contributions can be paid. The rules of the ex-employer fund determine the rules applicable in the preservation fund.
- *Approved and unapproved funds*: An "approved scheme means that it has been tax approved by the Commissioner for Inland Revenue. As a consequence contributions to such a fund are tax deductible although the benefits are generally taxed. A condition for approval requires the existence of an element of retirement funding. Contributions to "unapproved" schemes are taxable

although the lump sum benefit is free of tax. Schemes which contain only risk benefits and no retirement funding are always unapproved.[8]

5.13 There are essentially two retirement fund modalities unaffected by whether the retirement fund is a pension or provident fund. These are:

- *Defined contribution (DC) funds*: A defined contribution scheme refers to arrangements where the benefit is derived from the contribution to the fund, the return on investments, and less any costs, expenses or taxes. The member assumes the risk of market performance.
- *Defined benefit (DB) funds*: These are sometimes referred to as "final salary" or a "fixed benefit" fund. This type of fund offers the retiring member a benefit which is determined according to a formula, taking account the member's final salary, years of membership and an accrual or pension factor.

5.14 Funds supervised in terms of the Pension Fund Act:[9]

- The Registrar of Pension Funds identifies the following three categories of fund supervised in terms of the Act (Registrar of Pension Funds, 2003):
  - *Foreign funds*: Funds with head offices, or head offices of the participating employers, located outside the Republic: in terms of section 2(2) of the Act, these funds are exempt from certain provisions. They are required to apply for registration in terms of section 4 of the Act and furnish security for the payment of benefits which may be payable to their members resident in the Republic and who are South African residents.
  - *Underwritten funds*: Funds which operate exclusively by means of policies of insurance issued by registered insurers in the Republic: These funds are required to register under the Act, but in terms of section 2(3)(a) of the Act, they may be exempted from sections 5(2), 9 or 9A as well as from any other provisions of the Act which the Registrar deems necessary.
  - *Self-administered funds*: Funds that invest their assets with bodies and institutions in the public and private sectors of the economy on their own behalf and to which the provisions of the Act apply.

5.15 Funds not supervised under the Pension Funds Act:

- A number of funds have been established through special laws and include the pension fund for public servants and various parastatals.

[8] Hendrie *et al*, 2007, p.19.

[9] DSD, 2007, pp.57-58.

- *Official funds*: These funds are supervised by National Treasury under their relevant laws. There are currently four official funds in existence namely: Temporary Employees Pension Fund, Associated Institutions Pension Fund, Associated Institutions Provident Fund and Government Employees Pension Fund.
- *Transnet Fund*: A fund for the employees of Transnet was established by the Transnet Pension Fund Act, 62 of 1990, with effect from 29 June 1990.
- *Telkom Fund*: A fund for the employees of Telkom SA Limited was established in terms of section 9(1) of the Post Office Act, 1958 (Act No.44 of 1958), with effect from 1 October 1991. Another fund, the Telkom Retirement Fund, is supervised under the Act.
- *Post Office Fund*: The Post Office Pension Fund, that was established in terms of section 10 of the aforementioned Act, with effect from 1 October 1991.
- *Bargaining Council Funds*: Funds that have been established by collective agreements concluded by councils in terms of the Labour Relations Act, 66 of 1995 and have opted not to register under the Pension Funds Act. The Department of Labour supervises these funds, which are exempted in terms of section 2(1) of the Act from the provisions of the Act other than the requirement to furnish certain statistical information.

Coverage and Quality of Coverage

5.16 There are presently around 13,325[10] (**table 5.1**) private retirement funds of which around 4,000 are dormant[11], which generate an aggregate replacement rate of between 24%[12] and 28%[13] of final income. Thus although contribution levels are significant, involving an estimated 5.5 million active members[14] and around R1.5 trillion in assets[15], the quality of the protection offered is questionable.

5.17 An important consequence of the high number of funds is the resulting cost of both administration and asset management, both of which are very difficult to

[10] Financial Services Board, 2008. Although retirement annuities are included in this number they constitute only a small handful. (Hendrie *et al*, 2007, p.22).

[11] Hendrie *et al*, 2007, p.22.

[12] DSD, 2007.

[13] National Treasury, 2007.

[14] This is the figure indicated in DSD (2007) and removes the double count involved with conventional reported data. The reported figure for 2006 is 9.3 million with 7.4 million active members.

[15] Financial Services Board, 2008. This would apply to the 2007 financial year and apply only to retirement funds.

determine from official statistics. Industry surveys[16] occasionally provide some information, but these are not sufficiently reliable for conclusive recommendations. **Table 5.2** provides information from one survey which as reported by National Treasury.[17]

Table 5.1: Retirement Funds

Financial year ending	2004	2005	2006
Number of Funds	13,618	13,390	13,325
Membership ('000)	9,858	9,271	9,334
Contributions (R'million)	72,826	75,131	72,009
Benefits paid (R'million)	86,195	85,937	84,024
Assets (R'million)	1,091,807	1,283,921	1,454,827

Source: FSB Annual Report, 2008, p.56.

5.18 Contribution income to retirement funds in 2006 amounted to R72 billion with R84 billion in benefits/withdrawals.[18] However, this information does not adequately distinguish between risk and retirement contributions. There is consequently no reliable information source that can provide a control estimate of total contributions and benefits flowing through the retirement system.

5.19 For those earning above R1,000 per month in 2007 total participants amounted to 4.8 million[19] according to the Labour Force Survey (LFS). Around 2.7 million people who could contribute however presently do not participate. This is roughly consistent with the DSD estimate of 2 million in the formal sector and a further 3.3 million in the informal sector.[20]

[16] The Sanlam Employee Benefits Survey are nevertheless extremely useful in the absence of more authoritative studies.

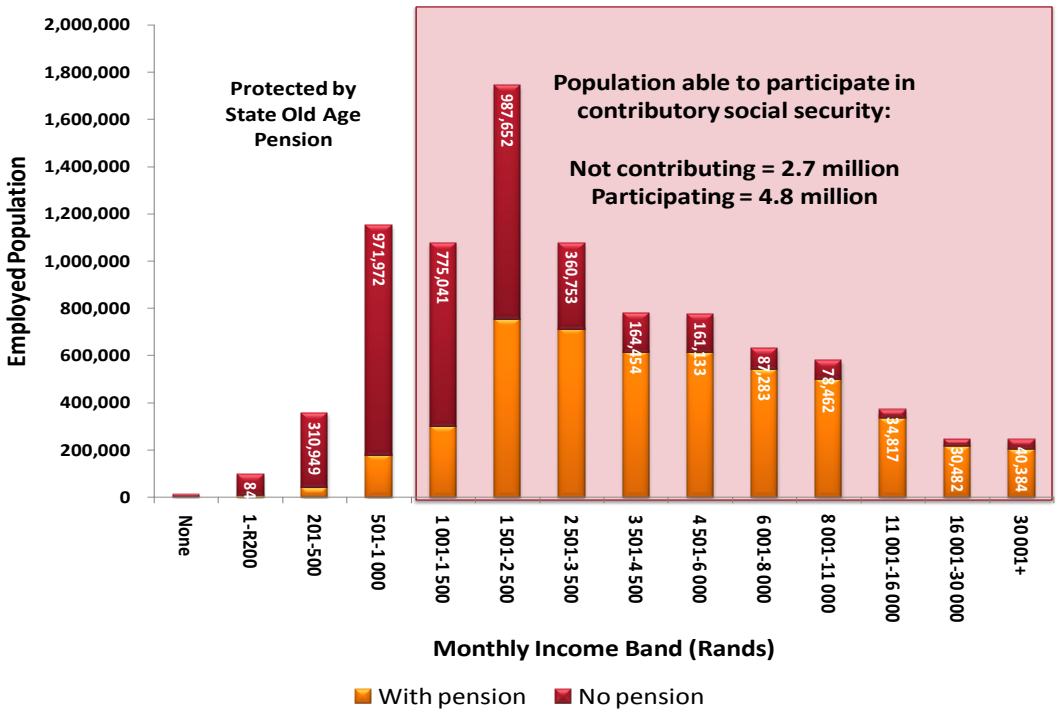
[17] National Treasury, 2009.

[18] Financial Services Board, 2008.

[19] This accords with a total of 5.5 million in total.

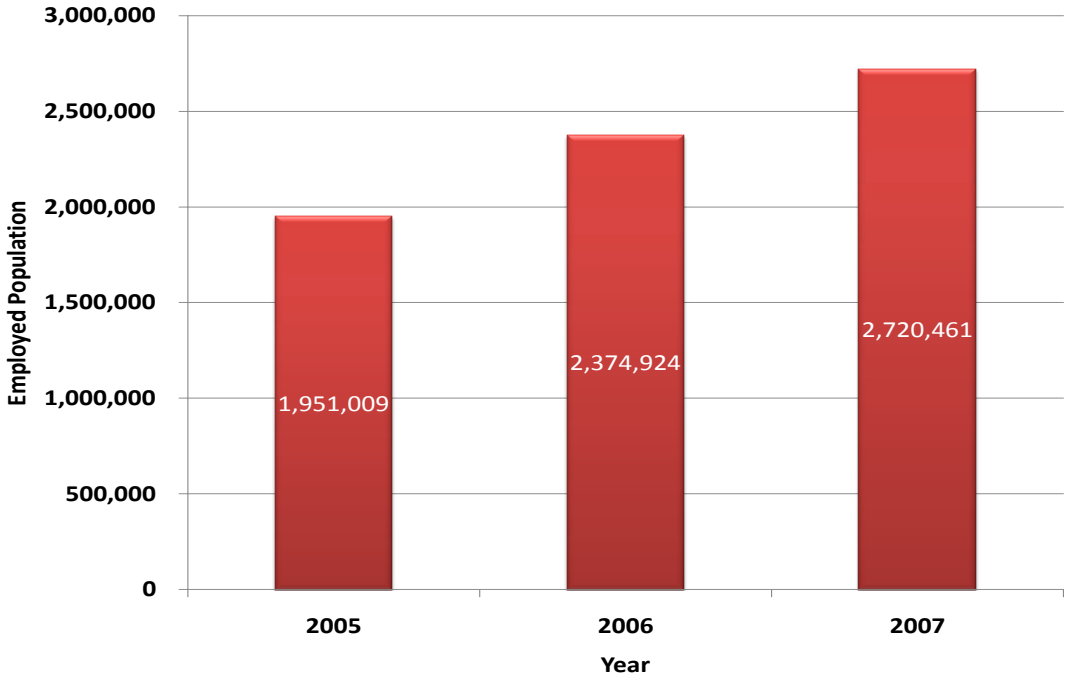
[20] DSD, 2007, p.63.

Figure 5.1: Population with and without private pension coverage (2007)



Source: Statistics South Africa, Labour Force Survey 2007.

Figure 5.2: Employed population earning more than R1,000 per month without a pension (2007)



Cost structure

5.20 The cost structure of the existing retirement system is regarded as high based on available information.[21] Given the absence of transparency within the industry in relation to cost, however, it is possible that costs are far higher than reported or estimated. **Table 5.2** for instance provides a breakdown of cost according to survey information. However, noticeable by its absence is any information on asset management charges, which are likely to be significant within an advance funded DC system which prevails in the private sector.

Table 5.2: Estimated average contribution rates and costs for private DC funds

	Percentage of payroll					
	2009	**2008**	**2007**	**2006**	**2004**	**2002**
Employer contribution	9.9	9.5	9.7	10.0	10.2	10.6
Less: Insurance premiums:						
• Death	1.9	1.7	1.8	1.9	2.5	1.9
• Disability	1.3	1.3	1.2	1.4	1.8	1.5
Less: Administration fees[22]	1.3	1.1	1.0	1.2	1.4	1.0
Savings component : employer	5.4	5.4	5.7	5.5	4.5	6.2
Member contribution	5.9	5.5	5.5	6.0	6.3	6.2
Total contribution toward retirement	**11.3**	**10.9**	**11.2**	**11.5**	**10.8**	**12.4**

Source: Sanlam benchmark surveys including that of 2009.

5.21 The impact of administrative costs, including asset management fees, on the final value of a retirement benefit is typically opaque to retirement fund members. Based on **table 5.2** in 2006 administration fees are indicated as 1.2% of payroll, which translates into 11.5% of contribution or equivalent to roughly R7.5 billion in 2006 based on reported contributions of R72 billion. Assuming that the Sanlam Survey is correct and that asset management fees average 0.6% of assets under management, this would translate into a recurrent cost of R8.6 billion, assuming total assets under management of around R1.4 trillion, or 12% of contribution.

5.22 In total, therefore, based on industry surveys, administration costs including asset management fees amount to 23.5% of recurrent contributions or R16.1 billion in 2006. This may however be an underestimate. Nevertheless, if this figure is represented as a *charge ratio*, defined as "*one minus the ratio of the accumulated net charges to the accumulation without net charges*"[23] approximately 37.2% of the accumulated

[21] In addition to what is presented here, note should be taken of the analysis provided in DSD, 2007.

[22] Asset management fees, which are substantial, are not reported separately or provided in any report that has been independently verified. This item consequently excludes administrative expenditure.

[23] Whitehouse, 2000, p.25.

value of contributions, and assuming a 5% real return on investment, will have been dissipated in administrative fees of one form or another.[24] Importantly, more than half of this affect is due entirely to the requirement for advance funding within private retirement funds, irrespective of whether they are DB or DC.

Investment returns

5.23 Private DC arrangements do not offer benefit guarantees and their final benefits are determined exclusively by the return on investment received, after deducting expenses, on savings placed with them. Investment returns are therefore crucial to the social impact of a system of retirement. The sustainability of investment performance through time is therefore important as are the associated fees charged.

5.24 Investment returns can be quite volatile where the underlying investment is affected by naturally occurring business cycles. Such volatility can be reduced through the use of balanced portfolios which offset pro-cyclical investments with counter-cyclical investments. In addition, portfolios can include investments which provide a steady low risk return, such as government issued bonds.

5.25 However, balanced portfolios may provide a long-run return which is lower than the average return of a more risky portfolio when seen over a fairly long-period of time. For instance, a 40 year moving average[25] of the Johannesburg Stock Exchange (JSE) produces a real annual rate of return (before accounting for taxes and expenses) of around 10% for the period 1939 to 2005. Therefore, any portfolio manager able to smooth benefit promises over a long period could offer relatively high rates of return relative to a balanced portfolio where average returns are protected by reducing the average risk of the portfolio over shorter periods of time.

5.26 **Figure 5.2** contrasts the 40 year moving average with 10 and 5 year moving averages, demonstrating how volatile returns would be if pension fund benefits are exposed to market fluctuations, even where smoothed over periods up to 10 years. Only when funds are smoothed over a 40 year period will pension benefit returns be maximized at the long-term rate of return.

5.27 The extensive advance-funded retirement system in South Africa has generated a demand for asset managers able to manage returns at a level sufficient to cover pension promises, in the case of DB funds, and reasonable benefits in the case of DC funds. Included in the array of possible products are those companies, typically with substantial assets under management, able to offer some form of guaranteed return via smoothing.

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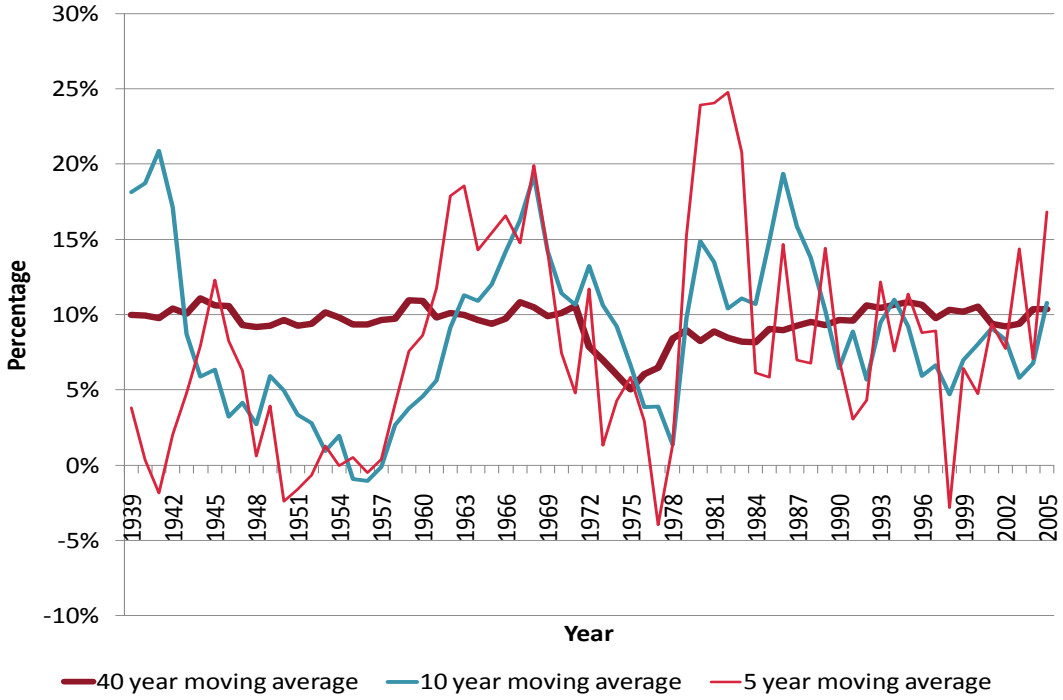
[24] This estimate assumes 40 years of contribution from an income earner with a constant income. The charge ratio will vary depending upon whether or not an individual faces a constant or rising real income over their lifetime.

[25] This is consistent with the working life of a potential pension fund contributor.

5.28 The Sanlam Survey[26] found that 63.5% of retirement funds surveyed regarded guarantees to fund members as important to very important. However, 41% felt they were only somewhat important with 13% regarding them as not important. Overall smoothed bonus and cash funds were most highly rated at providing stable investment returns to fund members.

Figure 5.2: Forty-year moving average of total real returns* in South African equity from 1939 to 2005 (percentage change)

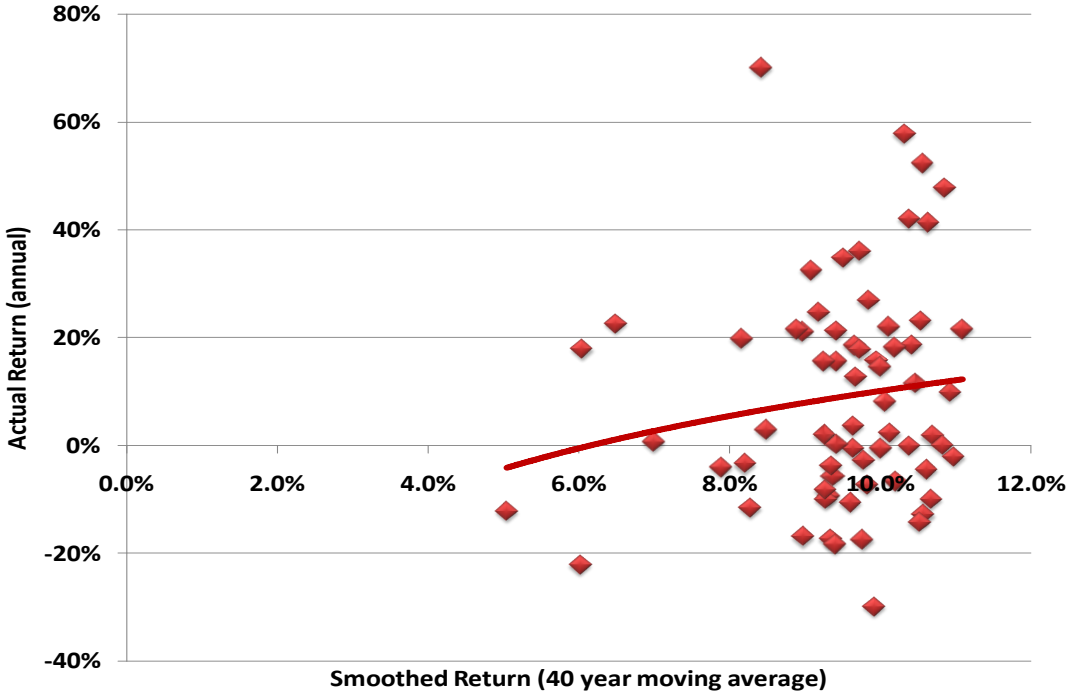


Source: JSE indices for the period 1900 to 2005

*This is inclusive of both capital growth and dividend yields.

[26] Sanlam, 2009, p.104.

Figure 5.3: Forty-year moving average of total real returns in South African equity from 1939 to 2005 compared to actual annual real changes (percentage)



Source: JSE indices for the period 1900 to 2005

5.29 The highest guarantees offered are the Consumer Price Index (CPI) plus five percent, which is lower than the long-run return as indicated in **figure 5.2**. Fees typically exceed 1% of assets.[27] Although it has been reported that the mean charge amounts to 0.6% of assets (see above), this figure is not reflective of the fees advertised in the market. The 2009 Sanlam Survey also fails to reflect asset management fees.

5.30 Although there is inadequate information on actual costs, the existing retirement fund environment pays a premium in investment advice due exclusively to the large number of funds. However, the large number of asset managers (around 300) clearly impacts on scale, market transparency, and efficiency. Going forward increased pension protection for contributors in South Africa will depend significantly on being able to guarantee investment returns while keeping costs low for any part of the system dependent on DC arrangements. Indications are that considerable consolidation will be required before such gains will be possible.

[27] Review of products on the market in 2009. An example is the Old Mutual Guarantee Fund which breaks up their fee into administration fees of 0.2% to 0.35% per annum, asset management charges of +/- 0.25% per annum, and a capital charge of 0.75% per annum.

Institutional framework

5.31 Contributing significantly to the high cost structure of the existing system of retirement is the high number of small funds. However, not much is publicly available demonstrating the distribution of funds by size, administrator, fund manager. From consultations with the industry the following could be ascertained:

- Number of administrators: 200[28]
- Number of asset managers: 300

5.32 Although there are around 13,000 funds the number of administrators and asset managers are likely to affect the underlying cost of the system. It is however not clear how the number of funds affects the contract prices actually realized for outsourced services. It is possible that a fair degree of price discrimination occurs with smaller funds being charged more than the true average cost of the relevant administrator. Again, the absence of adequate information means that a conclusive position cannot be reached.

5.33 A distribution of funds by size (**table 5.3**) shows that 73% of members are grouped into 88 funds, which although good when compared to the rest of the market, provides insufficient scale for efficiencies. Unfortunately, the data does not provide a more detailed breakdown for the funds in excess of 10,000 members which would be useful.

5.34 Bargaining Councils with retirement fund arrangements (**table 5.4**) also demonstrate a wide variation in scale, with only two showing the kind of scale required to minimize costs. Bargaining Councils nevertheless represent an important focal point for organizing group retirement and risk benefits distinct from the employer. Despite the inefficiencies, without Bargaining Councils it is quite probable that no benefits would have been organized. It would therefore be extremely important for any policy reform process to avoid undermining these achievements.

5.35 Aside from costs, an important consequence of this fragmentation is the fact that effective regulatory oversight is substantially undermined, placing many people at risk of governance failures. This is exacerbated by the existing model of governance which relied heavily on inexpert trustees to oversee predominantly outsourced administration and asset management arrangements. Conflicts of interest also arise consequentially through both the advice system (advisors have an interest in the contracts they advise on) and at the trustee level (due to poor oversight).

5.36 Enhancing governance would therefore require interventions that both strengthen the regulator while simultaneously making the market more regulatable. The latter can only be achieved by substantially reducing the quantum of regulated entities.

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[28] Financial Services Board.

5.37 The wide variety of retirement arrangements, noted above, also mitigates against standardization of: benefits (i.e. how do equivalent contributions compare between funds); the performance of benefits (return on investment and benefit guarantees); the quality of administration; and the cost of administration. The consequent low transparency therefore reduces market accountability on these parameters with an impact on performance.

5.38 The large number of funds, often with specific employer linkages, leads to reduced preservation as people shift between employers and types of employment. Each movement between employers consequently creates an opportunity for existing balances to be drawn down. Fewer multi-employer funds would allow participants to remain in the same fund despite a change of employer or employment status.

5.39 Persons not forming part of an organized group (e.g. the self-employed) face structural impediments in accessing affordable retirement arrangements that can offer value for money. They often need to purchase individual retirement policies of one form or another, which involve substantial costs that are not always apparent. Whereas individual products can perform a viable top-up role, they are not well suited to the provision of basic protection. This group could be protected through allowing non-discriminatory access to umbrella funds, and/or the introduction of a default government sponsored arrangement.

Table 5.3: Funds distributed membership size (2004)

Fund Size (band)	Number of funds	Percentage of total number of funds	Percentage of total number of members
1-20	7,696	56.5%	0.4%
21-50	1,944	14.3%	0.7%
51-100	1,173	8.6%	1.0%
101-500	1,769	13.0%	4.7%
501-1,000	447	3.3%	3.7%
1,001-5,000	440	3.2%	11.5%
5,001-10,000	61	0.4%	5.0%
10,000+	88	0.6%	73.0%
Total	**13,618**	**100.0%**	**100.0%**

Source: Financial Services Board

Table 5.4: Bargaining Councils with retirement funds by size

Bargaining Council	Employees	% of tot	Employers
Jewellery and Precious Metal Industry: Cape	-	0.0%	64
Furniture Manufacturing Industry: Eastern Cape	667	0.1%	65
Hairdressing and Cosmetology: Kwazulu-Natal	700	0.1%	200
Laundry, Cleaning and Dying Industry	850	0.1%	86
Canvas Goods Industry: Witwatersrand and Pretoria	1,000	0.1%	40
Laundry, Cleaning and Dying Industry: Cape	1,405	0.2%	22
Building industry: East London	1,500	0.2%	100
Hairdressing and Cosmetology: Cape Peninsula	1,800	0.2%	550
Diamond Cutting Industry: National	2,165	0.3%	49
Building industry: Bloemfontein	2,200	0.3%	160
Building industry: Kimberly	2,700	0.3%	90
Building industry: North and West Boland	3,678	0.5%	235
Meat Trade: Gauteng	3,697	0.5%	861
Hairdressing and Cosmetology: Semi-National	4,351	0.5%	1,617
Furniture Manufacturing Industry: Western Cape	5,000	0.6%	230
Furniture Manufacturing Industry: Kwazulu-Natal	7,000	0.9%	250
Building industry: Southern and Eastern Cape	10,000	1.2%	1,000
Contract Cleaning Industry: Natal	12,000	1.5%	235
Electrical Industry of South Africa: National	15,365	1.9%	3,342
Leather Industry of South Africa	17,256	2.1%	278
Furniture Greater Northern	17,261	2.1%	1,289
Restaurant Catering and Allied Trades	26,200	3.3%	5,500
Building industry: Cape of Good Hope	34,000	4.2%	1,000
Road Freight Industry: National	60,000	7.5%	3,000
Clothing Manufacturing Industry National	74,456	9.2%	1,048
Motor Industry Bargaining Council: National	200,000	24.8%	18,000
Metal and Engineering Industries	300,000	37.3%	9,500
Total	**805,251**	**100.0%**	**48,811**

Source: Budlander *et al*, 2007.

Simulation of the existing market

5.40 To provide a quantification of the existing social security system and its effective performance around key variables a microsimulation model has been developed using the 2006 General Household Survey (GHS 2006). It is fully described in **annexure A** to this report. **Box 5.1** provides a brief description of the model to facilitate an understanding of this section.

5.41 As this is a model, and the GHS 2006 did not contain information on contributory retirement and risk benefit participation, the simulation of the current environment required a few simplifying assumptions. This involved setting certain known parameters as controls (e.g. total number of contributors, average contribution rates, administration costs, and asset management fees).

5.42 The known number of contributors was set by determining which contribution floor achieved the known number of contributors. Total assets required for the

system was determined simplistically by setting the required value of assets to pay out benefits equivalent to current contributions with a 5% real return assumed. The simulation assumptions are listed in **table 5.5** and the key outputs listed in **table 5.6**.

