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Pension Coverage and Informal Sector Workers

INTERNATIONAL EXPERIENCES

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**PENSION COVERAGE AND INFORMAL SECTOR WORKERS:
INTERNATIONAL EXPERIENCES**

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ABSTRACT/RÉSUMÉ

Pension Coverage and Informal Sector Workers: International Experiences

Pension reform around the world in recent decades has focused mainly on the formal sector. Consequently, many of those working in the informal sector have been left out of structured pension arrangements, particularly in developing countries – a serious problem given this group are often low income earners, vulnerable to economic volatility and change. However, since the turn of the millennium, efforts in a range of countries have increasingly highlighted improving pension coverage for informal sector workers. This paper provides an overview of selected country experience in this regard, and provides some suggestions for governments in developing countries considering implementing their own pension reform to ensure that informal sector workers receive the retirement income they need.

JEL codes: G15 G18 G23 G28 J26

Keywords: compulsion, financial education, incentives, informal sector, micro finance, non-contributory, pension coverage, social assistance

La couverture des travailleurs du secteur informel par les systèmes de retraite : expériences au niveau international

Les réformes des systèmes de retraite mises en œuvre dans le monde au cours des dernières décennies étaient surtout centrées sur le secteur formel. Beaucoup de travailleurs du secteur informel sont donc restés à l'écart des régimes de retraite institutionnalisés, en particulier dans les pays en développement, ce qui constitue un problème grave étant donné que ce groupe est souvent composé de travailleurs à faibles revenus, vulnérables face à l'instabilité et au changement économiques. Cela étant, depuis le passage au nouveau millénaire, un certain nombre de pays se sont de plus en plus attachés à améliorer la couverture des travailleurs du secteur informel par les systèmes de retraite. Le présent document donne un aperçu de l'expérience de quelques pays à cet égard et formule, à l'intention des gouvernements de pays en développement qui envisagent la mise en place d'une réforme des retraites, des suggestions visant à ce que les travailleurs du secteur informel bénéficient d'un revenu suffisant au moment de la retraite.

Classification JEL : G15 G18 G23 G28 J26

Mots clés : affiliation obligatoire, éducation financière, incitations, secteur informel, micro-finance, non contributif, couverture des systèmes de retraite, aide sociale

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PENSION COVERAGE AND INFORMAL SECTOR WORKERS: INTERNATIONAL EXPERIENCES

By Yu-Wei Hu and Fiona Stewart¹

I. Introduction

Modern pension system can trace their roots back at least to late 19th century in Germany, when the Bismarckian social welfare system was introduced. Nowadays, pensions have spread and established around the globe, including in both developed and developing countries. Though the type of pension system varies, all play an important role in providing necessary income to elderly populations and in alleviating post-retirement poverty among the poorest sectors of society. However, despite the continued evolution and development of modern pension system over the past century, one issue which is yet to be resolved is how to extend such structured pensions arrangement to informal sector workers.

Though the definition of this sector varies by country, informal sector workers are generally those with low incomes or self-employed, working in very small (unregistered) companies or the household sector, often on a part-time basis (and migrant workers) in industries such as agriculture, construction and services². Compared to workers in the formal sector - who normally join either mandatory or voluntary pension systems, or both - those in the informal sector are typically not covered well (in many cases not at all) by modern, structured pension systems. They do not have access to pension plans organised or run by employers, may lack official registration papers or other documents which could help the relevant authorities target them for other schemes, may change job frequently and often live and work in rural areas which financial infrastructure is poor or non-existent. These workers may also come from lower income and educated groups, meaning their knowledge and understanding of pension and saving products is limited and their resources for long-term savings scare. Hence gaining access to a structured pension system is a challenge for these workers. This issue is even more severe in developing countries, and indeed a rise in the informal sector has been correlated³ with economic growth in several regions³. The challenge is greater in these countries partly due to logistical difficulties in getting informal sector workers to participate in pension schemes, and partly due to the traditional role of family support in pension provisioning.

Recently both the international community and national governments have realised the increasing importance and urgency of extending the pension system to the informal sector. Indeed, a range of different policy initiatives have been undertaken, aiming to tackle this problem given the country-specific conditions and environments. This paper provides a comparative overview of these policies, and aims to provide practical international experiences to other governments considering such pension reform initiatives. The remaining part of the paper is arranged as follows. Section 2 will give an overview of

¹ The views expressed are the sole responsibility of the authors and do not necessarily reflect those of the OECD or its member countries. The authors are solely responsible for any errors.

² See ILO definition <http://www.gdrc.org/informal/huss0772.pdf>

³ See ILO discussions – e.g. <http://www.ilo.org/public/english/employment/gems/eo/download/kilm07.pdf>

international experiences, organised by type of policy response, and focusing on Bangladesh, Chile, China, India, Kenya, South Africa and the United Kingdom (though other countries are referred to and cited), with further details of pension arrangements and informal sector policies in these countries provided in the Appendix. Section 3 provides some suggestions for governments – particularly in developing economies - which are looking to promote pension coverage for their informal sector workers. The last section concludes while summarising the main findings.

It should be noted that this is intended as an overview paper and is by no means an exhaustive investigation of this challenging topic. The OECD acknowledges the leadership of other international organisations in this area (notably the ILO, and World Bank) and encourages interested readers to follow up with the reports referenced in the bibliography.

II. Overview of international experiences

This section provides comparative information on how countries have been working to extend pension coverage to the informal sector. The discussion will be presented by type of policy initiatives which have been undertaken or are being considered by governments. It should be noted at the outset that it is possible that a government has adopted, or considered adopting, a combination of the following initiatives rather than a single policy.

1. Broadening access to social assistance programmes (non-contributory pensions)

Before discussing ways to bring informal sector workers into structured pension systems (either mandatory or voluntary), it needs to be acknowledged that in reality in developing countries - particularly those with the lowest income levels - there is always a group of population whose main challenge is to meet basic needs, e.g. food, clothing and housing. Informal sector workers (including agricultural workers) in developing countries are an important component of such population groups. In this context, it could be very difficult (if not impossible) for governments to undertake any meaningful actions to bring these individuals into formal pension systems. Therefore, an important policy tool is to provide social assistance to all of the poorest elderly, on a non contributory basis. In general there are two approaches - means-tested and universal. Under the means-tested approach, only those who are too poor to support themselves are eligible for benefits, whilst under the universal approach all older people (subject to certain criteria but not levels of income and wealth) are entitled to receive such benefits. There has been much debate concerning the advantages and disadvantages on these two approaches, (for example the former may discourage people from working, while the latter distribute funds to not only those most in need but also relatively wealthier groups and can therefore be more costly and arguably less progressive and equitable), which is beyond the scope of this paper, but is discussed in some of the references in the bibliography at the end of the report.

