

## **Pension Reform Proposals by the Malta Employers' Association**

### **Introduction**

The issue of pension reforms is definitely one that is a priority on the country's social policy agenda, since it is an issue that has important implications on Malta's fiscal situation and directly effects the well being of an ever increasing segment of the population.

Changing demographics and labour force structure dictate that action is taken to restore sustainability of the pension system. The aim of these proposals is to suggest measures to reform the pension system in Malta in a manner that:

- 1. will be financially sustainable and conducive to intergenerational equality**
- 2. will introduce any reforms gradually to avoid unnecessary financial and social shocks**
- 3. will guarantee pensioners a decent basic standard of living throughout their retirement age while presenting them with options to save for their retirement**
- 4. will allow for more flexibility in the labour force through agreements between employers and employees**
- 5. ensures social inclusion for retired persons**
- 6. will not have an adverse effect on the country's competitiveness**

The Malta Employers' Association is recommending the following measures to achieve these medium to long term objectives:

#### **1. Raise the retirement to 65 for both male and female employees**

The retirement age should be raised to ease the sustainability of the pensions schemes and to reduce the welfare gap. Appendix 1 attached to this report provides retirement ages in other European countries, which is already at 65 in most of them, and there are pressures to increase the retirement age even in those countries where the retirement age is already 65. This will respond to the reality of a higher mortality age and will increase the contribution in terms of production of an employee throughout his/her working life.

It is proposed to raise the retirement age gradually (e.g. by one year every two years over a period of ten years) to avoid sudden repercussions on the labour market.

The options available are not whether to raise the retirement age or not, as is commonly believed. Another alternative is to introduce a flexible age of retirement with new work conditions towards the end of a persons career to make an extension of the working life easier and more productive. The principles of the 'fourth pillar' are discussed in more detail in point 7 below.

#### **2. Incentivise a higher female participation rate in the labour force.**

It is known that because of the fall in birth rate and the increased mortality age, the ratio of working to retired persons will decrease from approximately 1:4 to 1:2 by

2025 if the current trends continue. This will result in an unsustainable pension system and part of the solution to prevent this situation will be to encourage a higher female participation rate in the labour force.

It should be considered that although the estimated overall female participation rate of women in Malta is 30% compared to an average of 60% in the EU, there is a stronger participation rate among the younger cohort and therefore it is not expected that the participation rate will remain at 30% in future, since a larger proportion of females will remain in the labour force. However, it will still be difficult to reach the EU objective of a 70% female participation rate by 2010.

Measures such as access to childcare and fiscal incentives (e.g. tax breaks on child care) may have an effect on increasing the female participation rate. However, there might not be an automatic causal effect between the introduction of such measures and an increase in female participation. Other socio-cultural factors play an important part in determining the extent to which such measures will be effective. For instance, many women may not join/re-join the work force because they choose not to.

Account must also be taken of the fact that although the 30% figure is frequently quoted, this ignores the amount of female workers in the informal/black economy. A recent study by Prof. Baldacchino revealed that if this is taken into account, the female participation rate in Malta rises to 42%, which presents a different tableau than what is traditionally described. Many women may prefer part time employment and the current social security contribution system is a disincentive for such persons to join the formal economy.

### **3. Pension funds must be accounted for separately from health and other benefits.**

The government's accounting system must be modified to ensure that the structure of the welfare gap is analysed more specifically. Health, in particular, should be accounted for separately, since a substantial part of the welfare gap is currently caused by expenditure on health, and not on pensions per se. Expenditure on health is expected to increase significantly in the near future because of the new hospital and also because of the increased demand for health services from an aging population. This measure will enable stakeholders to formulate specific strategies addressing welfare issues separately by identifying more clearly the source and the magnitude of the welfare gap, and to manage it more effectively.

### **4. Transition from the current system of total reliance on PAYG contributions to one which balances PAYG with Funded scheme**

The current system which relies exclusively on PAYG should be reformed to introduce a funded component to the pensions package. The problem with such a transition is that there will be an initial phase where payers will have to pay to sustain the old system and simultaneously contribute to the new system. This will also reduce the disposable income and therefore have an impact on aggregate demand.

This measure will yield positive results in the medium to long term. Countries that had the foresight to shift dependence on PAYG face a significantly lesser welfare gap problem than those who still rely exclusively on PAYG. The percentage of

government spending on pensions compared to GDP in the United States and Britain is 5-6% of GDP, compared to 15% Italy. In Malta this stands around 11%, but will rise steadily as expenditure on pensions increases.

It is understandable that a partial shifting to funded pensions will entail risks and may reduce the return on invested funds, as happened recently. The PAYG component will retain an element of stability to the pension entitlement.

### **5. Raise maximum Pensionable Income**

The current cap for pension entitlement of LM6700 should be raised to an agreed income (say, LM12000), subject to the following conditions:

- Social security contributions will remain compulsory up to an income of LM6700 by both employers and employees over thirty years of age;
- Employees over thirty years of age but less than fifty years will have an option of increasing their social security contributions to entitle them to a maximum pension higher than LM4500 (the current maximum), but not exceeding LM8000 (2/3 of LM12000). Employer contribution will remain at the maximum of 10% of LM6700.
- Employees under fifty years of age and earning less than LM6700 will still be given the option of participating in the scheme.
- This scheme will be made mandatory to employees below thirty years of age.
- The funds currently collected under the PAYG scheme will still finance PAYG. The funds collected from the supplementary scheme will be channeled into a separate fund that will be invested.
- Tax breaks will be given to contributors of this scheme.

