

IMPROVING PENSION SYSTEM COVERAGE: UNDERSTANDING & MEETING NEEDS

I. INTRODUCTION

Saving for old age is important. It allows individuals to transfer any excess income gained in the wet season of their earning years to the corresponding dry times of old age, when earnings income is lower or non-existent, reducing the burden on government.

In the last twenty of thirty years, a number of countries have introduced significant changes to their systems of old age provision. A large proportion of these have closed or scaled down national pension systems that rested in many cases on the foundation of social security taxes, choosing instead to require citizens to direct these contributions to individual accounts in their own names, with benefits directly linked to the contributions paid in. While this was motivated often by an urgent need to address a social security system that found itself in financial difficulty, part of the rationale for the change was to strengthen the link between contribution and benefit, and increase the motivation to participate, in turn improving overall coverage levels. It is unfortunately not clear that the objective of improved coverage has been achieved with consistency.

This paper looks at how a national system of long-term provision might be rendered more effective at expanding coverage. This objective should really be expressed differently, as meeting effectively the real needs of a larger proportion of the population, for a system is surely only as effective as the success with which it meets real needs.

As many of those living in developing countries survive on low income, the systems implemented by policymakers in these countries must pay special attention to the needs, behaviour and aspirations of these people, interrogating even the assumption of a conventional lifecycle, the childhood-education-working-retirement model that appears to dominate policy thought but may not reflect reality for the poor. This note therefore lays special emphasis on the so-called informal arrangements utilised by lower income working age individuals for long-term saving, asking whether and how policymakers might render these more effective.

This paper is based largely on a document written for the Pension Commission of Nigeria, financially supported by the FinMark Trust, whose research underpins much of the discussion on methods of saving in the informal sector.¹

¹ FinMark Trust is an independent trust, established by the United Kingdom Department for International Development, that supports and promotes institutional and organisational development towards the objective of increasing access to financial services by un-served and under-served consumers across Africa, through both private- and public-sector vehicles. Long-term savings and old age provision forms a key part of FinMark considerations as old age security is an important contributor to the well-being of citizens in these countries.

II. GLOBAL CONTEXT

A number of models or frameworks have been suggested to describe a system of long-term provision for old age. The World Bank's three-pillar model, later extended to five pillars, is perhaps the best known of these. The Organisation for Economic Co-operation and Development stresses the need for simplicity, encapsulating its approach in a two-part model. The International Labour Organisation, in support of its call for national systems meeting the benefit objectives of Convention 102 of 1952, frequently expresses its views in the form of a multiple tier system.

This section starts the discussion of improving informal coverage in a pension system by proposing that there are broadly six mechanisms for meeting the needs of the elderly residents of a country, social security, pension funds, compulsory individual accounts and three forms of voluntary provision.

If the description that follows appears to lean towards those members of society with lower levels of income, then this may be regarded as a deliberate strategy, for three main reasons.

- A key objective of social protection programs, of which old age provision is one, is to uplift the poor, as encapsulated in the by-line and vision of The World Bank, "*Working for a world free of poverty.*"
- Members of the lower socioeconomic strata of society are not homogeneous in their needs or survival strategies, should not be considered as a single group, and should not be expected to respond in the same way to participation incentives.
- Low levels of coverage in the formal-sector systems in a number of developing countries, are receiving significant attention, but this issue is dwarfed by the corresponding coverage concerns for those outside of formal employment, who are much less likely to participate in these systems, mandatory or voluntary.²

Government has a fundamental role to play across all of these areas, but its approach should differ according to the objectives of each stream and the needs of participants that stand to gain the most from each.

a. Social security

Provision of benefits to the elderly directly by government is central to government policy in virtually all countries around the world.³

This provision takes a variety of forms. It may be a comprehensive system of social security funded directly by contributions. It may be a broad-based social assistance program providing cash benefits to the elderly and supported only by tax revenue, or a combination of the social assistance program and its contributory counterpart. In some cases, limited fiscal resources enable no more than a minimum set of protection to the most needy of elderly citizens, perhaps in the form of a food basket or other tangible benefits.

² Palacios & Pallarès-Miralles (2000) provide an excellent, if slightly dated, survey of pension coverage around the world. This is well developed by Forteza *et al* (2009), who estimate that approximately 25 percent of the global labour force is currently accruing pension rights. Gill *et al* (2003) provide a careful assessment of the mandatory individual account systems in Latin America, highlighting coverage concerns, and Rofman (2005) considers coverage patterns in more detail, showing, for example, the enormous impact of employer size on the likelihood of worker participation in the system.

³ The World Bank (2009a) recently published a set of papers that considers the role of social pensions in long-term provision. The authors acknowledge the relative absence of research into the effectiveness of mandatory pension systems in preventing poverty (p 1).

In all of these instances, the government is directly involved in providing benefits, often through a dedicated social security arm, and in many cases government explicitly bears the costs of providing these benefits, through its tax revenues or external support from donors. Government usually seeks also to ensure that benefits are received by those elderly citizens in greatest need, so there is some form of targeting involved, but this is not always the case. A small group of countries scattered across the world provides a universal pension to all above a stipulated age, sometimes different for men and women, without any form of means testing.