Old-age social assistance programmes have already existed in many countries for a long time. For example, workers in the informal sector in South Africa are covered by a public pension financed from general government revenues, which provides a non-contributory, means-tested old age pensions. Benefits amount to up to Rand 940 a month for a single pensioner, and a means test is currently applied, which lowers the benefit by 50 cents for every Rand 1 of other income, to a level of zero when other income exceeds R1880 per month. This is the main source of income for 75% of retirees, most of whom receive the full amount of Rand 940 a month. The benefit has been considered to be relatively generous for South Africans. To some extent it can be contrasted with the minimum pension benefit provided by the Bangladesh government. The means-tested arrangement in Bangladesh covers low income citizens aged 62 and above, but only one member from each family is entitled to the benefit (currently 180 Taka per month). However, this amount is not felt sufficient to meet the all basic needs of such a population and only the poorest people are covered, with the majority of the poor consequently still relying on family

support. In view of the benefits of providing an appropriate old-age social assistance, Kenya is one country considering establishing a ‘zero pillar’ pension, which aims to basic a retirement income to all of the older population (i.e. over 65).

It has been argued that introducing such a basic social pension need not be prohibitively expensive for developing countries – with ILO estimating the cost at a few percent of GDP⁴.

Examples of universal and means tested schemes

	Age limit	US\$	% of GDP	
Bangladesh	57	2	0.03	means tested
Bolivia	65	18	1.3	universal
Botswana	65	27	0.4	universal
Brazil (Rural)	60 (M) 55 (W)	140	0.7	means tested
Chile	65	75	0.38	means tested
Costa Rica	65	26	0.18	means tested
India	65	4	0.01	means tested
Mauritius	60	60	2	universal
Moldova	62 (M) 57 (W)	5	0.08	means tested
Namibia	60	28	0.8	universal
Nepal	75	2		universal
South Africa	65 (M) 60 (W)	109	1.4	means tested
Thailand	60	8	0.005	means tested
Vietnam	60	6	0.5	means tested

Source: Willmore (2006). Universal pensions for low income countries

2. Adapting contributory pensions to the informal sector

A. Encouraging voluntary participation by the informal sector

i. Flexible terms for informal sector workers

One of the main reasons why informal sector workers do not want to participate in voluntary pension systems (and in some cases even comply with mandatory schemes) is that they find the strict criteria involved too onerous, e.g. in terms of contribution requirements, vesting policies and requirements on governance structure of pension fund itself etc.. In order to encourage participation of this particular group of population, it may therefore be necessary to relax some requirements to a level which is consistent with the situation relating to informal sector workers.

Indeed when governments start to address informal sector coverage, many of their reforms feature such increased flexibility. For example, in China informal sector employees are required to join the mandatory public pension scheme. However, due to lack of incentives and relatively high contribution rates, as well as lax enforcement powers of the labour ministry, very few comply with this requirement. In

⁴ Charts presented by Vinícius Carvalho Pinheiro, ITC - ILO at the OECD/IOPS Global Forum on Private Pensions, Istanbul, Turkey, November 2006 <http://www.oecd.org/dataoecd/62/23/37696140.pdf>

view of this problem, in many local regions across the country, restrictions have been modified to encourage participation. Specifically, the contribution rates for the system have been reduced from the standard 28% of earnings (20% from employer and 8% from employee) to 20% (of which 8% will be directed to an individual account). Meanwhile, in terms of voluntary private pensions in China, the central government has also been working to encourage the set-up of additional pension schemes among small and medium sized enterprises (SMEs). In this context, compared to the standard pension arrangements which normally apply to the large state-owned enterprises in China, simplification and flexibility will be the main features of the new pension products (e.g. easier application procedures and faster assessment processes).

In Chile and in other developing countries where there is a large agricultural sector, in order to encourage participation of the temporary and/or seasonal workers (most from the agricultural sector), flexible contributions are allowed. In other words, when there is a good harvest, due to good weather conditions and/or advances in fertilization technology, farmers can make larger pension contributions than normal. However, if bad weather conditions prevail (e.g. flooding or pest problems) farmers may not have sufficient funds to meet their basic needs, let alone to put aside extra money for pension contributions. Even during a period when weather conditions are relatively stable, it is still common in the agricultural sector for farmers to receive income from goods/crops during a specific period of the year (or for agricultural workers to only be employed for a specific season), making their earnings during the year highly volatile. Hence it can make sense to allow for irregular contributions which correspond to the income pattern of such seasonal industries and workers.

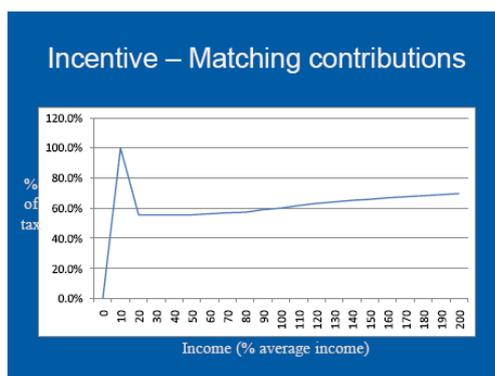
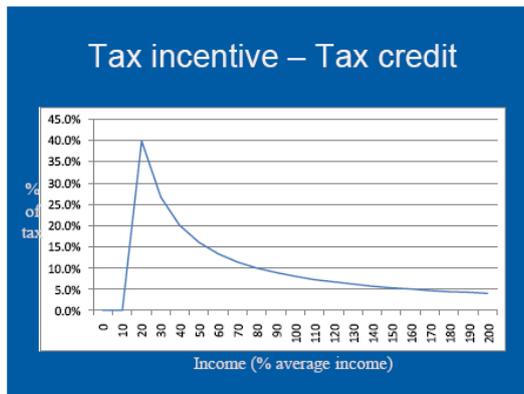
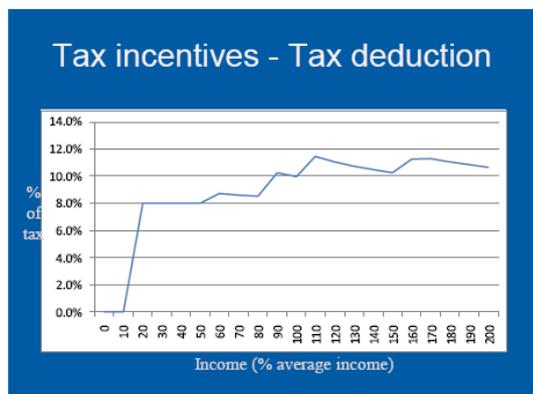
In addition to flexibility in terms of contributions, flexibility in terms of withdrawals may be necessary to encourage informal sector workers to participate in pension arrangements. Given in many countries these workers are from vulnerable groups of society, having access to long-term pension savings may be required to cover periods of unemployment, for emergency spending (such as on health care) or for other life essentials, such as housing. Some pension systems do therefore allow for withdrawals in specific circumstances. For example in Australia early withdrawals from superannuation funds are permitted in limited exceptional circumstances on compassionate grounds or in cases of severe financial hardship. However, this flexibility needs to be balanced with the risk of 'leakage' from the system, with large withdrawals leading to insufficient balances upon retirement (as has been a problem with the provident fund in Singapore and pension funds in South Africa, for example).

