Retirement reforms: Implications for public servants

A paper by the Public Servants Association (PSA)

Introduction

On 27 February 2013, the National Treasury Department issued a document titled: "Retirement reform proposals for further consultations." This came about as a follow-up to the announcement made by the Minister of Finance, Honourable PravinGordhan, in the 2012 budget speech. The 2013 document is a culmination of a long discussion on the transformation of the pension sector dating as far back as mid-2000. While the proposals back then were too general, the current document has made specific proposals that would have a long-lasting impact on the retirement investment sector.

Although the target date for the implementation of the proposals is 2015, it is important for the Public Servants Association (PSA) to engage them now for two reasons: (1) to make our members ready for the changes to come, and (2)to offer our union's perspective on the proposed reform with the view to contributing to the policy discourse.

Our general approach is that the proposed reforms must first and foremost not leave employees worse off. Secondly, the reforms must safeguard the government employee pension fund. Thirdly, the vested rights of individual employees should be protected. In other words, the principle that pension is individual money and the individual must have access and discretion regarding the use of his her money must remain. The best government can and should do is to create an environment that encourages savings. This, in the end, would be good for employees.

Context

The primary purpose of a pension fund or scheme is to prevent old age destitution, reduce dependency on the state, and inculcate a culture of saving and long term planning among the people. It is precisely for these reasons that governments all over the world feel they have a duty to encourage, induce, evencompel workers to become members of pension schemes or contribute to retirement investment schemes.

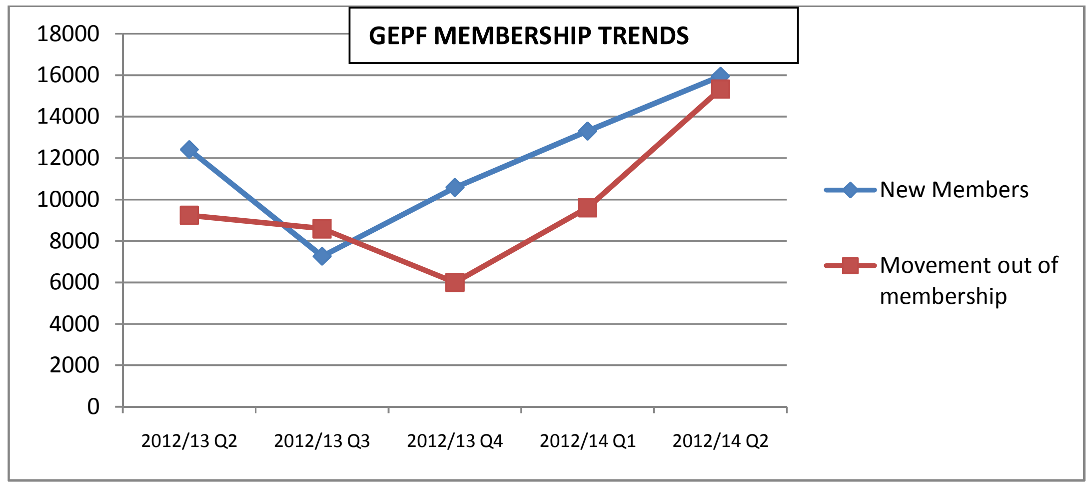
In South Africa there is a growing concern that too many people retire without adequate resources to sustain themselves. A recent surveyby Sanlam (2013) found that more than 51% of South African pensioners cannot make ends meet, while 78% were not satisfied with their income. This is because 56% of employees start saving for retirement too late.[1]This surely increases the burden on the state to provide for old age welfare support.