Unlike all of the categories that follow, the primary motivation or underlying ethos in this case, even in cases of universal pension systems, is redistribution, social protection designed to help the poor. There is considerable evidence that the benefits from these systems flow well beyond the elderly recipients.⁴

b. Occupational pension funds

Employment- or industry-based pension funds play a substantial role in providing income in old age. They do so in most countries, but their influence is generally greatest in developed nations, where they also play a significant part in allocating capital across economies, since they are substantial investors of the accumulated assets of their members. In many developing countries, occupational pension funds play a significant part in old age provision, but with those countries that have higher incidence of poverty and informalization of employment, the corresponding role played by these entities is smaller, because occupational pension funds are built on a formal employment relationship.

Like the individual account approaches that follow, occupational pension funds exist primarily to facilitate income smoothing, postponing consumption during working age in order to provide for the period of old age.⁵ Benefits received are proportional – in some way – to contributions paid, whether the arrangement is defined contribution or defined benefit in design. Redistribution from high earners to low is limited, at best, though pooling occurs within the employer group, and coverage is restricted in practice to those working for employers sufficiently large to offer an occupational pension fund, or as members of significant industry groups or professional associations.

Almost by definition, occupational funds provide membership only to those in the formal sector but inclusion levels vary significantly, even across wealthy countries. Coverage of occupational or industry funds is excellent in some countries, Denmark, the Netherlands and Sweden (Lasagabaster *et al*, 2002), most of which are quasi-mandatory systems, and Switzerland (Queisser & Vittas, 2000), in which participation is compulsory, but quite poor in others, among them Ireland (Lasagabaster *et al*, 2002) and the United States (Munnell *et al*, 2005, Buessing & Soto, 2006), countries that do not, at present, mandate participation in individual accounts.⁶

Except for provision to its own employees, government's role is usually to regulate the system, establishing an independent supervisory agency to ensure that it operates in the best interest of all participants. It has good financial reasons to do this: failure of the system is likely to result in higher costs to government under any social security promises that it may have committed itself to.

⁴ Examples of positive spin-offs in South Africa and Brazil are available in Duflo (2003), Ardington *et al* (2007) and De Carvalho Filho (2008) and a discussion of design implications in Samson *et al* (2006).

⁵ Though the discussion in this paper is concerned mainly with saving, in many countries occupational funds also provide insurance against the contingencies of death and disability.

⁶ Occupational fund coverage must not be considered in isolation of other forms of retirement protection. Countries choose to provide this protection in many different ways. Refer, for example, to Whitehouse (2007) and OECD (2007a) for country descriptions. OECD (2007b) provides a particularly helpful illustration of the heterogeneity of coverage models across countries.

c. Mandatory individual accounts

A growing set of countries has introduced a system of compulsory saving in individual accounts. Starting with Chile in the early 1980s and adding a number of Latin American neighbours in the 1990s, the system has also been adopted by a group of Eastern European countries and others, Nigeria, Kazakhstan and Australia, to name a few. With the exception of the last-mentioned, most of these nations would be regarded as middle- or lower-income countries. The majority of them have relatively low levels of government social security provision and generally poor occupational coverage.

Residents are required to contribute a fixed percentage of their income into the system, receiving pension benefits at retirement defined by the accumulation of contributions⁷ and often some survivorship and disability cover.

Conceived partly as a means of encouraging participation, on the basis that the direct link between contribution and benefit increases the sense of ownership by participants, individual account systems have, by and large, not resulted in increased levels of coverage, compared with the contributory social security systems that most of them replaced. The main reason for this is that it is not easy for governments to force participation by those who are not formally employed.

The self-employed, rich or poor, also have limited incentives to participate, not least because they are sometimes required to make contributions both as employer and as employee, a burden that they are not always prepared to bear. Members of this group also have a natural incentive to put spare income into their businesses rather than into retirement saving, and tend to regard their investment in themselves as more valuable than a corresponding investment in saving for retirement.⁸

For practical reasons, and to avoid inappropriate distortions to labour markets, the employees of firms with less than a stipulated number of employees – thresholds vary across countries – are often exempted from participating. While this is motivated often in the interests of continued development of the small business sector, it limits the reach of the system and the saving mobilised.⁹

As benefits are limited to the accumulation of the contributions of each participant, mandatory individual account systems are not redistributive, though their participants may be supported by some form of government-provided guarantee, flat contribution subsidy or uniform provision of survivor and disability benefits.

d. Voluntary supplementary provision

Many mandatory individual account systems also make provision for additional contributions on a voluntary basis, supplementing the accumulation of pension benefits from compulsory participation and making an effort to extend coverage to those not required to contribute under the rules of the mandatory system.¹⁰

⁷ These systems may provide some form of guarantee or protection, but in some cases no more than an implicit underpin from the social assistance programme.

