



Guaranteeing the Future of Social Security

As a response to the welfare gap the Government set up a national commission to study reforms within the social security system. Some months ago, the National Commission for Social Security Reform issued a preliminary report stating that a pensions crisis will hit Malta in the year 2005. GWU's Deputy Secretary General, Mario Cutajar, who represents the Union on the Nation Commission signed with reservation the preliminary report and at the same time presented the Commission with part one of the study carried by the GWU that concluded that the situation of pension in Malta is not as gloomy as the Government is trying to portray. In fact, the GWU's study shows that the pensions crisis will hit Malta in 15 to 20 years time and that if the government was to accept the predictions of the Commission's preliminary report there will not be enough time for social security system to be reformed gradually.

Facts and not Myths

One of the main achievements of the Maltese working class during this century was the setting up of a comprehensive social security system. Initially the system was geared to tackle only a small part of the social problems that were prevalent in Malta. However as the values of social solidarity and social justice became more widespread in our society, different administrations strengthened and widened the scope of social security. From a flat rate social safety net, social security became one of the main policy tools that the Maltese government used with considerable success to eradicate absolute poverty and improve the standard of living of the elderly and of workers in general. At first the system of social security was designed to be self-financing in that contributions by workers and their employers were intended to cover all expenses charged to the social security account. However the introduction of new schemes and the allocation of other expenditure items, notably the cost of the national health system, meant that the system went clearly into deficit by the early 1980's. From then on the welfare gap has been a constant item on the political agenda. In recent years, the financial problems of the system have been reassessed in the light of future demographic trends that will see the number of workers per pensioner (the support ratio) fall drastically by 2040.

Attempts have been made to determine the sustainability of the present system in order to devise a new social security strategy. The debate up to now has centred on pensions, a fact which in itself reflects the relative size and importance of this single program. Although there are other expenditure items that will also be affected by the ageing phenomenon, such as health expenditure and children's allowance, this study will also focus mainly on the question of the sustainability of pensions.

There have been two main studies carried out by government-appointed commissions to evaluate the impact of ageing on public pensions. The first one, the Camilleri Report (1998), utilised a model developed by the Central Bank of Malta whereas the most recent one, the

National Welfare Commission Report (2000), based its analysis on a World Bank economic model, known as PROST. The reasons behind the utilisation of two different models have not been adequately explained and this study will show that the results they generate differ widely and thus lead to different conclusions. Furthermore whereas the Camilleri Report analysed the implications of certain reforms to the system, and amongst other found that indexing pensions to the inflation rate solved the pensions problem, the National Welfare Commission Report made few if any suggestions. Nevertheless the projections of this study have been publicised and were reported in the national media.

This report will develop the thesis that whereas demographic changes will have a significant impact on pension expenditure, these effects are nowhere near those reported by the PROST model. Furthermore it will be shown that the projection of the pensions 'crisis' as a short-term financial problem is a result of wrong assumptions and faults in the underlying methodology of the PROST model. This critique, however, is in no way meant to project the idea that no demographic problem exists. Malta needs to review its social security system in order to improve it and adapt it to changing economic and social realities. Thus a number of concrete proposals will be made in the second part of this report on how the present regime can be reformed without drastically reducing the present level of benefits. Moreover a clearer analysis of the impact of the ageing phenomenon, which reveals it as a more medium term problem (affecting us between 2020-2040), also allows the consideration of structural and not simply parametric reforms to the system, such as partially pre-funding pension commitments. Any reformed system is to remain under direct government control, in order to minimise risks to pensioners and maximise economies of scale in investment and administration. The problems created through a greater reliance on private pensions are outlined in the second part of this report.

The line of thinking on social security prevalent in government and academic circles in Malta is based on some fundamentally wrong notions. First of all, the present system is portrayed as being too generous. This is hardly the case as recent estimates by the Central Bank of Malta show that the average pension is equal to just 37% of the average wage at present (Quarterly Review September 1999). Moreover if the system is retained with the present conditions, namely the ceilings on contributions and benefits, it will become quite disadvantageous to contributors. Social security reform is also being confused with the wider privatisation issue, on the basis that the private sector is more efficient than the public one in all cases. Efficiency is surely no monopoly of either sector. Other commentators, notably officials of major insurance firms, are creating the illusion that private pensions provide a way of escaping the burden of an ageing society. Once more this entails a misconception of the problem at hand, as the elderly will in all cases consume more of the gross domestic product (GDP) than they are consuming now for the simple reason that their share of total population will rise. So when we are told that pensions will be double as a proportion of GDP this should not strike us as being exceptional, as the share of the elderly will also be doubling (1). The only way to reduce the future share of pensions would be to decrease the standard of living of the elderly, a 'solution' which if studied better turns out to be no solution at all.