The salaried segment of our society is swamped by debts and has little left to save for retirement. Recently, the Reserve Bank reported that the ratio of household debt to disposable income was standing at 76.3%.[2]Access to non-secured loans and credit is a major contributing factor to this. A great number of South Africans spend their salaries to service debt on consumablesinstead of investingfor retirement. It is against this backdrop that government seeks to "nudge, rather than force, individuals into making decisions which serve their long-run interests."[3]

It is worse for low income earners. Either their jobs do not have retirement benefits or they do not earn enough to save for retirement. What is surprising, though, is that the majority of low income earners prefer to save for death. BothoMolosankwemakes the observation that most low income earners have "jobs [that] do not have benefits such as a provident fund and medical aid, and they will have to depend on the government to take care of them in old age. Still, many are paying the little they have to burial societies that, in most instances, also cover their unemployed relatives."[4]This is indeed a complex cultural condition that deserves to be a subject of a focused study.

The absence of a culture of saving is further illustrated by the sudden withdrawal of membership from pension schemes when people hop from one job to the other. Instead of preserving their investments, members choose to cash their benefits and spend the money they were supposed to save for life after retirement. This culture is also highly prevalent in the Government Employees' Pension Fund (GEPF).

As the graph below illustrates, GEPF membership losses rise from the fourth quarter. Coincidentally, this is the same time that GEPF issues benefit statements to its members. This means that as soon as members start to see their benefit statements, they opt to cash out and terminate their membership to the scheme. In most of these cases, this moneyis not saved for preservation and use after retirement, but is spent on consumables leaving the members dependent on state support at old age.



Source: GEPF

There is an important question here: How best could we reduce the burden on the state to provide a social security safety net? The biggest headache facing South Africa is that too few people have the opportunity to work. Unemployment figures are astronomical, reportedly at 24.7% by the third quarter of 2013.[5] Over 17 million or more than 34% of the population is dependent on state support for their livelihood. It is only through employment creation that these millions can be rescued from the jaws of poverty and reduce their future dependence on the state.

While government has been experimenting with such schemes as the job creation fund, their impact on the country's employment profile is yet to be felt.

The need for more saving and investment in South Africa cannot be overemphasized. One of South Africa's leading economists, Chris Hart, suggests that South Africa must achieve a 30% rate of investment if it were to reduce unemployment significantly. Currently, the investment rate is at 19% of GDP, while the saving rate is at 13% of GDP.[6] It is investment that will stimulate employment creation and subsequently reduce income inequality and poverty.

There is a global context to this. South Africa cannot ignore the changes that are taking place in the world. The 2008 global financial crisis was a sobering example. As the ILO notes, "The current global financial and economic crisis has led to increases in public deficits and public debts in many countries, placing strains on the financial equilibrium of their pension systems. In response, governments have typically accelerated the pension reform process in order to restore the sustainability of these systems."[7]On her part, South Africaexperienced a worsening budget deficit as a result of the financial crisis, now standing at 4.5% of the GDP.[8] While South African pension funds may not have been severely affected by the crisis, it is crucial that reforms are introduced to prevent the impact of future crises.

Implications of proposed reforms for public servants

In addition to nudging the public to save for retirement life, the strategic objective of the National Treasury proposals is to harmonise tax contributions on retirement planning and to improve regulation and governance of the retirement schemes. Thus the National Treasury proposals focus broadly on five areas namely, taxation of retirement funds, governance, preservation, annuitisation and non-retirement savings. These reforms are in line with international practice where reforms have tended to focus on, among other things, "raising the retirement age, change in the formula for calculating pensions, increase in the number of contribution years needed to access full pension rates and tightening of the rules of access to early retirement."[9]

It is important to note from the outset that the proposed retirement reforms will be applicable to the retirement schemes that are governed under the *Pension Funds Actof 1956*as amended in 2007. This means that since the GEPF has its own separate law – *theGovernment Employees' Pension Law Act of 1996* as amended in 2011 – itwill not be affected by the proposals, at least for now. We say at least for now because Treasury documents suggest that a process is "under way to bring the pension funds currently not governed under the *Pension Fund Act*, including the Government Employee Pension Fund, Transnet, Telkom and Post Office retirement funds, into the purview of the Act."[10] It will therefore be crucial for the GEPF and its members to mull over the proposals for future compliance and fully to understand their implications.

