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Retirement reform part of new-look social welfare system

The government's plans to overhaul the country's retirement system are part of a move to create a social security net that will combat poverty, Elias Masilela (left), the chief retirement strategist at Sanlam, says. Masilela, a former acting deputy director-general at the National Treasury, addressed a recent series of meetings of the acsis/Personal Finance Financial Planning Club about the aims of the retirement reform process. **Bruce Cameron** reports

Retirement reform is inextricably linked to the social security needs of society, Elias Masilela says.

He says social security is aimed at preventing people from becoming destitute. It does this by, among other things, ensuring they receive a minimum income during their working years and in retirement.

Social security can be highly redistributive, with people who are capable of earning high incomes supporting those who earn low incomes or who are unemployed.

The design of a social security system varies from society to society and emphasises the redistribution of wealth to a greater or a lesser extent, Masilela says.

He says retirement and social security reform in South Africa must have the following objectives:

◆ Increase the number of people who save for retirement;

◆ Increase the total amount of money that people save for retirement (long-term savings);

◆ Guarantee a minimum pension, which will be based on your final salary at retirement and will increase with inflation; and

◆ Complement the current redistributive effect (through taxation and government expenditure) of the social grants programme (for example, the social old-age grant) by introducing other social security instruments, such as a death and disability insurance structure to which every employed person should belong.

Masilela says the reform process is based on four pillars. Many of the details within each pillar must still be finalised. The four pillars are:

1 SOCIAL ASSISTANCE

This is the provision by the state of grants for things such as child support and disability, and of pensions for the destitute. The social old-age grant should be paid to everyone, and the current means test should be scrapped, he says.

2 SOCIAL SECURITY

The current proposal is that it should be compulsory for every employed South African to belong to a National Social Security Fund (NSSF), a state retirement fund that would also provide risk (death and disability) benefits.

Consideration is being given to allowing people to opt out of contributing to the NSSF and to contribute instead to a private sector fund. But this opt-out would apply only to retirement savings and not to risk benefit contributions.

The intention is for the NSSF to provide benefits to dependants on the death of a breadwinner, and/or an income on the disability of a breadwinner before retirement and/or a minimum inflation-linked pension at retirement.

The affordability of benefits for the social security system could be based on various cross-subsidy structures and subsidies, such as:

◆ A wage subsidy for low-income employees to compensate them for contributions to the fund, which would otherwise impact on their ability to support themselves.

In other words, employers of low-income earners would receive a government subsidy, which would be used to pay all or part of the retirement contributions of the low-income employees. This would relieve pressure on employers and employees, who would not be able to afford the contributions.

◆ A defined minimum benefit structure or a defined contribution structure or a hybrid of both.

With a defined contribution structure, your pension benefits would be based solely on your contributions. With a defined benefit structure, benefits could be based on members receiving a universal minimum benefit and an additional amount based on their final income at retirement.

The current proposal is that the state scheme should be a defined benefit scheme that pays a pension equal to a minimum of 40 percent of your final pensionable salary/wage.

A defined benefit scheme could either be fully funded by contributions from members or funded by contributions from members and by people who are currently working subsidising the pensions of people who are already retired (known as a pay-as-you-go scheme). Most European countries commonly use pay-as-you-go for their national retirement schemes.

◆ The wealthy contributing more than the poor. Cross-subsidies at the contribution level will be particularly obvious in the case of contributions to any risk benefits. This is because lower-income workers tend to be exposed to higher health and employment risks.

For example, a miner has a higher risk of being injured or of contracting an occupational disease than does the managing director of the mining company.

However, the cross-subsidy is reversed in retirement, because high-income people tend to be healthier and to live longer. So they draw a pension for a longer period than do low-income people, who have a lower life expectancy.

3 ADDITIONAL SAVINGS

Masilela says saving additional amounts for retirement would be compulsory for people above a certain income bracket. These savings could be made through the state fund or any other registered retirement fund. The proposal is that these additional savings should be tax-incentivised, but that the incentives should be capped at a fixed rand amount, as well as at a percentage of pensionable income.

The current proposals are that 10 to 12 percent of your earnings up to R75 000 a year should go to your retirement savings in the NSSF or an opt-out fund. If you earn more than R75 000 a year, a further 10 to 12 percent of that amount, up to between R700 000 and R1 million, must go to your retirement savings.

If you do not belong to a company-sponsored fund, you would be obliged to contribute to either the NSSF or to another registered retirement fund, such as a retirement annuity fund.

The non-state funds would have to be registered and meet strict standards of corporate governance to protect members.

4 VOLUNTARY SAVINGS

Any voluntary savings you make would be outside of the Pension Funds Act and would have no tax incentives.