The quoting of figures, such as the notorious Lm1 billion used ad nauseam in the press to represent the coming 'pensions disaster', is hardly commendable. In 40 years time, Lm1 will hardly be worth 15c, so the Lm1 billion in reality represents only Lm150 million in current purchasing power terms. It is important that analysts and government officials conduct the debate in a correct and informed manner rather than concentrate on raising unnecessary fears.

Section A: A Critique of the PROST Model Forecasts

Comparing the PROST Model Projections with those made in the Camilleri Report

The Camilleri report contained estimates of pension expenditure, derived 'as the product of an exogenously-determined per capita benefit and the number of beneficiaries'. National Insurance (NI) contributions were determined 'on the basis of the statutory contribution rates

applied to projections of the expected development of the wage bill', and a predetermined effective collection rate. The wage bill followed trends in GDP derived from 'the economic core of the model'. The average per capita pension benefit 'was allowed to exogenously grow by the average annual growth rates observed between 1992 and 1996' - that is by about 6.9% per annum. This rate of increase was higher than both the inflation rate and the average rise in wages registered during this period. The main projections of the Camilleri Report are presented in Table 1 and are compared with the initial estimates of the PROST model as presented in Appendix F of the National Welfare Commission Report.

Table 1: The Results of the Camilleri and the PROST models

| Camilleri Report | 1998 | 1999 | 2000 | 2005 | 2010 | 2015 | 2020 |
|-------------------------|-------------|-------------|-------------|-------------|-------------|---------------|----------------|
| Contributions collected | 95.4 | 101.4 | 108.1 | 154.8 | 207.2 | 262.0 | 329.3 |
| Pension expenditure | 63.8 | 69.7 | 76.0 | 115.4 | 197.8 | 314.6 | 487.2 |
| <i>Surplus/Deficit</i> | <i>31.8</i> | <i>31.7</i> | <i>32.1</i> | <i>39.4</i> | <i>9.4</i> | <i>(52.6)</i> | <i>(157.9)</i> |
| PROST Model | 1998 | 1999 | 2000 | 2005 | 2010 | 2015 | 2020 |
| Contributions collected | 134 | 145 | 158 | 193 | 219 | 249 | 290 |
| Pension expenditure | 61 | 67 | 73 | 114 | 192 | 283 | 399 |
| <i>Surplus/Deficit</i> | <i>73</i> | <i>78</i> | <i>85</i> | <i>79</i> | <i>27</i> | <i>(34)</i> | <i>(109)</i> |

At first sight the PROST model appears to present a less dramatic scenario than the Camilleri Report. However this is not in fact the case. The amount of contributions projected in the PROST model includes the state grant (which is equal to half the total contributions collected from employees, employers and the self-employed), whereas the Camilleri projections exclude this source of revenue. Notwithstanding this difference, which should boost contributions in the PROST model by about a third, the amount of revenue reported in the Camilleri report is higher than that projected by the PROST report by 2015. In order to visualise better this difference, we deducted the state grant from the revenue projections made by the PROST model. One should also consider the fact that whereas the Camilleri Report assumed the employee's contribution rate to be 8.3%, the PROST model incorporated the increase to 10% announced in the November 1999 budget. This should have boosted revenue in the PROST model by a further 20.5%.

Table 2: Comparable NI revenue from the two models

| | 1998 | 1999 | 2000 | 2005 | 2010 | 2015 | 2020 |
|-------------------|--------------|--------------|--------------|---------------|---------------|---------------|----------------|
| Camilleri Report | 95.4 | 101.4 | 108.1 | 154.8 | 207.2 | 262.0 | 329.3 |
| PROST Model | 89.4 | 96.7 | 105.4 | 128.7 | 146.1 | 166.1 | 193.4 |
| <i>Difference</i> | <i>(6.0)</i> | <i>(4.7)</i> | <i>(2.7)</i> | <i>(26.1)</i> | <i>(61.1)</i> | <i>(95.9)</i> | <i>(135.9)</i> |

These results show that the PROST model is projecting a significantly lower level of NI contributions than the Camilleri report. This may be partly due to the fact that the PROST model assumes that the collection rate of contributions will fall from 90.1% in 1999 to 80% in 2015. This drop is supposed to reflect the fact that the wages of many employees fall above Lm6400, the income ceiling on which contributions are paid. This proportion of workers is expected to increase in the coming decades, until 2015, when it is assumed that the ceiling starts being increased at the same rate of the growth in average wages. Although this point is certainly valid, the substantial difference between the two models requires further

investigation and explanation. The PROST model appears to be constraining revenue growth by too much.