There are obviously some, if not many of our members, who, in addition to being members of the GEPF, are also members of private pension and retirement schemes. It is precisely for these reasons that the PSA takes great interest in the proposed reforms. As the PSA, our interest in these proposals is simply to answer the question: How will they affect our members? Below we tease out the implications of the proposed reforms for our constituency –public servants.

<u>Taxation of retirement funds</u>
The National Treasury proposes a tax benefit of up to 27.5% of the taxable income to retirement funds.

"The employer contribution will become a fringe benefit in the hands of employees for tax purposes."[11] This means that employees will be able to dedicate up to 27.5% of their taxable income for retirement purposes and will derive a tax benefit from this. There is however going to be a limit of up to R350 000 per annum.

For government employees this means that the employer and employee contributions will be declared and appear in the payslips as fringe benefits. Currently,the employer's contribution to pensionable salary of 13%for national department employees and 16% for service (police, teachers, etc.) combined with the employee contribution of 7.5%remain less than the proposed 27.5%. This means, therefore, that national government employees will have about 7.5% more that they can use for retirement purposes which they can dedicate to private retirement annuities. The services employees will have an extra 4.5% to use for this purposes. It must be noted that the Treasury's proposed 27.5% is not compulsory but meant to benefit those that take up the entire percentage offering when it comes to tax. The proposed cap at R350 000 per annum means that employees whose 27.5% of income exceeds R350 000 will be limited up to this amount. More than this will not benefit from tax deduction purposes. This will affect senior public servants earning more than R1.3 million per annum.

The PSA welcomes this proposal;we believe it will encourage members to save. We therefore advise our members to calculate their current contributions to see if they are already at 27.5%; if not, we encourage them to take up to the proposed threshold when the reforms are implemented after 2015 so that they can reap the tax benefits and plan for a better retirement life.

Governance

Government intends to change the current Circular (PF- Circular 130), which guides the governance of pension funds, into a Directive. Whereas compliance is compulsory in a Directive, a Circular serves more as a guide on how a policy should be implemented. Thus, a Directive has more legal force; and through it, National Treasury seeks to enforce compliance with the governance provisions in the Directive.

Another new proposal relates to the appointment of Boards of Trustees of pension funds. It is proposed that trustees must be 'fit and proper' and must undergo training within six month of their appointment into Board of Trustees.This will be enforced through an Act of Parliament and the Financial Services Board.

The PSA cannot agree more with these proposals. Themany incidents of mismanagement of pension funds warrant these measures. The training of trustees is crucial and should be enforced even in the GEPF. Currently, the GEPF Board of Trustees is constituted of 50% of government representatives and 50% of union representatives. These members do require continualtraining on the management of pension funds.

The PSA further proposes that National Treasury should set the minimum standard and curriculum guide to be covered in the training. This will serve to standardise training. Collaboration with the Ministry for Higher Education and Training and private sector should be sought for the provision and accreditation of training as well as to cover the cost of training. Care should be exercised to minimise the cost of training on members' funds.

Preservation

It is proposed that all schemes must identify preservation funds to which members' accrued benefits will be transferred whenever a member decides to leave his employ or ceases his membership to a retirement or pension scheme.

Instead of cash withdrawals upon termination of membership, individual members will be required to transfer their funds into a preservation fund of their choice before they can make cash withdrawals. This will also be applicable to benefits payable emanating from divorce. It must be noted that the Treasury promises that "full vested rights with respect to withdraws from retirement funds will be protected."[12] This means that members will still have access to their funds, albeit that they will have to do it through a preservation fund.

Limitations on the amount to be withdrawn and the number of withdrawals per year will be imposed. In this regard, it is proposed that one withdrawal will be permissible per year up to 10% of their initial deposit to the preservation or the total of monthly old age grant, whichever is greater. This will only apply to funds deposited after the implementation date. This means that members will retain full rights to access the funds deposited to the preservation fund before the implementation date. It is the view of theTreasury that this will discourage people from withdrawing instant cash from their pensions as and when they change jobs or before they reach retirement age.