⁸ Self-employment is, for many, a tenuous existence in which every unit of spare cash is needed for the survival of the business, or to fund its expansion. As the self-employed are often employees themselves, the potential for labour market distortions from a system of compulsory participation cannot be ignored. Barr & Packard (2002) analyse the propensity of the self-employed to participate in Chile.

⁹ Rofman (2005) shows excellent evidence of the range of coverage by employer size. Unpublished analysis for policymakers in South Africa shows similar patterns in the occupational pension sector.

¹⁰ Antolín & Whitehouse (2009) show the significance of what they refer to as “the pension gap” in a number of OECD countries, urging consideration of a number of measures to encourage supplementary personal provision.

Countries that do not have compulsory individual account systems are also often characterised by systems of voluntary pension saving, usually incentivised by government through tax rebates, with a range of investment options available to participants. The so-called *401k* system in the United States is an example of such a system. South Africa does not mandate participation in a national scheme (yet) but with generous tax incentives achieves reasonable levels of saving in individual account entities called retirement annuities, at least among the wealthy.

Despite the prevalence of tax incentives and the existence of financial service providers in nearly all developed and middle-income countries, voluntary supplementary provision is usually not particularly strong, even where it might be rational put aside supplementary amounts for long-term saving. This is one of the reasons that so many countries have chosen to mandate retirement saving.

Some countries recognise the practical constraints to mandatory systems and seek instead to encourage participation on a voluntary basis. The Indian pension system, for example, incentivises voluntary participation by establishing first the administrative economy of scale through incremental compulsion on federal, state and then municipal employees, a mixed mandatory-voluntary system.

e. Facilitated additional provision

Tax incentives are a form of facilitation, but may not be particularly effective at encouraging participation by low-income individuals, those characterising the informal sector in many countries, who do not pay tax and are unmoved by the prospect of tax incentives.

A few countries have taken other approaches to these incentives. The Mexican government provides a flat addition to all contributors in the individual account system. Since it is flat it is relatively more valuable to participants with lower income, adding a higher proportion to their savings, than it is for wealthier participants. While the system itself is not redistributive, based as it is on individual accounts, the method of incentives is, focusing proportionally more on lower income participants.

The government of the Indian state of Rajasthan has agreed to provide similar support to a fledgling system of voluntary contributions run by a private-sector administrator and able to handle very small contribution amounts. Participants in the system are understood to number approximately 100 000 at the time of writing, not bad for a relatively youthful system based on voluntary participation. The governments of Madhya Pradesh and Andhra Pradesh have recently announced co-contributory pensions schemes for the informal sector.

These developments are part of a private-sector initiative that aims to provide what it calls “a scalable, secure and low-cost social security marketplace” of which just one component is an integrated, web-based centralised transactional and administrative platform (IIMPS, undated).¹¹ The platform manages nearly 200 000 accounts and aims to reach one million low income workers across fifteen Indian states by July 2010. Life and health insurance, and a simple bank account, are strong possibilities for the near future.

f. Unsupported informal provision

Informal provision is discussed in more detail in section III. Here a few of the main methods are touched upon, though there are considerable variations in practice and classification is not straightforward.

Microfinance organisations, in some cases encouraged and supported by government, at least indirectly through facilitating regulation, may require their members to save systematically as a means to pay back

¹¹ The project was launched and managed by Invest India Micro Pension Services, but it works with a number of partners to improve its reach, scale and growth potential.

their loans and gain access to incrementally larger pools of finance, thus inducing a form of long-term saving.

Other organisations have taken a fundamentally different view to the saving-finance balance. They have elected to focus on saving first, requiring members to accumulate a certain specified level of saving before they are permitted to access loans.

In a variation on this, village saving and loans clubs pool savings at the beginning of the year – effectively purchasing shares in a business – and use this capital to lend money to fellow-villagers. Interest rates may appear high to so-called sophisticated investors, but are transparently established by the operation of supply and demand within the village system and are usually significantly lower than in other informal lending schemes. Shareholders close the business at the end of the year and take out their profit, which they may plough back into the corresponding system for the next year.

Self-help groups often combine saving with other forms of community support and upliftment, and participants are less likely to ‘close accounts’ at the end of the year, rolling them over instead into a form of longer term saving, later perhaps investing in productive assets.

The extent to which the participants are required to demonstrate commitment to the saving varies from country to country and from model to model, and saving is not always long-term in nature.

Governments and large financial institutions may have important parts to play in improving the operation of these community systems, but it is crucial that they consider their role with the utmost sensitivity to the needs of participants. This is the central premise of this note.

III. TWO BROAD APPROACHES

The primary goal of an incentivised or mandated national system of retirement provision is to raise the rate of household saving. This should reduce a country’s exposure to the vagaries of capital markets but, more important in terms of government’s mandate to serve its people, increase the protection that households have against the uncertainty associated with old age. This is complemented in many cases by insurance coverage, providing a measure of income replacement in the event of death or disability.

Part of the policymaker’s responsibility is to ensure that the saving takes place in a safe environment and that insurance is provided by a financially secure entity. Regulation permits government to enhance the security of the savings and insurance coverage. It also gives a means to national leadership to enhance its understanding of the development of the system, the number of citizens participating and the size of assets in the system.