ii. Providing monetary incentives to participate

Tax relief on pension contributions may be one way to encourage pension participation, particularly for the voluntary schemes. It has been argued that one of the reasons why 401(k) plans in the US are so popular largely arises from government tax rebates and matching contributions. Consequently, when introducing new pension arrangements to increase (voluntary) contributions, tax policy has been frequently used as a tool in many countries – particularly an 'EET' policy (where by pension contributions and investment income are tax exempt whilst pension benefits are taxed as ordinary income). Such a 'deferred' tax policy is designed to encourage pension contributions, given that even a small deduction from accumulated pension assets (e.g. via tax charges) at the early accumulation stage can make a big difference to eventual pension wealth when compounded over 40 years. When Chile, for example, introduced its pension reform in the early 1980s, it was specified that employees contribute 10% of salary to their individual account, with all contributions and investment income treated as tax free, while benefits were considered as income. For the new NPSS in the UK, the government will contribute to the new system via a 1% tax rebate (which comprises a part of the 4% employer contribution).

Yet it has been debated as to whether tax incentives really provoke new savings rather than shifting existing savings to more efficient arrangements (Antolin and Ponton 2007). Moreover, tax benefits are not always a powerful tool, particularly for those in the informal sector who do not pay tax or are too poor to

put aside extra money for long-term savings. Other mechanisms, such as tax credits or matching contributions, may be more appropriate mechanisms for assisting these groups (see charts below from referenced report in OECD/IOPS 2007).



iii. Financial education

One reason why people may not join a pension scheme (even where available and advantageous for them to do so) is because of a lack of knowledge on pensions in general and the scheme in particular. For example, around 80% the informal sector employees in India surveyed by the Asian Development Bank (ADB 2006) did not know what a pension was. Likewise, even though they meet the criteria, very few informal sector workers join the Public Provident Fund in India. In developed countries, this same problem also exists. For example, in the United Kingdom up to over GBP 6 billion pension credit benefits are not claimed, largely due to lack of knowledge among this group of people (Stewart 2006).

Given such challenges, financial education may be able to play a role in raising public knowledge and awareness, and therefore potentially leading to increased pension coverage – including for the informal sector (Stewart 2006). For example the ADB (2006) have estimated that 20 million of 360 million workers in the Indian informal sector are financially able and willing to join the New Pension System (involving individual DC accounts, currently eligible to civil servants but to be made available to the entire population). One of their proposals for successfully bringing these workers into the system is through financial education –i.e. via public awareness campaigns. Similarly in China, projects have been undertaken to provide training for local social security bureau officials to ensure that they know how to effectively explain benefits available to eligible people (such as rural workers, only 11% of whom claim available pension insurance benefits). Financial education projects have also been conducted in the pension context in several OECD countries with some success. In the UK, a specific campaign was launched in

2006 to help self-employees understand current pension system and arrangements available to them, with the aim of including them into the formal private pension system.

3. Compulsory participation for the informal sector

i. Semi-compulsion of pension participation

Recently governments in a number of OECD countries have been considering introducing so called 'auto enrolment' mechanisms into pension systems for employees, including informal sector workers. Notable examples are the recent reforms in Italy, the United Kingdom and New Zealand. The reasoning behind these initiatives is the same as for compulsory participation - i.e. when faced with difficult choices (such as those around pension provisioning) people tend to make no decision. Semi-compulsion or soft-compulsion plays on this behavior by, rather than making individuals actively choose to join a pension scheme, automatically enrolling them and giving them the option to opt out – thereby using people's natural inactivity to deliver higher membership levels. The main reason why semi-compulsion is preferred to a pure mandatory approach is that individuals are offered more free choice (as there will always be a group of the population – whether in the formal or the informal sector - who would prefer to plan their own retirement, rather than being forced to join a scheme which might not be best choice for them).

Although the UK has a relatively mature pension system and developed pension market, employees in the informal sector are not well covered by private pension arrangements, which provide significant supplementary pensions on top of the relatively limited public pension provisions provided by the state. It is estimated that a population of around 7 million people are under saving in the UK, most being low income earners and those in the informal sector (DWP 2006). In addition, roughly 2 million of around 3 million self employees are not saving via private pension arrangements. Hence the UK government recently decided to introduce a personal saving plan, to be known as the National Pension Saving Scheme (NPSS), from 2012. According to Department of Work and Pensions (2006), all employees in the UK who earn more than GBP 5,000 annually will be required to automatically enroll into the NPSS (with employees allowed to opt out if they participate in other qualified pension schemes, e.g. stakeholder schemes). The minimum contribution for employees is 4% of earnings up to a maximum contribution of GBP 5,000. The employee contribution will be matched by a minimum 3% employer contribution of which 1% is in the form of tax rebate from the government.

A key component of the NPSS will be the establishment of a central clearing house, for collection, reconciliation and administration functions, which is designed to be similar to the Swedish PPM model⁵. The investment function is expected to be outsourced to external professional asset managers. The main advantage of having a centralized agency is cost efficiency (with evidence from various countries showing that competition of such functions does not always successfully reduce prices)⁶. It is expected that up to 10 million new contributors will join the NPSS and the annual new contributions to pensions will be around GBP 4 or 5 billion. Over the long term, it is estimated that the NPSS could accumulate up to GBP 150 billion (DWP 2006). Three reasons could explain why employees in the informal sector may be interested in this initiative. First, it is automatic enrolment, therefore mitigating some reluctance to participate. Second, the matching contributions from the employer and government should be attractive to informal sector workers, therefore encouraging them to stay within the scheme rather than opting out. Third, given that a central and single clearing house will be established, the cost should be lower than otherwise, which should encourage participation amongst lower income workers.

⁵ See <http://www.regeringen.se/content/1/c6/05/19/48/72712aef.pdf>

⁶ In the UK, for example, the decline in fees and charges for personal pensions since the mid-1990s has been attributed more to regulation rather than competition (DWP 2006).

In Italy following approval of the new pensions law by the Parliament in 2004, since July 2007 employee contributions to the severance pay (i.e. “trattamento di fine rapporto” or TFR) are automatically transferred to a public pension fund run by the INPS (i.e. the National Social Security Institute), unless they choose to stay with the old TFR or divert their funds to a pension fund. New employees are given six months to make their decision. Once decision is made, those who decide to go with pension funds cannot return back to the old TFR, although those who decide to stay with TFR can still join a pension fund at any time.

In Italy domestic employees are covered by the public pension system under administration of INPS. Participation in the system is voluntary for contract workers while self-employed persons in Italy are covered by special systems.