5.43 The assumed number of contributors, based roughly on estimates for 2006, is taken as 5.6 million (between the ages of 25 and 65) with an average gross contribution of 11.5% of affected income. This suggests, roughly, that individuals earning more than R22,000 per annum in 2006 were participating. An income ceiling of R700,000 is assumed as beyond this level alternatives to retirement vehicles are not regarded as socially relevant. This is roughly consistent with the level regarded as relevant for social security interventions of any form. It is also assumed that all retirement funds are advance funded and DC in nature.[29]

Box 5.1: Microsimulation Model Description

Using the GHS 2006 key parameters of the social security system are simulated on a cross-sectional basis, i.e. they focus only on a snapshot in time. This model should be distinguished from the *longitudinal models* developed to estimate the long-term implications of retirement and risk benefit reform options. The microsimulation model focuses on both aggregate and distributional affects of any configuration of the social security system. The model treats the survey population as a registry of potential social security beneficiaries that is subjected to alternative qualification or disqualification criteria for both contributions and benefits.

Table 5.5: Simulation Assumptions (2006)

Contribution as a % of affected income	11.5%
Contribution floor – individual income (Rands)	22,000
Contribution income ceiling – individual income (Rands)	700,000
Advance funded	yes
Benefit type (predominant)	DC
Administration cost (% of contribution)	13.0%
Asset management cost (% of assets)	0.6%
Interest rate	5.0%

5.44 The results indicate that gross contributions within these parameters amount to R72 billion, with R1.4 trillion required in assets. Administration costs are extremely high, estimated at R16 billion per annum, or 22.4% of gross contributions. The resulting charge ratio is 37.2%, which is not inconsistent with

[29] Although this does not reflect the position with the Government Employees Pension Fund (GEPF) and certain parastatals, it does predominantly reflect the prevailing position of the remaining private system. Nevertheless, all the relevant public funds are advance funded and therefore approximate key characteristics of a DC system.

voluntary arrangements internationally. However, such depletion in the final value of benefits is at variance with the minimum required performance of social security systems, particularly where reliance is placed to any degree on DC arrangements.

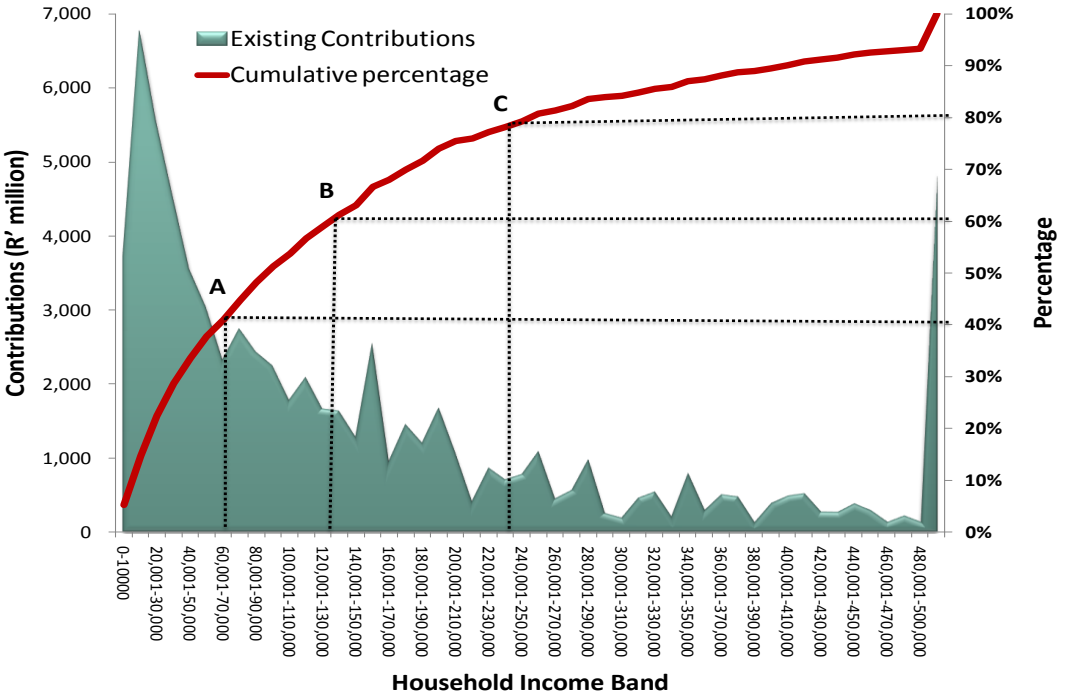
Table 5.6: Simulation Results (2006 prices)

Variable	NOW (situation analysis)
Contributors (between 25 and 65)	5,581,687
Contributions (R'000)	72,033,418
% of remuneration	11.5%
Affected Remuneration	626,377,549
Assets (R'000)	1,440,668,363
Administration (R000)*	16,135,486
% of contribution	22.4%

*Includes asset management charges.

5.45 Approximately 40% of estimated gross contributions toward retirement occur in household income bands between R0 and R70,000 per annum (A in **figure 5.4**), while 60% occur in households earning below R130,000 per annum (B in **figure 5.4**) and 80% in households earning below R140,000 (C in **figure 5.4**). Higher-income households, i.e. those earning above R140,001 per annum, consequently account for only for an estimated 20% if total contributions. It is important to note that these ranges refer to household and not individual income. *Nevertheless, it is clear that lower- to middle-income households account for a substantial proportion of existing contributions and are consequently heavily prejudiced by the poor performance of the system.*

Figure 5.4: Estimated Gross Contributions by Household Income Band (2006)



Source: Microsimulation Model based on the GHS 2006

Related social security arrangements

5.46 Aside from risk benefits, which are dealt with in **section 6**, unemployment benefits (via the UIF) provide protection strongly related to retirement provision. Although technically a form of social insurance the payment of unemployment benefits impacts on the capacity of particularly low-income groups to accumulate wealth. Frequent or extended bouts of unemployment will require affected households to draw down on savings. For low-income households this concern will be most acute.

5.47 To the extent that any low-income household has savings accumulated within a retirement vehicle it would be impossible to prohibit early withdrawal where they have exhausted any entitlement to unemployment insurance. Given this, *an important consideration going forward is whether unemployment benefits are so constructed that they minimize the need to draw down retirement savings.*

5.48 The UIF is the sole insurance mechanism for unemployment protection. It also provides maternity, sickness, adoption and survivor benefits. In the early part of this decade the UIF was in financial difficulties which were largely resolved after administrative reforms initiated from 2002/03. It also increased coverage to persons above the income ceiling as well as new groups regarded as particularly vulnerable such as domestic workers.

5.49 The UIF now has approximately 7.2 million contributors (including domestic workers) who contribute 2% of earnings (50% from the employee and 50% from the employer) to fund the benefits. During 2008/09 annual benefits were paid to around 474,793 unemployed persons; 25,648 sick persons; 94,336 women on

maternity or adoption leave; and death benefits to around 15,959 beneficiaries. In 2008/09 the UIF had benefit expenditures of about R3.8 billion and an operating surplus of R5.6 billion. Recent surpluses have resulted in an accumulated surplus of R34.6 billion or 9.6 times the value of current liabilities in 2008/09.

Table 5.5: Unemployment Insurance Fund, Statements of Financial Performance for the financial year ended 31 March 2009

	2009 R'000	2008 R'000
Revenue	10,324,507	9,164,632
Benefit payments	(3,847,236)	(2,921,460)
Changes in benefits payable	(60,008)	(306,344)
Gross surplus	**6,417,263**	**5,936,828**
Other income	2,335	1,949
Auditors remuneration	(8,566)	(7,315)
Administrative costs	(221,384)	(233,682)
Depreciation, amortisation and impairments	(3,183)	(4,786)
Employee costs	(349,014)	(335,110)
Other operating expenses	(175,358)	(158,410)
Operating surplus	**5,662,093**	**5,199,474**
Investment revenue	3,486,976	2,187,789
Fair value adjustments	70,255	(519,872)
Finance costs	(27)	(432)
Surplus of the year	**9,219,297**	**6,866,959**

Source: UIF, Annual Report, 2008

5.50 The operating surpluses of the UIF strongly suggest a systemic excess of contribution over benefit with investment revenue now approximating the current benefit liabilities of the fund (R3.8 billion in benefit payments versus R3.5 billion from investment revenue). In fact total equity and liabilities jumped by approximately R9.2 billion between the 2007/08 and 2008/09 financial years suggesting that virtually all revenue from contributions accrued to the accumulated surplus. Most importantly, only R420 million out of total contribution revenue of R10 billion (or 4.1%) went to paying for benefits.

Box 5.2: UIF Reserve

"*The UIF reserve has reached a level of about seven times its annual expenditure. This is several times higher than is required for a reasonable and prudent reserve. Social insurance schemes such as the UIF are risk pooling and redistributive mechanisms, not capital accumulation schemes. Unemployment and short-term cash benefits require only contingency reserves. A contingency reserve should have sufficient funds to meet expenditures in order to provide time for a scheme to adjust its contribution rate and/or benefit levels in the event of adverse experience, for example, unexpectedly high unemployment benefits resulting from a rapid economic downturn. A contingency reserve level of about one year's expected annual expenditure is generally regarded as appropriate.*"

"*The UIF pays benefits to about ten per cent of the approximately four million unemployed persons in*

South Africa. However, its reserves effectively take about R18 billion away from possible redistributive measures which could be introduced to alleviate hardship due to unemployment not covered by the UIF or caused by other contingencies."

Source: International Review Panel, 2008, p.5

5.51 The evidence is fairly clear that the 2% payroll tax used to fund the UIF exceeds its liabilities, with the result that a very substantial and unnecessary surplus is building up. Given the systemic nature of this excess, the UIF will continue to build this reserve indefinitely with inefficient social and economic consequences. A clear need exists therefore to restructure either the benefits (liabilities) or the contributions (revenue). However, even after making these adjustments, which would correct the relationship between contributions and liabilities, a substantial residual asset surplus is inevitable. It is unavoidable therefore that Government make a determination on the allocation of these reserves in the best interests of the country.

5.52 An increase in benefits would beneficially impact on the ability of the mandatory retirement system to preserve the accumulated entitlements of low-income households. *Importantly the design of unemployment benefits cannot be divorced from benefit proposals affecting retirement reform, and the tow need to be harmonized.*

Conclusions

5.53 In summary, therefore, the existing contributory retirement system reflects a range of positive and negative features. On the one hand a mature industry has evolved which both administers funds and manages the accumulated assets. On the negative side coverage is not complete and the estimated replacement rates of the system (around 24% to 28%) are considerably below what would be expected from the existing levels of aggregate contribution.

5.54 Poor performance in relation to the quality of benefits derives from the high cost of administering both member accounts and assets, which, according to the estimates provided here, result in cost ratios of around 37.2%. In total it is estimated that around R16 billion (in 2006 prices) is spent on administration and asset management. The high cost of the system can be attributed to the absence of scale in both administration (around 200) and asset management (around 300) and systemic poor governance arising from the vast number of funds.

5.55 Weak governance also arises from inherent conflicts of interest involved within the financial services industry, especially where the potentially more efficient multi-employer funds are involved (e.g. umbrella funds). Smaller occupational funds often suffer from chronic capacity constraints opening them up to exploitation by contractors and conflicted advisors. Furthermore, significant variations in service performance for members apparently quite significant, exacerbated by members having to change their retirement arrangements with every shift in employment.

5.56 International benchmarks suggest that South Africa should have only around 10 to 15 private funds for scale efficiencies to be achieved. Asset management also requires considerable consolidation to both bring down costs and to increase the efficiency of returns. Consolidation in the number of funds would however be expected to cause consolidation within the asset management and investment advice arena.

5.57 It is possible that a natural movement toward umbrella fund arrangements will occur even without government intervention due to the inherent problems with small occupational arrangements. This will positively impact on the standardization of benefits and fund design, increasing the feasibility of a regulated minimum benefit framework. However, the poor regulatory model overseeing governance, coupled with the absence of risk pooling within these funds, suggests that this shift on its own will achieve limited overall social gains.

5.58 The relationship between UIF benefits and retirement provision for low-income households is clear, with a resulting requirement to ensure that the benefits of both systems are designed together. Within this context the systemic "over-pricing" of the existing payroll tax for unemployment benefits creates an imperative for either restructuring the contributions and/or the benefits of the UIF as well as to reallocate part of the accumulated reserve. Given that existing UIF benefits are unlikely to adequately reduce the need for early benefit withdrawals for lower income households, benefit improvements targeted at low-income households appear logical.

6. RISK BENEFITS AT PRESENT

Introduction

6.1 Important risk benefits from a social security perspective involve survivor (death) and disability insurance. As with retirement provision, these insurance arrangements are entirely provided through voluntary private markets within South Africa. They are either provided on a group basis, through group risk arrangements sold to employers or via retirement funds. The remainder of the market involves individual insurance products that are individually underwritten and sold predominantly to higher income groups.

6.2 Where protection is provided through a group arrangement the costs are relatively low and poor and good risks can be pooled together. For those who cannot access insurance through a group arrangement it is possible to face higher costs, due to risk rating, and some possibility of exclusion. Overall the market is well intermediated with an extensive advice market advising employers and individuals on what products are available and their cost. However, intermediation is not free from conflicts of interest relating to how advisors are paid, with likely impacts on the quality of advice, and the quality of competition.

Background

6.3 The group risk market is dominated by several large players, with the top five insurers accounting for more than 90% of an estimated R7.2 billion in groups risk premiums written in 2006.[30] The largest market share is identified as being around 20% to 25% with profit margins small. The products offered are relatively homogenous resulting in the rapid diffusion of new innovation due to tight competition. The market is re-brokered relatively frequently with price playing a determining role.[3132]

6.4 Group risk arrangements however represent a fairly small part of the insurer's involvement is long-term death and disability arrangements. The largest part of the business are so-called "fund policies" which involve insuring the benefits of retirement funds, referred to as underwritten funds. The assets of underwritten funds are entirely made up of claims against an insurer. In 2006/07 premium income from fund policies amounted to R111 billion, or just over half of all long-

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[30] Hendrie *et al*, 2007, p.23. The estimates used were based on a survey by the Swiss Re Group produced in 2006.

[31] Hendrie *et al*, 2007, p.23.

[32] According to the Sanlam Survey (2009, p.17), "The proportion of funds that rebroke their risk business annually has dropped considerably from 65.5% in 2007 to 51% in 2009. There has been a marked increase in the number of funds that rebroke every two years. This proportion has jumped from 10.6% in 2006 to 26% in 2009. The number of funds that never rebroke or has increased from 1% in 2008 to 6% on 2009. The proportion of respondents that indicated that they rebroke when risk charges are increased is also 6%."

term insurance premiums for all lines of business. In the same period R120 billion was paid out in benefits from fund policies.[33]

6.5 Retirement funds therefore offer their members risk cover in the form of funeral, death or disability benefits in accordance with fund rules. These are summarized in **table 6.1**.

Table 6.1: Types of benefits provided in and out of funds

Cover which a fund may provide	Cover which a fund may not provide
Death benefits on the members life	Income disability benefits/Permanent health insurance
Accelerators paid when a member leaves the fund (e.g. lump sum disability benefits)	Total temporary disability
	Accelerators which do not require the member to exit the fund (e.g. dread disease cover)
	Spouses life/Disability cover Funeral cover which extends to family members

Source: Hendrie *et al*, 2007, and based on insurance industry sources

6.6 Individual life and disability products are most relevant to higher-income groups. In 2007 full coverage is observed only from an annual income of R180,000 upward. Low-income take-up is expected to be low where the disability grant is available.[34]

Insurers

6.7 Insurers offering life and disability products fall under the Long-term Insurance Act as they make long-term promises to policyholders. Insurers can offer individual products, group insurance arrangements, and policies that underwrite retirement funds offering risk benefits. Small group retirement arrangements would typically require underwriting as their risk pools are too small to carry the risk of severe variations in claims.

Administrators

6.8 Employee benefit administrators typically offer a range of services to employers and funds. They can: assist employers in designing a package employee benefits including retirement and group risk cover; source risk cover and asset management services; provide insurance themselves; administer in-house (employer-based) arrangements. The fact that many financial institutions offer a full suite of services, including administration, can result in problematic conduct

[33] Hendrie *et al*, 2007, p.23.

[34] Hendrie *et al*, 2007, p.37.

where advice and services are not in the best interests of clients due to conflicts of interest.

Brokers and intermediaries

6.9 As insurance, retirement and medical schemes are regarded as complex products employers and individuals typically require some form of advice when attempting to select appropriate cover. Financial advisors or brokers therefore act as agents on behalf of employers or individuals. However, financial advisors can also act on behalf of insurers or administrators and, in these instances, would not be regarded as independent. Many financial advisors act on behalf of any party they choose, which taints the advice provided to consumers and employers who may mistakenly regard them as independent.

Death benefits

6.10 Death benefits can take the form of a once-off lump-sum payment or a spouse's pension. Provident funds typically only provide lump sum benefits while pension funds prefer a spouse's pension. A separate group scheme may offer either a spouses pension or a lump sum benefit, although the industry prefers lump sum benefits as they are easier to administer.[35]

Box 6.1: Benefit types offered by the market at present

"*The majority of retirement funds and group schemes provide lump sum benefits upon the death of the member. A recent survey found that 20% of retirement funds also provide a spouse's pension which is usually paid in addition to an up-front lump sum benefit (on average 2x salary). A children's pension was preferred by 17% of funds surveyed…*"[36]

Source: Hendrie *et al*, 2007, p.27.

6.11 According to the Sanlam Survey[37] while nearly all funds provide lump-sum death benefits a declining proportion offer a spouse's pension. Larger funds tend to pay spouse's and children's pensions relative to smaller funds.

6.12 Lump-sum benefits are however not ideal when considered from a social security perspective. Although the lump-sum equivalent would naturally apply in all circumstances, benefits in the form of a spouse's pension provide better protection to households as they are not likely to be depleted all at once.

6.13 Coverage for the death of a contributor typically takes the form of a multiple of salary. The average level of benefit is regarded to be around *3.5 times* the member's

[35] Hendrie *et al*, 2007, p.27.

[36] Hendrie *et al*, 2007, p.27.

[37] Sanlam, 2009, p.18.

annual salary up from 3.2 in 2008.[3839] It is estimated that the cost of coverage equates to around 1.3% of salary for every year of salary covered.[40] This would imply, according to these surveys, that that coverage for the present average within the market would require a contribution of at least 4.2% of salary.

6.14 This is however an over-simplification as mortality rates vary significantly by income suggesting that the cost would be greater for low-income groups. Importantly, these figures are not supported by the Sanlam survey which indicates that the average cost for average cover of 3.5 times annual salary stands at 1.86% in 2009, up from 1.74% in 2008.[41]

Table 6.2: Cost of Death Benefits in Relation to Salary

Level of cover	Cost (% of a salary)
1 times salary	1.3%
2 times salary	2.6%
3 times salary	3.9%
4 times salary	5.2%

Source: Anderson, 2007, p.17.

6.15 According to an analysis commissioned by the Life Offices Association (LOA) on average insurance equivalent to 9 times annual income (of the insured) is required to preserve the lifestyle of survivors (see **table 6.3**). If some belt-tightening is assumed then coverage should be around 7 times annual income. The actual levels of benefit consequently fall below 50% of the levels required to protect the lifestyles of survivors. Furthermore, if the cost of 1.3% of salary for every year of salary as benefit is regarded as accurate the average contribution as a percentage of salary would need to be 11.7% and 9.1% of income for "preservation" and "belt-tightening" respectively.

6.16 The LOA study also demonstrates the drop-off in protection required as people approach retirement age. However, an important qualification is that the social importance of full protection for people in the under 35 category may not be as great as for older groups as older dependents may not be in a position to restart careers or enter the labour market as easily as younger cohorts. Nevertheless, given the high levels of early mortality amongst low-income groups, the design of the social security system would need to ensure that the protection for survivors is properly prioritized relative to savings benefits.

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[38] Sanlam, 2009, p.18.

[39] Many funds offer flexible benefits with some individuals within a group able to either decrease or increase their cover on the same plan.

[40] Anderson, 2007, p.17.

[41] Sanlam, 2009, p.17.

Table 6.3: Death Benefit Requirements for Reasonable Protection Expressed as Multiples of Annual Income

	Age Group	Definition 1: Preservation	Definition 2: Belt-tightening
Age	**<=30**	16 times	13 times
	31-45	11 times	9 times
	46-55	7 times	5 times
	>55	3 times	2 times
Income	**Low**	10 times	10 times
	Middle	10 times	9 times
	High	9 times	6 times
Total		9 times	7 times

Source: Hugo *et al*, 2007, p.36.

Disability benefits

6.17 Risk benefits discussed here include insurance for: dependents of a breadwinner in the case of death; and for the breadwinner in the case of disablement during working life. Consequently the range of benefit types provided by the market is fairly diverse. However, the value of the benefit, irrespective of its form, can be expressed similarly to a death benefit as shown in **table 6.4** which is equivalent to **table 6.3** (also derived from the LOA analysis). This indicates that disability requires a larger benefit to achieve similar levels of preservation and belt-tightening as for death benefits. In addition, variations in benefit requirements by age and income similar to death benefits occur.

6.18 Market surveys from 2007 indicated that average lump sum disability cover stands at around 2.7 times annual salary, while over 90% of income disability benefits schemes provide claimants with 75% of their salary as an income benefit.[42] However, the Sanlam survey of 2009 provides an overall average figure of *2.7 times* annual salary, an increase of 2.2 times salary from 2008. The Sanlam survey indicates that the average cost of the indicated average benefits stands at 1.33% of salary in 2009 compared to 1.27% in 2008.[43]

6.19 An indication of benefit adequacy can be found in the LOA study which found that disability benefits were on average set at around 32% of the ideal level of cover.[44] This would suggest an ideal average level of cover at 8.4 times annual income (slightly lower than the "belt-tightening" level in **table 6.4**).

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[42] Hendrie *et al*, 2007, p.32.

[43] Sanlam, 2009, p.17.

[44] Hugo *et al*, 2007, p.17.

Table 6.4: Disability Benefit Requirements for Reasonable Protection Expressed as Multiples of Annual Income

	Age Group	Definition 1: Preservation	Definition 2: Belt-tightening
Age	**<=30**	25 times	19 times
	31-45	18 times	14 times
	46-55	11 times	9 times
	>55	4 times	3 times
Income	**Low**	13 times	13 times
	Middle	14 times	12 times
	High	15 times	10 times
Total		14 times	11 times

Source: Hugo *et al*, 2007, p.36.

6.20 In 2009 around 37% of funds participating in a survey[45] indicated that they provided lump-sum benefits which were lower than for the comparable period in 2008. The survey indicated that a higher proportion of larger funds provide lump sum benefits compared to the smaller funds.

6.21 Unlike death, the contingency disability requires a complex assessment. Some disabilities may not impact on the ability to work, while others do. Some disabilities may be only temporary in nature, and sometimes a determination in this regard may not be straightforward. There is however no common standard of definition of disability used however, adding to some uncertainty concerning the quality of coverage. The predominant definition used to determine disablement is related to occupation involving around 60% of funds.[46]

6.22 Overall, therefore, occupational disability arrangements are subject to a high degree of voluntarism; vary in important respects across employers and funds; on a wide scale provide benefits unlikely to properly protect beneficiaries (i.e. lump-sum benefits); do not involve a single definition of disability; and do not provide adequate protection for individuals outside of group arrangements.

Related social security arrangements

6.23 A number of contributory social security funds provide some form of survivor and disability benefit in amongst other entitlements. These include the Compensation Fund (CF), the Mines and Works Compensation Fund (MWCF), and the UIF. Concerns with the existing framework include[47]:

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[45] Sanlam, 2009, p.18.

[46] Sanlam, 2009, p.18.

[47] See UNICEF, 2008 which provides a fairly comprehensive review of the challenges children have in accessing employment-based contributory social insurance benefits.

- Inconsistency in key definitions (e.g. dependency);
- Multiplicity of benefit entitlements without an effective mechanism to properly advise or protect beneficiary access to entitlements;
- Narrowness of contingencies with many vulnerable households falling foul of entitlement rule;
- Cumbersome and/or unjustifiable claims procedures which indirectly strip claimants of entitlements and create expensive access barriers;
- Failures to properly investigate claims as the balance between the duty of the relevant fund to investigate a claim versus that of the claimant is uneven;
- Hidden costs for low-income earners making claims are significant, and include time off work and transport costs;
- Most funds don't properly monitor information such as unclaimed benefits;
- Managing the benefit entitlement through time is weak, with processes to manage further contingencies, such as the death of a guardian (in the case of child awards), very weak;
- Trust arrangements (for handling beneficiary assets) are weak and inappropriate;
- There is no control over monies managed by guardians;
- Payments to foreign workers are poorly managed with inadequate systems in place;
- Access to independent adjudication is limited, with generally weak semi-judicial arrangements in place reducing the capacity of vulnerable households and individuals to enforce their rights;
- Delays in access to benefits are considerable;
- Personal information essential to managing the funds are poorly maintained and not shared within the social security system; and
- Investigative capacity is weak generally with inadequate skills and infrastructure in place.

6.24 Access to existing contributory social security benefits is deficient with many households unable to access entitlements. Presently there exists no co-ordination between social security funds on issues such as benefit design and systems. An important weakness involves the complex process of identifying benefit entitlements amongst numerous social security arrangements for a common contingency. *These weaknesses stress the importance of the need for reform including:*

- A simple basic contributory regime exists for all contributors;
- Proper co-ordination and review of benefit designs;
- Streamlined systems and processes subjected to common standards of performance and oversight; and

- Streamlined semi-judicial processes be established to ensure access to proper complaints processes.

Concluding remarks

6.25 The private market for survivor and disability benefits, as with retirement arrangements, offers a mixed picture. On the one hand a mature financial services industry has emerged to cater for the needs and demands of a very substantial number of employed households. On the other hand, the market is opaque, expensive, offers a wide array of protection, and is not effectively overseen.

6.26 For many people with cover, benefit offerings are capped at low levels within the group environment, requiring many to purchase top-up cover through individual arrangements. Although this is not an inherently problematic model, the important concern is *whether the base level of protection is sufficient*. This is especially important where lower-income groups face higher mortality and disability rates at present than higher-income groups, making adequate survivor and disability protection an important social consideration.

6.27 The provision of risk benefits tends to be segmented by income and risk, substantially reducing the level of risk pooling within the system as a whole. The net effect of this is that employers with higher extra mortality do not pool risk with low-risk employers, potentially reducing participation where costs become prohibitive. The fragmented risk pools therefore raise overall costs within the system, due to the loss of scale and transparency, and systematically discriminate against low-income and high risk groups.

6.28 Existing contributory social security arrangements require considerable re-alignment to ensure that vulnerable households are properly protected even for existing entitlements. However, a need also exists to broaden the benefit framework while also streamlining the multiple arrangements that exist for the same contingencies. This would need to go together with a major restructuring of existing systems and processes as well as full integration into the broader system of social security.

7. STRATEGIC REFORM

Overview

7.1 The situation analyses of both retirement and risk benefits (survivor and disability) suggest significant and inter-related concerns with the quality of coverage and protection offered by the existing private voluntary arrangements. Many of the concerns are not unexpected given the absence of a structural framework within which both public and private actors can operate with some coherence.

7.2 However, proposing a revised structural framework for South Africa presents many challenges given the maturity of the existing private system. Here it is important to determine whether any trade-offs should be made between the basic system of protection required and the preservation of parts of the existing environment. Quite clearly such determinations require very careful consideration and should be made with clear evidence of the costs and benefits involved.

7.3 Structural change also requires that consideration be given to the future role of existing social insurance arrangements which offer related forms of protection, and consequently need to be drawn into a holistic system of reform. These include the Road Accident Fund (RAF), the system of Compensation for Occupational Injuries and Diseases (COID), and the Unemployment Insurance Fund (UIF). All three provide some form of survivor and disability benefit, while the UIF offers unemployment protection that relates closely to personal savings.

7.4 This section provides an analysis of the possible and preferred strategic structural reform pathways for social security provision affecting retirement, survivor, and disability benefits. This is followed in **section 8** by specific proposals detailing benefits for retirement, while **section 9** covers risk benefit options. Consequently, the proposed benefits are not covered in this section as the focus is exclusively on the strategic configuration of the system.

Problem statement

7.5 Whereas it is possible to specify certain minimum social security benefit protections for the population, the manner in which they are to be delivered remains a central concern. As already noted structural reform needs to confront the existence of a mature but dysfunctional system, including both private and public arrangements. If too much weight is given to history, social protection may be severely compromised. However, if too much change is imposed too rapidly, important protections may be lost before the new system can ensure adequate delivery.