In all countries, however, some economic activity exists ‘below the radar screen’ that has positive economic value, even if largely unknown to government. Saving may fall into this category, enhancing the security of household finances and protecting against the uncertainty of disaster or the reduced earning potential of old age. The fact that it is hard to measure does not necessarily make such saving activity an inappropriate feature of the economy.

This section is the heart of the paper, asking how the effectiveness of government policy in the long-term saving space might be improved. It seeks to do this in two different ways. First, it considers how the formal system might be expanded to include individuals and groups that are generally difficult to reach, primarily because they are not connected to formal structures. Second, it looks at how saving by informal sector participants might be facilitated, meeting national goals of improved levels of saving for old age.

a. Expanding the formal-sector system

Individual account and occupational pension systems have not been consistently successful at achieving high levels of coverage. While inclusion has been high in a few countries, in other jurisdictions

the level of success at drawing citizens into the system as active participants has been relatively poor. Disappointment with coverage levels has characterised many assessments of these systems.

The natural starting point, in response to this, is to ask how the system might be expanded, reaching a higher proportion of the working population. A number of approaches have been tried and these might be arranged under three different headings covering broadly force, incentives and behaviour change.

Push the mandate to participate

The **rules of the system could be modified** to require participation by a higher proportion of the population. Most systems exclude the employees of small companies – or allow them to participate voluntarily – so one way to enlarge the group of participants is to reduce the company size limit below which employees are not compelled to contribute. Similarly, minimum age limits or minimum earnings thresholds, if they exist, may be lowered, increasing the pool of potential participants.

Of course, there are trade-offs involved. Company size limits exist with good reason. A system of mandatory saving has labour market impacts that can be most significant at the level of the small- and micro-enterprise: it is more difficult and more expensive to run a start-up operation if it requires compulsory contributions for all employees to a national system. Reducing these limits may induce higher levels of evasion or initiate increased informality of employment. The same concerns would apply to lowering existing age or earnings limits, where there is a strong rationale for these limits in the first place.

Another way to push the mandate to participate is to work to **improve compliance levels**. Trade-offs must again be considered. Too often, rules have been written that are idealistic and difficult to enforce. Forcing the self-employed to participate, for example, particularly if they are required to meet contribution obligations as both employer and employee, can be counter-productive, adding again to labour market distortions.¹² The extent to which the ‘stick approach’ of enforcement could succeed depends on the effectiveness of other state institutions, notably the income tax collection authority. This means that the government objective of improving contributions to the pension system may need to be prioritized behind other more pressing needs, because tighter rules could be rendered ineffective without the appropriate supporting framework.

Policymakers also need to ensure that they **define and measure success with care**, not underestimating the challenges of accurate, useful measurement. Experience in Latin America has shown that setting objectives in terms of system registration numbers can create a false sense of achievement, because the consistency with which registered participants actually make their contributions determines the security with which they are able to retire.

Finally, any efforts to broaden the system by expanding the number of participants require **concomitant attention to the infrastructure**. Registration, contribution collection, database management and payouts are all more difficult for participants that are not as soundly ‘plugged in’ to the national system. They may not be paying tax. They may not have steady banking access or a reliable postal address. Systems need to be flexible to these challenges. It may be necessary, instead of ‘calling the people’ to government, to find ways for government to ‘go to the people’. Various intermediary models are worth considering and these are discussed in more detail later in this note.

Provide incentives to participate

Instead of seeking to enforce a stronger mandate, government may choose to make it more attractive to participate in the system.

¹² Choi (2009) suggests that, while most OECD countries mandate participation by the self-employed, efforts to back this up with compliance are generally ineffective.

Flexibility of contribution payments is one of the design features that may be considered to make it easier to convince people to participate. While all workers suffer the challenges of myopia – the tendency to avoid short-term loss for the benefit of long-term gain – those with poorer resources or greater uncertainty of income are less likely to agree to the constraints imposed by a pension system with compulsory contributions. Permitting contributions as and when they can be afforded should increase participation levels at the margin.

Flexibility of access to benefits could also improve the attractiveness of participation. Since a well designed pension system should provide excellent security, cost-efficient administration and generally high investment returns, there is merit in saving into such a system, but the inability to access accumulated resources prior to retirement can quite easily render such an action irrational to those in tenuous financial circumstances.

Policymakers might consider making it easier to draw on accumulated savings to increase the attractiveness of the system to a larger group of potential participants. Early access to parts of the saving would help to allay the fears associated with financial distress in case of dire need and it may also encourage the self-employed, who could regard their businesses as their source of retirement income, to put money aside prudently.

While the need to unlock these savings to meet life-threatening circumstances is often acknowledged, it is tempting to impose rules for withdrawal to ensure that the accumulated wealth is not squandered. The rules may state, for example, that benefits may be accessed on unemployment or the death of a family member. This approach can be expensive and counter-productive, and rules are too often interpreted to suit different needs. It would usually be better to define parts of the accumulated saving that may be accessed by participants and parts that are not. Any government co-contribution, for example, could be defined as not accessible prior to retirement. Of the balance, perhaps half might be freely accessible and the balance not, particularly if this mirrors the respective split of contributions of employer and employee.¹³

While penalties for early withdrawal can be difficult to communicate, bonuses for loyalty to the system are more easily understood. Flexibility allows participants to see the value of the system, participate more enthusiastically and make their own assessment of the trade-offs in times of need. Nevertheless, the pitfalls of unnecessary complexity must be guarded against. Clear communication is crucial.