The government of New Zealand introduced a voluntary, long-term savings initiative in 2007 known as KiwiSaver⁷. Those in formal employment are automatically enrolled into an eligible saving scheme on starting work, with employees and employers both contributing, but can opt out within a certain period. Membership is not restricted to formal employment as all New Zealand citizens under the age of 65 and resident in the country can join the scheme, whether self-employed or not working. Incentives, for formal sector workers and other participants include a NZD 1000 contribution from the government on setting up the scheme, a NZD 40 payment from the government each year to cover scheme costs, tax incentives and the possibility of linking KiwiSaver savings to mortgage payments. As of May 2008, take-up of the scheme was estimated to have reached 673,000 (40% of the working population).

ii. Compulsion of pension participation

In addition to the above argument relating to the semi-compulsion, another policy initiative governments may consider is to make participation of private pension systems mandatory if workers in the informal sector are not properly covered by other forms of voluntary pension arrangement. However, before going into details it is worth noting that international experiences presented in this section should be more relevant to those African countries where households in the informal sector are capable of putting aside extra monies into a funded account. If such forced savings - which normally are unavailable for use until (or close to) the retirement age - would crowd out the present basic needs of the group of population, (e.g. foods, housing and education), this would not be an optimal policy choice (Martin and Whitehouse 2008). This is particularly the case when retirement is often not the (main) driver of savings amongst poorer households. One survey study shows that for poorer households with savings in South Africa, emergency needs, food, and funeral costs are the three most important reasons for saving, while retirement is only considered the eighth most important (Masilena 2005).

The argument for manditization comes from behavioral economics, with individuals tending towards inertia when facing difficult financial situations (partly due to the difficulty in making a right decision and the level of negative consequence of making a wrong decision and because many people – especially younger generations – live for today and are reluctant to think about their retirement several decades away and to save for the future). These arguments are particularly relevant for pension issues given that surveys consistently show that most people find joining an appropriate pension scheme a rather complicated task and difficult decision⁸. In this context, many people chose to make no decision - especially if there is no proper and effective incentive, as is often the case with the informal sector, which effectively leads to undersaving.

⁷ <http://www.kiwisaver.govt.nz/>

⁸ See the OECD's work on financial education and pensions
http://www.oecd.org/document/37/0,3343,en_2649_15251491_25698341_1_1_1_1,00.html

It is worth noting that although manditization increases participation in general, it may be particularly effective and necessary for the informal sector workers given that, in general, they may be less informed and more short-term in their financial planning than those working in the formal sector. Therefore, if arrangements are voluntary it is likely that they will not participate or simply do not know what pensions are and/or how to participate.

Around the globe, many countries have reformed their pension system by legalizing mandatory participation of private pensions, which in some cases apply to the formal sector only, e.g. in Chile, and in other cases which apply to both formal and informal sectors, e.g. in Australia (except the self-employed) and Hong Kong China.

Chile in 1981 introduced the well known privatisation of its pension system, under which employees in the formal sector were required to join the new mandatory pension system, with each employee allotted a personal pension account (fully funded and defined contribution based). Following its pension reform, pension coverage in Chile increased significantly from 48% in 1980 to 58% in 2000 (de Mesa et al 2006), and private pension assets increased from virtually zero to USD 111 billion in 2007, accounting for 61% of GDP. Yet the current system is only mandatory for those working in the formal sector (and voluntary for the self-employed), which means that many people are left out, and therefore face the risk of not having sufficient pensions when they retire. Current estimates are that around one third of workforce in Chile - including most of 1.2 million people working in the informal sector - are not covered by the mandatory system (Herald Tribune 2008). In view of this problem, a recent reform to the system has been to require the self-employed (who form a large part of the informal sector) to join the system on a mandatory basis.

Mandatory participation applies to both formal and informal sector employees in some economies, e.g. Australia and Hong Kong China. In Australia, the current superannuation pension system requires that all employees in the public and private sectors (including those in the informal sector with some exceptions⁹) participate in the system. The contribution rate for employers is 9% of payroll, while employee contributions are allowable and voluntary up to certain limits. Though participation may not be particularly popular or information sector workers and their employers (given tax incentives have limited impact for low income workers or for companies making a loss), compliance is strictly enforced (via severe penalties) by the Australia Taxation Office.

Self-employees in Australia are not required to contribute on their own behalf under the Superannuation system, regardless of income thresholds. However there are tax incentives - provided an individual earns less than 10% of their income as an employee, an individual can (from 1 July 2007) claim a tax deduction for personal contributions to a complying fund. There is no limit to the amount of the deduction, however the 2007 reforms also introduced caps on the amount of concessionally taxed contributions that can be made in a year to a fund.¹⁰

In Hong Kong China public and private-sector employees and self-employed persons aged between 18 and 65 must become members of a provident fund scheme. This obligation applies to both full-time and part-time workers holding a contract of 60 days or more. Employees in the catering or construction industry who are employed for less than 60 days or on a daily basis (casual employees) must also be covered. Self-employees must also enrol themselves in a scheme within 60 days of becoming self-employed. In order to encourage compliance by informal sector workers, more flexible arrangements have

⁹ In terms of participation there are limited exceptions, e.g. employee aged 70 and over, employee receiving salary or wages less than AUD\$450/month, part-time employees under age 18.

¹⁰ Contributions for which a tax deduction had been claimed and which exceed the cap are taxed in the fund at the top marginal rate instead of at 15%.

been introduced. For those employed in the informal sector, the contribution rate is 5% of earnings from both employers and employees, while for those self employees the contribution is 5% of their earnings. For casual workers paid daily, the contribution rules are adjusted to be flexible in order to encourage participation. Meanwhile, two industry schemes exist for the catering and construction industries in Hong Kong China, which help workers in these sectors to maintain their pension contributions even if they change job regularly.

In addition, some other countries have also considered making pension participation mandatory. For example, the Kenyan government has proposed a mandatory element into the current voluntary occupational and individual schemes, along with proposals intended to increase the coverage rate, particularly among informal sector workers. The current provident fund scheme would be converted into a national social insurance pension scheme, with membership of formal and informal sector workers and encouragement for the self-employed and seasonal workers to make voluntary contributions¹¹.

4. Alternative routes to informal sector coverage

A. Utilization of existing (non-pension) infrastructure

Though it may be necessary to establish institutions and infrastructure when setting up a new pension system, it can be more efficiently if existing infrastructure is utilized where possible. This can be particularly useful when attempting to reach informal sector workers who cannot join a pension scheme via existing employment related mechanisms. For example, when the Indian government was considering introducing the new National Pension Scheme (NPS) (which is mandatory for government officials, but voluntary for informal sector workers), much debate focused on the structure of points of presence (PoP) – i.e. the first point of contact between members (or potential members) and the NPS system. Making such contacts and facilities as convenient as possible is considered of great importance to ensuring the success of the new system. In India, the financial sector infrastructure related to the NPS (including arrangements not previously related to pensions) has been made as wide ranging as possible, and utilizes existing institutions. For example, banks, post offices, depository agencies, and pay and accounts offices are all permitted to conduct the NPS related business. This should greatly assist individuals' participation, particularly those living in remote rural area where many financial institutions are absent and the establishment of new branches is not financially practical.