7.6 Taking note of international precedent, contributory social security interventions focus on expanded risk pooling and income smoothing. Achieving these objectives typically requires intervention in the form of statutory agencies offering large-scale insurance pooling, usually not possible within private insurance environments, and the centralization of strategic administrative functions to generate economies of scale, again not always possible within private markets. The latter is extremely important when the effectiveness of income smoothing is

heavily influenced by the cost of managing long-term savings and related arrangements.

7.7 In prioritizing the social security interventions consideration needs to be given to the institutional flexibility required to balance the system established to provide minimum benefits and that part of the system offering quasi private benefits. As no rational public policy objective would be achieved by undermining the *quasi private* system offering retirement and risk benefits, the overall system needs to be designed to allow for choice, flexibility and consumer protection in a manner that is at all times in harmony with the system of basic social security protections. The central policy choice facing government at present, therefore, needs to focus on the hierarchy of social protections required and how each should be delivered such that the entire system is in harmony.

Hierarchy of Priorities

7.8 Social priorities are logically ordered by income group, with the lowest income groups requiring the greatest protection and the highest income groups the least. This does not imply, however, that high-income groups require no protection as noted in **sections 3** and **4**.

7.9 Maximizing protection, consistent with *tier 1* in **figure 7.1**, usually involves establishing minimum assured levels of income protection or access to services, systems and providers of any social good or service. As the individuals or households requiring such protection usually cannot afford to provide it themselves, their protection is underwritten by the tax payer. The level of protection offered is consequently constrained by macroeconomic considerations, i.e. the maximum amount of income that can be redistributed at any point in time without damaging the functionality of the economy.

7.10 Low-income earners and their dependants are also vulnerable to severe life crises which could push them permanently into poverty or onto dependency on the state. This group requires measures that avoid a preventable reversal in their standard of living. Achieving this objective requires ensuring protection that is unlikely to be effectively offered in competing private markets. This arises because an element of redistribution, centralized risk pooling, underwriting by the tax payer, and centralized administration are required to provide the needed level of protection, none of which can be effectively provided by a private market. This level of protection is consistent with *tier 2A* in **figure 7.1**.

7.11 As the most basic levels of protection involve redistributive spending, and underwriting by the tax payer, there are natural limits to how far government can provide protection before it begins using tax funds to prioritize expenditure with a lower social return than other social goods and services. This natural limit effectively is reached in tier 2A. However, the need for protection should continue beyond this limit where social returns are possible through enhanced risk pooling and income smoothing without resorting to additional taxation. This can be achieved by mandating a certain level of saving and insurance without any

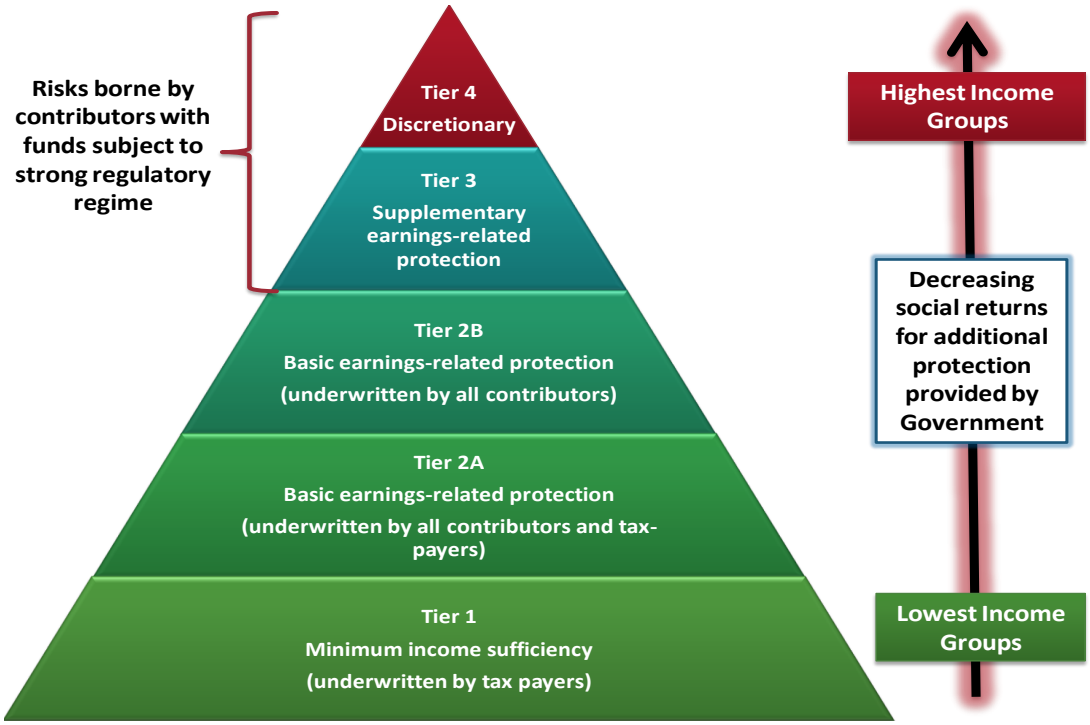
underwriting by the tax payer. Here social returns are maximized by spreading any risks amongst all contributors across the system.

7.12 Spreading risks across the system in this fashion cannot be achieved by private markets working alone, and require that institutional mechanisms be implemented by government. Interventions can include a statutory fund, statutorily provided reinsurance, or statutorily provided risk equalization mechanisms. Regardless of the form that the intervention takes, it would nevertheless avoid transferring any risk onto government (i.e. tax payers). Importantly, although lower income groups remain the primary target of protection here, this protection would not be possible without including high-income contributors within any risk sharing mechanism. This level of protection is consistent with *tier 2B* in **figure 7.1**.

7.13 The level of pooling and compulsion in tier 2B reaches a natural limit where the levels of required cross-subsidy become so severe that the system approximates a redistributive tax, with macroeconomic consequences.

7.14 Once the natural limits to protection of tier 2B have been reached, social objectives focus more on maximizing risk pooling and income smoothing to levels which are seen as desirable, but for which the income earners concerned may have alternative priorities which are at least as beneficial as the social goal, and where discretion is consequently preferred to compulsion. Here soft compulsion or incentives can be used to bias discretion in favour of the social optimum.

Figure 7.1: Social priorities by income, a conceptual framework



7.15 Given that government is still intervening in private decisions it is nevertheless important that basic protections are in place to ensure that the contributors are protected from unfair pricing and problematic conduct and poor market structure. These protections need not extend to requiring the use of statutory savings funds or insurers, as these interventions are only required when the state needs to

maximize a minimum level of risk pooling. They should however at the very least include regulatory interventions to maximize the efficiency of the private market so that contributors are not structurally compromised in the choices they are being incentive or required to make. This level of protection is consistent with *tier 3* in **figure 7.1**.

7.16 The natural limit to tier 3 is the level at which no further social returns are possible through any form of intervention as only the highest income earners will be affected. At this point government would essentially be reducing social returns, through creating market distortions, by attempting to influence private decisions one way or another. Market distortions would include the elimination of competition between substitute products through biasing choice with consequent increases in prices and the occurrence of super-normal profits. Government should however ensure that all the relevant products are subjected to proper regulatory oversight to prevent the possible abuse of consumers. This level of protection is consistent with *tier 4* in **figure 7.1**.

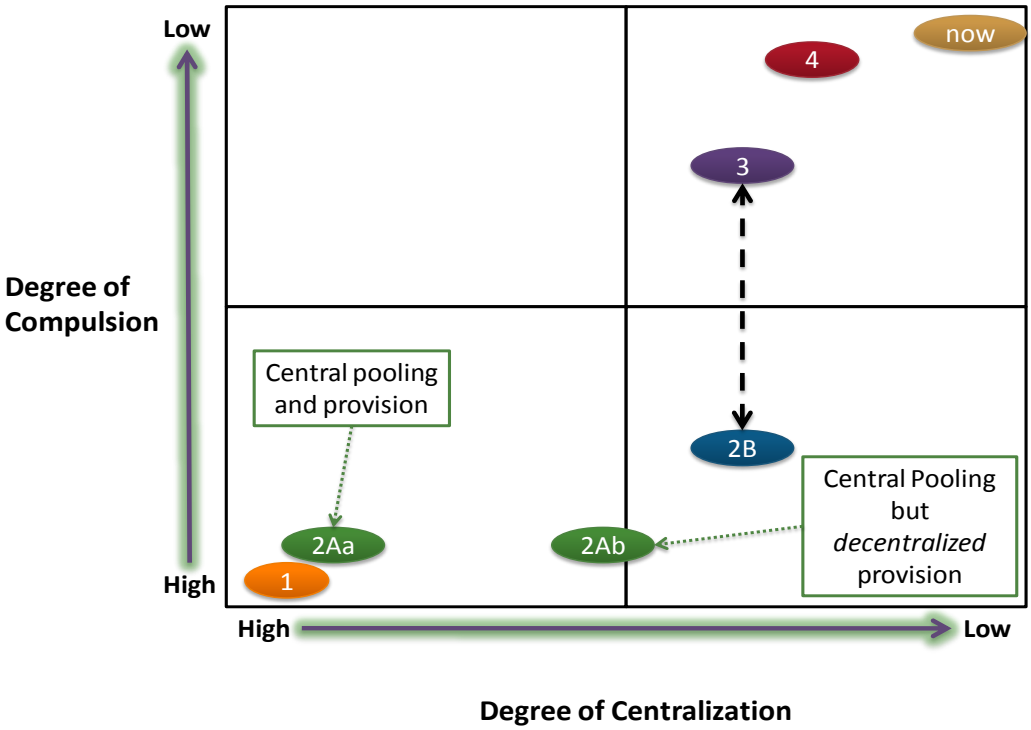
Strategic choices

7.17 Constituting the appropriate social security configuration from the present system requires consideration of the hierarchy of priorities outlines above. **Figure 7.2** provides a spatial representation of the tiers that would need to be constituted relative to the current situation ("now" in **figure 7.2**). The vertical axis indicates the degree of compulsion (contributions and benefit levels) while the horizontal axis shows the required degree of institutional centralization. The different tiers are indicated by their number and correspond to **figure 7.2**.

Tier 1

7.18 A number of key institutional choices apply to certain tiers, while in other instances the choices are fairly straightforward. Tier 1, applicable to the non-contributory State Old Age Pension (SOAP) and disability, is most reasonably provided on a centralized basis with a high degree of compulsion (as funding is via the tax system). Choices primarily revolve around the level of benefit and the extent to which benefits should be universalized. This will be discussed in **section 8**.

Figure 7.2: Strategic policy choices



Tier 2A

7.19 Tier 2A however involves a number of choices which require careful examination. The relevant benefits can either be offered via a centralized agency (*option 2Aa* in **figure 7.2**), which substitutes provision from the existing private market, or involve centralized pooling only but with decentralized provision (through private providers) (*option 2Ab* in **figure 7.2**). A decentralized option would be reasonable if the necessary pooling could still be achieved without compromising the quality of the benefit or coverage. (See **figure 7.3** for an illustration of the alternatives).

7.20 The rationale for the decentralized option would be to:

- Limit unnecessary disruption to the private system for financial services; and
- Prevent contributors from requiring multiple providers for benefits offered for alternative tiers.

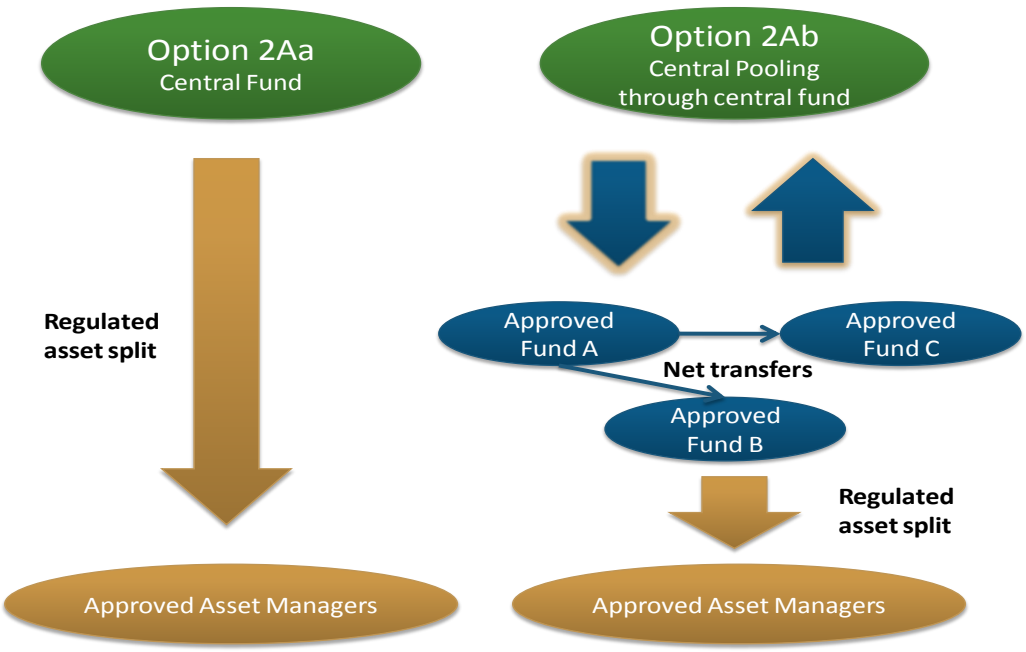
7.21 However, a decentralized option would, inter *alia*, be premised on achieving the following:

- Substantial consolidation of providers and asset managers to bring costs down to levels consistent with a centralized approach;
- A risk pooling mechanism is required for both retirement and risk benefits to achieve inter-fund transfers to achieve the system-wide cross-subsidies;

- The risk pooling mechanism would need to incorporate government as the final underwriter of minimum benefits without causing market participants to become subject to moral hazard;
- A centralised approach to asset management is required to ensure that fee charges and investment returns are at least equivalent to a fully centralized arrangement; and
- The governance model for private actors would need to be sufficient to avoid any risk transfers onto government substantially greater than would be possible through a centralized arrangement.

7.22 Option 2Ab would necessitate the development and implementation of an approved funds framework. For providers to be regarded as approved funds they would need to comply with minimum regulatory standards applicable to governance arrangements, reporting to the regulator, benefit management, transparency, and reporting to beneficiaries. This framework is in any case a requirement for tiers 2B and 3.

Figure 7.3: Options 2Aa and 2Ab Illustrated



7.23 However, even assuming that an appropriate risk pooling mechanism were possible for option 2Ab, it would invariably need to offer retirement benefits on a DC basis, requiring full advance funding. Option 2Aa, however, could be offered on a pay-as-you-go (PAYGO) basis with partial funding irrespective of whether or not it determined benefits on a DB or DC basis. The cost structures would invariably differ as the centralized administration coupled with the reduced asset

management fees would result in a significant differential in benefit, assuming both offered benefits on a DC basis with the same guaranteed rate of return.

7.24 Importantly, even if option 2Ab were ultimately able to approximate the administration and asset management fees, the time taken to get to this point would be an important factor. Even ignoring this time factor, however, the difference in asset management costs between the PAYGO and advance funded systems would be permanent and could not be removed.

7.25 *Given these considerations option 2Ab must be preferred for a minimum guaranteed benefit for both retirement and risk benefits*. The pooling and income smoothing modalities would be relatively straightforward and low-income groups much better protected. However, the success of this option would be premised on the corporate governance model implemented for the central agency that protected its operational independence.

Tier 2B

7.26 To limit the risk transfer onto government while nevertheless ensuring minimum levels of income smoothing, an option exists to mandate contributions, in excess of tier 2A, toward an advance-funded DC retirement benefit via a service provider chosen by the contributor or their employer (i.e. a decentralized approach). This tier would only apply to retirement benefits as the minimum levels of system-wide risk pooling for risk benefits would be optimally achieved through tier 2A arrangements.

7.27 The rationale for a decentralized DC option for tier 2B is to diversify the *longevity risk*[48] associated with the achievement of minimum levels of protection with regard to tier 2 seen as a whole. However, for this approach to be effective considerable efficiency improvements in private provision would be required. As with the decentralized option for tier 2A, an approved funds framework would be essential. However, in order to ensure that a fund operating with benchmark costs and open access was always available, a default statutory provider would usefully enhance the options available for contributors to this tier.

Tier 3

7.28 Beyond the requirements of tier 2, tier 3 should focus on incentivizing retirement provision in excess of the minimum requirements of tier 2, and minimizing leakage from the system through mandating a degree of preservation. A fully decentralized approach appears rational with advance-funded DC arrangements. Contributions to this tier should be tax privileged up to a reasonable income ceiling consistent with the rationale for government intervention described earlier.

7.29 As the funds offering benefits within tier 3 are also affected by government incentives, only approved funds should be permitted operate. The degree of

[48] This refers to the financing risks associated with the aging of the covered population.

market consolidation required for, and affecting, tiers 2B and 3 should consequently be the same over time, with the same efficiencies achieved. The only difference being that contributions toward tier 2B are mandatory and those toward tier 3 discretionary (or quasi mandatory).

Combining Tiers 2B and 3

7.30 A further option is to combine tiers 2B and 3 into a single system where participation is either quasi mandatory (as per the tier 3 proposal above), or mandated to the higher income ceiling (consistent with the framework for tier 2B apart from the higher income ceiling).

7.31 Consistent with the discussions above, any part of the system dependent on a decentralized arrangement faces the risk of inefficient performance. An advantage of consolidating tiers 2B and 3 with both mandatory contributions and preservation is that it makes it possible for a centralized statutory fund to be the compulsory annuity provider for the tier. Seen together with tier 2 (the original tier 2A) this would allow for a higher level of risk pooling than would be possible where tier 2B has a low income ceiling.

7.32 A centralized annuity arrangement, although it transfers some risk onto a statutory fund, will be able to provide the best social price for annuities than competing private insurers. Thus although the central fund carries some risk, so would the annuity purchasers, but far less than would be the case if they were to rely on private annuities.

7.33 To mitigate against the systemic risk of market inefficiency, it would be important for a statutory fund to offer an alternative choice to private funds. In the case of a quasi-mandatory system this would be a competing fund, while in the case of a mandatory system it would be both a competing and a default fund. The purpose of this intervention would be to provide an additional incentive for private funds to operate efficiently.

Tier 4

7.34 Beyond tier 3 no significant social security gains are possible from government intervention. However, providers (which would include non-approved funds) offering tier 4 benefits would potentially face positive spillover effects from the increased efficiencies of tiers 2 and 3 resulting from the approved funds framework. A degree of consolidation and product innovation could be expected.

Existing social insurance arrangements

7.35 As discussed in **sections 6** and **7** various social security funds (RAF, CF, MWCF, and UIF) offer survivor, disability, and near savings benefits. A strategic reconfiguration of these arrangements is needed to bring them in line with proposed reforms of the system of retirement and risk benefits. The area of overlap lies in tier 2A where minimum levels of system-wide protection are required in relation to both retirement and risk benefits. In dealing with this overlap it is necessary to take into account the varying benefit entitlements of the different social insurance mechanisms.

7.36 An option is to converge all overlapping benefits to the level set by tier 2A and have them provided through the system set up to operate tier 2A. However, in some key instances this could result in a reduction in social security entitlements offered through these other funds.

7.37 The solution to this is to ensure that the risk benefits proposed for tier 2 at least equivalent to the best benefits offered by the other funds, thus allowing for complete consolidation of similar benefit types. This would affect the loss of income and support benefits offered by the RAF, CF, and UIF which would invariably be subsumed into a single system.

7.38 The UIF however has a further crucial role to play in protecting the preservation of retirement savings in relation to tiers 2A and 2B through providing a minimum continuation benefit, in excess of existing benefits, targeted at low-income individuals experiencing abnormal periods of unemployment. This is discussed further in **section 8**.

Funding model

7.39 The centralized retirement and risk benefits offer the possibility of a consolidated social security contribution to fund all contributory social security benefits. This would however exclude contributions within the decentralized portion of the social security system which would go directly to regulated private providers.

7.40 A consolidated contribution will remove the possibility of deficits and surpluses that arise within individual funds with their own dedicated contributions. Such deficits and surpluses arise from changes in liabilities that occur over time for various reasons (e.g. price changes, benefit adjustments, demographic changes) or poorly costed liabilities. A single contribution could therefore be pooled centrally and fund benefit liabilities where they occur. There would consequently be no dedicated revenue stream for retirement or unemployment insurance.

Conclusions

7.41 To ensure adequate levels of protection in the area of retirement, survivor, disability, and unemployment benefits it is not sufficient to build off the existing institutional platform. Both public and private platforms face systemic limitations in what they can achieve. Conversely, the existing system cannot be ignored and needs to form part of the overall strategic configuration. Government therefore needs to prioritise, with a strong reconfiguration of the institutional platform where the social protection gaps are greatest, and a more progressive reform where the gaps are least.

7.42 The degree of appropriate government intervention is also an important consideration. On the one hand not all socioeconomic groups require the same degree of protection. On the other hand if all socioeconomic groups don't participate in some way, required levels of cross-subsidization to protect the most vulnerable socioeconomic groups will be undermined. The appropriate policy balance therefore requires universal participation to the level of an income ceiling, with increasing levels of individual discretion thereafter.

7.43 When institutional and benefit protection are considered together, a requirement emerges for a higher degree of compulsion for prioritized levels of benefit underpinned by a very reliable institutional platform. Over-and-above the highest levels of required benefit protection it appears reasonable for diminishing degrees of protection, both in terms of benefit and institutional design, to occur as incomes rise.

7.44 Taking these considerations into account options for retirement and risk benefits are discussed in **sections 8** and **9** respectively.

8. PROVISION FOR RETIREMENT

Overview

8.1 Constituting a coherent social security framework for pensions faces the unavoidable challenge of marrying the path-dependent effects of historical institutions with the need to alter institutions to improve the quality of social protection. When faced with the highly polarized institutional system of today[49] the extent of the required reform in itself could place the reform at risk. However, the benefit options themselves are fundamentally affected by the institutional directions chosen and cannot be considered independently. In addition, not all socioeconomic groups require the same degree of protection and the over-riding design needs to incorporate a hierarchy of interventions with those offering the greatest protection focused on the lowest income groups.

8.2 The pension benefit types that offer the most certainty of protection are DB in nature, with the complete elimination of benefit uncertainty eliminated by transferring the risk onto the fund. Pension types offering the lowest level of protection are individual account DC arrangements, where the benefit is not guaranteed and no risks are borne by the fund. Given the risk configuration, it is however very difficult for small private funds to accept the risk transfer associated with a pure DB arrangement. However, the country only has a pension infrastructure associated with a voluntary private system, and therefore the only benefit type that can be sustainably offered, even within the context of mandatory contributions, is an individual account DC benefit.

8.3 The question before government, therefore, is whether the existing institutional constraints should determine the design of the benefit configuration, which would result in an inferior benefit; or whether the benefit choice offering the greatest protection should determine the institutional design. As the decisions made now will have long-term implications for the system of social protection, they approximate an investment choice and should be considered differently to incremental changes to the system. This section therefore assesses various options before government within the tiers identified in **section 7**.

Tier 1

8.4 Tier 1 is non-contributory in nature and must therefore be funded either directly or indirectly through the tax system. The level of funding is limited by two factors: macroeconomic constraints; and *allocative efficiency*[50] considerations in the

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[49] This refers to the entire contributory system's reliance on a voluntary decentralized (private) approach, while the non-contributory system is entirely centralized. The two systems are also overseen by different government departments.

[50] "*Allocative efficiency*" refers to the process by which government allocated its resources in accordance with social need. Low levels of allocative efficiency occur where government resources are excessively allocated to programmes that achieve a limited social return.

determination of the government budget. A benefit consistent with tier 1, referred to as the *State Old Age Pension* (SOAP) has existed for many years in South Africa with access provided only to people who are below a specified income level (i.e. it is subject to a means test) and who are 60 years and over.[51]

8.5 The central purpose of this benefit is to prevent poverty for persons who would otherwise not have had the ability to accumulate adequate wealth in their working years to support themselves in old age. This benefit in effect recognizes that certain socioeconomic groups within South Africa, including certain categories of income earner, suffer from systemic barriers to the accumulation of wealth, and consequently require a strong support mechanism to prevent destitution in old age.

8.6 The SOAP has historically not been designed with the contributory pension system in mind and suffers from the following shortcomings:

- *Poverty trap*: for certain categories of income earner the accumulation of wealth is perversely discouraged as certain individuals choose to actively reduce wealth and income to fall within the means test for the SOAP. The present design therefore induces behavioural responses that are both understandable and socially undesirable. However, this perverse behavior has little relevance for wealthier individuals where their assets are worth more than the benefit.
- *Means test*: the means test falls far below the tax threshold, which allows many who have wealth and income in excess of the means test to easily evade any proper assessment as any verification of former income and assets via the tax system is not possible.
- *Inappropriate exclusion*: were it possible to apply the means test strictly it would exclude many people who are close to poverty and do require income support in old age.

8.7 An implicit basic pension is provided to persons over the age of 65 by way of the secondary tax rebate which is roughly similar in value to the SOAP. However, this benefit is not available to persons from the age of 60, unlike the SOAP, and cannot be claimed by income earners who do not pay taxes.

8.8 Between the SOAP and the tax rebate an implicit basic non-contributory basic pension system exists. However, the framework is incomplete and inexplicably excludes the following groups:

- Persons from the age of 60 to 54 and above the means test (illustrated in **figure 8.1**); and

[51] Historically males only qualified for the benefit from age 65 and females from age 60. A decision has been made by government equalize the ages at 60, and a process of convergence on this decision is in place.

- Persons over the age of 65 and above the means test but with insufficient earnings to benefit from the secondary tax rebate (illustrated in **figure 8.2**).

Figure 8.1: Gap in the provision of a basic pension – population from the age of 60 to 64

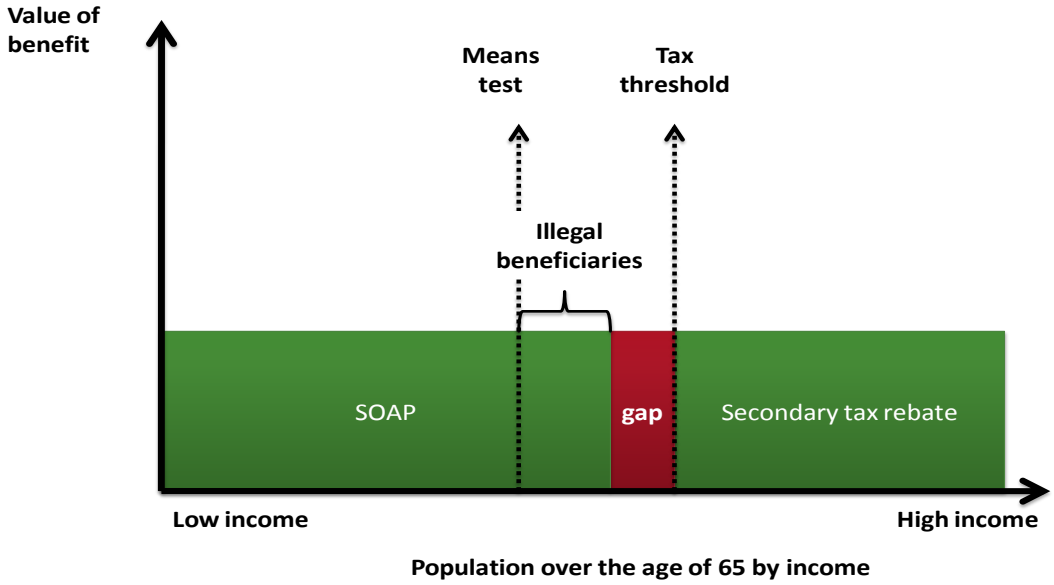
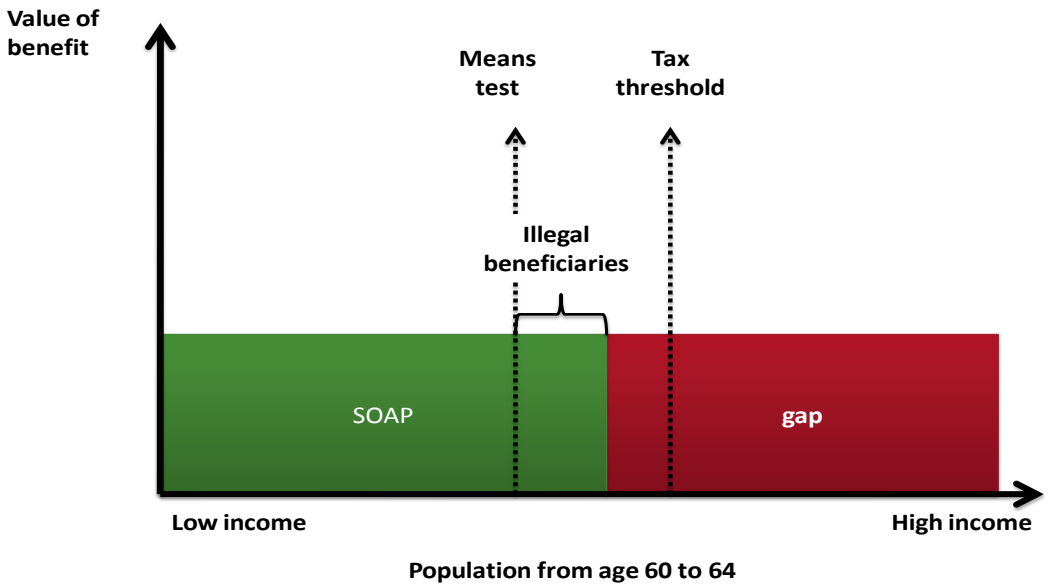


Figure 8.2: Gap in the provision of a basic pension – population from the age of 65



8.9 Establishing a universal basic pension arrangement consequently requires a correction to the means test and potentially to the tax system, with the former a far greater social priority. *The following reform configuration consequently appears indicated:*

- *The means test for the SOAP should be adjusted to a level consistent with the tax threshold, but not higher. This would expand eligibility for the grant to include all vulnerable persons over the age of 60.*
- *For persons above the tax threshold it appears appropriate to focus on removing any bias in the tax system due the benefit taking the form of a rebate. This can be achieved through the establishment of a tax credit option for persons not accessing the full value of the rebate.*
- *It however does not appear to be socially important to adjust the age of eligibility for the tax benefit to 60, given the financial implications involved for an income group with fairly good income protection and unlikely to be affected by the poverty trap. This group also benefits from tax subsidies flowing through the contributory system.*

Tier 2 – mandatory contributions

8.10 Tier 2 in general refers to the highest priority level of earnings-related protection for income earners operating in the formal sector. Here government needs to decide to what extent it is going to guarantee a benefit, in exchange for a mandatory contribution. Government can offer a hard or a soft guarantee. The former occurs where a DB is offered; or where a DC benefit is offered with government guaranteed minimum administrative costs and returns on investment. The latter occurs where government merely places certain regulatory requirements on retirement fund providers to optimize the returns on investment and minimize administration costs.