The validity of any model's projections hinges on the assumptions made about major macroeconomic developments over the long term. This calls for the utilisation of various sets of macroeconomic assumptions in order to test the sensitivity of the projections made. Macroeconomic developments are not modelled in any way by the PROST model but are derived from the Central Bank's economic model. No information about this model is presented anywhere in the National Welfare Commission Report. However the trends presented in Appendix F raise certain doubts about this model. In fact, real GDP growth is reported to have been 2.8% in 1998 and 2.5% in 1999. Official Central Office of Statistics figures however indicate a growth of 3.4% in 1998 and 4.6% in 1999 (COS News Release No.22/2000). Such understatements of GDP growth surely affect negatively the revenue projections made by PROST. At the same time, the assumption of real wage growth of just 0.8% in 2000 rising gradually to 2% in 2075 is hardly credible if real GDP growth is projected to be 3.3% in 2000 falling to 2.8% in 2075. Such an assumption implies that the share of labour income in GDP will fall significantly as most of GDP growth will accrue to owners of capital resources. In recent years, employment income amounted to just more than half of GDP. If we take the assumptions made by the National Welfare Commission Report for granted and extrapolate them, we could reach the conclusion that the employment component will fall to less than 25% of GDP by 2075. If confirmed, this drop in the share of labour income would prove to be the main factor causing the slump in contribution revenues (as these are computed as a fraction of employment income).

Similar doubts are raised when comparing the expenditure on pensions projected by the two reports. In the PROST model average pensions are supposedly indexed with wages (that are increasing annually by between 3.1% and 3.8%). The PROST panel however estimates that *'by the year 2005 retirement pensions will practically have doubled in real terms'*. The welfare gap is *'predicted to rise from its current ratio of 2.1% to GDP, to reach 11.3% by 2010 and peaking at 18.7% by 2040'*.

The report *'suggests a fifteen-fold rise in retirement pensions expenditure alone by 2025, and a thirteen-fold overall rise in total expenditure'*. Although in the Camilleri Report pensions were assumed to grow by 6.9% per annum, that is at twice the rate as in the PROST model, the projections of pension expenditure between 1998 and 2010 made by the two models are practically equal, as can be seen from Table 1. Only afterwards do the results of the Camilleri report exceed those of the PROST model. This cannot be reconciled with the fact that the Camilleri report covered the whole spectrum of pensions and at the same time assumed average pensions to rise at a higher annual rate than the PROST model. In some way or another, the PROST model appears to be seriously overstating pension expenditure in the next decade.

Another difference that arises between the two reports is that whereas the Camilleri Report indicated that inflation indexing would solve the welfare gap problem, the illustrative policy simulation presented in Appendix F of the National Welfare Commission Report forecloses this eventuality. The results of the PROST model are barely affected by the inflation-indexing proposal.

This is essentially due to the fact that the source of the welfare gap problem in the PROST model appears to be related to a slowdown in contributions (and apparently a steep acceleration in per capita benefits) rather than to the demographic changes which the country will have to face. Another cause of this overstatement of the welfare gap problem is the arbitrary way in which other social security benefits are estimated, i.e. as a simple proportion of pension benefits. Thus the errors made in the projection of pension benefits are magnified as they are also automatically reflected in the other social security outlays.

An in-depth analysis of the PROST Model projections

The main problem of the PROST model is that it appears to sustain the notion that the present system is unsustainable irrespective of demographic changes. This conclusion is diametrically opposed to that held by many commentators on the subject. The social security system is shown by the PROST model as becoming unsustainable even in the absence of demographic changes, as can be seen in the following Table.

Table 3: Demographic Changes and their Impact on Pension Expenditure

| | 1999 | 2000 | 2005 | 2010 | 2015 | 2020 | 2040 | 2075 |
|---|------|------|------|------|------|------|------|------|
| Increase in Old-Age Pensioners (000's) | 0.3 | 0.4 | 2.1 | 7.4 | 6.6 | 6.8 | 15.8 | 21.8 |
| Increase in Pension expenditure (Lm millions) | 6 | 6 | 41 | 78 | 91 | 116 | 650 | 3576 |
| Extra cost per new pensioner (Lm 000's) | 20 | 15 | 19.5 | 10.5 | 13.8 | 17.1 | 41.1 | 164 |

Thus the PROST model forecasts that an increase of just 2100 retirees between 2000 and 2005 will generate Lm41 million in extra expenditure on pensions. At the same time, an increase of about 7000 contributors during the same five-year period is only expected to generate Lm35 million in extra revenue. The short-term financial problem implied by this model is therefore unrelated to demographic trends, as between 2000 and 2005 the support ratio will remain virtually the same.

In essence the main cause for concern about this model is that it forecasts that the pensions sustainability problem will arise quickly in the short-term. On the other hand we believe that the problem is mainly a reflection of demographic changes, and so the social security system should start facing difficulties sometime between 2015 and 2020, as can be seen in Table 4. Furthermore it must be stressed that the ageing problem is also of a temporary nature, as the baby boom generation will eventually die out. Thus it is a 15-20 year financing problem, which could easily be surmounted if the necessary funds are built up to shore up the system. This means that the country has time to reform gradually and sustain the present system, rather than going for a rapid dismantling of the present scheme. The projections made in the National Welfare Commission Report foreclose this possibility - government has no time to reform, and must perforce renege on its present pension promises.