B. Utilizing existing (non-pension) financial sector institutions - Micro-finance

In addition to utilizing a wide range of financial sector infrastructure to access the informal sector, drawing upon financial sector players and institutions which already have a relationship with such groups outside the pensions realm may also be useful – for example, microfinance companies.

Microfinance is a generic term which refers to the mechanism by which financial services are provided to poor and low income earners. The first microfinance project was initiated by Prof. Muhammad Yunus in 1976 in a small Bangladeshi village, and later extended to over 73,000 villages across the country. His Grameen Bank provides microcredit services to poor people who otherwise cannot receive standard loans from commercial banks. One condition of granting loans from the Grameen Bank is trust or reputation between the Bank and its borrowers rather than collateral or credit history. In this context, an individual must join a group of borrowers in order to apply for a loan, with a small amount of money initially being lent. Depending on the punctuality of repayments, the amount of subsequent loans may be increased.

¹¹ See ILO report:

http://ilo.law.cornell.edu/public/english/protection/socsec/pol/campagne/files/kenya/2page_info_health_pensions.pdf

In 2000, the Grameen Bank started to offer a product specifically designed for the purposes of old-age protection. Under this scheme, all borrowers in the Grameen Bank are required to deposit a minimum of 50 taka each month in a personal pension savings account (Barua 2006). The guaranteed interest rate is 8% if the deposit period is one to three year, 10% if three to five years, and 12% if longer than five years.

Since the introduction of microfinance in Bangladesh, such programmes have been adopted in many other countries, particularly developing economies (Hu 2008). For example, in the Philippines a variant of such ‘micropension’ schemes operates, i.e. the retirement saving fund, which features greater flexibility in terms of contributions and vesting rights. For example, members are allowed to make contributions at a level as low as USD 0.12 per week, which is intended to make the programme as low burden as possible.

In addition, regarding the Indian pension reform a single administration agency has been selected to serve as the centralised clearing house for the new system for a period of 10 years. The main purpose of having a single agency is to achieve economies of scale and reduce costs, in line with the UK’s NPSS and the Swedish PPM as discussed earlier. This institution (often referred to as CR in India) is responsible for the collection and transfer of member contributions via various points of presence (POPs), the allocation of the funds by pension fund managers, and crediting and reporting the allocation of units into each individual personal account.

III. Some policy recommendations for countries with developing pension systems

The section above provides a review of international practices relating to how to extend formal pension coverage to informal sector workers, drawing on experiences from both developed and particularly developing countries. Based on the above analysis, some suggestions are now made for other governments to consider when reforming their pension systems and working to increase informal sector coverage.

Old-age pension guarantee

Given that many of those working in the informal sector in developing countries are amongst the poorest of workers, fully funded pension arrangement – such as those in more developed economies - may not be the best solution, given the more immediate demands on this group is for food, clothing, housing, education and health etc. Asking such individuals to save extra money for the distant future, either via a mandatory regime or through various means of incentives, may not be practically feasible. This issue becomes more compounded once the fact that life expectancy in many of these countries is lower than other regions is taken into account. Similarly, the former World Bank pensions expert, Estelle James (1999) argued that “extending coverage by requiring low income informal sector workers to contribute to social security would not be in the best interests of these workers...” . Therefore, in order to prevent poverty among the poorest, including informal sector workers, governments should consider at least providing a basic old-age safety net which can be fully financed by the general budget – such as the proposals currently being considered by the Kenya government.

Benefits need to be pitched at a level so as not to disincentivise people’s own efforts to alleviate poverty. However, benefits should also be sufficient to meet basic needs, such as food and clothing. For example, Michael Cullen - Finance Minister of New Zealand put forward (2003) that citizens should retire in a degree of personal comfort, without worry and with dignity; however, they should not expect that the state would provide incomes to a level as they were used to during their working lives. In addition, the question of which approach should be used when distributing the benefit largely depends on the country-specific situation, although the means-tested model may be the more appropriate in many cases, as this allows for the targeted allocation of scarce fiscal sources.

Flexible terms

Allowing more flexible contribution and withdrawal terms for informal sector workers can be important for encouraging their participation in mandatory or voluntary pension systems. Contribution schedules should be able to reflect part time or seasonal work (with larger contributions allowed at certain times of the year and contribution holidays during other periods), with access to benefits allowed (though strictly controlled) for emergency and essential purposes. Setting up industry based schemes for workers on short contracts who move jobs frequently (such as those in Hong Kong China for workers in the catering and construction industries) also allows flexibility and should therefore help to raise participation rates.

Target and incentivise those who are capable of extra saving

In order to encourage more people in the informal sector to join the structured pension system, it may be useful to target those who are capable of extra saving. Therefore, before launching a new pension system, those who are able to put aside additional money and are therefore most likely to be the new entrants to the system should be investigated and considered (see ADB 2006). Research studies could be conducted to identify and analyse the main concerns of this identified group, their income profile, social characters, etc.. With this information, it should be possible to design new policies to be as attractive and flexible as possible, and adapted to the specific needs of the targeted group. Financial education campaigns may also be used to promote participation in the new system. The benefits of introducing a new system are consequently more likely to be maximized. An example of such research has been undertaken by the Indian government, which has sought measures to encourage private sector employees to join the new National Pension System (NPS).

Tax incentives should also be carefully designed, with mechanisms such as tax credits and matching contributions considered to ensure that incentives successfully reach the informal sector.

Utilize existing infrastructure from a broad range of sectors and broad financial sector players

Targeting the informal sector is no easy task. Such workers are a disparate group, often from rural areas, with unstructured working arrangement – precisely the reasons for formal pension provisioning not reaching them. Consequently governments may need to think broadly and to use different routes to reach this group and provide them with coverage for their retirement. Using everyday contact points, such as post offices, credit unions, money transfer agents or rural banks as partners may be one option (as is being explored in India) or alternative finance providers, such as the retirement related microfinance programmes which are being developed in countries such as Bangladesh and the Philippines.

Centralised administration agency

Costs are an important aspect of any pension system, with even small fees and charges able to erode accumulated pension assets considerably over the long-term. Designing low cost systems is particularly important for informal sector workers who are likely to have smaller pension balances due to lower incomes (and therefore contributions) and often interrupted and uncertain working patterns. When designing a new pension system governments may therefore wish to consider establishing a centralised administration agency, which serves as a national clearing house and can provide several functions – such as transaction settlement, account administration and record keeping etc., as one way of reducing costs. This agency could be established in the form of semi-governmental agency, or at least at arm's length from the government, in order to avoid conflict of interests. As reviewed earlier, the Indian and UK governments have considered setting up a central clearinghouse as a key integrated part of their new pension reforms.

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ANNEX 1: CASE STUDIES

Bangladesh

Bangladesh is one of the poorest countries in the world, with poverty among the elderly one of the major challenges facing the government. Though Bangladesh is still a young country, the population is aging, if more slowly than in other countries. Government employees in Bangladesh have been covered by generous pension arrangements for several decades. However, employees in the private sector - particularly those in informal sector work - were not covered by any formal pension system until 1998 when a means-tested system was introduced.