8.11 A DB arrangement, which is the only construct that offers the highest level of guarantee, can take a number of forms:

- A formula-based benefit which is either directly or indirectly related to a contribution record:
  - An example of the former would be very similar to a DC arrangement where the final benefit related to the value of contributions adjusted for a guaranteed rate of return on accumulated funds less administrative expenses and is referred to as a *notional defined contribution* (NDC) arrangement.
  - An example of the latter is a pension equivalent to a fixed percentage of the most recent years of earning before retirement (e.g. the last 5 or 10 years). This is the conventional design and is equivalent to what is offered via the Government Employees Pension Fund (GEPF).
- An intermediate construct would involve a fixed annual accrual of pensionable income for every year of contribution. For this to be worth introducing, however, it should not result in a lower benefit for the same contribution as a NDC benefit.

8.12 One advantage of a DB benefit is that it can be funded on a pay-as-you-go (PAYGO) basis, which reduces the requirement for advance-funding (sometimes referred to as "full funding") with a consequent reduction in the administration costs for asset management.[52] A PAYGO system finances current liabilities (i.e. benefits) from current contribution income. The extent of advance-funding is consequently discretionary and depends of the extent of risk carried by the fund.

8.13 However, DB arrangements with formulae based on the last or best years of earnings creates risky cross-subsidies that break the link between the value of an individual's contribution record and their final benefit payout. Many countries have moved, or are considering moving away from such arrangements due to this risk. *Consequently it is recommended that South Africa avoid any final salary or similar DB arrangements.*

8.14 The alternative DB approach involves an annual accrual of pensionable income, which is economically fair (i.e. it relates the contribution to the benefit) and can be used to generate a relatively predictable replacement rate. Proposals along these lines are contained in studies commissioned by the DSD where alternative accrual rates are proposed and measured.[53] Such options were also appraised by the IEP (see **box 8.2**) where the target of a 40% replacement rate after 30 years of contribution was indicated as possible with a 1% annual accrual in relation to a reference wage.

8.15 A DC benefit can also be offered on a PAYGO basis where the formula that determines the benefit is identical to an individual account DC arrangement but is notional rather than based on actual accumulated savings, i.e. NDC, and can generate benefit results very similar to that of a DB based on a fixed annual accrual. (See **box 8.1**). As with the DB arrangement there is no need to advance-fund as contributions are used to pay benefits. *Technical concerns with this approach however occur where a system is not yet mature and the contribution income could vastly exceed the requirement to pay benefits*. Once the system is mature, however, this consideration falls away.

Box 8.1: Notional Defined Contributions

"*In a notional defined contribution plan the worker has an individual account that is credited with his contributions plus interest. However the accumulation is notional rather than actual since the money paid in by workers is immediately paid out to pensioners rather than being invested, so the system remains pay-as-you-go. For each individual the account balance is based on bookkeeping entries recording contributions to the system and interest earnings credited to it. … "The notional account system in Italy is commonly described as a defined contribution scheme, but it could also be characterized as a revealed career average defined benefit scheme, with entitlement depending directly on the relevant contribution*

[52] Various hybrid arrangements including forms of DC benefits can also be partially funded.

[53] DSD, 2007c and 2008.

record." ILO, 2000, p.595.

"*The NDC model has been described as a way to make worker's age of retirement more flexible. The reason is that the eventual pension benefit is based on total contributions over the years. Each year counts. This allows those who are willing to accept a lower pension benefit to retire at a relatively early age and those who elect to remain in the labour force out of the desire to work or economic need to do so without any penalty with respect to their eventual pension benefit. In short, the NDC model removes the economic incentive in many PAYGO DB schemes to stop work at a certain age, often a rather early age.*" Williams *et al*, 2003, p.24.

"*Another strength of the NDC model is that such schemes are less vulnerable to political risk than are PAYGO DB schemes. They are less vulnerable because of increased transparency and the lack of redistribution. Also contributing to the political viability of such schemes are the mechanisms for automatic benefit cuts that have been built into the indexing procedures. This way, any cuts needed due to an increase in life expectancy, a decrease in the number of contributors, or fluctuations in the economy can be made without the need for additional legislative action.*" Williams *et al*, 2003, p.25.

"*An NDC scheme will typically provide good income replacement (something in the range of 50% of pre-tax earnings) for workers who have contributed for 40 years or more … However, for many rural workers, women, irregular low-wage workers, and those who spend much of their working lives in the informal economy, the number of years of contribution will fall far short of 40 years. … Many of these workers will need to depend on the guaranteed minimum pension for their retirement income.*" Williams *et al*, 2003, p.26.

8.16 When considering tier 2 holistically an appropriate configuration suggests the need to split contributions between benefits with a *hard* and a *soft* guarantee; with the hard guarantee focused on achieving a *minimum target level of protection*. Noting that tier 1 already provides the floor protection for irregular low-paid workers and those working much of their lives within the informal sector, the question is at what level should the guaranteed tier 2 benefit should be set. Two benchmarks are worth noting:

- The ILO social security Conventions (no. 102) provide some guidance as to the minimum level of generosity of benefits, specifying a 40% replacement rate for a *manual worker* after 30 years of such work.
- An International Expert Panel (IEP) (see **box 8.2**) recommended that a target tier 2 replacement rate (based on final income) for a full career average income participant should be set at around 40% after 30 years of contribution including the BCP.

8.17 Prior to specifying exactly how the benefit would be constructed, therefore, it appears appropriate to recommend that the minimum guaranteed tier 2 pension achieve a 40% replacement rate after 30 years of contribution income for a reference income group. This would be consistent with a 50% replacement rate for the reference income group after 40 years of contribution (see **box 8.2**).

Box 8.2: International Expert Panel Recommendations on Tier 2 proposals for South Africa

"*Tier 2 should provide retirement benefits based on earnings up to a ceiling:*

- *The ceiling should be set at a level to include all the earnings of, say, 80 per cent of the insured persons.*
- *The ceiling should be adjusted annually to take into account increases in average earnings.*
- *All income earners, including civil servants, should participate in the Tier 2 scheme:*
- *Including all income earners in the national pension scheme gives effect to the principles of universality, risk-pooling and solidarity.*
- *There should be no exemptions (e.g. for alternative schemes which have benefits equal to or better than the statutory scheme). The Tier 2 scheme would be "carved out" of existing occupational schemes.*
- *Existing schemes would provide supplementary benefits by applying accrual rates in excess of the statutory scheme accrual rate and for earnings above the statutory scheme earnings ceiling.*

A target Tier 2 replacement rate for a full-career participant should be set (e.g. an accrual rate of 1 per cent per year would produce a 40 per cent replacement rate after 40 years of contributions)…"

Source: International Expert Panel, 2008, pp.7-8.

"*A DB scheme has predictable replacement rates and thus enables personal financial planning. After 30 years of contribution, a pension formula that guarantees 1 per cent of the reference wage per year of contribution would, along with Tier 1, lead to a total replacement rate for the average earner approximately at the 40% level set out in ILO Convention No. 102. After 40 years of contribution, the replacement rate would be around 50%.*"

Source: International Expert Panel, 2008, p.9.

Reference Income for Retirement Contributions

8.18 An important consideration, with significant institutional and contribution design implications, involves deciding on the *reference income*.[54] **Figure 8.3** illustrates the resulting array of replacements rates for various income groups with alternative contribution rates assuming 30 years of contribution, a 1% accrual, and a 1% per annum real increase[55] in income.[56] This shows that if the reference income were

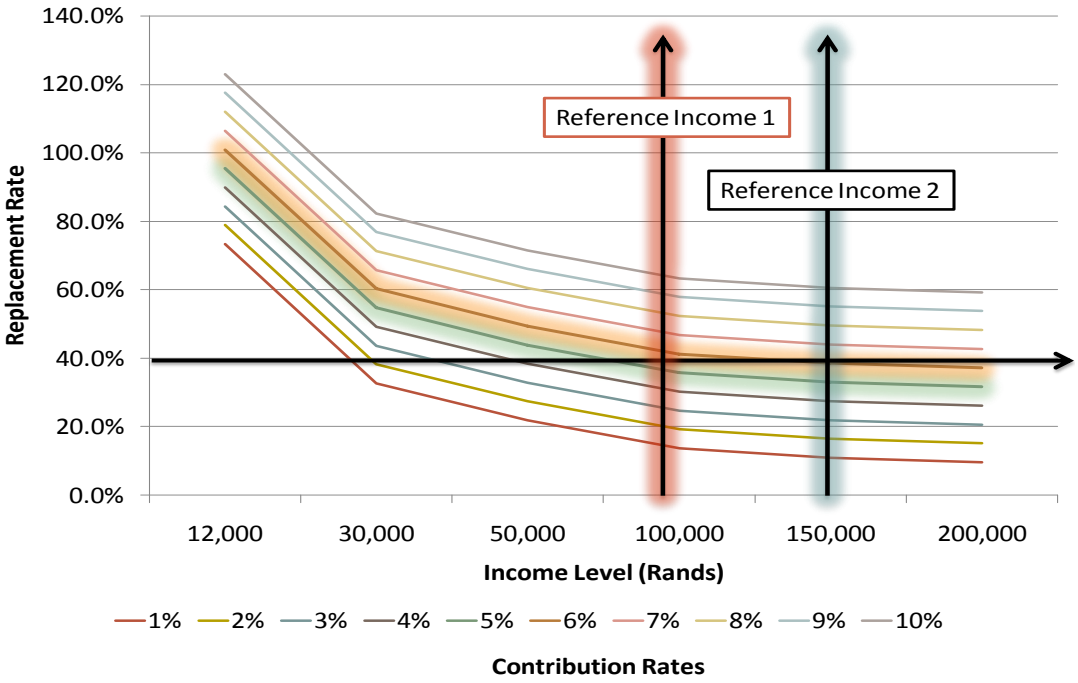
[54] The use of the term "reference income" here should not be confused with the term "reference wage" mentioned in **box 8.2**. The latter refers to the pensionable income of the contributor while the former refers to a benchmark income for policy purposes and is equivalent to the "average earner" referred to in **box 8.2**.

[55] The addition of a 1% per annum real increase in income causes a deviation from the "*average earner*" referred to by the IEP in **box 8.2** with a higher contribution required to achieve the resulting replacement rate. However, it is important to note that the exercise in the section is to decide on key policy benchmarks

set at R150,000 per annum, a 6% contribution rate would be required to achieve a 40% replacement rate and around 8% to achieve a 50% replacement rate. However, all income groups above the reference income would achieve less than this, while all those below would achieve more.

8.19 Consequently, assuming that the contribution rate is uniform for all income groups, the reference income group should be the lowest income group regarded as requiring the maximum level of benefit protection as all higher income groups will only achieve the target with supplementary contributions. The central question is, therefore, what criteria should inform the selection of the reference income.

Figure 8.3: Alternative reference income levels for tier 2 with indicative contribution rates and their resulting replacement rates after 30 years of contribution and a 1% per annum growth in real income



8.20 There is no entirely objective method to determine the reference income. A fairly straightforward approach is to consider the "average earner" as indicated in **box 8.3**. The average earner could be considered from two angles, either the overall average, or the average of those who are targeted for the contributory social

(i.e. contribution ceilings and contribution rates) and the level of protection they can provide to priority income groups.

[56] Note that this assessment is intended as an illustration of a DB and NDC arrangement with equivalent guarantees. In practice an NDC arrangement can be designed with automatic stabilisers of various forms which would make the outcomes differ. The central purpose of this assessment is however to illustrate the affect of alternative reference incomes given the same assumptions for each benefit type. Automatic stabilisers are discussed later in the report and are not relevant to this issue.

security system – i.e. those earning more than R12,000 in 2007 (or approximately R11,000 in 2006 prices).

Box 8.3: Reference Income

The reference income referred to in this and later sections, defines the *ceiling* income level regarded as a priority for social security protection. This ceiling would regard higher income levels as a lesser priority, and all those below as a greater priority for the purposes of protection. Such a ceiling is as important for survivor and disability protection, but could be set at different levels. Importantly, the ceiling applies to contributions but nevertheless impacts on benefit entitlements.

8.21 An alternative is to consider a broad occupational category that is reflective of the maximum group of earners considered important for the purposes of income protection. A third approach is to refer to existing practice within existing social security entities with roughly similar requirements such as the UIF. A fourth approach is to consider the ILO social security Conventions which provide some guidance on the minimum generosity of benefits and specify "*a 40% replacement rate for a manual worker after 30 years of work*".[57] This approach is consistent with selecting a broad category of occupation, i.e. the first approach.

8.22 **Table 8.1** provides the average income by occupational category according to the 2006 General Household Survey. **Table 8.2** selects a potential range of reference incomes including that of the UIF. **Table 8.2** suggests two potential choices which could fall within the ILO Convention category of manual worker. However, both fall significantly below the average income of potential contributors (R86,497).

8.23 The average of potential contributors also falls below the average of "*technicians and associated professionals*" which would appear to be a potential benchmark income for a ceiling (R99,886 in 2006 and R130,453 in 2009). The UIF ceiling (only shown in **table 8.2**) is relatively high at R147,736 in 2007. However, the UIF threshold has not been adjusted from 2007. Had it been adjusted for wage growth it would be valued at around R179,789.

8.24 Taking account of the need to balance social protection with the extent of risk transferred onto government, consideration should be given to more than one ceiling (reference income). The first would establish the ceiling for a minimum level of strong social protection, consistent with tier 2A, while the second would establish a softer protection framework consistent with tier 2B (more risk transferred onto contributors). An alternative, with the same objective, is to have one ceiling, consistent with a higher reference income, and split the contribution in some proportion between tiers 2A and 2B.

[57] ILO, 2000, p.496.

Table 8.1: Average incomes by general occupational type (2006)

Occupations	Per capita Income (Rands)				
	2006 prices	**2007 prices (CPI)**	**2007 prices (wage)***	**2009 prices (CPI)**	**2009 prices (wage)***
Legislators, senior officials and managers	166,208	178,006	180,785	212,285	217,070
Professionals	189,897	203,376	206,552	242,540	248,008
Technicians and associate professionals	99,886	106,977	108,647	127,577	130,453
Clerks	94,369	101,068	102,646	120,530	123,247
Service workers and shop and market sales workers	51,347	54,992	55,850	65,581	67,059
Skilled agricultural and fishery workers	29,742	31,853	32,351	37,987	38,844
Craft and related trades workers	41,977	44,956	45,658	53,614	54,822
Plant and machinery operators and assemblers	36,989	39,615	40,233	47,243	48,308
Elementary occupations	23,362	25,021	25,411	29,839	30,511
not defined	20,486	21,940	22,282	26,165	26,754
Average earning more than R11,000 in 2006	86,497	92,637	94,083	110,476	112,966
Total	62,200	66,615	67,655	79,443	81,234

*The public sector wage index was used.[58]

Source: General Household Survey, with incomes derived from Servaas van der Berg[59]

[58] This index is used as it will not necessarily be distorted by large changes in the ratio of low to high-income workers.

[59] The income data was generated by extrapolating the Income and Expenditure Survey (Statistics South Africa) onto the household asset information provided in the General Household Survey of 2006. This work has been performed by Stellenbosch University (Department of Economics).

Table 8.2: Potential reference income options (Rands in 2006, 2007 and 2009 prices[60])

Criteria/option	2006	2007	2009
Average income	62,200	67,655	81,234
Average income of likely contributors	86,497	94,083	112,966
UIF maximum income threshold	139,944	149,736	179,789*
• Technicians	99,886	108,647	130,453
Manual worker			
• Craft and related trades	41,977	45,658	54,822
• Elementary occupations	23,362	25,411	30,511

*Adjusted to 2009 prices using the public sector wage index.

8.25 Three options for tier 2A are therefore considered:

- *Option 1*: use average income (R62,200) with a 10% contribution to the ceiling;
- *Option 2*: use average income of contributors (R86,497) with a 10% contribution to the ceiling; and
- *Option 3*: use UIF ceiling (139,944) with contributions split 60:40 between tier 2A and 2B respectively and a total 10% contribution to the ceiling.

8.26 Option 1, although having the lowest ceiling of the three, nevertheless requires that tier 2A have 48.1% of all social security contributions (for tiers 1, 2 and 3) going toward retirement. Option 2, however, requires that 56.7% of all contributions go toward the PAYGO system which increases the risk transfer to government over option 1. Option 3 requires the lowest gross contribution despite having the highest ceiling but offers the least protection to low-income groups.

Table 8.3: Gross contributions resulting from

	Option 1	Option 2	Option 3
Gross contributions	R336 billion	R397 billion	R291 billion
% of all 3 tiers	48.1%	56.7%	41.5%

8.27 **Figures A1** to **A3** (**annexure A**) simulate options 1 to 3 respectively using information from the GHS 2006. They illustrate that option 1 comes close to

[60] The 2007 and 2009 years are adjusted using the public sector wage index.

option 2 in protecting low-income households without transferring the same degree of risk onto government. By contrast option 3 pushes far more of the benefit into tier 2B for low-income households, reducing their levels of protection. *On balance therefore, option 1 appears to be the most reasonable configuration of ceilings between tiers 2A and 2B of the three and is therefore preferred. This would therefore involve a reference income for tier 2A of R62,200 in 2006 prices (R81,234 in 2009 prices), and a reference income for tier 2B of R139,944 in 2006 prices (R179,789 in 2009 prices).*

8.28 Based on this recommendation, it would be important for both tiers 2A and 2B to achieve the target of at least 40% replacement for the relevant reference income groups after 30 years of contribution, including the affect of tier 1 benefits. However, tier 2B would focus on ensuring that this objective is achieved for the average income earner, while tier 2B would try to ensure this for a reference income equivalent to that used by the UIF for unemployment insurance, and related risk benefits, protection. Given that tier 2B would need to rely significantly on the efficiency of tier 2A as residual contributions (over-and-above tier 2A) will go toward funding benefit within a more inefficient decentralized, advance-funded and individual account DC environment.

Tier 2A – guaranteed benefit portion

8.29 Taking account of the reference income recommendations made above, tier 2A would need to guarantee at least a target replacement rate, for a reference income of R62,200 in 2006 prices), of 40% after 30 years of contributions. It has been assumed in various reports produced to date that a contribution rate of roughly 10% of affected income is seen as desirable. However, the contribution proposals to date have not been set specifically in relation to a target replacement rate, and nor have alternative benefit configurations been compared in relation to the indicated levels of proposed contribution. The choice matrix is however not straightforward. The following are the choices:

- *Option 1 – set the contribution rate*: and opt for the benefit options which optimizes the benefit achievement for the chosen contribution rate; or
- *Option 2 – set the benefit target*: and adjust the contribution rate and the benefit configuration to most efficiently achieve the benefit target.

8.30 Option 1 would involve setting a contribution rate which could result in benefit achievements in excess of the policy target (i.e. 40% replacement rate after 30 years of contribution for a reference income), while option 2 would fix the benefit achievements of tier 2A to the policy target.

8.31 Option 1 would therefore see the contribution level as the policy target, with a requirement that benefit achievements *at least* not fall below the target replacement rates. The rationale being that lower income groups should never be forced to make contributions toward benefits that systemically under-perform (due to high administration costs and poor rates of return), i.e. toward advance-funded DC arrangements whether centralized or decentralized.

8.32 Option 2 would see social policy objectives sufficiently met if target benefit levels are met; i.e. going beyond this level, even for low-income groups, constitutes excessive and unnecessary protection. Furthermore, as the tier 2A benefits technically cannot be withdrawn for various life crises (e.g. excessive periods of unemployment) an excessive level of benefit could prove counterproductive to the interests of those it seeks to protect.

8.33 It appears reasonable, however, for the ILO policy guideline of a 40% replacement rate after 30 years of contribution to be seen as a guide to a minimum level of protection rather than a maximum (i.e. option 1). *A contribution of 10% of the affected income (i.e. up to the reference income level or ceiling), should therefore be adopted as the minimum contribution in relation to tier 2A.*

8.34 However, central to the effectiveness of tier 2A is the design of the benefit itself. Based on the analysis in **section 7** *the benefit should preferably not take the form of an individual account DC arrangement offered through a decentralized institutional configuration*. In addition, *DB arrangements based on a pre-determined replacement value of the final salary or periods of best earnings, are not supported as they are now regarded as too risky for national pension schemes with many countries shifting away from them* (**box 8.4**).

8.35 However, whereas the early shift in international policy trends involved extreme movements from highly centralized PAYGO DB arrangements, based on final salary or best working years, to the opposite extreme involving individual account DC arrangements offered within a decentralized system (e.g. Chile from 1981), more intermediate arrangements are now seen as reasonable for social security systems provided they are accompanied by automatic stabilizers. These can involve the introduction of NDC schemes with partial funding as one tier within a multi-tier system. An alternative is to establish a DB scheme which offers benefits based on an annual fixed accrual rather than using final salary or best years, which should produce a relatively similar benefit for the same contribution. Both these approaches would be superior to an individual account DC approach in that pension benefits are at a reduced risk from financial market movements.[61]

Box 8.4: Trends in social security retirement provision

"*In several developing countries in Africa and Asia, provident funds (publicly-managed funded defined contribution schemes) were introduced … However, this model declined in popularity in recent years due in large part to the history of paying poor returns, often substantially below inflation …*"

"*While the trend in recent years has been away from the PAYGO DB model, the preponderance of public old-age pension schemes around the world today are based, at least in part, on this model. … Most nations that have relatively mature PAYGO DB schemes in place are facing current or projected problems financing these programs due to a combination of factors such as: program maturation, population aging, prior promises of overly generous benefits, changes in employment patterns (e.g. the trend*

[61] Williamson *et al*, 2003, p. 42.

toward early retirement), and in some cases fiscal problems associated with the transition to a market economy)."

Williamson *et al*, 2003, pp.1-2.

8.36 Two options therefore remain:

- *Option 1*: a NDC scheme funded on a PAYGO basis with partial reserving and provided through a centralized administrative arrangement.
- *Option 2*: a DB scheme based on a fixed accrual, specified as a percentage of affected income for each year (or part thereof) of contribution.

8.37 A NDC benefit is determined in much the same way as an ordinary DC benefit except that key parameters are underwritten by government. These are:

- Final benefits are determined by:
  - Aggregate contributions (mandatory) *plus*
  - Accumulated return on investment of accumulated balances (guaranteed) *less*
  - Administrative expenses, including asset management charges (fixed to a minimum)

8.38 A DB scheme based on an annual fixed accrual would calculate the final pension entitlement without reference to a return on investment or administrative charges as these would be implicit.

- Final benefits are determined by:
  - An annual accrual of a fixed percentage of pensionable income (related to tier 2A) adjusted through time using an index of general inflation or wages.

8.39 *The DB scheme calculated in this way would pay out a benefit equivalent to the accrual in the form of an income. By contrast the NDC would determine a final lump sum which would need to be annuitized to pay out a benefit in the form of an income. The lump sum would consequently be implicit in the DB scheme and explicit in the NDC. However, the benefits, in the form of an income, should be the same as the accrual as they can be structured in such a way that the promised DB benefit equates to the NDC benefit for the same contribution assuming both involve similar determinants.*

8.40 For the DB scheme to achieve final benefits that approximate the NDC arrangement, implicit factors relevant to the chosen accrual rate (expressed as a fixed percentage of pensionable income for each contribution period) would need to be made explicit and subjected to appropriate scrutiny and reflection. These include: administration charges, asset management charges, and the calculation of returns on investment.

8.41 *Illustrated* in **figure 8.3** is a scenario where a fixed annual accrual for the selected reference income for tier 2A is set in such a way that it matches the required contribution for a NDC scheme consistent with the parameters outlined in **box 8.5**. This shows that the benefit equivalent to option 1 in **box 8.5** approximately consistent with the ILO convention 102[62] would be achieved roughly with a 10% contribution. This would require a 1.5% annual accrual if the policy target is benchmarked against a lifetime income that grows at 1% per annum in real terms. (It would be significantly less if the policy benchmark involves a constant real income without growth.)

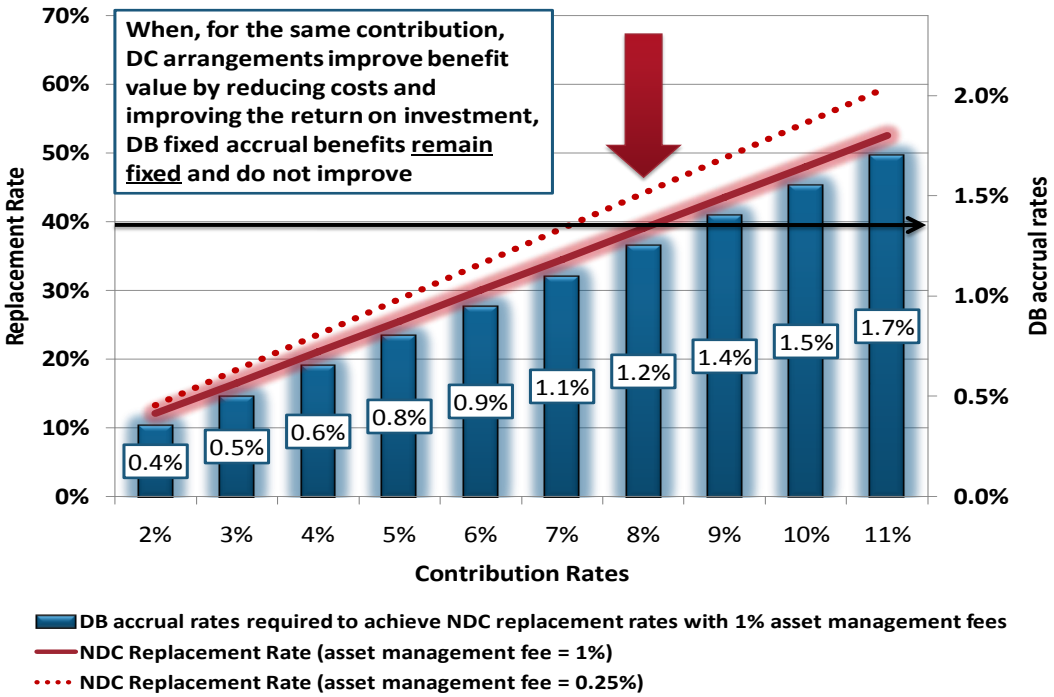
8.42 However, if the administrative charge in the NDC benefit formulation is reduced from 1% of assets under management to 0.25% (consistent with a scenario where the PAYGO construct allows for partial reserving), the possible benefit rises for each contribution level to the extent that the minimum benefit target consistent with convention 102 of the ILO could be achieved now with an 8% contribution instead of 10%. Such improvements in benefits would be possible also through an improvement in the return on investment promised through the NDC (noting of course that within a partial funding scenario such returns would be implicit, not based on actual investment returns, and funded largely from contributions).

