RETIREMENT PENSIONS IN MALTA: A HOLISTIC PERSPECTIVE

The decision to opt for one particular system of financing retirement pensions and medical services in the Maltese Islands is political for two reasons. First, it has to be taken by government – that much is obvious! One may debate the issue from whatever angle deemed fit – demographic, actuarial, economic, psychological, regulatory regarding capital movements and quality of services for the elderly. In the end, a political decision will have to be taken. It is this unavoidable step that various governments worldwide keep on postponing, passing on the critical decision from one legislature to another.

Malta is no exception. Several national conferences were held in the past decade on “the pensions time bomb”; studies were commissioned and discussed; and, even, two national commissions/study groups were set up to recommend measures on how the present Pay As You Go (PAYG) system of welfare financing can be sustained as

Based on a paper read during a Seminar organised by the Institute of Financial Services, Malta on *Defusing the Pensions Time Bomb: A European and Maltese Perspective a*t the Corinthia Palace Hotel, Attard on 7 February 2003 the share of the sixty-plus in the population starts approaching the twenty percent plus in two decades time. At some stage, policy makers have to pass from deliberations to action.

Indeed, in the budget speech for fiscal year 2002 the Minister of Finance proposed that the present systems of allocating costs under the social security account will be altered: contributions will cover the costs of contributory retirement pensions, care of the elderly and health with revenue split on a 50:50 basis. The other benefits under the 1987 Social Security Act, amounting to circa Lm108 million in 2003, will be financed directly from the consolidated account. Health care is to fall under a health insurance programme. (Budget Speech 2002: 26-29)

The arrangement indicated by the Finance Minister leads to the second reason. There is a reconsideration of the fundamental relationship between the individual and the collective, represented by the State, with regard to the allocation of resources in an economy over a time period and the terms on which such resources may be exchanged. It demands an assessment of the social contract. Over time, successive Maltese governments built up an extendable income and consumption support network for individuals that demanded in the first place the transfer of resources from households to the public sector. Many, if not all, came to assume that such complementary income-support systems are here to stay and they acted accordingly when they entered into long-term financial commitments.

The social welfare network in the Maltese Islands is quite extensive. It covers housing, education, medical

services, and care for the elderly: such schemes boost personal incomes directly, like students' stipends, or personal consumption. In addition, social security payments under the various contributory and non-contributory schemes – including, unemployment, widows', sickness, and retirement income benefits - ensure a regular flow of resources at the disposal of individuals or households. The purchasing power of such income will depend on the consumption needs of the individuals and the prices at which commodities are exchanged.

The projected allocation of tax financed services for social welfare in 2003 amounts to Lm 375.8 million out of a total recurrent expenditure of Lm 677.4 million, representing 55.5%. These include the outlays on social security and welfare (under the contributory and non-contributory schemes), health (Lm73million), care of the elderly (Lm13.5million), education and housing. An additional Lm22.9 million are allocated for pensions to retired civil servants, members of parliament or the widows of former retirees. The income support programme rises to Lm398.7 million, or 58.9% of the recurrent outlay. Besides, if one considers the subventions of Lm31.7 million given by government to the recurrent and capital budgets of several corporations, thereby supporting employment in these industries, the 'welfare budget' in 2003 increases to Lm430.4 million, or 60.7% of the adjusted 'recurrent expenditure' amounting to Lm709.1 million.

The funding of pension schemes is carried out on different assumptions from the financing of medical care.

In the case of retirement pensions it is assumed that the majority who save will reach retirement age while for medical insurance it is assumed that many of the insured will not claim benefits at any time period. This presentation focuses primarily on the issue of pension funding.

The costs of "retirement pensions" will reach Lm117.1 million in 2003, made up of Lm87.6 million on pensions under the contributory scheme, Lm7.5million under the non-contributory Old Age Pension Scheme, and Lm22.9 million going to 13,200 former members of the civil service, police, the armed forces, members of parliament and their widows. This outlay represents 17.3% of the recurrent expenditure for 2003. At a rate of return of 6% per annum, the pensions bill represent an imputed capital stock of Lm1.95 billion, being 2.2 times Malta's official foreign reserves in December 2002 of Lm873 million.