Pension arrangements related to the informal sector

As mentioned, employees in the informal sector (such as agricultural workers) were not covered by any formal pension arrangements until the Bangladeshi government introduced a social assistance system with the aim of alleviating old-age poverty in 1998. This system features a means-tested arrangement and is totally government financed. The system covers low income citizens aged 62 and above, but only one member from each family is entitled to benefits which currently consist of 180 Taka per month. Though the social assistance system is moving in the right direction in terms of helping the poorer, elder sections of the population, it is not deemed to be sufficient to meet all the basic needs of such a population and only the poorest people are covered. Therefore, most of old-aged population in Bangladesh, particularly those in rural areas, continue to rely heavily on traditionally family support.

Recent reforms and proposals

In 2000, the Grameen Bank in Bangladesh (the microfinance institution founded by Prof. Muhammad Yunus in 1983) introduced a Grameen Pension Scheme for the poor people. The Grameen Bank now provides microcredit services to individuals who otherwise cannot receive standard loans from commercial banks. One condition of granting loans for Grameen Bank is trust or reputation between the Bank and its borrowers rather than collateral or credit history. In this context, an individual must join a group of borrowers in order to apply for loans. The loan normally is for a small amount of money and can be renewable after repayment of previous loans has been received from any members belonging to the same borrowing group, including the individual himself or - far more usually - herself.

The Grameen Pension Scheme (GPS) is one of the products offered by the bank and is specifically designed for the purposes of old-age pensions. All borrowers of Grameen Bank are required to deposit a minimum of 50 taka each month in a personal pension savings account (Barua 2006). The guaranteed interest rate is 8% if the deposit period is one to three year, 10% if three to five years, and 12% if longer than five years. It is estimated that for a regular deposit of 50 taka per month, in 10 years time, the borrower will be able to receive 11,214 taka, almost double the amount he/she deposited with the GPS.

The GPS has proven popular in Bangladesh in recent years. For example, the total amount of assets has increased from USD 4.8 million in 2000 to USD 163.5 million in 2006. The number of membership has also increased from around 0.5 million in 2000 to more than 6 million in 2006.

Chile

The Chilean pension system started its most significant reform in 1980s with the introduction of a mandatory individual account, defined contribution pension system. Public pensions also exist in Chile, which aim to ensure a minimum pensions for older people. In addition, personal pensions and life insurance are available for individuals on a voluntary basis. The existing pension system was reformed in 2008 to expand access to the minimum pensions for the “left out” population, many of whom are self employees and/or working in the informal sector.

Pension arrangements related to the informal sector

Though members in the individual account system is mandatory for those in the formal sector, participation by self-employees (most of whom are in the informal sector) is voluntary. The contribution rate is 10% of earnings for all participants. The system is DC in nature, and therefore the benefit depends on the level of assets accumulated and investment returns. However, if for whatever the reason, the fund is not sufficient to finance the minimum pension pre-specified by the authorities, the Chilean government will make up the deficit. The funds accumulated are managed by six professional pension managers (i.e. AFPs). Each AFP offers four types of different investment vehicle in order to accommodate needs of members with different risk-return preferences.

Employees in the informal sector can also join the voluntary personal schemes offered by financial institutions, including AFPs, mutual funds and banks, etc. The amount and periodicity of contribution is flexible in order to meet needs of this specific group.

Recent reforms and proposals

On December 19, 2006, the Chilean President sent Congress a pension reform bill in order to introduce changes into the pension system created in 1980. This Bill has been recently passed. Some components of the reforms are related to improving the current low coverage among informal sector workers.

First, a Solidarity Pension System (SPS) will be created for members unable to save towards their retirement. The SPS will replace the current means-tested pensions and the guaranteed minimum pension with two types of pension benefits for the country's low-income population aged 65 or older who have lived in Chile for at least 20 years.

Second, the proposed pension reform mandates that the self-employed, who currently are not obligated to contribute to the pension system, join the individual retirement account system within 7 years after the reform has been implemented.

Third, in order to promote participation of younger workers, the reform proposes a monthly subsidy to low-income workers (those who earn less than 1.5 times the minimum wage) between ages 18 and 35 for the first 24 months of employment after they are formally employed.

China

The pension system in China is segregated between urban and rural populations in China. The pension system in urban areas (modified in 1997) features multiple tiers, consisting of both public and private pension components. In rural areas (60% of the total population), the formal pension system is effectively absent, despite pilot schemes run locally by some (wealthier) provinces, and many still rely heavily on informal family support. Public sector employees are covered by separate, generous pension arrangements.

Pension arrangements related to the informal sector

Several options are available for providing pension coverage to informal sector employees in China. First, they can join the pension system which is designed to be compulsory for both formal and informal sectors. However, due to lax regulation and low compliance rate, very few employees in the informal sector join these schemes. In order to encourage participation, more flexible terms are applied in some provinces (it should be noted that local governments have the authority to revise the rules related to pension contribution rates according to local, specific situations and conditions). For example, in many cases the contribution rate for self employees is reduced from 28% (of which 20% by employer and 8% by employee) to 20% of which 8% is credited to individual accounts. The government in 1999 introduced a minimum income guarantee scheme which aims to provide an amount equivalent to around 20% of the local average salary to those in urban areas who cannot provide sufficiently for themselves. Second, in addition to the public pension, workers in the private sector in principle can also join voluntary, occupational pension arrangements, known in China as enterprise annuities. However, given the nature of voluntary participation and that the majority of employers in China have not participated in the mandatory public pension (a precondition for setting up supplementary pension arrangements), in practice very few employees in the informal sector are covered by such schemes (which tend to be concentrated at large, former State Owned Enterprises).

Third, for self employees in China, another form of participating in the pension system is to buy life insurance, which is indeed increasingly common. Given marketing efforts from insurance companies and generous terms offered, many individuals in the informal sector have started to purchasing such insurance policies.

The above options are mainly open to employees working in urban areas. Those working in rural areas, e.g. farmers, are effectively not covered by any pension system at all. The only exception is the social assistance scheme which provides a minimum income for those who cannot support themselves. Hence older people in rural areas largely rely on their own savings and particularly their family members. Although some pilot schemes have been launched in wealthier regions, the success of such schemes remains to be seen.

Recent reforms and proposals

Chinese government is concerned about the low coverage of pension system in the informal sector, particularly those in rural areas. Therefore, in order to encourage voluntary participation in the occupational (enterprise annuity) pensions, the central government has been considering the establishment of collective pension funds (CPF) which directly target small and medium sized enterprises in China. CPF are designed to be more flexible than traditional EA arrangements which require stricter participation criteria. Meanwhile, for the large rural population China's insurance regulator has been encouraging insurance companies to offer appropriate products. For example, some products similar as micro credit programmes in other countries are now available in the market, featuring increased flexibility and convenience of participation. Furthermore, given that many farmers lost their lands due to rapid industrialization in China, some insurance companies offer products which are linked to financial compensation they receive. In other words, such financial compensation is used to buy certain types of insurance products for their retirement and/or other purposes, rather than being given to farmers directly.