The retention of the rights of people to access their funds is welcome. This is in line with our view as the PSA that pension is individual's money and access and discretion to use it must remain. Our only concern, though, is that the limitation of withdrawals to one year is too rigid. The PSA is of the view that retirees should at least be allowed two withdrawals per year equal to 10% of their available savings. The is no magic to the number two, but we believe that two withdrawals in a year would allow members to avoid being cash strapped for the whole year when, in fact, they have money lying in the preservation schemes.

Annuitisation

There is a proposal to harmonise the annuitisation requirements of provident and pension funds. The means test of old age grant will be phased out by 2016. The members of the provident fund will still have access to their lump sum upon retirement and will no longer have to be subjected to means test in order for them to access the old age grant. The minimum of R75 000 for annuitisation will be raised to R150 000 and adjusted for inflation thereafter. People who are 55 years and older at the time of implementation will not be subject to annuitisation requirements even on their new contributions. They will be able to make lump sum withdrawals off their benefit.

The PSA welcomes the proposal to phase out the means test for access to old age grant and to increase the minimum annuitisation threshold to R150 000. The removal of the means test means that our members who have saved enough money for retirement will no-longer be discriminated against and can now benefit from the old age grant as well. This means that in addition to the pension pay-outs, our members will also get the old age grant. The increase on the minimum for annuitisation to R150 000 means that those who have saved less than R150 000 in their schemes can access the full amount without being required to follow the annuity procedures.

Non-retirement savings

In order to induce citizens to save, it is proposed that tax-preferred and investment accounts be introduced. As a start, citizens will be encouraged to save up to R30 000 per year and R500 000 in life time, and these savings will be exempted from tax. These will be increased regularly in line with inflation.

PSA perspective

Leading by example

Saving and investing is not a popular culture in South Africa. Neither the government nor citizens exude a culture of savings. In fact, government is leading in this regard and has become notorious with its endless wasteful expenditures. Year in year out, the Auditor General reports exorbitant amounts of wasted money by government. In 2012, government's wasteful expenditure amounted to R24.8 billion[13]and increased to R31 billion by 2013.[14]From the arms procurement deal to Nkandla gate, government is failing to lead by example. The PSA is worried that with incidents of rampant corruption in government and conspicuous consumption by ministers, government will soon lose its credibility and moral authority to prod ordinary citizens to save money.

Government must regain the moral high ground if it were to succeed in its efforts to inculcate a culture of savings among ordinary citizens. It is precisely for these reasons that the PSA supports Minister PravinGordhan'spronouncements during the mid-term budget statement to cut government waste and ministers' extravagance.[15]

It is our view that the culture of savings will only take root when we defeat the demon of crass materialism that has taken over the lives of our people. As a nation, we need to redefine the concept of success and give it new meaning. Currently, expensive cars, designer clothes and expensive alcohol are considered honorific and a symbol of wealth. Conspicuous consumption is the order of the day. As the PSA, we have a duty and responsibility to educate our members about the importance of savings. This we shall continue to do.

Bringing GEPF under *Pension Fund Act*

The PSA will support the decision to bring GEPF under the purview of the *Pension Fund Act*, only if it satisfies the following principles. The decision should not affect members negatively; should not add administrative costs to the fund; and should retain the 50/50 constitution of the Board of Trustees between government and union representatives. The transition into the PFA should not result in the loss of any job.

We also suggest that GEPF should conduct an impact assessment study to evaluate the benefits and disadvantages of taking the GEPF under the Pension Fund Act. The results of this study must be shared with all stakeholders and members before a decision is taken to migrate into the new system.

Discouraging early retirement

Government reforms should discourage people from early retirement. Instead, they should encourage the "live longer, work longer" stance of OECD countries. There are benefits for both country and individuals from this. As Richard W. Johnson and Janice S. Park of the Washington-based think-tank, the Urban Institute, remind us "By working longer and earning more, older workers can boost savings, and shrink the period (that) their retirement savings must fund.Employment at older ages also expands the nation's labour pool, accelerating productivity, increasing national income, and raising living standards for both workers and retirees."[16]Of course, this must take into consideration the peculiar context of South Africa's youthful population and high unemployment. There must be a balance between the preservation and transfer of scarce skills and the need to encourage people to work longer and save more.