Financial incentives are important as well. Conventional tax incentives probably do not encourage lower income participants, but an explicit government co-contribution may do so.¹⁴ It is puzzling that so many governments require their citizens to participate and are happy to forgo tax revenue – at the average income tax rate of the participant – to encourage their contributions, but are not as prepared to pay an explicit amount into the accounts of these participants to provide tangible reward for their partnership in the system.

Incentives need not necessarily be financial. As the state expands its ability to provide services to its people, it may be able to find ways to link accessibility to membership of a system. Such membership would provide certain benefits – faster access to health care or subsidised public transport, for example –

¹³ It is understood that the contributions of self-employed members of Ghana's Social Security and National Insurance Trust scheme are split into two funds, an occupational scheme account and a retirement account. Participants may withdraw accumulated funds without limit from the first of these accounts after a minimum contribution period of five months and may use the balance in that account as partial collateral for loans.

¹⁴ Palacios & Robalino (2009) describe a system of matching defined contribution schemes as promising. Research in South Africa (Genesis, 2008), discussed later in this paper, suggests that financial incentives may not be sufficient to overcome an unwillingness (often rational, but not necessarily so) to contribute to a long-term saving arrangement. Experimental design and micro-simulation may usefully complement the fiscal analysis provided by Palacios & Robalino (2009).

but it also permits the establishment of conditions that must be met for the rights of membership to be enjoyed, one of which may be a certain level of participation in the national pension system. While such an approach goes much further than the conditional cash grant systems growing in acceptance in various parts of the world (World Bank, 2009b), the principles are similar.

Incentives can also be provided in the design of the system. The easier it is to pay contributions, receive notification of the value of accounts and withdraw any portion that may be accessible before retirement, the greater the chances of participation by those more loosely connected to state structures. The infrastructure of branches provided by a national postal system may be a good place to start. Banks, mobile telephones, microfinance networks and communities themselves may all have some part to play in improving the connectivity of the system, its accessibility to potential participants and the flow of communication back to the people, the most important stakeholders in the system.

Establish a culture of participation

The third broad approach is the most difficult to achieve and probably needs to go hand in hand not only with some of the approaches suggested earlier but also with a substantial and sustained effort at nation-building that cuts across all areas of government and its interaction with its people.

A culture of participation can only be built in an atmosphere of transparent communication together with good levels of understanding of participants. Financial education is a crucial element of this development. A national pension system provides an excellent opportunity for the dissemination of financial education through a wide variety of media. The challenges should not be underestimated, but neither should the benefits.

Promising developments

Can these initiatives work? The Chilean system depends strongly for its success on the participation of the people of that country. Many would describe that system as enormously successful and, to an extent, they are correct. Coverage levels, for example, have been generally high. Not all participants have saved enough, however. More careful scrutiny of the coverage statistics shows that, while registration numbers are high, the corresponding data on contributions is significantly lower, pointing to a disappointing consistency of contribution, the so-called 'density' of participation.

A safety net has always been provided in Chile for those unfortunate enough not to achieve satisfactorily high levels of saving but access to this benefit was dependent on 20 years of contributions to the system. Recent research has shown how many participants would fail to achieve this threshold, due mainly to the inconsistency of their working history, hence their earnings.

The authorities responded by introducing last year a number of changes that aim to produce a more coherent system that meets social goals more effectively. Some of these changes (Iglesias-Palau, 2009)¹⁵ are:

- the launch of a basic social pension and a complementary pension, with an income test, payable at just over half the level of the minimum wage,
- the introduction of compulsory participation to the individual account system by the self-employed (pragmatically, all of those paying income tax),

¹⁵ This list doesn't do justice to the remarkably thorough set of reforms introduced by these changes, which make provision for the children, spouses or parents of voluntary members to make contributions on their behalf, for example, and establishes a member's council to represent their interests. Two other papers contribute helpful to an understanding of the Chilean reforms: Valdés-Prieto (2008) comments candidly on political economy issues and Larrañaga (2009) assesses the role of social security in income distribution and poverty concerns.

- improved tax incentives on voluntary savings, and
- special subsidies for mothers, other women and young workers, incentivising participation and addressing equity concerns.

The Chilean 2008 reform is remarkable in the diligence of its efforts to meet a range of clearly defined social goals, as opposed to efforts to improve measures like coverage or cost efficiency at the margin.

The lesson surely is that, while every effort needs to be made to improve the level of compliance of a country's people to the requirements of its government, failure is possible and additional protection may be required.

b. Facilitating saving in the informal employment sector

The second broad approach to improving national long-term saving is to support the development of the system for those working informally. As a substantial proportion of those living in low-income countries survive through informal means, such an approach is simply essential. Even so, it may rest uneasily with government organisations that, with the best motives in mind, would like to understand the financial activities of their citizens, not least to build the regulatory infrastructure that protects and supports the products and services that are used.