Pension plans are not an end themselves. They are a means of allocating lifetime consumption. The aim is to ensure enough resources, from own means or supplemented in cash and kind from the means of others, in order to gain command over what may be termed a 'socially acceptable' living standard. This level changes with time both in terms of the goods and services included in a 'basket' and in terms of the monetary value that such a basket is worth. Hence, individual pension plans have to be considered in relation to a person's ability to save; the opportunities available for such savings to earn positive rates of return that rely ultimately on the prospects for economic growth worldwide, given freedom of capital

movement; and the possibility to participate in income and wealth creation.

Discussions on pensions and insurance in the Maltese economy have to be based on a set of considerations and facts. Several of these have already been taken up in other fora and publications.(Vide. Delia, 1993; 1998; 2002:71-91; 117-141) These facts and considerations are presented first. In turn, several theoretical observations are introduced and, finally, a number of policy related propositions are examined.

1. The Background: Facts and Constraints

Factual data may be organised under various headings: demographic, actuarial, income distribution and poverty levels, policy: actual and prescribed, and fiscal.

Demographic Considerations

- The Maltese population is projected to be around 400,000 by 2025. However, if the present fertility trend persists in the future, the population will start falling steadily thereafter, 360,000 in 2060 and 306,000 in 2100. Half a century may appear to be a long time ahead; but it is not really that long for pension consideration! The socio-economic implications of this massive demographic upheaval are tremendous. Maltese society is ushering in the time frame that will witness a peak of postwar baby boomers reaching the sixty-plus bracket after 2005. Twenty years after that date, the effects of the decline in fertility will make themselves felt. The average live births per marriage fell from 5.1 in 1945 to 1.9 in 1995 when the last census was held.
- Males exceed females at all ages 0 to 49. The gender gap is wider in the 10 to 49 brackets. In 2001, there were 111,100 males and 92,400 females, giving a ‘surplus’ of 18,700 males. The implications of these gender-age differences for interpersonal relationships, family formation, and extra-community marriages are many.

- Life expectancy at birth is 75 years for males and 79.29 years for females. At age 60, it is 22.82 years for males and 26.32 years for females.
- The population aged 15 to 64 was 259,700 in 2001; it is projected to be 250,700 in the year 2025. At the same time, the population aged 0-14 and 65 years and over is seen rising from 123,600 to 151,700. The relationship between the potentially active population and the potentially dependent cohorts is seen falling from 2.1 to 1.65.
- There were 64,700 Maltese aged sixty and over in 2001. There will be an estimated 104,800 in 2025. The 'old old', those aged 75 and over, are projected to rise from 19,000 in 2001 to 34,400 in 2025.
- The Maltese elderly are physically and mentally healthy. They are also more socially interactive than in the past. However, they tend to suffer from chronic, non-communicable diseases such as arthritis, high blood pressure, and diabetes. Such illnesses are costly to control but they do not hamper the state of well being of the elderly nor do they render them functionally disabled. Females are more prone to such diseases than males.
- These data point at the role of productivity enhancement in order to support a sustained welfare programme by households and by government. There is a pending liability with future retirees in order to support their pension programmes. The sixty-plus of the year 2025 are the present thirty-five plus. Their expenditure pattern and expectation for life are very different from those of the present seventy-five plus! (Delia, 2002:117-141)

1.1 *Income Considerations*

- The median income for Maltese households who participated in the Household Budgetary Survey 2000 was Lm3394 at purchasing power standard. It is estimated that 15% of households in the income range surveyed by the HBS have an income below the 60% level of the national equivalent income median i.e. below a standardized income of Lm2033. Fifty seven thousand persons are thought to fall under this level. However, one fourth (25.3%) of one-person household aged 65 and over fall below the poverty threshold, and another quarter (24.6%) of couples with one member at least 65 years, may also be considered to be poverty-prone. (National Statistics Office, 2002:Table 38 – Vide Annex 1).
- If social transfers were excluded, 30% of sampled households will be at risk-of-poverty. Once pensions are included, this proportion falls to 21% dropping further to 17% when account is made of all social transfers (NSO, 2002:41).
- Males are more at risk of falling in the poverty trap, whether they are employed or unemployed. Women record higher incidence for the inactive group. There is no difference for retirees.
- Official data suggest a falling household saving ratio.