Cost effective regulation

We need simple, effective and low cost administration of pension funds. Currently, the model used by GEPF seems to be the most cost effective. With a total of 1.279, 514[17]million members, the GEPF spends an average of R22.13 to administer the pension per person per month. The average in the private sector is at R35.[18] It would be ideal for the National Treasury to regulate the charges for administration and cap it at a reasonable maximum level. A study can be conducted to make comparisons and identify international best practices. This must be done with the sole purpose to reduce the cost of administration and for members to receive optimum benefit from their schemes when they reach retirement. The regulations should also not be too expensive to comply with. They must be simple and yet efficient enough to protect the schemes from potential abuses.

Make savings possible

The PSA is of the view that parallel to pension reforms,other avenues should be explored to make saving an attractive option. The current proposal to induce the general public to save through tax exemption, as in the case of the R30 000 annual tax free savings and R500 0000 lifetime tax free savings, is a step in the right direction. We obviously need more of these. The PSA therefore pleads that the government should assess the impact of these inducements and raise the threshold timeously to encourage South Africans to save.

Minimize risks

When in financial crisis, governments usually fail to resist the temptation to dig deep into the public pension scheme to rescue themselves. This was particularly the case in European countries and America in response to the global financial crisis. As the ILO noted, public pension funds were used by governments in recapitalising failing banks and financing public works programmes in countries like Ireland and Norway. In Hungary it was worse. Pension funds were used to cut public debt and more than €18.2 billion worth of second pillar assets of civil service pension fundswere taken over by government to boost its financial standing in the middle of the financial crisis.[19]This was indeed a desperate measure applied to address a desperate situation, at the expense of hard-earned worker incomes. This is a situation that must not be allowed to recur.

Our biggest concern as a union operating in the public service is that the governance mechanisms should be enhanced to insulate funds from these potential risks. The recent debacle over the Gauteng e-toll, where government pension funds were used to buy Sanral Bonds provides a good lesson for the future. The Boards of Trustees should have exercised caution before endorsing the decision to invest in the e-tolls. The fact that other pension schemes did not want to invest in Sanral Bonds should have been a warning signal for the Trustees of the GEPF. If this project fails, it will be the funds of the government employees that will go down the drain. Financial risks must,at all times, be minimized.

Conclusion

Generally, the PSA agrees with the spirit of the Treasury’s proposals. We think that they will go a long way to inculcate a culture of saving among workers. The tax benefits proposed, such as the 27.5% dedicated towards retirement will serve the interests of workers. The proposed inducements to saving, the tax free annual and life-long savings are a step in the right direction.More can still be done. It will be crucial to assess their impact and increase the threshold timeously to encourage a culture of savings. But government need to lead by example. It cannot nudge people to save while it continues recklessly to spend tax payers’ money. Corruption and wasteful expenditure must be eliminated.

The governance reforms will enhance compliance and efficiency within the schemes. The PSA welcomes the initiative to train all members within six months of their appointment into Boards of Trustees. The training should be continual and must be tailored to empower members optimally to work diligently in the management of people's pensions.

We would like to reiterate our position that pension is individual's money and access and discretion to it must remain. Taking away the right of individuals to access their money would be grossly inappropriate. Thus we welcome the proposal to retain the vested rights of workers to access their funds before and after the implementation of the reforms.

The previous rule to conduct means test for retirees to access old age grantsserved to exclude rather than reward those who save. The PSA welcomes the proposal to phase out the means test for access to old age grant and thereby make it accessible to all.

It would be reckless to migrate the GEPF into the Pension Fund Act without due diligence. A comparative assessment of the state of affairs under the GEPF Law and the Pension Fund Act must be conducted before the decision is taken. The principles of no losses must guide the decision either to retain the *status quo*or to migrate into a new order.

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