Table 4: Flow of Beneficiaries and Contributors

| | 1999 | 2000 | 2005 | 2010 | 2015 | 2020 | 2040 | 2075 |
|--|------|------|------|------|------|------|------|------|
| Increase in Old-Age Pensioners (000's) | 0.3 | 0.4 | 2.1 | 7.4 | 6.6 | 6.8 | 15.8 | 21.8 |
| Increase in Labour Supply (000's) | 2 | 1 | 7 | 2 | - | 1 | 11 | 9 |

The forecasts made by the PROST model appear to be seriously defective and present policy makers with the wrong inputs upon which to base reform proposals. It is relevant to pinpoint the various implications of the PROST forecasts, so that an effort can be made by the National Welfare Commission to reassess them and arrive to more realistic figures. Once more we would like to stress that we do not contest that the present social security system, on account of it being a pay-as-you-go (PAYG) scheme, requires substantial reforms in order to surmount the demographic transition. However the extent of the problem is no way near that

implied by the PROST model and in particular the portrayal of the problem as being of a short-term nature is misconceived.

The Over-Estimation of Pension Expenditure

The figures in Table 5, which are derived from the forecasts in Appendix F of the National Welfare Commission Report, once more raise certain doubts about the accuracy of the PROST results. First of all, the rate at which pensions per capita are rising is in no way related to the growth in nominal wages. The latter in fact are projected to grow in the range of 3.1% and 3.8% per annum during the 2002-2075 period. In contrast pensions per capita rise by between 4% and 8.6%. No reasons are presented to justify why this exceptional rate of growth is appearing. Per capita pensions at one point end up rising to nearly 97% of the per capita GDP. In reality they are supposed never to exceed two thirds of the previous wage of employees.

Table 5: Developments in the Per capita Old-age Pension Benefit

| | 1998 | 1999 | 2000 | 2005 | 2010 | 2015 | 2020 | 2040 | 2075 |
|--|------|------|------|------|------|------|------|-------|-------|
| Pension Payments (Lm millions) | 61 | 67 | 73 | 114 | 192 | 283 | 399 | 1049 | 4625 |
| Old-age pensioners (000's) | 22.3 | 22.6 | 23.0 | 25.1 | 32.5 | 39.1 | 45.9 | 61.7 | 83.5 |
| Per capita Pension (Lm) | 2735 | 2965 | 3174 | 4542 | 5908 | 7238 | 8693 | 17002 | 55389 |
| Annual Percentage Change | - | 8.38 | 7.06 | 8.62 | 6.01 | 4.5 | 4.02 | 4.78 | 6.45 |
| In Per capita pension ¹ | | | | | | | | | |
| Per capita pension as a % of GDP per capita ² | 76.6 | 80.2 | 82.3 | 93.4 | 96.5 | 91.1 | 87.1 | 63.6 | 38.3 |

1. Average annual growth since the year indicated in the preceding column.
2. GDP figures were deduced from the various ratios to GDP given in the National Welfare Commission Report.

A look at the per capita pension figures in absolute terms also reveals a large inconsistency. In fact, by 2005 the per capita pension has reached Lm4542, which is higher than the maximum pension benefit allowed by the present system. This is not even possible if all retirees were receiving the maximum pension, as the latter amounts to just Lm4225 (that is two thirds of Lm6400) according to the Report. Furthermore it is highly debatable whether all pensioners will be retiring in 2005 after earning an average of Lm6400 in their last three working years, given that the same Report states that in 2000 the average wage in Malta will be only Lm4213. By 2015, the time when the Report says the ceilings on contributions and pension benefits will be increased, the pension per capita according to the PROST forecasts will be a full 171% of the maximum payable pension. This overstatement of the per capita pension is the main reason why an increase of just 2,100 pensioners is able to generate an increase of Lm41 million in retirement pensions.

The steep drop in the ratio between the pension per capita and the GDP per capita after 2020 is in essence a reflection of the sharp reduction in the share of labour income assumed by the World Bank model. As already said elsewhere, this reduction makes little economic sense. Data for the average wage throughout the forecast period were not available. This does not

permit the calculation of replacement ratio inferred by the model. However from the initial average wage in 1998, Lm3940, and the wage growth rates given in the report we can try to estimate some relations.

Table 6: Developments in the Replacement Ratio of Old-age Pensions

| | 1998 | 1999 | 2000 | 2015 ¹ |
|-------------------------|-------|-------|-------|-------------------|
| Per capita Pension (Lm) | 2735 | 2965 | 3174 | 7238 |
| Average Wage (Lm) | 3940 | 4082 | 4213 | 6400 |
| Replacement ratio | 69.4% | 72.6% | 75.4% | 113.1% |

1. In its report the National Welfare Commission states that the average wage should be equal to the maximum pensionable income ceiling, Lm6400, by 2015.