India

In India, there are many different schemes in operation, which could be grouped roughly into 3 parts – the social safety program, (mandatory and voluntary) occupation related schemes, and individual voluntary

arrangements. Note only around 12% of population in India is covered by the formal pension system, while the remainder are supported either by community, charity or family.

Pension arrangements related to the informal sector

Employees in the Indian formal sector are covered by occupation-based defined contribution (DC) or defined benefit (DB) pension plans on both a mandatory and voluntary basis. In comparison, those in the informal sector can participate in voluntary pension arrangements while very few are covered by mandatory pension system (ADB 2006). The only exceptions are seamen and coal miners which have their own industry funds¹².

In addition to the above-mentioned mandatory plans, individuals (including those working in the informal sector) can join a range of voluntary plans which are typically offered by insurance companies. The plans include the public provident fund which is partially funded, DC, unit linked pension plan, offered by life insurance companies, and mutual fund pension plans.

30% of the poorest elderly, regardless of whether they have contributed over their career life, are covered by the National Old Age Pension System (NOAPS), which pays a monthly pension of Rs 75. Currently there are around 7.3 million people covered. Meanwhile, at the state government level, additional pensions may be available for the elderly with marginal contributions from employees and employers. The benefit ranges from USD 2.2 to USD 4.4 per month.

Recent reforms and proposals

The Indian pension system has been declared sustainable in the long run, largely due to the fragmentation of the system, low coverage and the generousness of benefits. In order to tackle the issues (particularly to encourage participation of the informal sector workers, despite the availability of certain products in the market), in 2004 the Indian government introduced a new system, called the National Pension Scheme (NPS). NPS is mandatory for those employees in the central government who start their employment after 1 January 2004, while it is voluntary for state employees and all the other Indian citizens. One of the main features of the new system is its low cost, which consequently intends to encourage voluntary participation of those people who do not have any form of private pension.

The new system is fully funded and has two accounts, i.e. Tier-I and Tier-II. Tier-I does not allow premature withdrawals before retirement, while Tier-II is withdrawable and does not have tax incentives. Members are entitled to receive pension benefits at age 60. Upon retirement, members are mandated to invest 40% of the accumulated assets to buy annuities. The remaining assets can be withdrawn in the form of lump sum. The amount and periodicity of contributions are subject to the discretion of employees and employers, with no mandatory requirements. Several institutions play a major role in the new system, including the following:

Pension Fund Regulatory and Development Authority (PFRDA): the PFRDA was established in 2003 as an essential component of the reform of the pension system. The PFRDA is a specialized agency

¹² The Seamen's Provident Fund was established for Indian Merchant Navy Seamen. It is a DC plan with matching contribution of 12% of basic salary from employees and employers. The return is specified or administered by the state.

Two types of plans exist for coal miners, i.e. Coal Miners Provident Fund and Coal Miners Pension Fund, the former being a DC plan, while the latter is a DB arrangement. Concerning contributions, the provident fund receives 10% from employees and 10.84% from employers, while the pension fund receives 2.16% from employees, 1.16% from employers and 1.6% from government.

responsible for the regulation and supervision of Indian pension funds. For example, any financial institutions intending to conduct pension related business needs to have approval from the PFRDA.

Central reporting agency (CRA): a single institution was selected by PFRDA to serve as the centralized clearing house for the new system for a period of 10 years. This institution (often referred to as CR) is responsible for the collection and transfer of member contributions via various points of presence (POPs), the allocation of the funds by pension fund managers, and crediting and reporting the allocation of units into each individual personal account. The CRA is interlinked with the other major players (including individual members) electronically and shares information with the PFRDA.

Point of presence (POP): as the first point of contact with individuals, the POP is of crucial importance in the new pension system. Existing infrastructure has been utilized to facilitate the establishment of the new system, largely with the aim of reducing costs. Currently POPs include banks, post offices, depository participants, pay and accounts offices and all the other entities which can serve as service providers.

Pension fund manager (PFM): under the new system, employees are offered the opportunity to select from professional Pension Fund Manager (PFM), which are licensed by the PFRDA. Each PFM provides three types of funds to be selected by members, and the funds feature different combination of risk and return in order to take into account the risk preferences of individual investors.

In addition, in 2006 Asian Development Bank (ADB 2006) produced a report with a focus on how to encourage people in unorganized sector to join the NPS. The recommendation was that the system should be designed to target those who are capable of saving (given that there will always be a certain proportion of population in the informal sector who are too poor to save, or to put aside extra money for the distant future, so that tax incentive, low entry costs, etc might not be sufficient to encourage their voluntary participation). For those who are capable for saving for their retirement, the ADB recommended actions be taken to facilitate their participation, e.g. innovative marketing strategies, public awareness campaigns for private pensions etc.. Specifically, the ADB (2006) recommended that such public education focus on a range of themes, e.g. the message that people are not saving enough to support themselves in retirement and may consequently fall into poverty in later life; or the message that informal family support in retirement that has been important in the past is likely to reduce in the future (due to social changes).

Kenya

The Kenyan pension system has three main components: the public PAYG system administered by the National Social Security Fund (NSSF), privately managed voluntary occupational schemes (DB or DC plans) and individual retirement schemes (all are DC plans). Employees in the government are covered by a separate civil service scheme.

Pension arrangements related to the informal sector

For informal sector workers, two opportunities are available to provide pension coverage. The first is the public provident fund, i.e. National Social Security Fund (NSSF). This covers employed persons, traders, the self-employed and, since 2004, some workers in the informal sector. It is mandatory for all employers with at least 5 employees to enrol their members, but open to all other individuals mentioned above. Members of the scheme contribute 5% of monthly earnings up to a maximum of 200 shillings a month, which is the contribution rate for those earning more than KShs. 4,000. Employers pay 5% of payroll, with subject to a maximum of KShs. 400. Self-employed persons contribute 5% of their monthly earnings, with no minimum or maximum earning limits for contribution purposes. With effect from June

2007, members of the NSSF can top up their savings at any point in time with any amount that is less than or equal to KShs. 1,000.

Meanwhile, the private sector provides certain products which allows for individual participation. Currently in Kenya there are 14 individual personal pension schemes which have registered with the Retirement Benefits Authority (RBA). The schemes are all defined contribution and mostly offered by insurance companies. Examples include the Zimele Personal Pension Plan established in May 2007 and the Amana Personal Pension Plan. However, according to latest statistics (Odundo 2008), only 1% of the total USD 4 billion pension assets in Kenya belonged to such individual schemes.