Though the informal sector is, almost by definition, difficult to reach, government may have a significant role to play in its development. A small set of examples illustrates the point.

- Research that facilitates the development of financial markets to enhance the extent to which low-income citizens are able to make good use of them may be encouraged, part-funded or undertaken by government or a related state entity.
- Market facilitation investment may follow from this research. By way of example, Colombia's *Banca de las Oportunidades* (Opportunity Bank) is a government-established program that seeks, through research and facilitation, to enhance access to financial services, particularly for lower income households, in an effort to promote development while enhancing social equity.
- Investment in telephonic infrastructure, or a policy that encourages private sector development of that infrastructure, and an effective, fair and competitive telephone market directly benefits the level of access of lower income citizens to financial services, as banking and telephony grow inextricably closer together.
- State grants, where provided as part of a national social assistance program, should be given in such a way that the potential for recipients to access good financial products is maximized, for example, by opening a bank account for recipients that do not have access to banking and by developing a range of contact points for withdrawing (and using) grant money.¹⁶
- Government should consider a flexible regulatory infrastructure for banks and insurers that permits the development of non-bank deposit-taking institutions and quasi-insurers with less onerous supervisory burdens. This should stimulate the development of products and services that are more beneficial to the poor, the majority of whom exist in the informal sector. South Africa, for example, is in the process of developing a second tier regulatory infrastructure for microinsurance.

As a start (and surely a bare minimum), policymakers must seek to understand the needs of their citizens and the manner in which central institutions may be able to assist them.

¹⁶ Access is very important, but should not be implemented blindly, without regard to the cost and quality of the products and services provided, for example. Finding a sound balance is not trivial.

These are examples from across the financial services section. The discussion that follows focuses on long-term saving.

Recognise that long-term saving is not always rational

A study of the attitudes of low-income South Africans to long-term saving (Genesis, 2008) shows a number of important hurdles that needed to be overcome before embarking on a formal saving program:¹⁷

- **High long-term discount rates.** While the large majority of people of all socio-economic backgrounds suffer a tendency to overstate the importance of the short-term at the cost of actions to benefit the long-term, those with shorter expectation of life – generally with lower levels of income – are more likely to do so. As no more than half of 20-year-old South Africans are expected, under current mortality experience, to reach 65, and the prognosis for poorer citizens is worse than for the population as a whole, the decision not to save for retirement, particularly if access to savings prior to retirement is limited, has a strong rational foundation.
- **Affordability.** Disciplined saving of a fixed proportion of income is more difficult for lower income individuals than for their wealthier counterparts, not necessarily because that proportion may mean more to them, but because this group of people tends to suffer much greater volatility of income and outgo. It is more difficult for the poor to insure (or self-insure) against catastrophe and much more difficult to manage volatility if a fixed proportion of income is being directed to another goal.
- **Community.** The research found strong evidence of mutual protection within communities, with individuals both giving and receiving remittances in the course of a year. A program of disciplined saving, while good for the individual, may not be as helpful to the community.
- **State provision.** The means test of the old age grant in South Africa tends to reduce the marginal propensity to save. Individuals interviewed were not always sure how the means test worked, but they were aware of its existence and were nervous about accumulating too much in assets themselves, in case it reduced their access to a state grant.
- **Alternatives.** With considerable sophistication evident in their thinking, many of those interviewed explained how education – whether or not they expected their children to look after them in the years ahead – and housing took precedence over formal saving. Bricks in the yard, for example, were regarded as more tangible than a bank statement, for they hold the promise of a roof overhead, improved social esteem, and an income-bearing asset.
- **Unattractiveness of formal products.** The large majority of formal-sector bank, insurance or investment products designed to accommodate long-term saving were described as inflexible, intangible and inappropriate to need.

The implications of this research for policy are significant. A policy of compulsory saving may not be appropriate at all levels of society. Savings needs to be defined more broadly. Rather than imposing (often rather complex) financial products on individuals, ways should be found to allow the accumulation of appropriate assets, at an appropriate pace, and matching real needs. Finally, policy needs to be holistic.

These findings suggest that the informal saving arrangements (discussed below) both

- complement state old age assistance programmes, whether universal, as in Botswana and Mauritius, or quasi-universal, as in Chile, Brazil and South Africa, and

¹⁷ Context is important. Among the payments made under the social assistance program in South Africa is a means-tested old age grant paying at a level, over USD100 monthly, that is generous by the standards of the country (and its widespread poverty) and has positive impacts on the extended families of the recipient (Duflo, 2003, Ardington *et al*, 2007).

- substitute for other formal public or private pensions contributory programmes that are not generally well suited to the needs of those in the informal sectors.

Whether they are able to meet savings objectives as well as their formal-sector counterparts is open to question, but they are surely better than nothing, particularly where the state social pension is paid at a low level or is completely absent.