8.43 An important consideration, therefore, is that benefits based on a fixed accrual are unlikely to change through time to accommodate changes in administrative efficiency or changes of realizable average market-related investment returns. Both factors should be readily identifiable in standard reports on operations and markets and therefore could be used to properly make adjustments to NDC benefit determinations. The failure to adjust will arise largely as a consequence of the reduced transparency associated with the benefit type.

8.44 *Despite the relatively similar benefit results possible through both options, option 2, the DB determined on the basis of an annual accrual, is preferred.*

[62] As indicated earlier, the addition of the 1% per annum real income increase for the reference income earner increases the required accrual to achieve the 40% replacement rate. Without this assumption a lower accrual would be required.

Figure 8.3: Required DB accrual rates to achieve NDC equivalent replacement rates after 30 years of contribution



Box 8.5: NDC parameters for scenarios indicated in figure 9.2

The benefit results are determined based on the following fixed parameters:

- Option 1:
  - Contribution period: *30 years*
  - Annual assumed real return on investment: *5%*
  - Administration expenses: *10% of contribution*
  - Asset management fees: 1% of assets under management
  - Reserving approach: *full advance funding*
- Option 2:
  - same as for option 1 except that asset management fees are assumed as 0.25% which is consistent with partial funding involving a 25% reserve.

8.45 Based on the strategic directions identified above and in **section 7**, a set of potential parameters for a tier 2A benefit arrangement are set out in **table 8.4**. The parameters are specified in 2007 prices to be consistent with other government reports and are indicative for the purposes of establishing a point of departure for consultation. Important considerations in relation to the proposed configuration are:

- To minimize costs, reserving is limited to 25% of the value of the current liability in any period. Some reserving is still proposed in order to limit the reduction in aggregate assets within the economy as a whole rather than to smooth any possible mismatch between contributions and investments.
- Some flexibility in the retirement age should be permitted to allow for early retirement, provided there is no negative impact on the implicit cross-subsidies within the system as a whole. Negative consequences would arise where a mismatch emerges between current contributions and current benefit payments within the context of a PAYGO system. Such consequences are however relatively easy to mitigate.
- The administration and asset management costs are critical to the value of final benefits offered through tier 2A. The proposed cost options are low and would benefit from feedback by way of consultation.
- The return on investment of 5% is high for such an arrangement but appears consistent with achievable market returns (see **section 7**). However practical considerations would suggest a lower rate of at least 3% should apply to any statutory guarantee with smoothed pooled investment achievements beyond this accruing to contributors as and when they occur.
- Early withdrawal of benefit would destabilize the relationship between contributions and benefits and is consequently not appropriate for this tier, particularly as key life contingencies that may justify such a withdrawal should be relatively well protected provided the recommended risk benefit configuration (unemployment insurance, survivor benefits, and disability benefits) is implemented. Also, tier 2B, which involves individual account DC benefits, will allow for limited early withdrawals which should be sufficient to deal with key life crises (i.e. the only legitimate basis for an early withdrawal).
- The potential need for grandparenting arises from problem that contributions will greatly exceed benefits in the start-up phase of the retirement system. Technically this creates the option of starting contributions low and growing them through time. However, this is not advisable as contributions may not always be adjusted appropriately at the appropriate time due to political constraints, creating some financing risk.
- The social security contribution should, as far as possible, be implemented at a level close to or at the level required for the system at full maturity to mitigate against the risk of inadequate increases.
- An *automatic adjustment mechanism* similar to recent reforms within the Swedish PAYGO tier of their retirement system should be considered for tier 2A. Such mechanisms seek to ensure that the relationship between current revenue and liabilities remains stable through time without the need for major structural changes to the system, or new political decisions. Although some uncertainty may arise in relation to the value of final benefits, these would be substantially less than the uncertainty that arises in individual account DC arrangements offered via private funds.

Table 8.4: Proposed tier 2A pension configuration (2007 prices)

Parameter	Proposal
Contributors	Income earners earning more than R12,000 per annum.
Mandatory contribution	10% of pensionable income for tier 2A.
Reference income/ceiling	Equivalent to the average income of income earners: R67,655 (R81,234 in 2009 prices).
Retirement age	65 with the option of early retirement (with reduced pension) from age 55.
Pensionable income	All earnings of contributors to the income ceiling.
Real return on notional balances	Five percent.
Costs:	
Administration	Assumed at 6% of contribution.[63]
Asset management fees	Assumed at 0.45% of assets under management.[64]
Funding strategy	PAYGO with a maximum reserve of 25% of the current liability in any period to minimize asset management fees and maximize the value of the benefit for this tier.
Early withdrawal	Full preservation - as early withdrawals in the case of key contingencies such as the death or disability of a breadwinner are catered for and unemployment is provided for through a proposed continuation benefit for UIF and the option of early withdrawal in the case of tier 2B benefits.
Relationship to risk benefits	In the case of either death or disability the accrued benefits should be transferred to fund the social security survivor and disability benefits, with the result that risk benefits would not end at the age of retirement.
Final benefit	Paid out exclusively as a monthly pension with no option of a lump-sum as this would be possible as part of the tier 2B and tier 3 benefits.
Grandparenting	Benefits should be offered to persons who would have qualified for benefits had the social security system allowed for it and who have recently retired, or who will retire within a specified period – in order to speed up the maturation of the arrangement.
Automatic	Given that tier 2A is PAYGO in design, consideration needs

[63] This is based on comments provided by industry participants on the achievements of large funds in the South African private market.

[64] This is based on inputs provided by Rob Rusconi on what appears possible in South Africa. Clearly this assumption will require inputs from market participants.

Parameter	Proposal
adjustments	to be given to automatic adjusters to be implemented to smooth any systemic shifts in the proportion and configuration of contributors to beneficiaries over time. Although these may impact periodically on the certainty of benefits, this should be far less than the affect of pure DC arrangements. Automatic adjusters would involve: changes in the retirement age; and/or changes in the value of current benefits to keep them in line with current contributions at 10% of pensionable income.

Tier 2B – non-guaranteed portion

8.46 Derived from the strategic framework outlined in **section 7** tier 2, which is part of an overall mandatory tier, is divided between a PAYGO and individual account DC sub-tiers. *In accordance with the evaluations above relating to reference incomes, it is further recommended that the division between the tiers occur on the basis of income ceilings rather than a split in the contribution with a common ceiling*. Given this, tier 2B has the same contribution rate as tier 2A, and the same contributors. It differs from the tier 2A in that, although also DC in nature, the benefits are *not guaranteed*, and provision occurs within a decentralized system (i.e. private approved funds are responsible for provision), and the reference income is higher at R149,736 in 2007 prices.

8.47 Benefits are not guaranteed in that they will be a function of the system cost levels and the return on investment achieved by each approved fund, neither of which will be underwritten by government. *Government would, however, be relying on extensive regulatory reform to ensure that private funds are able to considerably improve their performance relative to the situation analysis reported in* ***section 7***. These regulatory reforms would in fact be a pre-requisite for permitting a portion of tier 2 to be offered through private providers. The statutory provider serving tier 2A would however also be regarded as one of the approved fund choices open to employers and individuals. This will serve the function of a benchmark for the market as well as provide a default scheme for anyone structurally excluded from the private market (e.g. the self-employed and small employers).

8.48 Were such regulatory reforms found to be slow in development, consideration would then need to be given to adjusting the tier 2A ceiling higher to limit any harm to contributors from inefficiencies likely to persist in tier 2B.

8.49 Given the decentralized model for tier 2B there is no alternative to full advance-funding with all the associated costs. Full advance funding would also apply to the tier 2B portion of the statutory fund operating as a *default scheme* which should also offer benefits on the same basis as private providers.

8.50 **Table 8.5** summarises the central elements of the tier 2B configuration. Central issues to note are:

- Early withdrawal is regarded as appropriate in certain circumstances that are likely to affect low-income groups more than higher income groups. These relate to various life crises or to providing access to home loans.
- The final benefit can be split between an annuity and a lump sum payout, with the annuity purchased from a statutory annuity provider. Using a statutory annuity provider retains a degree of risk pooling within this tier and reduces the costs associated with annuity provision. The annuity should take the form of a *living annuity* to maximize risk pooling opportunities and consequently reduce the costs and insurance-related risks associated with private annuity markets.
- As the reference income group for tier 2B is still of a relatively low income, they remain vulnerable to hardship in old age where private savings have been exhausted. For this reason, the option of a lump sum benefit is limited to one-third of the capital sum accumulated at retirement. Furthermore, it is proposed that the lump sum be drawn down over a period no shorter than 10 years. In this way income earners up to R149,736 (in 2007 prices) would be protected by both a living annuity and a supplementary ten-year income stream.
- The rate of return, benchmarked at 5% in real terms, would need to be achieved by way of improved oversight and fund governance. Regulatory reforms would need to involve limiting the spread of investments to a more limited range of approved fund managers. This would have the effect of consolidating retirement fund managers, which would improve regulatory oversight and reduce costs due to increased scale.

Table 8.5: Proposed tier 2B pension configuration (2007 prices)

Parameter	Proposal
Contributors	Income earners earning more than R12,000 per annum.
Mandatory contribution	10% of pensionable income for tier 2B.
Reference income/ceiling	Equivalent to the average income of income earners: R147,736 (R179,789 in 2009 prices).
Retirement age	65 with the option of early retirement (with reduced pension) from age 55.
Pensionable income	All earnings of contributors to the income ceiling.
Benchmark return on investment	Five percent.
Costs:	
Administration	Assumed at 6% of contribution for the default fund. However, no assumption is made for private providers which would respond only to regulatory reforms.
Asset management fees	Assumed at 0.45% of assets under management for the default fund. As with administration costs, private funds would need to respond to regulatory reforms.

Parameter	Proposal
Funding strategy	Full advance funding.
Early withdrawal	Full preservation except in cases of severe life crises or need. These are: death, disability, or excessive unemployment of a breadwinner. These withdrawals would only be permitted where related social security benefits have been exhausted. Consideration could also be used to using the accumulated benefit as a guarantee to access home loans given the positive social implications of property-related wealth accumulation.
Relationship to risk benefits	Apart from the option of conditional early withdrawal in relation to death, disability and unemployment, no further relationship to risk benefits is proposed.
Final benefit	The final capital sum available at retirement would be divided between the mandatory purchase of a statutory annuity equivalent to two-thirds of the total, and a lump sum withdrawal equivalent to one-third of the total. The lump sum should be drawn down over a period no shorter 10 years to limit the tax implications on benefits and to spread the protection over a longer period. In those instances where the beneficiary dies within 10 years the draw-down would continue in relation to dependents or accrue to the estate of the deceased. The annuity should take the form of a "living annuity", whereby benefits are only paid while the principal beneficiary or any dependent spouse (or related category of dependent) survives.

Tier 3

8.51 Over-and above the income ceiling for tier 2, supplementary tax-incentivized contributions to approved funds, including the statutory default scheme, on a discretionary basis is proposed.

8.52 As the income groups affected by tier 3 are relatively high-income earners, the degree of protection can be relaxed as this group has a far wider range of wealth creation opportunities than income groups below the reference incomes for tier 2. For this reason the mandatory contribution and annuitisation via a statutory annuity provider is also not seen as necessary. The income ceiling for this group is roughly R700,000 in 2007 prices to limit the group able to benefit from the tax incentives.

8.53 To enhance the quality of the final benefit emerging from tier 3 the following is seen as important:

- Only those funds approved to offer tier 2B benefits can offer benefits to tier 3. This would ensure that adequate levels of oversight and governance prevail.

- The statutory default fund for tier 2B should also operate in tier 3 to enhance efficiencies through providing a competitive benchmark fund. As with tier 2B it should also provide coverage to individuals and groups structurally excluded from conventional private funds.
- The same degree of mandatory preservation would be required as with tier 2B. This limitation on early withdrawals would effectively improve the replacement rates possible at retirement and limit the risk of inadequate income smoothing of the life span of an affected income earner.

Alternative configuration

8.54 As indicated in **section 7**, combining tiers 2B and 3 into a single mandatory option holds out the possibility of efficiency gains over their separate treatment. Seen together with the efficiency savings possible from a consolidated contribution and benefit framework for both centralized contributory risk and retirement benefits an alternative, but similar configuration would involve:

- Tier 2:
  - Would involve a single tier 2, and not be divided between tier 2A and 2b;
  - Would have a ceiling consistent with tier 2B in order to be equivalent to that for risk benefits discussed in **section 9**; and
  - A consolidated social security contribution would be established for all contributory social security benefits.
- Tier 3:
  - Would involve consolidating tiers 2B and 3 into a single tier 3;
  - Would involve a mandatory contribution and preservation framework to a ceiling consistent with an annual gross income of R700,000-R750,000 in 2007 prices;
  - Annuities would be purchased from a statutory annuity provider to ensure that contributors can obtain the most reasonable prices possible in the market (resulting from the efficiencies possible through system-wide pooling); and
  - Contributions would be paid directly to approved private funds, one of which would include a statutory default and competing fund.

Tier 4

8.55 Over-and-above tier 3 no further social security interventions are seen as necessary at this juncture. Income earners would have the full discretion to contribute toward any form of savings arrangement made available by the market.

Unemployment insurance

8.56 One of the most efficient measures possible to reduce the need for low-income households to deal with the all-important life crisis contingency of unemployment,

is to ensure that an effective and targeted system of unemployment insurance is in place. Unemployment insurance is more efficient than individual accumulations of savings to mitigate the same contingency due to the pooling possible using an insurance modality. As not all low-income households, or households of any income, will experience periods of unemployment it is more logical to cross-subsidize between employed and unemployed to reduce the contribution required to provide the same level of protection in comparison to a savings approach.

8.57 Given the systemic overfunding of the UIF it appears reasonable for consideration to be given to an expansion of unemployment insurance benefits to reduce any need for low-income households to draw down retirement savings. This would allow the existing contribution at the existing level (i.e. 2% of affected income) to be used rather than establishing an additional contribution for this purpose. However, merely increasing the maximum UIF benefit by a few days, e.g. from 238 days to 300 days, is unlikely to deal with the problem of extended periods of unemployment affecting low-income households and their need to draw down savings (from tiers 2B and 3).

8.58 For this reason it is proposed that consideration be given to a two-tier benefit structure, with the first tier providing a higher level of benefit consistent with the existing configuration of entitlements. The second tier would kick in after exhaustion of the first tier benefits, be flat rate in nature and last for a longer period. It is proposed that consideration be given to having the second tier benefit lasting for a maximum of three years and valued at around 50% of a designated minimum wage.

Box 8.4: International Expert Panel Review of the Strategic Reform Options for the Unemployment Insurance Fund within the context of comprehensive social security

"*The UIF recognises that there is a need to improve its coverage and concurs with the DSD that a number of improvements can be made. Measures suggested include:*

- increasing the maximum number of benefit days the unemployment benefit is payable from 236 to 300;
- de-linking the benefit entitlement in the different benefit categories (for example, allowing women to receive the maximum number of daily unemployment benefit payments after having received the maternity benefit);
- improving the malfunctioning placement service and developing effective active labour market services (e.g. demand-oriented training and retraining services);
- extending for an unlimited period the payment of a continuation benefit of 50 per cent of the minimum wage (i.e. a monthly benefit of around R500) to beneficiaries who have exhausted their normal unemployment benefit entitlements, subject to their being available for work and following required measures to qualify for the benefit (e.g. participation in skills assessment and

training programmes);

- increasing the lower limit of the graduated benefit replacement rates (presently 38 to 70 per cent) to 45 per cent;
- inclusion of self-employed persons and civil servants.

The panel agreed in principle with the above measures subject to the following qualifications:

- The period of payment of the continuation benefit should be limited in order to avoid creating dependency. This should not create hardship if a social assistance benefit for unemployed persons is introduced (see Section 3).
- The development of an effective active labour market policy is a matter of urgency. The services can be made available to the wider group of unemployed persons, with the cost of services to the uninsured reimbursed by the state.
- To avoid manipulation of the scheme, self-employed persons cannot be covered for unemployment benefits.
- The inclusion of civil servants is a matter of national solidarity.
- In the short- to medium-term, the above measures will not reduce the reserves of the UIF to the level of one times expected annual expenditure. Thus, for a number of years, it is possible to reduce the contribution rate. This would free funds for financing urgently needed social assistance benefits."

Source: International Expert Panel, 2008, p.5

8.59 To eliminate any negative incentive effects associated with the implementation of a continuation benefit it is proposed that it be linked on a conditional basis to properly developed active labour market strategies. In addition, whereas for moral hazard purposes the self-employed should be excluded from benefits civil servants should be included as their employment is no longer as secure as in the past.

8.60 The introduction of a second tier unemployment benefit should complement an improvement in the first tier benefit, which should be expanded to around 300 days. Both the first and second tier benefits should be determined on the basis of accumulated credits.

8.61 As far as possible the restructured unemployment benefits should be designed to remain within the funding constraints of the existing payroll tax. However, careful consideration should be given to the distribution of existing surplus assets of the UIF in such a manner that their social return can be maximised.

Alternative contribution options

8.62 Although the overall contribution of 10% of gross income, subject to the proposed income ceilings, appears reasonable when compared to existing private contributions, some consideration needs to be given to the structural risks faced by employers that have historically not offered employee benefits. It would be

important to introduce the contributory social security system in such a manner that it promotes rather than undermines formal employment expansion.

8.63 Potential options include subsidizing contributions for low-income workers, i.e. those earning less than the tax threshold, and reducing the value of the pension contribution.

8.64 Subsidising contributions has the advantage of increasing the incentive to be in formal employment (rather than informal employment or unemployed). The more the funding of the subsidy is dissipated across the tax system the stronger will be the employment enhancing effects relative to the negative impacts on economic production.

8.65 Reducing the value of the pension contribution would mitigate any price shocks to employers resulting from social security contributions. However, it would also reduce the retirement protection offered to low-income employees who will find it difficult to find private options able to give equivalent value for money. Any reduction in the contribution for retirement provision should therefore be accommodated by an enhancement of the non-contributory pension (tier 1) to ensure that the target replacement rates for tier 2A are maintained. i.e. 40% for a reference income of R81,234 in 2009 prices.

8.66 A reduced mandatory contribution could be considered at the level of approximately 6%.

Summary of the recommended retirement framework

8.67 **Figure 8.3** provides a representation of the retirement system options proposed in this section by tier which is summarized as follows:

- *Tier 1*: This tier provides for a basic non-contributory level of retirement protection in the form of a grant to persons earning below the tax threshold, and in the form of a tax credit to compensate those unable to claim the full secondary tax rebate for those above the tax threshold. The service provider for this tier is SASSA (already established) supported by the South African Revenue Services.
- *Tier 2A*: This tier provides for a basic contributory NDC pension funded on a PAYGO basis and derived from a mandatory contribution equivalent to 10% of the pensionable income for this tier. The ceiling annual income is based on the average for income earners and is valued at R67,655 in 2007 prices. The service provider for this tier is a statutory pension fund, referred to as the National Social Security Fund (NSSF), as discussed in **Report 2** and **section 12** of this report, which would need to be established for this purpose.
- *Tier 2B*: This tier provides for a further basic mandatory contributory pension in the form of a DC individual account provided through private approved funds or a default public pension fund. The contribution would equal 10% of the pensionable income for this tier, with the ceiling annual income level set at R149,736. The service providers for this section include approved pension

funds, which should include a default statutory pension fund (the NSSF), and approved asset managers.

Figure 8.4: Representation of the proposed system of retirement with tier 2 split, and tier 3 quasi mandatory

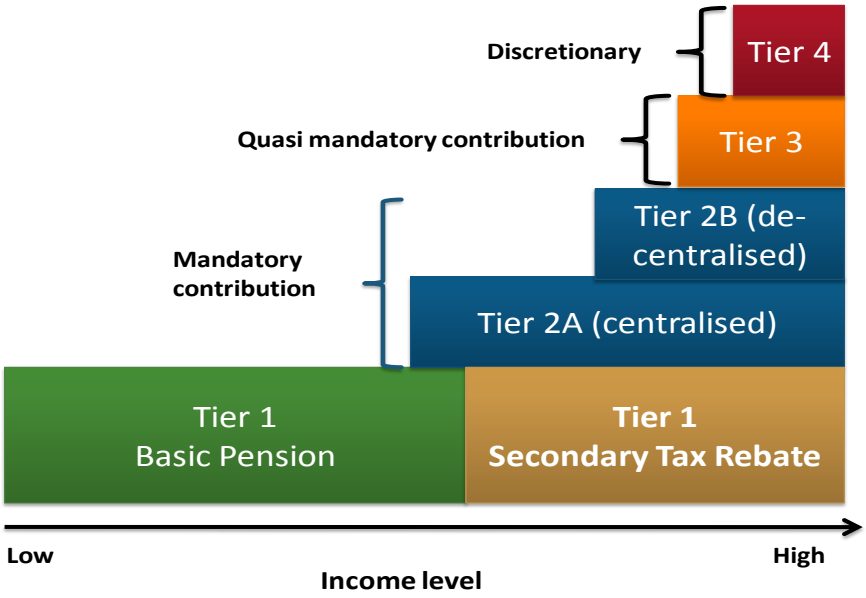
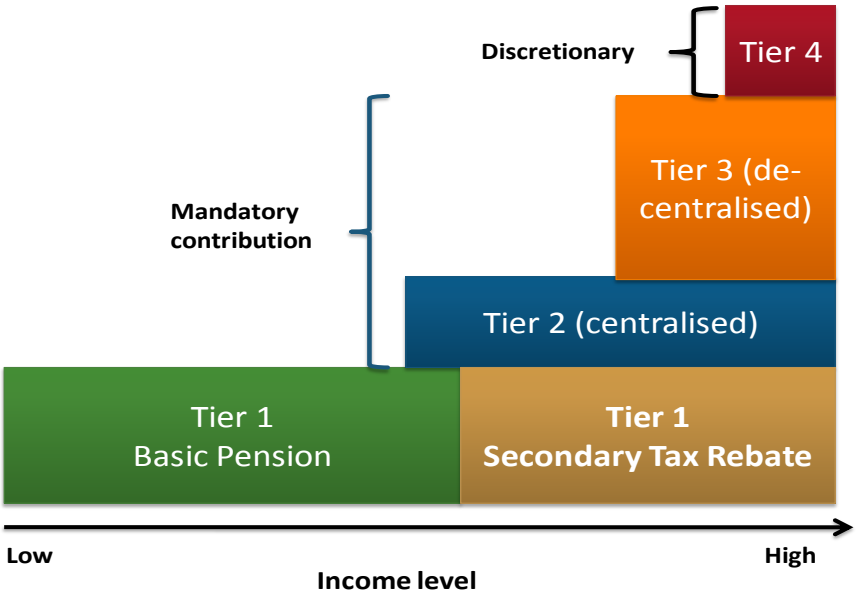


Figure 8.5: Representation of the proposed system of retirement provision with tier 2B and 3 combined into a single mandatory tier operating on a decentralized basis



- *Tier 3*: This tier provides for a tax incentivized supplementary contribution equivalent to 10% of the pensionable income for this tier which involves contributions in respect of incomes above the tier 2B ceiling and up to R700,000 per annum in 2007 prices. The service providers for this section include approved pension funds, which should include the default statutory pension fund (the NSSF), and approved asset managers.
- *Combined tier 2B and 3*: This option sees a uniform tier 2 and 3, with the former provided on a centralized PAYGO basis, and the latter provided on a decentralized basis through individual DC accounts. The contribution for both tiers would be 10%, with tier 2 to an income ceiling of R149,736 and tier 3 to R700,000 (to R750,000) (both in 2007 prices).
- *Tier 4*: This tier, which applies to pensionable income in excess of R700,000 per annum, is entirely discretionary with contributors able to select any fund or substitute product type. No tax incentives or mandates of any form are applicable to this tier.
- *Contribution alternative*: To mitigate any implementation risks associated with the framework, consideration can be given to reducing the retirement portion of the social security contribution from 10% to 6%, while enhancing the tier 1 benefits to compensate.

8.68 It should be noted that the contribution proposals highlighted in this section are for benefit costing purposes and that a final consolidated social security contribution would not be split between different components (i.e. retirement and risk) of contributory benefits managed on a centralized basis.

Concluding remarks

8.69 The retirement benefit framework outlined in this section derives from the systemic gaps existing within the present system of retirement provision and recommends consideration of a four tier structure involving: a non-contributory component; a mandatory contributory arrangement divided into a PAYGO DB and individual account DC components; and a supplementary quasi mandatory component.

8.70 Altogether the benefit configuration matches the institutional reform requirements arising from the analysis in **section 7** which argued that at least one part of the mandatory tier involve a PAYGO arrangement managed centrally. This together with the tier 1 basic non-contributory benefit would provide strong protection for all families with individuals earning up to R67,655 per annum (2007 prices). This policy focus would not be altered in any of the options examined.

8.71 Over-and-above the PAYGO tier the extent of protection via centralized administration and guaranteed benefits diminishes, with much of the benefit protection derived from improved regulation of private funds and the introduction of a statutory default fund and competitor. Mandatory contributions however continue to an income ceiling of either R149,736, in the case of a split tier 2, after which they are tax incentivized to an income ceiling of around

R700,000 (both in 2007 prices). The alternative scenario is to combine tier 2B and 3 to create a uniform mandatory tier 3 provided on a decentralized basis. The tax incentives, to the extent that they involve a system of deferred taxation rather than a subsidy, remain in place.

8.72 Consideration could be given to a lower contribution rate earmarked for retirement benefits, at 6%. This would be to mitigate any impact on employers and to minimize the start-up risks of the new social security system. To the extent that this reduces retirement protection for low-income employees, the tier 1 benefits should be enhanced through additional funding from general taxes.

8.73 In order to avoid the need for early withdrawals from retirement savings due to extended periods of unemployment extended unemployment benefits through the UIF focused on low-income earners should be considered. Other life crises should however be mitigated by the survivor and disability benefits framework recommended in **section 9**.

9. SURVIVOR AND DISABILITY BENEFITS

Introduction

9.1 The situation analysis in **section 6** revealed that the extent and quality of coverage for survivor and disability benefits is presently quite poor despite the relative maturity of the insurance industry and the large number of participants. Furthermore, more the voluntary nature of the market exposes vulnerable individuals and groups to structural exclusion due to risk rated premiums. At its essence survivor and disability insurance suffer from an absence of effective risk pooling, resulting in structurally less participation and higher costs than are possible if pooling were broadened.

9.2 Although many aspects of the private insurance market are competitive, the system as a whole is unable to structurally converge on a market solution which can overcome the consequences of fragmented risk pools. This situation has not been helped by a regulatory framework that is very hands-off and relies exclusively on complaints procedures to regulate improper conduct. In particular, the regulatory framework does not prohibit the exclusion or differential treatment of vulnerable risk groups. However, even were the regulatory framework to be optimal, which is an important consideration going forward, it could never be relied upon to close existing gaps in social protection.

9.3 Inconsistencies in survivor and disability insurance protection can also be found within existing social insurance arrangements such as the RAF, UIF and the Compensation Fund. The absence of consistency between these funds and their relationship to the private arrangements derives to a large extent from institutional weaknesses within the social security policy determination processes of government. Any social security intervention that seeks to cut through the fragmentation will therefore need to do so taking account of the need to integrate such interventions with existing social security interventions. Such integration need not involve the consolidation or elimination of existing institutions and need only extend to mechanisms that ensure that the roles and responsibilities of different arrangements are clearly delineated, streamlined and subject to common standards and procedures.