Once again these figures place serious doubts on both the data inputted in the PROST model and on the model itself. First of all, the present system is supposed to replace only two-thirds of the previous wage of a retiree. Thus it is rather improbable that at present the average pension amounts to 70% of the average wage. Furthermore the replacement ratio by 2015 reaches 113.1%, that is the average pensioner will be getting a benefit which is higher than the average wage that workers are receiving. This is a barely credible development.

The Under-Estimation of NI Revenue

Besides these problems on the benefits side, the PROST model also exhibits serious deficiencies when analysing its revenue forecasts. The shrinking of the contributions base is, in fact, one of the main reasons why the PROST model projects an immediate fiscal crisis arising from social security. This is shown in Table 7.

Table 7: The Shrinking of Social Security Revenues

| | 1998 | 1999 | 2000 | 2005 | 2010 | 2015 | 2020 | 2040 | 2075 |
|---|------|------|------|------|------|------|------|------|-------|
| Contributions (Lm millions) | 134 | 145 | 158 | 193 | 219 | 249 | 290 | 563 | 1874 |
| Labour Supply (000's) | 142 | 144 | 145 | 152 | 154 | 154 | 155 | 166 | 175 |
| Per capita Contribution (Lm) | 944 | 1007 | 1090 | 1270 | 1422 | 1617 | 1871 | 3392 | 10709 |
| Annual % Change in per capita contribution ¹ | | 6.7 | 8.2 | 3.3 | 2.4 | 2.7 | 3.1 | 4.1 | 6.2 |

| | | | | | | | | | |
|---|------|------|------|------|------|------|------|------|------|
| Per capita contribution as a % of per capita pensions | 34.5 | 34.0 | 34.3 | 28.0 | 24.1 | 22.3 | 21.5 | 19.9 | 19.3 |
| Per capita contribution as a % of GDP per capita ² | 69.7 | 71.5 | 73.8 | 66.5 | 57.8 | 50.7 | 45.2 | 30.7 | 18.9 |

1. Average annual growth since the year indicated in the preceding column.
2. GDP figures were deduced from the various ratios to GDP given in the National Welfare Commission Report.

There is no logical explanation for the slowdown in contribution revenue growth. Even though the Report leaves the contribution rates unchanged and wages are rising by 3.1%-3.7% per annum, contributions as a percentage of GDP fall from 9.9% to 7.8%, and to an insignificant 5.1% of GDP in 2040. In contrast, if wages are equal to 50% of GDP, and contribution rates (including the state grant) are 30% of wages, contributions should be equal to 15% of GDP. For the Report's projection to be realised wages and salaries must fall to about 25% of GDP. At the same time, according to the PROST forecasts, the per capita contribution becomes irrelevant when compared with the per capita pension. This shows that whereas contributions are being constrained by some assumption, no such restriction exists as regards the projection of average pensions.

Table 8: Developments in the Effective Contribution Rate

| | 1998 | 1999 | 2000 | 2015 ¹ |
|----------------------------------|--------------|--------------|--------------|-------------------|
| Per capita Contribution (Lm) | 944 | 1007 | 1090 | 1617 |
| Average Wage (Lm) | 3940 | 4082 | 4213 | 6400 |
| <i>Implied Contribution rate</i> | <i>24.0%</i> | <i>24.7%</i> | <i>25.9%</i> | <i>25.3%</i> |

1. In its report the Welfare Commission states that the average wage should be equal to the present maximum pensionable salary, Lm6400, by 2015.

Table 8 shows clearly that the per capita contribution amounts to a fairly constant percentage of the average wage until 2015. In contrast, during the same period, the average pension rises from 69% to 113% of the average wage, as can be seen from Table 6. This comparison seems to imply that whereas the ceiling on contributions is being applied by the PROST model, that on the maximum pension benefit is being ignored. If this is in fact the case, the PROST model is seriously flawed and its results must be used with caution if not discarded completely.

Table 9: Demographic Developments

| | 1998 | 1999 | 2000 | 2005 | 2010 | 2020 | 2040 | 2075 |
|--|------|------|------|------|------|------|------|------|
| Elderly Dependency Ratio | 25.5 | 25.8 | 26.0 | 28.6 | 35.0 | 44.4 | 48.7 | 55.7 |
| Social Security System Dependency Ratio ¹ | 15.7 | 15.7 | 15.9 | 16.5 | 21.1 | 29.6 | 37.2 | 47.7 |

1. This is the ratio between the amount of pensioners and the amount of contributors.

The Maltese pensions system will however be faced with a demographic problem after 2020. Although long-term demographic projections are notoriously unreliable, particularly as they do not capture immigration patterns, there is a significant chance that there will be a demographic shock to the social security system. However there is ample time for the system to be prepared through a gradual (but significant) reform in its basic structure.