But the most important lesson for those involved in the research was this that policymakers need to work harder to understand the needs of the people that they seek to serve. Scrutiny of the financial activity of those who survive on low levels of income shows heterogeneity of objectives and strategies, high levels of financial awareness and sophistication, an understanding of the different places for saving, borrowing and insurance, and a blurring of the perhaps rather synthetic distinction between short-term and long-term saving activity.¹⁸

Communities have other ways of meeting goals

Remittances form a very important part of the global financial system and governments should do everything they can to facilitate the smooth operation and low cost of money transfers like these. Nevertheless, concerns across the world that the family structure is no longer providing the support to the elderly that it used to appear to be valid.¹⁹ Mobility is improving and, with it, urbanisation and cross-border movement. The social obligations of family seem to be fading.

Communities support one another through catastrophe, often literally by sharing, more commonly by forming clubs or groups intended to provide a combination of saving, usually rather short-term in nature, and insurance, frequently to cover some or all of the costs associated with a funeral. Individuals are willing to contribute a relatively high proportion of their income to save in community schemes offering a mix of benefits, though generally not on a long-term basis.

Should it be cause for concern that long-term saving is not the norm? For a number of the reasons identified in the South African study, saving for the distant future is not always rational, so difficulty finding these types of arrangements should not be a great surprise.

Nevertheless, longer term saving exists at grass-roots level.

- Indian women have developed a culture of saving in gold, gradually accumulating what small amounts they can gather together until they have sufficient to change it into an item of gold, often jewellery, which they purchase from their local jeweller and then use frequently not as a sellable asset but as collateral for credit. This practice has been taken one step further: instead of converting the cash to gold, the jeweller writes a promissory note, acting as informal deposit-taker.²⁰
- Self-help groups exist in a number of forms, but have in common the bringing together of poor people – usually women – for mutual support, practical advice and a commitment to uplifting themselves and their families through saving, growing crops or vegetables, and in some instances obtaining or granting loans. These groups provide encouraging examples of long-term provision that may not necessarily be focused on retirement, but give the opportunity for a more comfortable period of old age. They frequently band together into local and regional organisations with the

¹⁸ The Financial Diaries studies (Collins *et al*, 2009) measure in details the cash flows and balance sheets of a number of households in Bangladesh, India and South Africa, providing unique insights into their motives and activities.

¹⁹ Also, remittance flows are dependent on economic conditions, as recently demonstrated.

²⁰ Women in this study in southern India (Alcala & Koshy, 2007) also buy land in instalments, a saving activity with long-term benefits, surely,

scale to influence political office bearers to improve the provision of government services to the benefit of villagers.²¹

- Village savings and loans schemes in India and Africa, notably in the countries of the Sahara, mobilise saving by putting it to work, lending to fellow-villagers at a rate appropriate to make a reasonable profit each year, which is often then rolled over into the new year of operations. Schemes are always independent and self-managed. Those who work with these groups²² suggest that, perhaps paradoxically, they operate most successfully in conditions of poor literacy – they use a very simple record-keeping system understood by all members – and in areas isolated from developed financial services and infrastructure, since they are mutually self-sustaining and built on the foundation of trust.

Village savings and loan schemes are similar to self-help groups but differ in that they are rarely linked to external sources of finance, they use simplified record-keeping methods and they are time-bound, sharing out all capital and accumulated profits at the end of the period. This simplifies record-keeping, but does not rule out long-term accumulation. The capital is often re-used at the beginning of the next year and instances of schemes with portfolios of between USD2,000 and USD5,000 are becoming more common, with some managing up to USD10,000 (CGAP, undated, VSL Associates, 2007).²³

In summary, policymakers have a long way to go to understand the full range of approaches to long-term provision in the informal sector, but it is possible to identify some of the attractions of these systems. Some of these benefits are not unique to these informal-sector schemes, like liquidity, ease of access to money, though replicating them in formal arrangements would not be easy or cheap. But they also offer benefits that could surely only be achieved at community level, excellent ease of access, for example, low levels of intrusion from regulatory constraint and the extraordinary levels of trust.²⁴

Government support: bringing the formal and informal together

Policymakers seeking to improve the long-term position of their people in such a variety of conditions face many challenges. Two principles should underpin any government efforts to bring together the structures developed for the formal economy with the corresponding needs – in many countries considerable – in its informal counterpart:

- to ensure that the development of government policy is coherent across areas of responsibility, working consistently to meet the most important objectives most effectively, and
- to make every effort to understand and prioritize the needs of those that the policymaker seeks to assist and serve.

²¹ The model established by Sinamandla in South Africa, over seventeen different sites covering hundreds of villages, mandates saving as a condition of participation, but at levels that are agreed upon by the members of the group, as low in some instances as ZAR0.50 (USD0.06) weekly.

²² They are promoted, among others, by CARE and VSL Associates. Donor funding is usually required to establish a scheme in a particular village, but external support phases out within a year or two, leaving a sustainable scheme.