9.4 Within the context of the situation analysis provided in **section 6** and the strategic framework provided in **section 7** this section therefore provides for necessary social security interventions to ensure the broadest possible protection for income earners and their families.

Why are survivor and disability benefits important?

9.5 When a breadwinner dies or becomes disabled an entire family's life chances and options can be permanently harmed due to a contingency entirely outside of the control of any member of the household. When seen from an individual's perspective the contingencies of death and disability may seem remote and infrequent and only worry when it happens to them. However, from a social perspective a relatively predictable number of households will face these

contingencies every year. In each case, where there is no adequate insurance, the impact on the family will be devastating and result in a severe social reversal.

9.6 In the absence of a properly pooled system, therefore, a relatively predictable number of families will face catastrophic social reversals each year for no other reason than the structural defects in the pooling mechanism. Correcting for these market imperfections will therefore seek to remove preventable social reversals for families that have managed the transition into the formal economy and whose continued participation is essential to medium- and long-term economic development and to the general well-being of society.

9.7 Where is protection important?

- *Disabled breadwinner who is no longer able to work*: such a person may be living alone or have a family to support.
- *Surviving spouse*: a spouse may be pregnant, have children to support, and be unable to find employment in time to compensate for the loss of financial support. In the absence of adequate insurance the children may lose the nurturing role of their mother, important to human development, as well as suffer severe financial hardship.
- *Surviving dependent children*: children are financially dependent on their parents for an extended period, often including continuing education. In the absence of insurance, children could lose the nurturing and supervisory role of their parents, as well as support for their future advancement. This would apply to any child financially dependent on the breadwinner, including formally placed foster children, as well as informally placed children.
- *Dependent adults other then the spouse*: some households need to support persons who are themselves disabled. The death of a breadwinner could place the continued support of such an individual at risk.

Benefit types

9.8 Social security interventions consequently need to maximize risk pooling to ensure that an adequate minimum level of protection is in place to cater for the above needs. Maximising the minimum level of protection requires consideration both of the level of benefits and how they are structured. For instance, lump sum benefits skew the efficiency of benefits by potentially over-compensating some beneficiaries[65] while at the same time creating the possibility that the benefit is rapidly dissipated. A system based on lump-sum payouts, although simpler to administer, may therefore provide almost no protection for any given level of

[65] A large payout could occur to a beneficiary who then lives for a very short period. If the benefit took the form of a pension the benefit would cease with the death of the beneficiary, leaving more funds available for beneficiaries who live longer.

contribution. *Given this, lump sum payments should be avoided when considering minimum benefits for social security.*

9.9 Based on the recommended retirement framework in **section 8**, no post-retirement benefits would be provided via the retirement system, apart from social grants and related benefits (i.e. adjustments to tax benefits). Given this, all risk benefits would need to cater for both the pre- and post retirement period and, in the case of periodic payments (e.g. a spouse's pension), would need to provide benefits for as long as the relevant beneficiary survives. In the case of disability benefits, the exhaustion of a periodic payment is inappropriate as the disabled individual would clearly not be able to survive when payments cease (apart from accessing social assistance).

9.10 It is therefore proposed that both survivor and disability benefits take the form of a monthly pension, which can be exhausted only where appropriate such as children that have reached an age where they can reasonably be expected to be self-sufficient.

Periods of cover

9.11 Irrespective of whether survivor or disability benefits are considered, there is a need to relate the benefit payouts to the design of the social security system for retirement provision. Importantly, if the retirement system is designed to offer adequate benefits in retirement, despite the death or disability of a contributing breadwinner, then the need for insurance protection post retirement falls away. *However, as the design of the retirement system sees the contingency of death and disability as generating an accelerated access to retirement benefits, then risk benefits need to extend into the post retirement period and where possible to the death of the relevant beneficiary or the exhaustion of benefits due to established limits (i.e. in the case of child dependants).*

Contribution toward risk benefits

9.12 To keep an overall social security contribution within a reasonable range, the combined contribution for all social security survivor and disability benefits *should be kept to 5% of affected income (i.e. income up to a specified income ceiling). In addition to retirement benefits, therefore, the total social security contribution, subject to the relevant ceilings, would not exceed 15% of affected income.*

Qualifying income group

9.13 There is no apparent reason to vary the qualifying income categories for contributory social security risk benefits from that for retirement provision. *It is consequently recommended that for both survivor and disability benefits the income above which contributions are mandatory is R12,000 in 2007 prices.*

Qualifying age categories

9.14 Where a person has reached retirement age with a full contribution record, there is little reason to continue with mandatory contributions toward risk benefits. *It is therefore recommended that the mandatory social security contribution toward risk benefits apply to all formal income earners regardless of age up to the age of 65 (i.e. the 65th birthday).*

Income ceiling(s)

9.15 As with mandatory retirement provision, an income ceiling is required to ensure that protection is prioritized toward the most vulnerable. *The ceiling applied to tier 2B for retirement provision, which is in effect the ceiling for tier 2 overall, appears most appropriate. This would be consistent with an annual income of R149,736 in 2007 prices (or R179,789 in 2009 prices).* The splitting of the ceilings within tier 2 for risk benefits is not appropriate as this would undermine the risk pooling objectives of the overall scheme.

9.16 No ceiling consistent with tier 3 retirement provision is proposed for risk benefits as the fragmented supplementary market is not sufficiently efficient to be regarded as part of the social security system. However, it can be expected that approved funds serving tiers 2 and 3 of the retirement system, including the default statutory fund, will offer supplementary insurance on a voluntary basis. The quality of benefits offered within approved funds should benefit from the improved regulatory framework primarily focused on retirement provision.

Indicative affordable benefit options

9.17 **Section 6** provides the reported industry data on average cover, average cost, and average benefits for both death and disability. Also provided are the estimates of what would be regarded as needed (preservation and belt-tightening) cover to ensure adequate protection. This information is summarized in **table 9.1**, which also indicates the implied contribution cost required for each additional multiple of annual salary covered.

9.18 Based on the survey information the cost per year of salary covered on average amounts to 0.5% of affected income separately for both death and disability. A simple extrapolation of this information suggests that coverage equivalent to 4.9 times annual salary could be covered separately for both death and disability for a total contribution of 5% of affected income. This would require a contribution of around 2.6% and 2.4% for death and disability cover respectively. In both instances the level of protection would be greater than the present market average, but still short of the "needed" preservation and belt-tightening options.

9.19 An important consideration, however, *is the possible universalisation of the disability social grant to include all income groups*. This would enhance the protection offered by the disability benefit although the potential impact on dependants may not be that straightforward.

9.20 Although the benefits are described in **table 9.1** as multiples of annual income, this is merely indicative of the average lump-sum equivalent of the average benefit offered, which needs to take a very different form, i.e. spouse's pensions etc..

Table 9.1: Indicative estimates of benefits that can be afforded within the 5% contribution

	Death	Disability	Total
Benefits (multiple of annual salary)			
Market average now	3.5	2.7	6.2
Preservation	9.0	14.0	23.0
Belt tightening	7.0	11.0	18.0
Social security option	**4.9**	**4.9**	**9.8**
Contribution required (% of affected income)			
Market average now	1.9%	1.3%	3.2%
Preservation	4.8%	6.9%	11.7%
Belt tightening	3.7%	5.4%	9.1%
Social security option	**2.6%**	**2.4%**	**5.0%**
Contribution per multiple of salary covered	**0.5%**	**0.5%**	**1.0%**

9.21 The social security risk benefits serve the purpose of ensuring a base-level of protection above which additional cover can be obtained on a voluntary basis. *Many funds, including the default public scheme (the NSSF), would be in a position to supplement this minimum benefit on an affordable basis*. With supplementation the levels of protection could come very close to optimal.

9.22 Based on the above, benefits roughly equivalent to an average of 4.9 times annual income should be provided for death and disability to be consistent with the contribution constrain of 5% of affected income.

9.23 *It is further recommended that the actual benefits offered not take the form of lump sum benefits, but involve appropriate replacement rates of the affected income, payable until the death of the relevant beneficiaries or the achievement of a ceiling age in the case of dependent children*.

9.24 Given the budget ceiling implied by the 5% contribution a pension-type benefit would have to adjust to a lower replacement rate if provided for the life-span of the survivor or the disabled beneficiary. *However, as the retirement benefits would not be available to survivors or the disabled, consideration of annuity-type benefits to death appears to be unavoidable requirement*.

Quantitative evaluation of the indicative options

9.25 As the demographic and income profile of the contributory system will change after the introduction of mandatory contributions incorporating fairly low-income groups there is some risk that the indicative contribution limit of 5% of affected income will not realize the proposed benefits. To validate the estimates provided in **table 9.1** use is made of the GHS 2006 to model the financial implications of an expanded system of contributory benefits with central characteristics specified in **table 9.2**.

Table 9.2: Model parameters and assumptions for mandatory (tier 2) survivor and disability benefits

Parameter	Proposal
Contributors	Income earners earning more than R12,000 per annum.
Age of range of contributors	From ages 20 to the 65th birthday.
Administration costs	Not directly modeled as these must be additional to any benefit estimate. A reasonable assumption would be equivalent to 2% of gross contribution income.
Income ceiling	Equivalent to the average income of income earners: R147,736 (R179,789 in 2009 prices).
Survivor benefit	3.5 times annual income at the death of the contributor/breadwinner.
Disability benefit	75% of the annual income of the contributor/breadwinner at the time of the disablement of the breadwinner.
Mortality estimates	These are used to estimate the survivor benefits liability. The standard scenario for the 2003 ASSAlite demographic model is used to provide: • The estimated *non-AIDS mortality rates* for 2010 and 2060 for the age group 20-64. • The estimated *overall mortality rates* for 2010 and 2060 for the age group 20-64. • The above allow the model to provide AIDS-affected and normal mortality for both the immediate future and 50 years into the future. The differences between the *non-AIDS* and *with-AIDS* mortality rates provide the parameters for an adjustment factor to be applied to contributors in households where per capita household income is less than R50,000 per annum. This is a fairly high income level and is adopted to err on the side of caution in the estimates. As the employed population does not experience the same HIV and AIDS-prevalence as the general population, and has good access to anti-retroviral treatment, mortality experience is likely to be lower than that for the general population. The standard scenario therefore assumes an adjustment equivalent to *30% of*

Parameter	Proposal
	*the difference between the non-AIDS and with-AIDS mortality rates (see **figure 9.1**).*[66]
Disability prevalence	Disability by age (see **figure 9.2**) is obtained from the GHS 2006 and extrapolated onto the contributor population to estimate the number of claimants in any given year.
Survivor claims	Claims are estimated by multiplying the estimated number of claims, based on the estimated mortality in a given year, in a given year by the benefit expressed as a multiple of annual income. This is calculated by income and age.
Disability claims	Disability claims are estimated by multiplying the disability prevalence, which is calculated by age and income, by 75% of the applicable income group.

9.26 The model results reported in **table 9.3** indicate that a survivor benefit of 3.5 times the annual salary of contributors subject to the mandate will require a payroll contribution of 2.4% of affected remuneration based on the mortality rates applicable in 2010 which is higher than the 1.9% indicated in **table 9.1** which is based on the presently covered lives. The model therefore predicts an additional cost of 0.5%. The industry estimate (**table 9.1**) however comes very close to expected cost without adjusting for extra-AIDS mortality which is estimated at 2% of affected income (see **figure 9.1**).

9.27 The extra-AIDS mortality of the new group entering the contributory system is expected to have some impact on the cost of the benefit. Were the lower income households (taken here to mean households earning less than R50,000 per annum per capita) to experience the mortality rates of the non-contributing households, the contribution would move up to 3.3% of affected income. However, the evidence is fairly conclusive that the employed population has a lower HIV prevalence than the unemployed and a reduced risk of dying from AIDS even when infected.

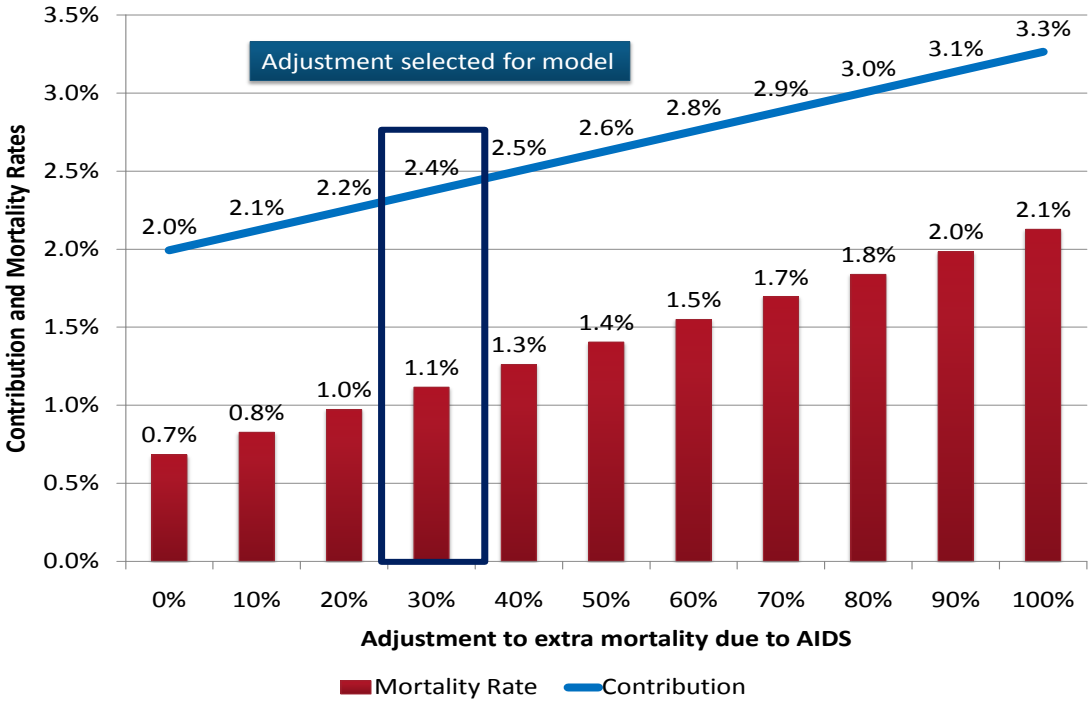
9.28 The selected extra-AIDS mortality is however sufficiently conservative. (See **figure 9.1** for a range of extra-AIDS mortality adjustments and their effect on a social security contribution offering a benefit of 3.5 times annual salary).

9.29 Survivor benefits would be expected to decline over time based on a projection to 2060 using the ASSA 3003lite model. Superimposing the mortality rates of 2060

[66] See Colvin et al, 2007, where a workplace survey found prevalence of 10.9% across a range of companies compared to 27.9% for the Department of Health's antenatal clinic survey for comparable age groups. This would suggest that workplace prevalence is 40% of the national experience. Assuming reasonable access to treatment the mortality experience of the employed population is reasonably assumed to be around 30% of the general population.

over the current contributor population indicates that the contribution rates would decline to 1.5% of affected remuneration.

Figure 9.1: Alternative mortality and survivor benefit contributions with different adjustments for extra AIDS mortality (2006 population and 2010 mortality rates)



9.30 A disability benefit offering a 75% replacement of the contributor's income will require a contribution of around 2.5% of affected income excluding administration costs. These results are however not directly comparable to the industry estimates reported in **table 9.1** which are calculated from *incidence* and benefits expressed as a multiple of annual income. The results reported here are instead based on a living *annuity*[67] set at 75% of the income at time of disability which is best estimated using prevalence by income rather than incidence.

9.31 In total there are around 1.5 million disabled people representing approximately 4.5% of the total population. Of this number the non-contributory disability benefit would support around 1.2 million beneficiaries, assuming the means test continues, with the contributory benefit supporting 335,518 beneficiaries.

9.32 Were the non-contributory disability benefit to be made universal this would involve an increase in cost of around 27% to the existing budget allocation. However, this would be offset from the contributory benefit reducing the required contribution to 1.9% from 2.5%. *The universal benefit scenario allows for a part of the*

[67] A benefit paid until the death of the principal beneficiary.

universal benefit to be paid for by general taxes, which may be desirable where there is a need to limit the impact of the contributory social security system on employers.

Figure 9.2: Disability rates by age band (percentage)

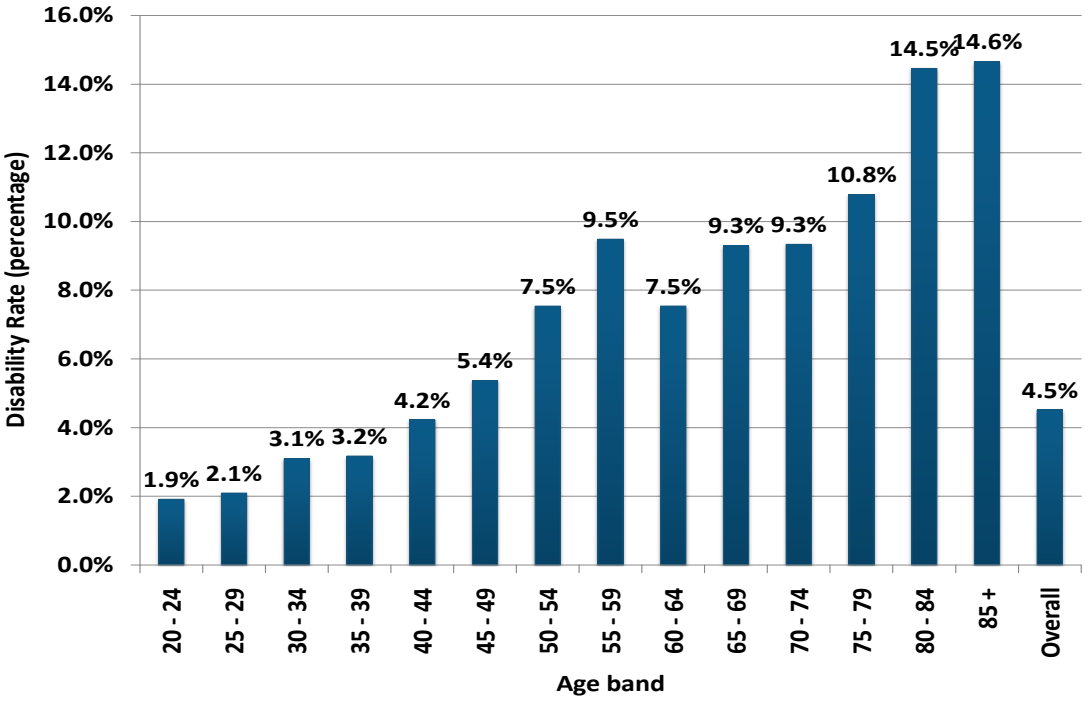


Table 9.3: Survivor and disability cost estimates with mortality applicable to 2010 (2006 prices)

	Tier 1	Tier 2
	Survivor	
Population covered		7 987 383
Benefit		
Multiple of salary		3.5
Claims : annual (mortality)		89 112
% of covered population		1.1%
National mortality rate (%)		1.7%
Claim cost : annual (R'000)		11 694 021
% of affected remuneration		2.4%
	Disability	
Population covered (denominator)	27 130 101	7 987 383
Benefit		
Cash grant (monthly) 2006 prices	820	-
Replacement income	-	75.0%
Claims : annual beneficiaries	1 224 570	335 518
% of covered population	4.5%	4.2%
Claim cost : annual (R'000)	12 049 769	12 481 377
% of affected remuneration	n/a	2.5%

Table 9.4: Survivor cost estimates with mortality applicable to 2060 (2006 prices)

	Tier 1	Tier 2
	Survivor	
Population covered	n/a	7 987 383
Benefit	n/a	
Multiple of salary	n/a	3.5
Claims : annual (mortality)	n/a	59 732
% of covered population	n/a	0.7%
Claim cost : annual (R'000)	n/a	7 154 293
% of affected remuneration	n/a	1.5%

9.33 *Overall, therefore, the risk benefit component of the proposed contributory social security system is consistent with a 4.9% payroll contribution, with the possibility that the cost of the benefit will decline over time. Taking account of administration expenses, which should not exceed 3% of the total contribution, the required payroll contribution would come to 5.05% with the expectation of a systemic decline in cost over time. This is therefore sufficiently consistent with an overall risk contribution of 5% of payroll as recommended.*

Survivor benefits

9.34 Within the context of the budget constraints outlined above the following configuration of survivor benefits is proposed for consideration:

- *The benefit should take the form of a "living annuity"[68] in respect of any surviving spouse, at an average replacement rate based on the income of the contributor at the time of death;*
- *Surviving children should receive an orphan's benefit in the form of a monthly benefit at a fixed ratio to the income of the contributor at the time of death, which should be paid out:*
  - *To age 18 in the case of dependent children not pursuing further education;*
  - *To a maximum of age 25 where any further education is pursued;*
- *Annuity benefits should be adjusted annually for general inflation rather than a wage index in order to reduce the cost of the overall benefit and spread the protection over longer periods.*

Disability benefits

9.35 As with survivor benefits, disability benefit offerings must be offered within the overall available budget constraint. *The following general benefit configuration is proposed for consideration:*

- *The benefit should take the form of an annuity payment at a fixed replacement rate to the income of the contributor at the time they became disabled, with a rate of 75% considered;*

[68] This indicates that the payments terminate upon the death of the beneficiary.

- *In those instances where the disabled beneficiary dies with a dependent spouse (which would include a designated long-term partner), a survivor's annuity benefit should be payable at 50% of the value of the original disability benefit;*
- *Where the disabled beneficiary dies, dependent children would receive benefits in accordance with the rules governing survivor benefits.*

Operational considerations

9.36 Given the nature of the benefits and the need for complete risk pooling across all contributors and their dependents, *a centralized service provider for the mandatory tier appears unavoidable. This provider should also be permitted to operate as a default provider for supplementary benefits, given that certain individuals and groups may find themselves structurally excluded from any voluntary market.*

Relationship to related social security arrangements

9.37 Given that similar risk benefits are provided via the RAF, Compensation Fund, and UIF, it would be important to clarify which social security arrangement carries the liability for the benefits described in this section. *If a statutory insurer other than these funds carries the liability, then the contribution income must flow to this institution. However, if any part of the indicated benefits can be claimed from any other social insurance fund, then the relevant contribution income would need to be set to match the relevant liability.* As different social security funds may offer more generous benefits than provided through general social security arrangements, it would be important to avoid merely consolidating all arrangements into one as vulnerable groups and individuals could be prejudiced.[69]

9.38 *The most reasonable approach therefore appears to involve designating which social security entity carries the principle liability for general social security benefits, while the other funds merely pay out any differential benefits.* As discussed in **section 12**, *it is recommended that a specialized social security organization take primary responsibility for general social security benefits including contributory retirement and risk benefit provision, and carry the full liability for these benefits. To prevent double-dipping[70], operational platforms for all social security funds need to be integrated, with legislated requirements for electronic co-ordination.*

Summary of recommended framework

9.39 In contrast to retirement provision, risk benefits have fewer tiers when viewed simplistically. However, this is not necessarily the case in every instance:

- *Tier 1*: There are no survivor benefits. However, a means-tested disability grant is available with the option of ultimately making this benefit universal. However, a universal benefit is not a necessary requirement for a complete

[69] This would occur where a consolidation resulted in the downgrading of previous entitlements.

[70] This refers to instances where beneficiaries effectively claim indemnity benefits for the same contingency from two separate funds.

system and only becomes important where a need exists to minimize the size of a payroll based social security contribution. Were a universal benefit to be introduced this would reduce the required payroll contribution for risk benefits to around 4.4% of affected income.

- *Tier 2*: Although the tiers are not split using differential income ceilings as in the case of retirement provision, the overall income ceiling recommended to be equivalent that for tier 2B applicable to mandatory retirement provision. An overall payroll contribution of 5% for the following benefits:
  - Survivor: equivalent to 3.5 times annual income; and
  - Disability benefits: a living annuity equivalent to 75% of the contributor's income at the time of the disability.

  The tier 2 benefit would be administered by the NSSF to maximize the risk pooling requirements. The cost of administration is assumed at roughly 3% of contribution income.
- *Tier 3*: Although technically there is no tier 3 equivalent to that for retirement provision, as no tax incentive is proposed, it is likely that AFs will offer supplementary top-up arrangements for risk benefits as well as for retirement. Tier 3 for risk benefits therefore involves voluntary top-up provision within highly regulated funds with large risk pools, including the proposed statutory default scheme (the NSSF).
- *Tier 4*: As in the case of retirement provision tier 4 revolves around top-up provision via insurance carriers other than approved funds, e.g. individual insurance policies.

Conclusions

9.40 The market for risk benefits is presently extremely inefficient with many people who could easily be protected either under-insured or not insured. A significant efficiency gain in contributory risk benefit protection is possible through the introduction of a social insurance fund.

9.41 A negative consequence of this involves the impact on established private and public infrastructure servicing the present market. However, aside from the clear need to engage fully with all affected stakeholders to ensure that negative implications are mitigated where possible and appropriate, government will ultimately need to weigh up the consequences of industry impact with the social effects of inadequate survivor and disability protection.

9.42 An important proposal is the potential introduction of a default public scheme to operate technically in competition with private providers. However, the primary purpose of this fund is to ensure that no-one is excluded from a large affordable provider within the voluntary market rather than to compete with private providers. A positive consequence of the default scheme, as is the case with supplementary retirement provision, is that a transparent benchmark fund will

exist in the market with systemic cost and conduct implications for the private system.

9.43 Aside from the private market, introducing general social security risk benefits requires that existing social security fund arrangements be rationalized to remove inefficiencies and inconsistencies. To date many individual social security arrangements have operated in silos, with an accumulation of inconsistencies over time. Aside from the imperative to rationalize arrangements due to the introduction of general benefits, there is a need to ensure that social security policy is determined holistically in future. This is discussed further in **section 12**.

11. PAYGO AND SAVINGS

11.1 The existing private pension system in South Africa is predominantly DC in nature and consequently largely fully funded with substantial savings involved. An important question therefore arises as to whether the envisaged introduction of a substantial PAYG tier, which can be expected to involve the substitution of some contributions, will impact negatively on aggregate savings and the macroeconomy.

11.2 The international evidence suggests that national PAYG systems do not undermine aggregate savings level.[71]

Box 11.1: Evidence of PAYGO retirement arrangements on aggregate savings

"*Despite numerous attempts to measure the effect statistically, no consistent evidence has emerged linking the creation of pay-as-you-go social security schemes with reductions in personal savings rates. This suggests that, if these schemes have had a negative effect on personal saving, it probably has been a modest one. At the same time studies also suggest that advance-funded schemes can lead to an increase in personal savings, though by less than the gross amount of the assets accumulated in them. Although pay-as-you-go pension schemes may not be responsible for depressing personal saving, relying instead on advance funded approaches may nevertheless cause personal saving to rise*."

Source: ILO, 2000, p.361.

11.3 Studies examining savings offsets within households find that some portfolio substitution occurs, but is very dependent on income. Low-income households will have a limited capacity to save outside of a mandatory PAYG arrangement, while higher-income households are not significantly affected.[72]

11.4 However, pension fund systems are seen as impacting on economic growth and development through the development of liquid capital markets. Capital markets are weakened where only one or two actors hold substantial reserves in relative to the national economy[73]. This argument therefore focuses on the institutional effects of social security design rather than the level of aggregate savings.

11.5 Ensuring that capital markets remain efficient is thus a crucial consideration in social security design. Internationally the question has been raised whether social objectives should be subordinated to this objective. However, this is potentially a non-debate as this is primarily a matter of how asset management arrangements are designed and does not require the imposition of a particular social security model.

11.6 Design options include:

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[71] Also see: Orszag *et al*, 2001, p.21.

[72] ILO, 2000, p.361.

[73] Thompson, 2004, p.5.

- A DC individual account system in which contributors decide amongst competing private and/or public pension arrangements (e.g. Chile); and
- A DB pension system where the assets of any reserve are allocated on a competitive basis to a range of private asset managers (e.g. Japan).

11.7 Where a national pension system is operated on a PAYG basis and government does not favour contracting out the management of assets, or accumulates minimal reserves, the capital market institutional objectives can be achieved through encouraging the growth or maintenance of advance-funded pensions designed to supplement the national pension system.