OUTSTANDING ISSUES

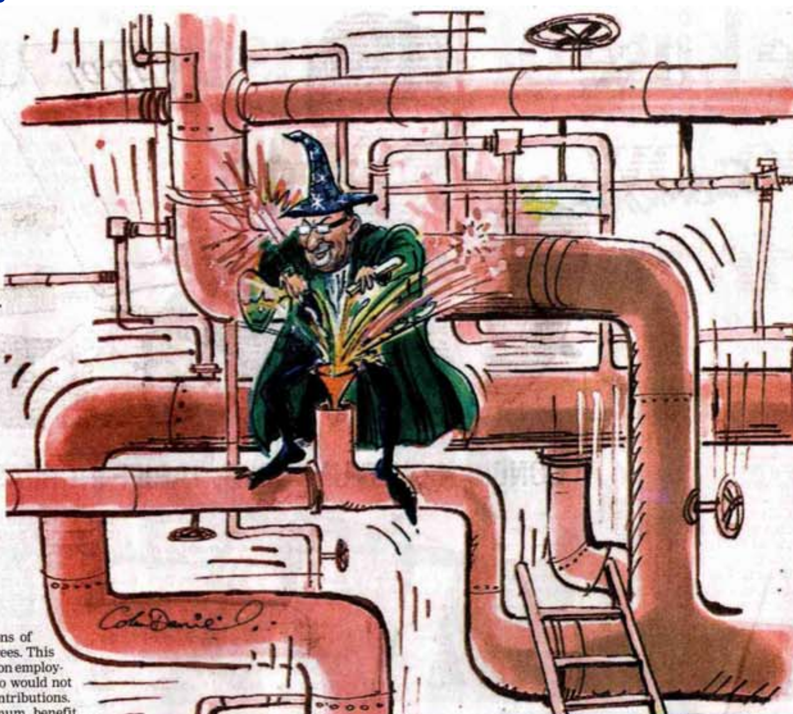
Masilela says the government's second document on retirement reform contained about 38 main proposals and many of the issues are still being discussed in the government's inter-departmental forum.

Among the other issues still being discussed are:

◆ The incorporation or interface with other state social security mechanisms, such as the Unemployment Insurance Fund, the Workmen's Compensation Fund and the Road Accident Fund;

◆ The funding of post-retirement medical care; and

◆ How people who lose their jobs will be able to support themselves before retirement. Masilela says that although there is agreement that it should be compulsory for you to preserve retirement savings, a mechanism will have to be created to permit withdrawals should you face a financial crisis.



No 'golden years' await most retirees

The vast majority of employed South Africans will enter retirement without sufficient financial resources, Elias Masilela says.

Research by Sanlam shows that average contributions to retirement funds have been falling, he says. In 2002, contributions averaged 12.4 percent of pensionable income. By this year, they had dropped to 10.9 percent of pensionable income.

At the same time, investment costs have been edging up, he says. This has resulted in dismal replacement ratios (the percentage of your final salary/wage you will receive as a pension).

Replacement ratios in South Africa average about 30 percent, compared with between 56 and 58 percent for the 30 developed and medium-developed countries that belong to the Organisation for Economic Co-operation and Development, and between 70 and 75 percent for developing economies.

He says there is an urgent need for you to avoid destitution in retirement by saving more, saving for longer and preserving your retirement savings until retirement, while watching cost erosion. Sound and responsible investing are also critical.

Culture of saving depends on creating healthy economy

The success of retirement reform is fundamentally linked to the state of the economy. Conversely, retirement reform can have a significantly positive affect on the economy, Elias Masilela says. Retirement reform can fail if the economy is not sound, and successful retirement reform can contribute to economic growth, he says.

The main reason retirement reform could fail is that people cannot afford to save under arduous economic conditions, particularly when employment levels drop.

Masilela says all the signs that people would be unable to afford compulsory retirement fund membership are already evident against the background of a worsening economy. Among other things, commodity prices are rising, pushing up inflation to its highest levels in five years, and economic growth is slowing, with an increasing risk of a decline in employment, he says.

Masilela says the impact of these factors on individuals is:

◆ Average debt as a percentage of household income has soared from about 50 percent to almost 80 percent over the past five years. And with this have come higher interest rates, which are putting more pressure on household budgets.

◆ Household savings have been steadily dropping from 2.7 percent of disposable income (after-tax income) in 1991, to 0.8 percent in 2001 and to the current situation where savings are being withdrawn. There was a negative saving of 0.7 percent in the first three months of this year.

It is to be hoped that the current economic difficulties are a passing phase, he says.

South Africans, particularly those in the low-income groups, do not place retirement savings high on their list of saving priorities, Masilela says.

A 2007 survey by Eighty20 on behalf of Finmark Trust and the South African Savings Institute showed that in the lower-income groups 43 percent of family savings are for emergencies.

The survey showed that only 33 percent of people in low-income groups save and that of those only five percent save for retirement.

Masilela says people only really decide to save for retirement when they generate higher incomes, thereby making saving affordable.

"Your marginal propensity to save is positively related to income. That is the basis of a country's savings performance," he says.

Masilela says South Africa can learn a lesson from Chile, where the priority was to improve the macro-economy and to address poverty. "Retirement reform was not undertaken in isolation from the macro-economy."

The Chilean government improved economic conditions by budgeting for a surplus, setting an inflation target (three percent), having a floating exchange rate and making the labour market more flexible, he says.

In South Africa "we have boldly attempted the first three, but we have been cautious on labour market flexibility owing to our unique circumstances", Masilela says.

As a result of the Chilean government's policies, that country achieved economic growth of seven percent, an average real (after-inflation) return on savings of 10 percent a year and a savings rate of 24 percent of disposable household income over a sustained period.