Section B: The Private Pension Pillar Solution is Simply an Illusion

In recent years, we have seen the rise in our country of a small but well-connected lobby group that is arguing that the introduction of private pension schemes is the only solution for the ageing problem. This lobby group frequently airs its views in certain sections of the media, and therein tries to destroy the public's trust in the present state system by portraying it as a time bomb that will leave most people without protection in their old-age. These warnings are not however driven by these commentators' unmotivated public interest but rather serve as a marketing campaign with which these individuals hope to attract the majority of workers to buy their products.

These commentators have emphasised that many foreign countries have adopted the private pension pillar to solve their fiscal problems and enable their citizens to get a better pension. At the same time, the World Bank, which is helping the Maltese government to reform its system, is a well-known supporter of the multi-pillar approach where one of the pillars is a mandatory (or compulsory) private system modelled on that operating in Chile. The aim of this section is to contest this approach by showing that it is misconceived and totally ignores what in reality accompanies an increased reliance on private pensions.

It is relevant to clarify the wrong impression that in most developed countries the majority of workers depend exclusively on private pensions. On the contrary the main player in the old-age retirement provision industry in the majority of European countries continues to be the state. This also applies to countries such as the United States, Canada and Singapore. Employees in large firms also participate in occupational pension schemes offered by their employers. However these plans are not available to workers in smaller companies and the self-employed.

Personal pension schemes in most countries are a voluntary additional provision that people make to top up what they receive from the state and their employer. It makes little sense to look at the situation in Eastern Europe, Africa and Asia where the concept of retirement is not quite widespread and the economic and social system differs greatly from the local one. Meanwhile in Latin America public pension schemes did not cover the majority of workers, were administered by corrupt bureaucracies operating under military dictatorships, and hyperinflation, civil disorders and foreign debt crises frequently disrupted government provision.

The pensions 'problem' is strictly speaking a demographic one. Introducing private pensions will do nothing to stop the increase in the number of elderly or stem the drop in the labour supply. The financing problem will remain there. The pensions of present retired persons will have to be financed by the state no matter what happens. Furthermore a significant proportion of the present work force cannot be expected to finance its own pension. This because the process of saving for a pension is a lengthy one, as a fund must be accumulated. Thus the older part of the work force, probably all those aged above 40, cannot realistically enter into a private pension scheme profitably.

This also applies for the majority of low-income workers. Introducing private pensions will not automatically dispose of the state's obligation to provide a pension for these three categories, namely present retirees, older workers and low-income earners. Thus social security contributions will still have to be paid in order for these liabilities to be covered. At the same time, younger workers and new entrants in the workforce would have to pay premiums to accumulate funds for a private pension. As a result the new generations will end up paying twice, for themselves and for their parents. This is neither equitable nor politically acceptable.

There are two main countries, Chile and the UK, which have reformed their public systems through the process of privatisation. These reforms were undertaken under the Pinochet and the Thatcher administrations, both of which cannot seriously be credited as having a particular concern for social equity and low-income workers. On the contrary these reforms were ideological driven with little thought dedicated to their long-term implications. In the UK the basic state pension was reduced to just 18% of average earnings and government itself carried out a massive advertising campaign to convince workers that they should purchase a personal pension if they wanted to retire comfortably. As regards Chile, the reform was carried out in spite of its huge fiscal cost. In fact the reform, which was a shift to a mandatory private pension system, continues to be a main drain on government finances amounting to about 6% of GDP per annum. To remedy for this cost, government carried out several cutbacks in expenditure, privatised most of its enterprises and raised the average taxation rate.

Private pensions are notoriously difficult to supervise. The recent experience of the UK is particularly revealing in this regard. Customers were afraid of the inadequacy of public pensions, whereas pensions' salesmen were untrained and were prevalently paid on commission. Between 1988 and 1992, under the condescending eye of the Conservative government, insurance firms defrauded 2.5 million individuals by giving them wrong advice to join private pension schemes which resulted in an overall financial loss to them. The regulatory bodies had been solely concerned with the solvency of insurance firms and did not give so much importance to selling and marketing practices as these were deemed not to affect solvency.

However following a major review of the personal pensions industry, the British government is now forcing these financial firms (which included such names as Guardian Financial Services, Lloyds, Midland, Prudential, Commercial Union, NatWest & Barclays Life) to compensate these losses, estimated at about £ 11 billion. Many firms were also forced to withdraw their sales forces for retraining and were fined heavily. The extent of the scandal was such that the newly elected Labour government in 1997 ordered a parliamentary committee to corroborate the investigations of the financial services regulator. Interestingly during this investigation the chairmen of major financial firms, such as Prudential, seemed to imply that they had perceived government's attempts to promote personal pensions as a license to sell aggressively without bothering about their underlying product.