> "*Encouraging the growth of complementary pensions probably requires that replacement rates (the ratio of retirement benefits to pre-retirement earnings) in the public system be no more than 50 per cent (perhaps less), at least for higher earners. That implies that replacement rates for all workers be constrained or that benefits for higher earners replace a smaller fraction of total earnings than do benefits for lower earners. The latter can be achieved by capping the earnings that are covered by the pension system at or near the average wage.*"[74]

11.8 Taking the above into account a reasonable balance between social security objectives and capital market efficiency can be achieved through the sensible construction of a PAYG tier which provides universal earnings-related protection up to an income cap, with support for a complementary DC individual account system in addition. To the extent that savings levels may be compromised, for which there is little evidence, the PAYG tier could be partially funded. Where partial funding is considered in this way, capital market efficiencies would be fostered through the allocation of investments on a competitive basis to multiple asset managers.

11.9 The alternative decentralized model, applied in Chile from 1982, mandates coverage through private funds offering advance-funded individual accounts. This approach is however criticized as too extreme as it compromises social security performance[75] in order to develop capital markets.

11.10 As South Africa already has well developed capital markets it would be important to ensure that retirement reform does not in any way undermine the achievements to date. As indicated, this is achievable through a balanced social security design and does not require the retention of an extreme decentralized model. However, achieving the institutional objectives through statutory social security arrangements is strongly premised on the existence of good governance arrangements and capacity to manage investments generally.[76]

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[74] Thompson, 2004, p.5.

[75] The DC individual account approach transfers investment risk onto individuals and significantly increases administration expenses. Both these factors compromising benefit performance relative to PAYG DB or NDC systems.

[76] See Robalino, 2005.

11.11 It has also been argued that PAYG social security tiers could impact negatively on economic growth. This view is premised on the following logic: PAYG pensions reduce savings levels impacting on capital formation and subsequently on growth. The converse position therefore applies to advance-funded arrangements, which supposedly promote savings and subsequent capital formation. However, close examination of the growth experience of the "Asian Tigers" has revealed that "*growth had accelerated before their savings rates rose, suggesting that rapid growth was generating higher savings rates rather than the other way around*."[77]

11.12 It is now generally accepted that the existence of efficient capital markets is a more important consideration for social security design than impacts on aggregate savings. Advance-funded systems may in fact only create the appearance of higher savings levels where the financial system translates these balances into higher consumption expenditure rather than additional business investment.[7879] Aggregate savings levels could also be offset by government dissaving.

11.13 Overall therefore the social security configuration proposed in this report should not impact negatively on aggregate savings, the efficiency of capital markets, or economic growth.

[77] Thompson, 2004, p.7.

[78] Thompson, 2004, p.7.

[79] For example financing consumer credit, salary loans, or borrowings against retirement account balances. (Thompson, 2004, p.7).

12. INSTITUTIONAL FRAMEWORK

Overview

12.1 The quality and timeliness of social security policy development and implementation is driven almost entirely by the institutional framework underpinning the social security system. Whereas the policy configurations recommended in this report imply the establishment of new public entities, sustainable reform requires a more fundamental reconsideration of the responsibilities within government, and their relationship to both existing and new public entities responsible for delivering essential social security services and benefits. This section provides a strategic overview of the broader institutional requirements for a well-functioning social security system. A more detailed analysis and assessment is provided in **Report 2** of this series.

Institutional impediments to social security reform

12.2 There is strong evidence of structural imbalances within the overall system of social security, with publicly driven (whether by way of regulation or statutory provision) contributory social security under-represented. Private contributory arrangements are in many instances compensating for this gap. Private arrangements, where they operate outside of a social security framework, are however poorly placed structurally to achieve needed social security objectives. *These structural imbalances have however evolved due to the inability of government to establish coherent policy which can be attributed directly to institutional weaknesses in the policy-making structures of government.*[80]

12.3 To date government has implicitly not recognized *social security*, and in particular *contributory* social security, as a stand-alone function in and of itself. Whereas non-contributory arrangements, such as social grants, have much greater policy coherence due to their consolidation under a single department, non-contributory arrangements have been seen as subordinate components of other functions. For instance, the RAF is seen as a subordinate function of transport policy, due to their location within the Department of Transport (DOT) rather than social security policy. Similarly, UIF and COIDA are subordinate functions of labour policy (falling within the authority of the DOL); the regulation of private pension and insurance arrangements subordinate functions of policy relating to financial services (falling within the authority of the National Treasury); and contributory healthcare arrangements as subordinate functions of both health policy and policy relating to financial services (falling within the authority of the Department of Health (DOH) and National Treasury).[81]

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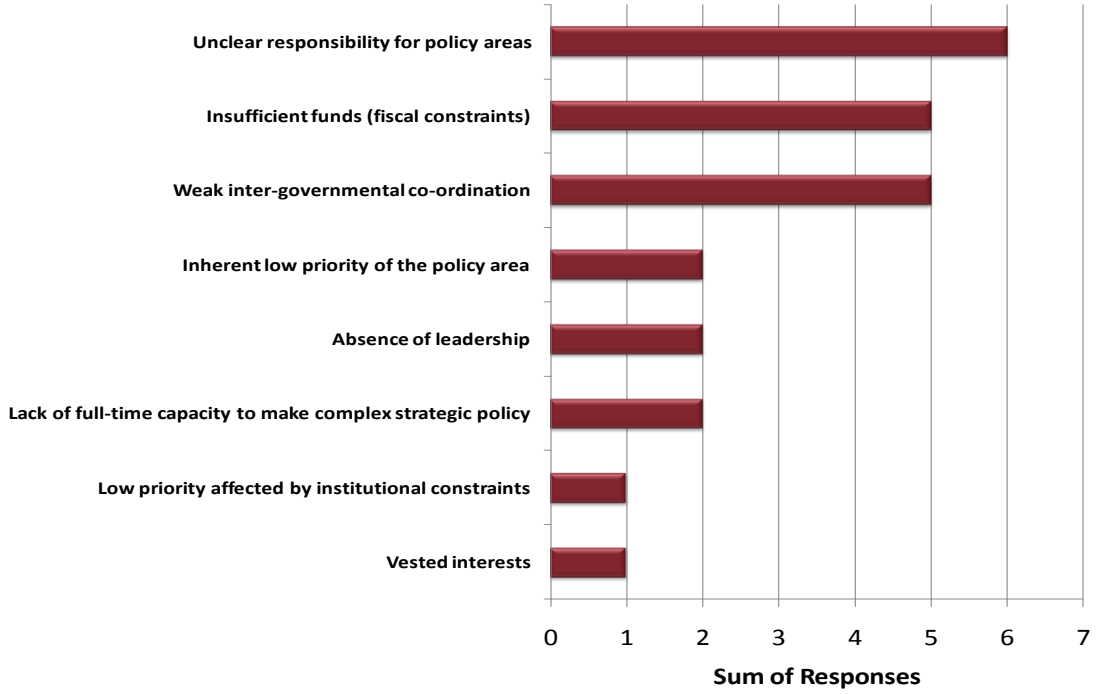
[80] DSD, 2009.

[81] These were central findings in the Taylor Committee report of 2002, and subjected to further evaluation in DSD (2009).

12.4 The manner in which the authority for social security policy has been split therefore, does not allow for a single department or process to effectively lead the development of a holistic strategy in relation to what is presently the notional function, social security.[82] Furthermore, the failure to recognize contributory social security as a distinct function has resulted in an *implicit de-prioritisation* of the entire area of policy, despite general recognition of its importance.[83] *Although there has been growing recognition of the relevance of the notional function of social security, through various committees of inquiry and inter-departmental structures, this has as yet not been formalised structurally within government.*

Figure 12.1: Reasons for Poor or Moderate Progress in Achieving Comprehensive Social Security



Source: Roleplayer survey, DSD (2009)

12.5 The implicit organisational structure of the "notional" social security function is dysfunctional, often with low-level departmental structures often responsible for extremely important and complex policy areas that require specialist expertise. The unclear allocation of authority for social security has made inter-departmental co-operation a pre-requisite for reform, while at the same time making efficient co-operation extremely difficult. (See **figure 12.1**).[84]

12.6 Resolving the dysfunctional institutional framework is consequently *needed to ensure that:*

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[82] DSD, 2009, p.61.

[83] DSD, 2009, p.60.

[84] DSD, 2009, p.61.

- Policy can be properly developed, maintained, and sustained into the future;
- Existing social security organizations can be properly mandated, overseen, located and governed within the context of a broader set of social security goals; and
- New social security organizations can be better designed and incorporated into a more integrated system.

12.7 Achieving this requires careful reconsideration of:

- How policy is led and coordinated;
- How public entities are mandated, overseen, governed, designed, and integrated within the social security system;
- How private arrangements central to the social security system are mandated, overseen, and governed within the social security system;
- How the general public are effectively empowered to interact with, and impact on the running of, the social security system as a whole; and
- How the operational architecture of the social security system is organized to ensure the full integration of all elements of the social security system.

Over-riding strategic approach for social security

12.8 The institutional framework for social security can be conceptually divided into the following:

- *Strategic architecture*: which deals with designing the mandates for different components (i.e. policy development, policy implementation, public entity oversight, independent public entities, and regulated private entities) of the system and the supporting organizations. The mandates should embed the various inter-relationships between government, public entities, private role players, and the system beneficiaries to ensure that social security operates as a system.
- *Governance*: which involves the oversight and management arrangements for all components of the system to ensure that each perform their functions efficiently and in the public interest.
- *Operational architecture*: which deals with the information technology (IT) platforms, accounts management systems, etc.. The various service platforms need to be designed to co-ordinate between government, public providers, and private providers where social security contributions and benefits are involved.

12.9 This approach has been followed in the government discussion document on comprehensive social security[85], and forms the basis for recommendations and approaches discussed in this section.

12.10 The overall framework involves the following configuration:

- The establishment of a *Department of Social Security* (DSS) to consolidate the authority to develop and lead social security policy, which authority would include both contributory and non-contributory social security;
- The establishment of an *independent Social Security Council*, made up of the key social partners, to oversee social security organizations and to advise on social security policy;
- A *revised governance model* for all social security organizations, which would include independent boards, following the social partner model, responsible for direct oversight, appointing and removing the CEO, and where the board members are held accountable for their decisions.

Strategic framework for retirement, survivor and disability provision

12.11 **Section 7** outlined the strategic choices facing government in relation to both non-contributory and contributory social security interventions related to retirement, survivor and disability protection. The framework emerging from that section is outlined below.

Non-contributory system

12.12 Social assistance for retirement and disability benefits should be offered by way of a public entity as there is no more efficient alternative to a centralized provider governed by statute. *The existing provider, the South African Social Security Agency (SASSA) is best placed to continue in this role, subject to a revision of its governance structure to become consistent with the revised governance model recommended for social security organizations*[86].

Contributory system

12.13 *Retirement provision*: mandatory benefits should be provided by way of a partially decentralized approach, with tier 2A offered through a centralized statutory provider, and tier 2B through highly regulated approved funds including the statutory provider as a default fund.

12.14 Survivor and disability provision: to maximize risk pooling and administrative efficiency, mandatory risk benefits should be managed through a statutory provider, which would also be available as a default provider for voluntary benefits.

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[85] RSA, 2009.

[86] RSA, 2009, pp.57-59.

12.15 *Unemployment insurance*: due to the specialized nature of unemployment insurance, it is appropriate for this function to continue to be the responsibility of the UIF. *However, with respect to the proposed continuation benefit consideration should be given to shifting this function to the statutory provider established to manage mandatory retirement provision*. This should involve a restructuring of the existing contributions and accumulated assets of the UIF to ensure that the restructured revenue, assets and liabilities are properly aligned.

12.16 *Consolidated social security provider*: the functions of general contributory retirement and risk benefit provision are sufficiently close for a single statutory provider to offer both. This consolidated provider would also be a default provider offering tier 2B and tier 3 benefits for retirement and supplementary insurance. The proposed name for this fund is the National Social Security Fund (NSSF).[87]

12.17 *Approved funds*: would share the responsibility for a substantial portion of mandatory retirement provision as well as offer supplementary retirement and risk benefits. These funds would require an upgraded regulatory framework, which should include the option of a *specialist regulator*.

12.18 *Specialist regulator for approved funds*: the approved funds framework, in order to achieve the minimum objectives of the social security reform must transform the quality of regulation in relation to: retirement and risk benefit providers; asset management; and advisory functions. *For this reason it is proposed that the regulatory framework for approved funds be entirely separated from the regulation of non-approved funds, as the regulatory requirements too different.*[88]

Cross-cutting institutions

12.19 *Adjudication*: the legal rights and obligations established through the social security system need to be enforced via a semi judicial framework established to ensure greater access for all beneficiaries regardless of income and literacy, and to meet the requirements for the development of specialized jurisprudence. *The establishment of a single specialized tribunal for social security matters is therefore proposed, which would replace all existing arrangements relating to any part of the non-contributory and contributory parts of the social security system.*[89]

12.20 *Revenue collection*: both mandatory and voluntary collections required by any part of the social security system would most reasonably be managed by a single public entity specialized in revenue collection. *The existing authority carrying out this function, the South African Revenue Services (SARS), is best placed to perform this role, and it is*

[87] The establishment of this provider also forms part of the government proposals in discussed in RSA, 2009, p.60.

[88] This proposal is raised as an option in RSA, 2009, p.59.

[89] This proposal is also contained in RSA, 2009, p.62.

proposed that it expand its functions to support the full social security system with appropriate customization where required.[90]

12.21 *Public interface*: consistent with government's overall recommendations, *it is proposed that a specialized public entity be established to manage the direct interface with the public*.[91] This would involve the establishment of single contact points for all parts of the social security system, with the proposed public entity operating as an agent acting on behalf of the public in accessing social security benefits and organizations.

12.22 *Disability assessments*: both the non-contributory and contributory social security arrangements dealing with disability would benefit from a common external disability assessment system. It is consequently proposed that all disability assessments required by SASSA, the NSSF, and approved funds be carried out by an independent, neutral and impartial disability assessment system operating separately from the providers. This will ensure that sufficient economies of scale can be generated to maintain a more complex assessment system while also eliminating any potential conflicts of interest, i.e. separating the assessment from the risk carrier (provider) removes any perverse incentives that may exist to exercise discretion in reaching a determination.

Concluding remarks

12.23 The framework outlined here requires careful consideration as the recommendations involve substantial changes and new institutions. The implementation of this framework will invariably be difficult with each element raising its own complications. It will also be essential that these reforms be implemented within the context of a holistic institutional framework for comprehensive social security. Notwithstanding the need to locate specific reforms within an overarching strategic framework, once broad aspects have been agreed to, most reforms should proceed on a piecemeal basis to prevent unnecessary delays in the implementation process.

12.24 Central themes underpinning these proposed institutional reforms involve the need for policy coherence through a degree of consolidation; properly mandated independent oversight arrangements, including a SSC and independent boards; specialized public entities arranged around clear functions rather than a single consolidated public entity for all social security which would dissipate the allocative efficiencies; independent disability assessments; properly mandated independent regulatory arrangements; and a consolidated semi-judicial function to adjudicate all disputes and complaints related to any part of the social security system.

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[90] This proposal is also contained in RSA, 2009, p.61.

[91] RSA, 2009, p.61.

13. FINANCIAL EVALUATION

Overview

13.1 The financial implications of the proposals covered in this report affect both conventional government budget allocations, involving the non-contributory social assistance benefits relating to old age and disability protection; and the introduction of a mandatory contribution for earnings-related retirement and risk benefits (survivor and disability). These are evaluated in this section at a strategic level taking note of the following:

- Changes to the non-contributory system have implications for tax revenue and general government spending where a net *programme expansion* is implied, while the mandates impact on the cost of employment where *new* contributions result from the mandate.
- The implementation of a mandatory social security levy will have implications for employers, particularly those where employees are predominantly low-income and previously did not contribute to earnings-related retirement and risk benefits. The extent of any new financial impact on these employers needs to be both understood and mitigated.
- In addition to any new current liabilities generated for government, to the extent that government (and by implication the tax payer) assumes long-term risk for any part of the social security system, these need to be identified to ensure that any promise made today is sustainable through time. All potential contingent risks for government consequently need to be identified and evaluated.
- The tax treatment of contributions to both mandatory and "quasi mandatory" benefits requires careful consideration to ensure that government intervention is limited to areas where a reasonable social return is possible and the extent of implied inter-household transfers are proportionate and fair.

13.2 All analyses provided in this section are presented in 2006 prices to ensure compatibility with the 2006 General Household Survey (GHS2006) upon which the microsimulation model used here is based.

Non-contributory benefits

13.3 Non-contributory reform proposals are as follows:

- *Basic pension*: the proposal is to make this benefit effectively universal by allowing for an explicit grant up to the tax threshold. Universality is consequently achieved by taking account of the secondary tax rebate which is already in place.

  Using this design part of the universal benefit is off-balance sheet, i.e. it does not show up explicitly in the national accounts. In reality the rebate portion of the benefit really forms part of the earnings-related pension and is income smoothing and not redistributive in nature. Consequently, it should not be

regarded as contributing to the macroeconomic constraints limiting government revenue as the benefit returns to the contributor over time.

- *Disability*: the proposal is to make this benefit universal in the form of an explicit social assistance grant and would be entirely on-balance-sheet, i.e. it would show up as voted government expenditure.

13.4 It is proposed that both the above provisionally take the following design:

- Both benefits would be paid monthly and have the same value based on the existing grants for the SOAP and the disability grant. Both grants presently have the same value and in 2009 are set at R1,010 per month. The grant values for the period 2006 to 2009 are:[92]
  - 2006: R820
  - 2007: R870
  - 2008: R940
  - 2009: R1,010
- Both benefits should, at the very least, adjust with *general inflation*, with consideration given to periodic one-off adjustments to cater for improvements in general economic growth and wages. It would be important that benefits not systemically fall behind general improvements in the economy, employment and incomes.

Table 13.1: Medium-term budget projections for social assistance

	2005/6	2006/7	2007/8	2008/9	2009/10
	Expenditure R'million				
Old age	19,470	21,222	22,801	25,992	28,500
War veterans	28	25	22	20	17
Disability	14,099	14,261	15,280	16,600	17,218
Grant-in-aid	57	67	87	123	130
Foster care	1,996	2,851	3,414	3,943	4,701
Care dependency	916	1,006	1,132	1,322	1,521
Child support	14,143	17,559	19,625	22,537	28,158
Social relief of distress	0	41	106	624	135
Total	**50,709**	**57,032**	**62,467**	**71,161**	**80,380**
	Percentage of GDP				
Old age	1.3%	1.3%	1.2%	1.2%	1.2%
Disability	0.9%	0.9%	0.8%	0.8%	0.7%
Overall grant total	**3.4%**	**3.4%**	**3.2%**	**3.3%**	**3.5%**

Source: National Treasury, Budget Review, 2009

[92] National Treasury Budget Review for the financial years of 2008/09 and 2009/10.

13.5 Despite the implementation of new social grant entitlements social grant expenditure has remained at roughly 3.4% of Gross Domestic Product (GDP). Both the SOAP and disability grants have in fact declined as a percentage of GDP from 2005/06 to the provisional budgets for 2011/12. In 2009/10 expenditure for the SOAP and disability grants were R28.5 billion and R17.2 billion respectively, with a combined value of R45.7 billion or 2.0% of GDP.

13.6 Were social grants to be frozen with their present entitlements and real values total grant expenditure as a percentage of GDP is likely to decline even if the absolute number of grant recipients increases.[93]

13.7 The universalisation of the social grants for retirement and disability would have different financial implications depending on the following:

- Whether both benefits could be paid to the same recipient (i.e. there is no offset); and
- Whether above-tax-threshold benefits are paid off-balance sheet.

13.8 **Table 13.2** summarizes the alternative options using 2006 (with 2006 prices) as the base year. The following are noteworthy:

- The General Household Survey of 2006 (GHS2006)[94] indicates that the total number of disabled are 1.5 million with 1 million grant recipients. However, in 2006 there were 1.3 million reported grant recipients. Using the reported data, this would suggest that a universal grant would only need to cover an additional 200,000 beneficiaries.
- Whereas the GHS2006 understates the grant recipients for disability, it overstates the number expected to be on the SOAP. If the grant were made universal total beneficiaries would move from a reported 2.1 million to 3.4 million, an extra 1.3 million. Based on the GHS2006 number recipients would move from 2.5 million to 3.4 million, an extra 0.9 million. The slightly higher estimate for the SOAP would arise because the eligibility age is 60 in the estimate, while the reported information would still indicate the higher qualification age for males of 65.
- It is possible that the GHS2006 tracked some people as SOAP recipients when they were in fact receiving disability grants as the combined total for both grants nearly matches the reported combined total (apart from a discrepancy due to the higher age qualification for the SOAP). This error is quite possible as the grant value is the same and the beneficiary may be confused about which grant they have where they are eligible for both.

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[93] This phenomenon is expected as GDP growth exceeds population growth, and the ratio of grant recipients, for these grants, to the general population will decline with improvements in employment and income levels (resulting from increased growth).

[94] Produced by Statistics South Africa.

- Overall the universalisation of both grants results in an increase in expenditure of roughly R10 billion per annum where there is no offset between the basic pension and the disability benefit. Removing the offset adds an additional R2 billion. The bulk of the increase is attributed to the universal pension.

Table 13.2: Financial impact of universalisation (2006 prices to be compatible with the GHS2006)

Scenario	Beneficiaries	Expenditure
Combined		
Reported	3,463,653	35,483,000
GHS2006	3,556,701	34,997,938
Model		
Universal with offset	4,510,104	44,379,423
Universal no offset	4,698,866	46,236,841
Basic Old Age Benefit (or SOAP)		
Reported	2,144,117	21,222,000
GHS2006	2,514,729	24,744,933
Model		
Universal with disability offset	3,379,330	33,252,607
Universal no disability offset	3,379,330	33,252,607
Disability Benefit		
Reported	1,319,536	14,261,000
GHS2006	1,041,972	10,253,004
Model		
Universal with disability offset	1,130,774	11,126,816
Universal no disability offset	1,477,724	14,540,804

13.9 Based on the above, *it would appear reasonable to universalize both the basic pension and the disability grant with no offset between the grants*. As the universalisation of the disability benefit implicitly forms part of the earnings-related contributory system, its funding, through a slight increase in personal taxes (to compensate for the loss of tax income in the post retirement period) and the slight increase in expenditure on the disability grant, amounts to a zero-sum adjustment between the proposed contributory benefit and the non-contributory benefit. For the purposes of the analysis in this section, however, the costing is performed as if the full liability for the contributory system falls on its balance sheet.

Contributory retirement provision

13.10 **Section 7** provides three strategic institutional scenarios for contributory social security design leading to a preferred approach involving a mix of centralized and decentralized arrangements. Centralized arrangements presume delivery through a statutory social security arrangement (the NSSF); while decentralized delivery is

presumed to occur through *approved private funds* with the NSSF operating as a *default approved fund*.

13.11 The alternative strategic options for tiers 2 and 3, articulated in **section 7**, for retirement reform are also evaluated here for the purposes of comparison. This includes the preferred option detailed in **section 8**. The configuration of tier 2A in all options is the central driver of what happens to tiers 2B and 3[95]. Consequently the alternatives can be expressed largely as tier 2A alternatives. The options selected for evaluation here are based on the preferred option provided for in this report, and the two options outlined in the government consultation document on comprehensive social security.[96]

- *Scenario 1 for tier 2A*: is based on the preferred option in **section 8** with the key parameters outlined in **table 8.4**:
  - The contribution is 10% to an income ceiling of R62,200 for all persons earning more than R11,000 per annum; and
  - The NSSF provides the benefit with partial funding equivalent to 25% of the requirement to fund the current liability.
- *Scenario 2 for tier 2A*: is based on *option 3* in **section 8** and the PAYGO option outlined in the government consultation document on comprehensive social security.[97] It is also selected because it usefully illustrates the implications of important parameter choices made in option 1 and 3.
  - This option splits a 10% the contribution 60:40 between tiers 2A and 2B up to an income ceiling of R139,954 for all persons earning more than R11,000 per annum.
- *Scenario 3 for tier 2A*: is based on scenario 2 above except that the benefit is offered on a decentralized basis with full advance-funding. This is similar to the decentralized option outlined in the government consultation document on comprehensive social security.[98]
- *Scenario 4*: is based on a combined tier 2B and 3, with a 6% mandatory contribution to an income ceiling of R139,954 for all persons earning more than R11,000 per annum and is discussed as the "alternative configuration" in **section 8** and reflects a potential pragmatic starting point for a reform of this nature.

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[95] This is because the ceilings and thresholds for tier 2A determine the floors for tier 2B. Similarly the ceilings and thresholds for tier 2B determine the floors for tier 3.

[96] RSA, 2009.

[97] RSA, 2009.

[98] RSA, 2009.

13.12 The results presented below can be contrasted with the simulation provided in the situation analysis shown in **section 5** (**table 5.6**). The tier 2A benefit is quantified using an NDC formula for modeling purposes.[99]

13.13 The model assumptions for each tier and the results are presented below with some discussion on the public policy implications of each. Differentiating the options, apart from the income ceilings, are the selected costs for administration and asset management. It is important to note that the achievement of the chosen cost levels are *assumed* and *not proven*. However, the scheme demonstrates the sensitivity of the chosen configuration to alternative cost configurations. Thus, although the chosen levels cannot be confirmed, a reasonable assumption can be made about relative differentials.

13.14 The following are the cost assumptions made:

- An NSSF could reduce asset management fees to 0.5% of assets under management through its increased negotiating power.
- An NSSF could reduce administration costs to 7% of contributions.
- Improved regulation of approved funds could reduce asset management fees to between 0.9% and 1.0% of assets under management. For the purposes of analysis tier 2B is assumed to achieve 0.9% and tier 3 1.0%.
- Improved scale and regulation of approved funds could reduce administration costs to 8% of contribution, which is slightly higher than the assumption for the NSSF.

13.15 In all the scenarios the return on investment (ROI) is assumed at 5% in real terms which is consistent with sustained long-term returns.[100] Where the benefit is partially funded the ROI is notional rather than based on actual investment returns.

Scenario 1 - results

Table 13.3: Scenario 1 main assumptions

Scenario assumptions	Tier 2A	Tier 2B	Tier 3
Contribution as a % of affected income	10.0%	10.0%	10.0%
Contribution starting point (Rands)	11,000	62,200	139,944
Contribution ceiling (Rands)	62,200	139,944	650,000
Advance funded	25.0%	100.0%	100.0%
Benefit type	DB PAYGO	DC	DC

[99] This is done to make the final benefit calculation as transparent as possible. An accrual designed to achieve the same result could also be used, but would not illustrate as clearly the sensitivity of the final benefit to factors such as administration and asset management fees and the return on investment.

[100] See analysis in **section 5** which indicates that before expenses and taxes equities on the whole return an average of 10% when smoothed over a 40 year period.

Administration cost (% of contribution)	7.0%	8.0%	8.0%
Asset management cost (% of assets) - best price	0.5%	0.9%	1.0%
Interest rate	5.0%	5.0%	5.0%

Table 13.4: Scenario 1 high level results

Variable	Reform			
	Total	**Tier 2A**	**Tier 2B**	**Tier 3**
Contributors	8,278,008	8,278,008	2,922,210	1,249,151
Contributions (R'000)	69,559,473	33,648,426	14,823,918	21,087,129
% of remuneration	10.0%	10.0%	10.0%	10.0%
Affected Remuneration	695,594,730	336,484,265	148,239,177	210,871,288
Assets (R'000)	886,463,063	168,242,132	296,478,354	421,742,576
Administration (R000)*	12,806,976	3,196,601	3,705,979	5,904,396
% of contribution	18.4%	9.5%	25.0%	28.0%
Distribution of contributions %	100.0%	48.4%	21.3%	30.3%

*Includes asset management costs.

13.16 Consistent with the income selected to begin making mandatory social security contributions of R11,000 per annum, total participation in the retirement system increases from 5.6 million (see **table 8.8**) to 8.3 million. This result is the same for all three scenarios.

13.17 Overall administration costs for all three tiers is estimated at R12.8 billion with the NSSF in tier 2A responsible for R3.1 billion (or 9.5% of contributions) of this total. This contrasts with a total of R16.1 billion estimated for the situation analysis (**table 8.8**). However, it should be noted that all the scenarios analysed here do not account for contributions and savings in excess of tier 3, which can be expected to remain at current levels.[101]

13.18 Total assets required for all three tiers is estimated at R886 million in contrast to the R1.4 trillion indicated in the situation analysis. As already noted, this scenario does not take into account assets outside of tier 3. Nevertheless, the PAYGO tier will impact on the aggregate level of assets required within the retirement system.