²³ This calls into question both the apparently short-term nature of the arrangements and the claim that external finance is required to support them and provide meaningful levels of credit. Incidentally, the village saving and loan model mobilises finance for loans more effectively than the microfinance networks can by sourcing it from within the community in which borrowers live (forward by Jeffrey Ashe to Allan, 2002).

²⁴ To top it all, many of these arrangements provide relatively high returns to savers along with low rates of default. It is difficult to imagine a shareholder in a village saving and loan system opting to forgo the return opportunity and contribution to the community in favour of an intangible remote investment in a vehicle that is difficult to understand, very difficult to access and provides unknown but generally poorer returns. How much worse it might be for a policymaker in the national capital to force this form of saving on the relatively wealthy villager.

Both of these are enormously challenging. Through parliamentary and inter-ministerial structures, most governments make a serious attempt at meeting the first imperative but too often fail in efforts to achieve the second. Understanding the needs of the people is surely the foundation to all policy, but it requires a dedicated commitment to research that includes not merely the gathering of information but a disciplined enquiry into the currents underlying that data.

National statistics may provide a measure of overall employment, for example, which could be refined through analysis of household- or census data. It takes careful research, however, through open-ended enquiry, to understand well the dynamics of employment and the survival strategies of those labelled ‘unemployed’ in the large but not necessarily insight-providing statistical surveys.

Another analogy in banking helps. FinScope is a consumer perception study run by FinMark Trust that looks at people’s interaction with and engagement in, the financial sector. It runs in a number of countries, all but one of them in Africa, and has reached its seventh iteration in South Africa. The headline figure in that country is that use of bank accounts is increasing. More valuable than this, however, is the set of reasons for not having a bank account and the corresponding lists for those who were previously banked against those who have never had a bank account. Even better is a breakdown of these figures by geographical region and socio-economic group. This information helps policymakers interested in improving the reach of banking services to understand why people are electing not to use banks and where more attention needs to be laid in the pursuit of a policy objective.²⁵

In the area of financial education, measuring people’s knowledge of financial services terminology is helpful, particularly when the same data is available by education level, but it is even more useful to understand people’s *desired* financial knowledge. The success of financial education initiatives is likely to be greatest where it matches the perceived need.

Banking access and financial education are both linked to the success of a national saving initiative, mandatory or not. Policymakers should seek to understand their citizens’ perceptions of long-term saving rather than taking it as read that, since it is broadly rational to engage in income smoothing, everybody will seek to do so given the opportunity. Government is in a position to play a strong role in facilitating such research.

The question remains, should be more directly involved in the promotion of informal sector provision. This is for policymakers in each country to decide on the basis of their priorities and capabilities, but most important the needs of their citizens. The initiatives across much of India show what can be achieved in facilitating saving by the very poor with the assistance of government and the initiative of private sector entities, but success is attributable not only to the efficiency of the platform and the support of government but a strong and diverse partnership and a serious commitment to understanding real needs.

This then facilitates the development of coherent policy. By way of summary, some of the areas in which policy can improve the opportunities for long-term saving are:

- sound banking and insurance environments with a sensible balance between prudential regulation and opportunities for innovation at the customer level;
- good investment in telephony infrastructure to improve the opportunity for technological innovation in banking, insurance and saving, that could expand the reach of these products and reduce their costs; and,
- a sensitive appreciation that communities often engage in strong, coherent, independent and secure methods to improve financial standing.

²⁵ The growing proportion of the unbanked in South Africa who have a mobile telephone, for example, has recently crossed the 50 percent threshold, with important implications for banking models.

Though there may be ways to facilitate these systems, for example through permitting microfinance institutions to collect pension contributions and pay out benefits, care needs to be taken to understand what works in these systems and how central involvement might change their dynamics.

IV. CLOSING COMMENTS

Informality of employment is an established feature of working patterns on the African continent and in many other developing countries.²⁶ Even if this represents at least partly a natural response to the failure of formal sector enterprises and the state to adjust policies, it appears to have created a generation of do-it-yourself citizens with little connection either to formal-sector employers or to the governments that serve them.

This makes the roll-out of centralised programs challenging, particularly those that require an active decision of citizens to participate, even more when such participation involves a financial contribution with pay-off only in the distant future.

Mandatory national saving systems fall into this category. Since the infrastructure that might enable coercion by policymakers does not, in the majority of cases, extend deep into the employment- and community structures of working age citizens, *incentives* to participate may prove to be more important and more effective than a *mandate*.

Governments embarking on such a program effectively have a product to sell, and may need to work hard to sell it. To do so they must put substantial effort into understanding the needs and aspirations of their customers.

²⁶ “In recent years, the informal sector in Africa has been celebrated for its ability to generate employment, income and skills outside of the regulatory framework of the state. Much of this optimism has been fed by the rapid expansion of the informal economy as the state and formal enterprises fail to adjust rapidly to the structural adjustment policies of the 1980s. Thus, rather than the informal sector playing its previous supplementary role in the provision of employment and welfare, it is now expected to be the primary medium for sustaining the livelihoods of millions of people who have been retrenched from their jobs, or whose incomes are no longer sufficient to support basic needs.” (Meagher & Yunusa, 1996: preface)

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