The main advantages of this scheme are:

- it will reduce dependency on PAYG;
- it will enforce savings on the younger generation of employees;
- it will offer options for improving pension entitlement to older employees.

### **6. Introduce Fiscal Incentives for Private Pensions**

Tax breaks should be offered to employed persons opting to have a private pension scheme.

### **7. The Fourth Pillar**

Incentives should be created to encourage persons reaching retirement age to remain in employment – on a whole time or on a reduced hour basis – if agreement is reached with the employer. The fourth pillar, as proposed by The International Association for the Study of Insurance Economics (also known as the Geneva Association) involves ‘supplementing the conventional three pillars with resources from a fourth, that is, income from part time work for some years after reaching retirement age or earlier in the case of early retirement’. Proponents of the fourth pillar argue in favor of *gradual retirement* rather than *early retirement*, and have also as one of their objectives ‘*the adaptation of working conditions to longer working lives*’.

Government, employees and employers may all benefit from such work arrangements, particularly as our economy becomes more dependent on service sector, where flexible work arrangements are frequently more possible.

A scheme to encourage the fourth pillar may entail:

- Increase the retirement age to 65 for both male and female employees
- Introduce the option whereby, upon agreement between the employer and the employee, the employee may work beyond the age of 61 on reduced hours and will have the status of ‘whole timer with reduced hours’.
- Employees who will still work more than 30 hours per week beyond the age of 61 will still be entitled to the full pension when they retire at the age of 65. This makes sense because government would still be saving a pension, and they would be contributing to the GDP, and paying pro rata contributions in the meantime.
- Employees may still opt to retire at the age of 61, but at a reduced pension, and provided that they have contributed a minimum number of years to PAYG (say, 40 years). This will create a safeguard in cases where employees doing manual work may not be fit to continue with their duties beyond the age of 61. Others may voluntarily prefer to retire at an earlier age.
- Employees who retire at age 65 will benefit from an enhanced pension.

## **8. Buffer Funds**

Government may consider setting up a buffer fund to back the PAYG schemes, and which will further supplement the revenue from the funded scheme proposed earlier in this paper. This will be run on the lines of other countries (e.g. Ireland, France, Belgium) that have similar schemes. Ireland puts aside 1% of GNP in its buffer fund. The French Fonds de Reserve pour les Retraites seeks to raise EU150 billion by 2020 to supplement PAYG.

## **9. Generation of productive employment**

Ultimately, the eradication of the welfare gap will depend on the country’s overall productivity. It is through the maximization of output that the country will be able to afford to sustain the demands for adequate welfare benefits.

A major source of the country’s fiscal malady is the amount of unproductive labour trapped within inefficient government and parastatal corporations. For years, these have been draining funds that could have been channeled into more productive uses. The social partners should agree on a plan to reduce this unsustainable burden on the economy and to reduce employment in the public sector according to agreed targets (by 10,000?) over a period of seven years.

The success of such a plan will depend on the collective determination of the social partners, including the opposition, and the ability to attract investment in the private sector to absorb the increase in labour force that will result from:

- The increase in retirement age
- Increased female participation
- Shifting employees in govt./parastatal organizations to the private sector

This is a Herculean task in itself and may generate social problems that have to be anticipated. One of these will be reduced opportunities for first time job seekers if the economy does not grow.

## **Measures to Avoid**

Government should resist being tempted to introduce measures that may be politically appealing in the short term, but do not offer long term solutions. Two of these are means testing and early retirement schemes.

### **1. Means testing**

The main objective of any means testing measure is to ensure that benefits are provided for free, or subsidized, to those who may not afford them, and to act as catalyst for a more equitable distribution of income.

It is advised to keep such measures to a minimum for the following reasons:

- a) They are frequently perceived as a fiscal cost cutting measure, rather than promoting social justice;
- b) Many employees will pressure employers to reach agreements to keep declared income low to retain their eligibility for benefits. Means testing can demotivate employees from applying for promotions, particularly at middle management level.
- c) The latest scientific measure of income inequality in Malta registered a Gini coefficient of 0.32. This means that wage differentials in Malta are among the lowest in the world. These differentials should not be reduced further in real terms through means testing measures.
- d) Means testing may reduce the labour supply, and/or benefit tax evaders and incentivise employment in the black economy. For example, today many female workers do not accept declared part-time employment because of the opportunity cost incurred through foregone social benefits.
- e) There are more effective and direct tools of reducing income inequalities that are already in force in Malta – e.g. progressive income tax, VAT.

### **2. Early retirement Schemes**

Offering retirement to persons below 61 is to be discouraged, particularly in the public/parastatal sector. The negative effects of early retirement schemes are:

- a) They are expensive
- b) They reduce the labour force, and thus may be conducive to upward pressures in labour costs
- c) They create resentment by the productive labour force as they are perceived to be a reward for an unproductive career (classic cases: the golden handshakes at Drydocks and Kalaxlokk)
- d) They are inconsistent with a policy aimed at increasing the retirement age to extend the working life.

**Strong efforts should also be made to eradicate ‘early retirement loopholes’ whereby persons well below pensionable age are boarded out for no valid reason. Stories abound of people who are in their best of health and enjoying early retirement.**

Every endeavor should be made to devise ways of enabling an aging labour force to make a valid social and economic contribution to the functioning our economy.

### **Conclusion**

It is clear that decisions to reform our pension system cannot be delayed indefinitely. Procrastination will only worsen the situation and ultimately lead to greater hardships. The solution to such reforms have to be designed according to economic constraints, even if certain measures may not have popular appeal in the short run. Ultimately, all regulations governing pensions, social security and taxation should have among their objectives that of extending occupational life. This requires a collective effort from unions, employers and government.