Recent reforms and proposals

Low pension coverage is a big challenge facing the Kenyan government. In order to increase coverage and encourage more of the old-age population to join the formal pension system, the authorities are considering several options. Firstly, the introduction of a “zero” pillar has been proposed, which will provide a universal minimum pension to the population over 65. Secondly, there have also been proposals to introduce a mandatory element into the voluntary occupational and individual schemes and to create a “fourth” pillar in the form of tax incentives for family support and the purchase of a home.

South Africa

The South African pension system consists of a public PAYG tier, a voluntary occupational pension system and voluntary personal saving arrangements. The occupational system can be thought of as quasi-mandatory for employees in the formal sector as many employers require a new employee to join the occupational fund offered by the employer as a condition of service. Employees in the public sector are covered by separate pension schemes.

Pension arrangements related to the informal sector

Workers in the informal sector in South Africa are covered by the public pension system, which serves as the main financial resource for this group. The public pension provides a non-contributory, means- tested old age pension, financed by general revenues. The pension is payable to women at 60 and men at 65 who are resident citizens of South Africa. Benefits amount up to Rand 870 a month for a single pensioner, with married couples receiving double this amount. The pension is reduced to 25% of the full amount for pensioners who are resident for more than 3 months in a private care institution. A means test is currently applied, which lowers the benefit by 50 cents for every Rand 1 of other income, to a level of zero when other income exceeds R1,740 per month. This is the main source of income for 75% of retirees, most of whom receive the full amount of Rand 870 month. The benefit level is informally linked to wages (following inflation erosion in the 1990s), and - relative to average formal sector wages - provides a reasonable replacement rate to lower income workers, as well as acting as an important source of poverty relief for those who are unemployed through most of their working lives.

In addition, additional tax-incentivised saving for retirement is available for employees in the informal sector through voluntary savings vehicles. They are mainly in the form of Retirement Annuity (“RA”) fund policies, primarily offered by insurance companies. Estimates by the National Treasury place coverage of occupational and personal pensions at approximately 60% of workers in the formal sector. No statistics are available for pension provisioning in the informal sector, although unofficial estimates are around a mere 1%.

Recent reforms and proposals

In order to increase pension coverage, the South Africa government is considering the introduction of a mandatory pension system for all formally employed workers. The main objective of this proposal is to ensure a basic level of retirement income for all South Africans. Meanwhile, specifically for employees in the informal sector, the government is currently thinking of establishing a national savings fund. This fund will be designed in a way to accommodate needs of the informal sector workers, e.g. flexible contributions and less strict terms for withdrawal.

United Kingdom

The UK public pension provides a relatively modest retirement income for workers, based on a contribution-based basic pension, supplemented by means-tested social security benefits, and an additional, earning-related top-up - the Second State Pension – provided either by the State or the occupational pension scheme sector. These are supplemented by a large voluntary private pensions sector, comprising DB or DC occupational schemes (run on a trust basis) and personal pension arrangements.

Pension arrangements related to the informal sector

Under the current UK pension system, informal sector employees are mainly covered by the Basic State Pension and/or personal pension arrangements.

Self-employees are entitled to the Basic State Pension as long as they contribute to the system for a certain amount of years (i.e. 30 years) and reach the state pensionable age which is currently 65 for men and 60 for women. In 2006 the basic state pension was GBP 84.25 per week, which is adjusted at least in line with inflation. In order to help low-income pensioners, the UK government offers Pensions Credit, consisting of a means-tested Guarantee Credit and a Savings Credit. The Pension Credit amounts to GBP 114.05 a week for a single person or GBP 174.05 for a couple. Self-employed persons pay a flat-rate GBP 2.75 a week if earnings are greater than GBP 4,465. In addition, self-employed persons with annual profits between GBP 5,035 and GBP 33,540 pay an earnings-related contribution of 8%, plus 1% of any profits above GBP 33,540. 15% of contributions (insured person, employer and self-employed) are allocated to the National Health Service, while the contributions also help finance sickness and maternity benefits, work injury benefits and unemployment benefits.

In addition to the above-mentioned public pensions, self-employees can also participate in stakeholder pensions. Stakeholder pensions are available to almost everybody, including people in employment, fixed contract workers, the self-employed and people who are not actually working but can afford to make contributions. There are no maximum contribution limits. Contributions can be paid on a weekly or monthly basis or can be made as a one-off payment. Schemes must offer a default investment option, which has to include a lifecycle investment pattern (requiring less risky investment from 5 years before retirement). Schemes must have either trustees or stakeholder managers (insurance company, bank or building society). These stakeholder schemes are also decided to be low cost, with charges restrictive to 1% per annum.

Recent reforms and proposals

Despite the availability of pension arrangements in the market, stakeholders and other private insurance products have not proved popular amongst private sector workers.

In response to both the publication of the Pensions Commission Report and the subsequent national pension debate in 2005, the Department of Work and Pensions in 2006 made specific proposals regarding how to address challenges facing the UK pension system. One such proposal involved encouraging the

establishment of pensions among self-employees and/or those who are under saving. Research has suggested that in the UK around 7 million people are not saving enough for their retirement, i.e. this group of population (mostly low income earners) are not saving at a level which will enable them to maintain their current life and consumption style after retirement. In other words, in addition to participation in the state pensions, they typically do not have in any other occupational or personal pension arrangements. In this context, it is estimated that 2 million of the around 3 million self-employees in the UK are not saving in via private pension arrangement.

Given this observation, the UK government proposed to introduce a personal-account-based, automatic enrolment scheme (DWP 2006). Under this scheme:

- individuals will be automatically enrolled if they earn above GBP 5,000 a year;
- employees will pay contributions of around 4 per cent on their earnings between approximately GBP 5,000 and GBP 33,500 a year;
- the employee contribution will be matched by 3 per cent from the employer together with around 1 per cent in the form of normal tax relief from the State;
- the band of earnings on which contributions will be paid will be uprated in line with earnings to ensure the scheme is sustainable;
- employees aged over 22 and below State Pension age will be eligible for automatic enrolment and;
- employees outside these age bands will be able to opt in to the scheme, with access to an employer contribution if they fall within the earnings bands.

Under this system, known as the National Pension Savings Scheme (NPSS), any employees will be automatically enrolled into the scheme, except they choose to opt out and participate in other qualified pension schemes, e.g. stakeholder schemes. The main thrust is to tackle the inertia of individuals towards pension decisions, given their complexity and concerns relating to the inefficiency of individual pension arrangements (which can be costly products).

One important component of the new system is the establishment of a single organisation to administer the funds at the national level. This institution – similar as the centralised pension agency in Sweden, the PPM - will be at arm's length from the government and consist of staff with relevant expertise. The advantages of such a delivery agency are lower costs and higher efficiency when compared to the existing market providers. As a central clearing house, this agency will be responsible for collection, reconciliation, and administration functions. Investment functions, meanwhile, may be outsourced to professional financial institutions.

It is estimated that this new system will potentially cover new contributions from up to 10 million people and the increase private pension savings could be around GBP 8 billion a year, of which GBP 4 to 5 billion will be new saving. From the long term perspective, the pension market could witness an expansion of up to GBP 150 billion assets.