Occupational pensions are scarcely less risky, as was demonstrated by the notorious Maxwell scandal. Robert Maxwell drained the pension funds of the employees of his firm, the Mirror Group Newspapers, to extend his business empire and finance his losses. Besides misusing funds, many English firms are known to use them to discriminate against workers who are troublemakers or union members. Some firms also use occupational schemes as barriers so that workers do not leave their firm, by for example transferring only in part the accumulated

funds to the person's new employers. In essence employers structure pension schemes to further their own corporate interests not that of workers. This is in part remedied in firms with a significant and militant union presence, which monitors the scheme.

The problem with private pensions is technically speaking known as one of asymmetric information. The pension provider usually has a sounder knowledge of the product that he is selling than the individual who is buying it. Thus he can manipulate information and lead people to buy products that are risky or are too costly. Defined contribution schemes are particularly dangerous in that one has no guarantee of the eventual pension entitlement. The latter will depend on how well the provider invests contributions and the extent and timing of commissions and management expenses. However even if a person chooses a good firm which charges low commissions, a sudden crash of the stock market before retirement would result in an inadequate pension.

The complexity of the choice to be made is usually beyond the capacity of the average worker, thus necessitating the utilisation of independent financial advice. Recent studies carried out by government in the UK have shown that few people are saving adequately for their old age, especially following the distrust generated by the pensions mis-selling scandal. The Consumers' Association in Britain has argued that the regulatory system cannot simply rely on the principle of *caveat emptor* (let the buyer beware), because of the complexity of the products, the imbalance of information between supplier and customer, and the fact that the effect of the consumer's choice may not become apparent for a number of years. Thus the New Labour government is introducing 'stakeholder pensions', which in essence are government-approved pension products (complying with a number of minimum standards) provided by the private sector. In this way government is trying to restore confidence in the industry.

The private pension pillar solution is also increasingly being criticised by mainstream economists. The World Bank's former chief economist, Joseph Stiglitz, has recently called on the Bank to rethink its promotion of private pension funds in developing countries, saying '*it had been motivated partly by ideology*'. He pointed out four main problems that had arisen in countries where the World Bank's advice had been followed. These are:

- **Heavy transaction costs** - Stiglitz emphasised that more than 40% of the benefits of private pension schemes in Britain had been eaten up by transaction costs charged by fund operators. At the same time, in Chile about 25% of contributions are spent on marketing costs. Recent studies show that publicity expenditure has risen by 73% in real terms in just four years. Pension firms employ one salesman for every 300 active workers in Chile. These administration costs reduce the returns earned on contributions and thus lead to lower pensions. The accumulated funds must also be converted into a lifetime annuity upon retirement. This is quite costly.
- **Volatility** - Private pension funds invested in developing country markets are subject to high volatility, which endangers retirement incomes. In an analysis of the Chilean system, the ILO estimated that a 4.5% return is required in order to have a replacement ratio of 70%. A 3% return would create a 44% replacement ratio, and only half of the contributing workers would receive a pension above the statutory minimum. The early high returns of the Chilean system have disappeared in the last three years, with the average return even dropping to negative figures in recent years.
- **Regulatory Issues** - In countries where investors are unsophisticated, close regulation of the pensions industry is critical. The funds deposited must be invested correctly, the fee structure should not hide costs, marketing must be based on reality and not on hyped future returns, and contributors must be protected if firms go bankrupt. However few small developing nations have the human resources and the expertise within their regulatory institutions to

provide such a foolproof framework. Even developed countries, which have promoted private pensions, have faced major crises.

- **Lack of Insurance** - The private market does not cover a lot of risks, such as longevity and unemployment risks. In Chile, as elsewhere, women tend to earn less, are more often out of work as they bring up children, and then get lower pensions than men with the same level of savings because of their longer life expectancy. Since administration fees are charged equally to both small and large accounts, the former end up paying more in relative terms. Thus the private system tended to increase income inequality.

When comparing the higher rate of return earned by private pension schemes with that of the PAYG system, one must keep in mind that the private system carries more risk, has higher transaction costs, and must be regulated at a cost to prevent fraud or negligence. The shift to a private system also raises complex transition issues. Since government cannot simply ignore the pension entitlement of existing workers and of pensioners, social security contributions will still have to be paid by people who opt out of the public system. However the latter will definitely not accept to pay twice, and this will force government to grant rebates in NI contributions to people who opt out. This is what happened in the UK, and several studies show that this opt-out is costing the British Exchequer dearly. The government gave rebates amounting to over £ 17 billion during the first 8 years after its reform (reducing social security revenue by 8% per annum). This deficit prompted an increase in the employee's contribution rate from 9% to 10%. However the eventual savings accruing to government (due to lower pension entitlements) are estimated to amount to just half of the rebates given. The higher debt servicing costs induced by these allowances must also be set off against the higher returns earned by the private funds when considering if society is better off with private pensions.