[101] Note that the situation analysis used an aggregate contribution rate of 11.5% while these scenarios only use 10%.

Scenario 2 - results

Table 13.5: Scenario 1 main assumptions

Scenario assumptions	Tier 2A	Tier 2B	Tier 3
Contribution as a % of affected income	6.0%	4.0%	10.0%
Contribution starting point (Rands)	11,000	11,000	139,944
Contribution ceiling (Rands)	139,944	139,944	650,000
Advance funded	25.0%	100.0%	100.0%
Benefit type	DB PAYGO	DC	DC
Administration cost (% of contribution)	7.0%	8.0%	8.0%
Asset management cost (% of assets) - best price	0.5%	0.9%	1.0%
Interest rate	5.0%	5.0%	5.0%

Table 13.6: Scenario 1 high level results

Variable	Reform			
	Total	Tier 2A	Tier 2B	Tier 3
Contributors	8,278,008	8,278,008	8,278,008	1,249,151
Contributions (R'000)	69,559,473	29,083,407	19,388,938	21,087,129
% of remuneration	10.0%	10.0%	10.0%	10.0%
Affected Remuneration	695,594,730	290,834,065	193,889,377	210,871,288
Assets (R'000)	954,938,362	145,417,033	387,778,753	421,742,576
Administration (R000)*	13,514,554	2,762,924	4,847,234	5,904,396
% of contribution	19.4%	9.5%	25.0%	28.0%
Distribution of contributions %	100.0%	41.8%	27.9%	30.3%

*Includes asset management costs.

13.19 In this scenario the aggregate assets under management increase slightly to R985 million which results in a slight increase in aggregate administration costs (including asset management) to R13.5 billion or 19.4% of contributions. However, as this scenario reduces the level of contribution going toward tier 2A compared to scenario 1 despite the higher income ceiling the overall annual administration cost of the centralized portion of the NSSF would amount to R2.8 billion, including asset management costs.

Scenario 3 - results

Table 13.7: Scenario 3 main assumptions

Scenario assumptions	Tier 2A	Tier 2B	Tier 3
Contribution as a % of affected income	6.0%	4.0%	10.0%
Contribution starting point (Rands)	11,000	11,000	139,944
Contribution ceiling (Rands)	139,944	139,944	650,000
Advance funded	100.0%	100.0%	100.0%
Benefit type	DC	DC	DC
Administration cost (% of contribution)	8.0%	8.0%	8.0%
Asset management cost (% of assets) - best price	0.9%	0.9%	1.0%
Interest rate	5.0%	5.0%	5.0%

Table 13.8: Scenario 3 high level results

Variable	Reform			
	Total	Tier 2A	Tier 2B	Tier 3
Contributors	8,278,008	8,278,008	8,278,008	1,249,151
Contributions (R'000)	69,559,473	29,083,407	19,388,938	21,087,129
% of remuneration	10.0%	10.0%	10.0%	10.0%
Affected Remuneration	695,594,730	290,834,065	193,889,377	210,871,288
Assets (R'000)	1,391,189,460	581,668,130	387,778,753	421,742,576
Administration (R000)*	18,313,316	7,561,686	4,847,234	5,904,396
% of contribution	26.6%	26.0%	25.0%	28.0%
Distribution of contributions %	100.00%	41.8%	27.9%	30.3%

*Includes asset management costs.

13.20 This scenario sees a significant increase in the overall administration cost of the system from both scenarios 1 and 2 to R18.5 billion per annum. Importantly, the administration cost for tier 2A is more than double that for scenarios 1 and 2, requiring R7.6 billion per annum. This compares unfavourably with scenario 2 which has the same parameters. Assuming that the contributions and ROI are fixed, the higher administration costs would have to be funded by reducing benefits within tier 2A by the amount of the additional costs.

13.21 The required assets for this scenario are far higher than in scenarios 1 and 2 and close to the levels of the situation analysis at R1.4 trillion. The big difference is in tier 2A where in scenario 2, which has equivalent parameters apart from full advance funding for tier 2A, only R145 billion in assets are required compared to the R582 billion in this scenario.

Scenario 4 – Results

13.22

Table 13.9: Scenario 4 main assumptions

Scenario assumptions	New Tier 2	Tier 2B	Tier 3
		New Tier 3	
Contribution as a % of affected income	6.0%		6.0%
Contribution starting point (Rands)	11,000		139,944
Contribution ceiling (Rands)	139,944		650,000
Advance funded	25.0%		yes
Benefit type	PAYGO		DC
Administration cost (% of contribution)	7.0%		8.0%
Asset management cost (% of assets) - best price	0.5%		0.9% - 1.0%
Interest rate	5.0%		5.0%

Table 13.10: Scenario 4 high level results

Variable	Total	Reform		
		New Tier 2	Tier 2B	Tier 3
			New Tier 3	
Contributors	8,278,008	8,278,008	8,278,008	1,249,151
Contributions (R'000)	41,735,684	17,450,044	11,633,363	12,652,277
% of remuneration	6.0%	6.0%	6.0%	6.0%
Affected Remuneration	695,594,730	290,834,065	193,889,377	210,871,288
Assets (R'000)	572,963,017	87,250,220	232,667,252	253,045,546
Administration (R000)*	8,108,732	1,657,754	2,908,341	3,542,638
% of contribution	19.4%	9.5%	25.0%	28.0%
Distribution of contributions %	8,108,732	1,657,754	2,908,341	3,542,638

*Includes asset management costs.

13.23 This scenario sees a significant reduction in the value of contributions going into tiers 2A (New tier 2) relative to those relying on a 10% contribution rate with a drop from R33 billion to R17 billion. Total contributions going through all three tiers amounts to R42 billion, which is significantly less than existing contributions which are estimated at R76 billion.

13.24 The assets managed by tier 2 also drop to R87 billion. Although administration costs drop, the ratios are the same as in the other three scenarios as the assumptions were the same.

13.25 Existing private arrangements would not be significantly impacted by this proposal as the tier 2 contributions involve limited substitution relative to current contribution levels, with an important portion made up of new contributions.

Discussion of results

13.26 Overall the results show that a partially funded PAYGO configuration is superior from a cost perspective to an advance-funded arrangement. Partial funding is also more important as a cost saving measure than unit cost differences due to potential economies of scale. *Given the extent of the cost differential and its likely impact*

on benefit promises within tier 2A, the partially centralised approach recommended in ***section 7*** *appears justified.*

Contributory risk benefits

13.27 As risk benefits are funded on an insurance basis, and it is assumed that the contribution parameter of 5% of income to the relevant income ceiling is fixed as a budget constraint, the benefits would need to be tailored to this budget constraint. Given this, the financial implications beyond the discussion in **section 9** are quite limited.

Tax proposals

13.28 Consistent with recommendations made by National Treasury, it is proposed that contributions for tiers 2 and 3 toward retirement be taxed on an EET[102] basis. This approach which essentially defers taxation to the retirement period does not necessarily imply a full tax subsidy unless the tax rate in retirement is lower than the tax rate while employed. *Nevertheless, this approach is regarded as technically fair and neutral and equivalent to smoothing the tax treatment of income earned over the lifetime of an individual.*

Impacts on employers and the option of a contribution subsidy

13.29 The introduction of the social security contributions at the levels proposed which total 15% of affected income (i.e. subject to the ceilings) will not pose a problem for employers and employees already contributing toward private retirement and risk benefits. However, those employers with large numbers of employees who will enter the contributory system for the first time the impact could prove problematic. The bulk of new entries will occur for those earning between R11,000 and R22,000 per annum (in 2006 prices), and involve around 3 million people if everyone identified as a potential enrollee is ultimately enrolled.

13.30 To minimize this impact it is recommended that a targeted contribution subsidy be introduced which achieves the effect of a progressive contribution structure sufficient to offset a large part of the cost of the additional 3 million contributors. The contribution can take the form of a tax credit or a transfer to employers which would effectively spread the cost of the new expense across all tax payers. Given that the new group has a relatively low-income, the required cross subsidy should not be significant.

13.31 Assuming the new group only participated in tier 2, and contributed at the average for tiers 2A and 2B, a net cross-subsidy of around R14 billion would be required. In reality less than half this would be needed as the new group earns considerably less than the half the reference income for the tier. This would be reduced in the

[102] This refers to contributions and ROI being exempt from tax, while earnings are taxed at the marginal tax rate.

case of scenario 4, although an increased allocation to tier 1 benefits would be required to achieve target replacement rates.

Industry impact

13.32 The existing retirement and insurance systems will be affected as follows:

- There will be some consolidation of existing group schemes offering retirement and risk benefits from several thousand to below 20. This would imply a reduction in the number of administrators from around 200 to at least 20. This scenario is expected regardless of whether the partially or fully decentralized model discussed in **section 7** are implemented.
- The number of fund managers should also reduce considerably from the 300 at present. It is likely that the profit margins of existing asset managers would realign to the more competitive and transparently priced environment. As with the number of funds and administrators, it is expected that fund managers servicing the approved funds and the NSSF will consolidate and improve their efficiencies. This scenario is expected regardless of whether or not the partially centralised or decentralized models evaluated in **section 7** are implemented.
- There may be some thinning out of financial advisory services. However, as it is envisaged that the full group covered on a mandatory basis by the NSSF will also have the option of choosing their own scheme for part of the contribution, as well as supplementing the contribution, a significant need for advisory services will remain. In particular, as the employer will in many instances intermediate the relationship between the NSSF and their employees, it is likely that employers will continue to utilize the kind of support services they have now. Much of this structural change will also occur regardless of whether or not the partially centralised or decentralized models evaluated in **section 7** are implemented.

Contingent liabilities for government

13.33 Two areas where a contingent liability for government exist are:

- Where government underwrites the guaranteed benefit proposed for tier 2A irrespective of whether it's offered on a PAYGO or advance-funded basis; and
- Where government underwrites the risk benefits.

Tier 2A (tier 2 in scenario 4)

13.34 The risks associated with tier 2A derive from potential structural relationship between contributors and beneficiaries through time as well as periods of severe economic decline. Irrespective of whether or not the tier 2A benefit is advance-funded or PAYGO, to the extent that this relationship is disturbed in favour of a higher aggregate benefit relative to aggregate contribution income, contributions will need to adjust. An additional problem will occur where economic growth goes into structural decline for extended periods.

13.35 There are two options to mitigate this risk:

- Remove the benefit guarantee by relating benefits to contributions and realized investment returns; or
- Retain the guarantee but allow for certain automatic adjustments to kick in when fundamental parameters alter.

13.36 Quite plainly both the above involve automatically altering the benefit promise in some way or another against some prospectively determined criteria. However, the options chosen can have different institutional implications. In the case of the former, altering the benefit promise in this way removes the option of lower cost administration. This systemically reduces the value of the benefit in order to constitute a particular form of automatic adjuster, as well as reducing certainty of benefit in a manner that may over-compensate for the risk that needs to be mitigated.[103]

13.37 The alternative approach alters the promise by targeting only those parameters that absolutely need to change. Furthermore, it remains compatible with a lower cost delivery model for retirement which ensures that, despite any contingency that may require the automatic adjusters to kick in, it will systematically offer a higher risk free benefit than occurs with the removal of the guarantee.

13.38 For this reason it is recommended that the PAYGO structure, together with partial funding, remain the preferred option, with automatic parameter changes used to stabilize systemic risks that go beyond the capacity of government to underwrite.

Risk benefits

13.39 The risk benefit promises are affected by systemic changes in the incidence of the contingency ensured. Given that the contribution is fixed as a percentage of income it however cannot change dynamically with any change in the underlying liability as occurs in private markets. However, the incidence of early mortality (i.e. the contingency most likely to change structurally over time) is likely to decline systemically over time. Although this decrease may be offset by a consequent structural increase in disability prevalence (due to longer life spans), there is a possibility that the contributions for risk benefits will incrementally exceed the liability on a PAYGO basis, causing an undesirable surplus.[104]

13.40 Two directions are possible to mitigate this risk:

- Re-set the benefits structurally after an appropriate length of time, say every five years after an actuarial assessment; or

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[103] Note that a guaranteed ROI can be set so low that it is tantamount to the removal of the guarantee.

[104] Such a problem is evident in the UIF where contributions exceed the actuarial liability resulting in a social undesirable accumulation of reserves.

- Retain the benefit levels as a permanent construct but permit the surplus contribution over time to accrue toward the tier 2A benefit.

13.41 It is however important to note that the structural changes resulting in lowered early mortality in risk benefits, creating an unwanted surplus, are the same that are likely to destabilize the tier 2A retirement benefit promises. Both problems essentially result from increased longevity. Given this it would appear logical to allow the required parameter shift in risk benefits to offset the required parameter shift in PAYGO retirement benefits, before any consideration is given to allowing the automatic adjusters (where longevity risk is concerned) to kick in.

13.42 A technical problem occurs here, however, where an NDC (PAYGO) benefit relates to an explicit contribution and ROI, while the parameter shift impacts on the PAYGO contribution to fund current liabilities. Consequently, if the contribution were shifted from risk to retirement it would alleviate a short-term, but systemic, shortfall, but increase the tier 2A benefits – although only for the people making the contribution. This would be an instance where the proposed DB construct is superior to NDC as the benefit promise remains constant with the increased contribution serving to fund the increasing liability (due to longer survival).[105]

13.43 Consistent with the recommendations in **section 8**, however, consideration should be given to keeping both the DB and risk benefit promises constant through time as well as the aggregate contribution with any aggregate surplus on risk benefit promises used to implicitly compensate for structural changes in longevity of the protected population. What this implies is that the DB benefit entitlement would be based on an explicit benefit, which could over time be supplemented by implicit contribution switching deriving from a surplus of risk benefit contributions over their liabilities. This implicit contribution switch would compensate for and defer any required parameter changes to the DB retirement promises.

13.44 *It is consequently proposed that the contribution parameters for risk and retirement benefits be used to specify the initial benefit configuration*. When implemented no distinction between risk and retirement contributions is required. The aggregate social security contribution would consequently seek to fund the aggregate retirement and risk liability allowing.

Conclusions

[105] An NDC approach would implicitly resolve this problem through its pricing of any annuity on retirement. However, this raises the possibility that people with the same income and contribution period will be treated differently depending upon when they retired. The DB approach would however adjust for imbalances in funding across all beneficiaries, with everyone treated the same. It is important to note, however, that any living annuities resulting from an NDC approach could be adjusted in the same way.

13.45 The financial implications of social security reform are significant and require very careful consideration before final decisions are made. The expansion of non-contributory benefits in part underpin changes to the contributory system and are not intended to be redistributive. These differences in the character of a single modality of benefit need to be recognized and made explicit in design to avoid focusing on the form rather than the substance.

13.46 Within the contributory system the affect of administration and fund management costs have to be interrogated as part of any final design. This section reinforces the work of **sections 7** and **8** where it was recommended that a partially funded NDC benefit design be adopted for tier 2A. However, an important success factor will be the design of the public service provider, the NSSF, which if subject to inadequate governance arrangements will not meet its objectives.

13.47 The design of contributory risk benefits raises a number of fundamental design challenges the most important of which is how to dynamically adjust entitlements between retirement and risk benefits as the incidence of early mortality declines over time. It would be important to keep the overall contribution rate fixed through time and merely switch between benefit types (i.e. from risk to savings).

13.48 Managing the contingent liabilities associated with tier 2A of the retirement system requires consideration of embedded automatic adjusters that do not overshoot and consequently undermine the objectives of the earnings-related part of the social security system. Automatic adjusters consistent with protecting the integrity of a PAYGO system for tier 2A are preferred to alternatives which will result in systematically lower benefits.

13.49 The tax regime underpinning retirement contributions should be neutral and focus on merely smoothing tax payments over an individual's lifetime rather than providing subsidies to retirement beneficiaries. The proposed EET framework, which is generally regarded as the most fair, is consequently supported up to tier 3, but not beyond.

13.50 The industry impact (retirement, risk, and asset management) of the recommendations will materially alter the existing industry. Nevertheless, the bulk of the system will remain supported by private operators who will be important to its functionality. Apart from asset management and some administration, the impact on the system is similar regardless of whether or not a partial or fully decentralized approach is adopted.

13.51 There is the possibility that employers exposed to large numbers of low-income staff who were not previously contributing to savings and risk benefits could face difficulties. For the rest the mandatory contributions are likely to involve some substitution of existing voluntary contributions and no impact is really expected. To mitigate the impact on exposed employers, therefore, it appears appropriate to consider some form of subsidy targeted at low-income employees.

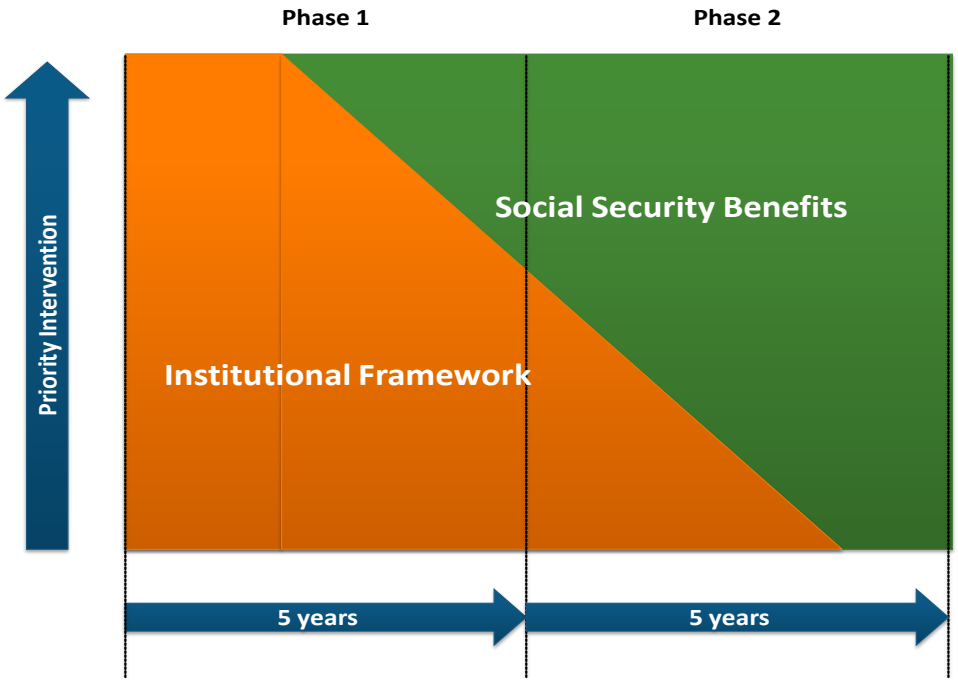
14. IMPLEMENTATION STRATEGY

Overview

14.1 The various findings and recommendations outlined in this report pose significant implementation challenges and indicate the need for a carefully developed medium- to long-term implementation strategy. Such a strategy would need to recognize that certain objectives are achievable only over time and may involve significant contingent risks for government and the country if careful consideration is not given to institution-building. *This section consequently seeks to group key reforms into two phases over a maximum ten-year time horizon, which is seen as the most probable period for the full implementation of the social security system. Priority in the initial phase is given to the institutional framework, with the benefit framework progressively deepened during the second phase.* The indicative ten-year period is divided into two equal consecutive phases, with the priorities for each specified.

14.2 The strategy outlined in this section is based on the pragmatic scenario for retirement reform, scenario 4 in **section 13**, which is associated with a 6% contribution from an income level of R12,000 per annum to an income ceiling of R700,000 (to R750,000) in 2007 prices. The risk benefits are as described in **sections 8** and **9**.

Figure 14.1: Strategic priorities by phase



Implementation risks and their mitigation

14.3 Although **sections 7** and **8** clearly indicate partial decentralization for retirement provision as preferable to a fully decentralized system based on an efficiency rationale many of the institutional and financial pre-requisites for this approach still require implementation. These include:

- The implementation of the NSSF;

- The design and implementation of the Approved Funds framework, including a reconstituted regulator;
- The design and implementation of a subsidy framework for low-income contributors; and
- The implementation of a universal basic non-contributory pension.

14.4 The combination of fiscal and institutional restructuring of a significant scale increase the implementation risks of the overall reform in the following areas:

- Stakeholder resistance where existing private and public sector interests are affected;
- Unforeseen impacts on the financial services industry due to the envisaged restructuring of administration and asset management arrangements;
- Fiscal impacts resulting from:
  - The revised subsidy framework;
  - The reform of the tax expenditure subsidies; and
  - The universalisation of non-contributory benefits.

Risk mitigation

14.5 Although the strategic risks are both institutional and financial in nature, the former is more serious given the relative immaturity of the institutional framework. South Africa presently lacks coherent governance for the contributory social security system, which places the design, management and implementation of new policy at risk of failure. For this reason the proper constitution of the policy functions of the social security system, together with the required public entities is an important pre-requisite for success.

Phase 1 – institutional framework

14.6 This phase seeks to establish a revised social security platform off which deeper interventions will become possible. The central implementation priorities for this phase would involve the following:

- The establishment of the NSSF, which by the end of the period must have the capacity consistent with the authority to operate as a default fund for retirement benefits and the exclusive provider of tier 2 risk benefits.
- The establishment of institutional changes to the structure of government affecting social security policy determination and the broader architecture of the social security system.
- The implementation of the Approved Funds framework, including the implementation of a specialized independent regulator and additional supportive regulatory changes.
- The universalisation of the basic pension, made up of the SOAP and the secondary tax rebate, as the fiscal implications are minimal.

- The implementation of a revised tax expenditure subsidy framework which would be capped at the income threshold applicable to tier 3.

Phase 2 - contributory system implemented

14.7 In this phase the financial and benefit components of the reform need to be implemented, including:

- A consolidated social security contribution, replacing the existing fragmented contributions and supplementing it to fund the new benefits;
- Finalising the mandates and benefits in respect of the decentralized part of the social security system; and
- A contribution subsidy for low-income contributors.

Conclusions

14.8 The challenges posed by the implementation of a contributory social security system within a country with no prior history of such arrangements suggests that reasonable caution should be exercised when devising an implementation strategy. The approach adopted here prioritizes the implementation of the institutional framework first focusing primarily on existing voluntary contributors. Once the system is stable, capacitated and in place the more complex reforms should be considered. The implementation of a well functioning contributory social security system consequently needs to be seen as a long-term social protection investment built on strong foundations. Rapid strategies framed around the existing weakened institutional framework should consequently be avoided.

15. SUMMARY OF RECOMMENDED FRAMEWORK

Overview

15.1 All elements of an integrated reform framework are summarized in this section, based on the findings and recommendations of this report.

Provision for retirement

Tier 1

Tier 2

Tier 3

Tier 4

Institutional framework

Insurance benefits

Unemployment insurance

Loss of income in the case of death

Loss of support in the case of disablement

Institutional framework

Revenue framework

Contribution subsidy

Tax subsidy regime

Foreign nationals

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ANNEXURE A: EVALUATION OF ALTERNATIVE REFERENCE INCOME OPTIONS FOR RETIREMENT REFORM

Figure A.1: Option 1 – gross social security contributions toward retirement provision assuming a 10% contribution toward tiers 2A and 2B (2006 prices)

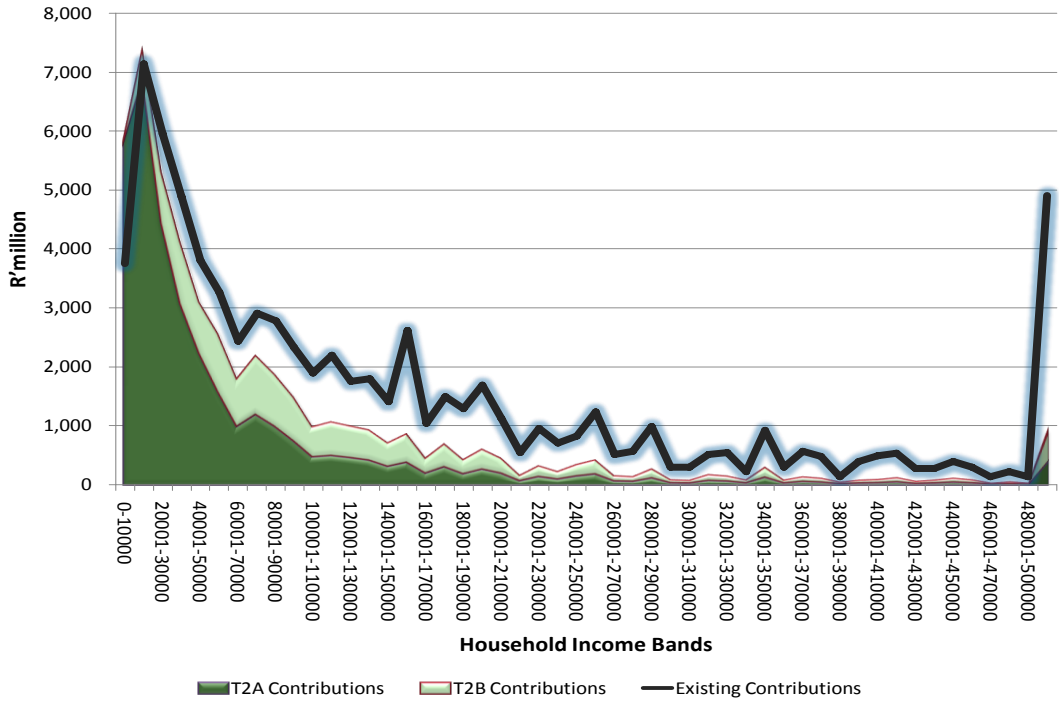

Figure A.2: Option 2 – gross social security contributions toward retirement provision assuming a 10% contribution toward tiers 2A and 2B (2006 prices)

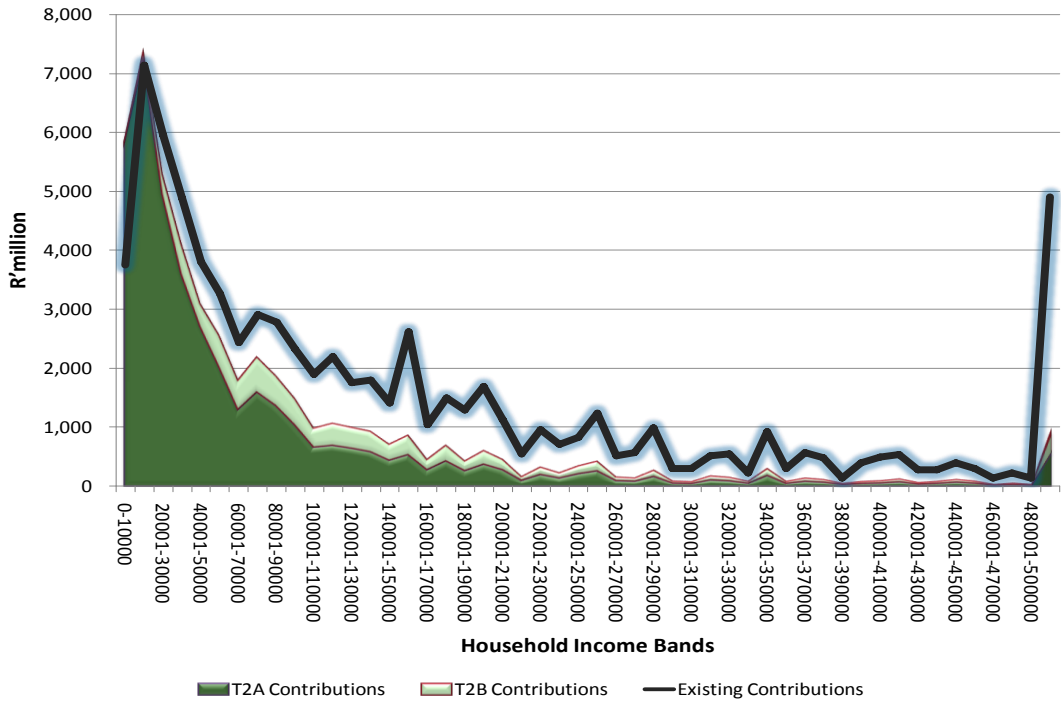

Figure A.3: Option 3 – gross social security contributions toward retirement provision assuming a 6% contribution toward tier 2A and a 4% contribution towards 2B (2006 prices)