Proponents of the private pension pillar counter charges that their solution would result in an increase in income inequality by proposing that government should maintain a social safety net - by guaranteeing a minimum pension to everyone. They also argue that government should assume the same roles it has as regards the retail banking system, that is acting as a lender of the last resort and insuring deposits in the case of bankruptcies. However if government assumes these roles, both private firms and to some extent contributors would have an incentive to invest in very risky assets as they can rely on the minimum pension guarantee. Furthermore as is happening in Chile many self-employed or other workers may opt not to contribute throughout their working lives in order to qualify for the minimum pension. Thus the risk of higher public expenditure to bailout the pension system is not that low under a fully privatised system. The enforcement of a mandatory private pension system is basically a handout to the local financial services industry, guaranteeing it an annual flow of savings irrespective of its performance.

Competition between private pension providers precludes monopoly profits, but does not ensure low costs. A centralised approach under which individual investment choices are restrained and economies of scale are captured has lower administration costs than a privatised system, where each small firm must collect funds, market itself, administer accounts, invest funds, pay benefits, and comply to government regulations. These costs are quite substantial. A commission set up by the US government to study the implications of a fully privatised system estimated that administrative costs charged to a worker would over a 40-year career consume about 20 percent of the value of his pension account. In Sweden the government has tackled this problem in a quite innovative manner. Government maintains all records and negotiates fees with private mutual funds.

While workers are able to select among various funds, contributions are aggregated and invested by a government agency allowing it to capture economies of scale and bargaining power, thereby reducing administrative costs. Workers are discouraged from switching by making them pay for the costs involved, and funds do not have information identifying their members thus preventing the use of sales commissions.

The fact that the public pension system has been less than ideal means that it should be reformed rather than be dramatically scaled back. One should never compare an idealised not-yet-implemented system (the private pension pillar) with one that has actually been set up and administered for a number of years. The implications of implementing a new system must be carefully assessed. In essence the private pension systems adopted by Latin American and East European countries appear to be highly risky, require immense regulatory and administration efforts, and provide little value for money. The latter factor, that is the possibility that many private pension fund holders will not have an adequate pension, will probably require government bailouts to resolve the social problems that will arise. An article in the Economist (August 15 1998) rightly points out that *'while privatisation may generate greater returns for some individuals than Social Security, it cannot solve the funding problems that already exist'*. It also argues that *'fulfilling the commitments made to today's workers will require higher taxes from tomorrow's'*. The elimination of the funding problem requires changes to the present conditions of the social contract. This will be dealt with in the forthcoming part two of the GWU's report. The introduction of private pensions will only shift the ageing problem from government and onto current workers. The latter at the same time will also have to bear the brunt of the reduction in the fiscal deficit, the possibility of the integration in the European Union and industrial restructuring.

Conclusion

The National Welfare Commission Report is in essence a go-ahead for the downsizing of social security in Malta. Given that we will face a pensions crisis of massive proportions in just 5 years, there is nothing that government can do in the short term to remedy the situation except reducing average pension benefits or raising contribution rates drastically. Telling young people to save for their own pension would remedy nothing as this would neither reduce the outlay on pensions in 2005 nor raise total revenue. The projections of the PROST model foreclose the possibility of structural reforms. It is as if we were faced by an extraordinary rise in consumption.

There is no way we could reduce this impact by saving for it. We would have to face it from our current income or from our accumulated savings. If the projections of this Report were true, there is little opportunity for reform except for a significant downsizing of the present system. This would mean denying an adequate pension to people who have fulfilled their obligation to contribute to the system. However if the Report is wrong in putting the crisis so near, we have a way out. We can start saving now in order to foot the future bill. Building up a fund and earning returns on it, staggering increases in contribution rates and other parametric reforms, would help us to finance our way out without having to resort to the unfair move of cutting benefits drastically at once. This is why the National Welfare Commission Report's financial projections were analysed in so much detail in this study.

Social solidarity and social justice are important values for the Maltese society, which transcend political and class allegiances. Thus, the guaranteeing of a decent standard of living for pensioners is seen by many to be immensely more important than a faster growth of private sector financial services or a reduction of state intervention in the economy. The state must remain the main player in social security. Dismantling the public system, or reducing it to a flat rate minimum pension system, is not an option.

If anything increased reliance on private pensions will create a new series of problems for government, a fact aptly demonstrated by the UK experience with personal and occupational pension schemes. The question of unsustainability arises only if one assumes that the basic parameters of the social security system (such as contribution rates, average pension benefits and retirement age) remain unchanged during the next two decades. In reality these parameters have changed a number of times in recent years, and there is no reason why they cannot continue to be modified.

Malta cannot as a society escape the effects of ageing by simply dismantling the social security system. This does not mean that the system cannot be modified to enable the country to face better the challenge of an ageing society. To ensure sustainability we must start saving now to pay for tomorrow's expenses. This means that we must curb the fiscal deficit without creating a social deficit, and at the same time introduce economic reforms that lead to faster GDP growth so that our society can afford to finance increased social outlays. Government needs to devise a new strategy, based on facts and not myths, that guarantees the future of social security. The proposals to be made in our second part of this study are meant to be a step in this direction.