The average propensity to save ratio fell from 14% of the early nineties to 1.4% in September 2002. (Economic Policy Division, 2002:43). The reliability of saving statistics is a moot issue; yet the observed trend in household saving cannot be omitted from considerations related to the possible funding of pension schemes. (Delia, 2002:245-260)

- However, past savings are significant. Seventy percent of Maltese households are homeowners; many are bond and shareholders in locally listed companies. Deposits in domestic financial institutions alone amounted to Lm2.6 billion in December 2002!

1.2 Actuarial Considerations

- Costs of pension plans are gender related. Since women live longer than men, they ought to pay higher premiums per time period.
- Costs are also dependent on the age of retirement: the longer the working life, the lower will be the periodic contribution required to build up a capital base on retirement – the less one has to save or the more one may consume. (Vide Annexes 2 and 3)
- Costs depend on the income targeted: the higher the real income target on retirement, the higher will resources saved have to be.
- Costs depend on the imputed inflation rate (the accumulator), the return on investments to which the savings are committed (the yield), and to the difference between the two (the yield gap). The higher the yield gap, the lower the periodic contribution will have to be; the lower the yield gap, the higher the contribution.
- Life insurance premiums in Malta increased from Lm5.6 million in 1992 to Lm23.4 million in 1999. The sums assured increased from Lm460 million to Lm1047 million. (NSO, 2002a: 227).

1.3 Policy Considerations: Present set up

- The social security system is based on a tri-partite arrangement incorporating employees, employers, and government or, in the case of the self-employed, a bi-party scheme between the self-employed and government. Altogether they contribute 30% of earnings capped at Lm6750 per annum. Maximum pension is set at two-thirds of said cap, namely Lm4500 adjusted annually for cost of living allowances. Entitlement to this pension is the official retiring age of 60 years for men (optional 61 years) and 60 years for females. Self employed 'retire' at 65 years.
- There are income constraints for retirees between the ages of 61 and 65. Pension can be supplemented without any loss if additional income is less than the national minimum wage. There is no such limit after age 65. Retirees do not pay weekly contributions.
- The retirement pension is based on the best three years of the last decade of working life. The pension is intended to reflect the salary attached to a particular post and it is reviewed accordingly. Pensioners receive cost of living adjustments, as dictated by government

– two thirds of the cost of living adjustment given to workers, up to year 2002; full adjustment from 2003 based on a separate price index that is based on the expenditure pattern of the elderly sub-group – it may be claimed that, in principle, pensions in Malta are wage and inflation adjusted up to the specified maximum.

- There are no gender differences regarding contributions. Weekly contributions are earnings and not gender related.

1.4 Policy Considerations: Proposed Changes

International organisations and local study groups put forward several proposals to modify the existing pension funding worldwide and in Malta. These are:

- Introduce a multi-tiered (pillared) pension scheme with one tier (pillar) being mandatory and state run and based on taxation, another tier being also mandatory but contributors are free to chose the vehicle through which they save, and a third tier of saving is voluntary. Third tier commitments will be, ideally, income tax exempted.
- Increase retiring age to, say, 65 years. Those who retire earlier will continue paying their weekly contributions until that year.
- Retain the PAYG system, but pensions will be determined on 'lifetime' earnings not on the best three over a defined period. The pension thus established

will then be inflation-proof, with annual cost of living adjustments. The reference to earnings will not be retained.

- Internationally, several variants based on the PAYG system or on funded schemes have been put forward for consideration or actually implemented. But, in Europe at least, no radical break with the past has yet been recorded (European Central Bank, 2003: 39-53). Pension system reforms keep resurging in various countries a few years after 'reforms' are supposedly introduced. In itself, this performance is an indication of the complexity of the intended reform, which cannot be undertaken in isolation of the economic performance and the other fiscal measures being considered. Changes in the existing retirement pension schemes are only one factor in a comprehensive assessment of the state's welfare support set up.

Quite expectedly, there are conflicting views. They are:

a) The relative viability of the present schemes in place. Thus, in Malta both trade unions and pensioners' associations sustain that the scheme is actually self-financing at present if the medical bill and other family support income transfers, such as children's allowance, are taken off the pension account. Surpluses will be annually recorded if the weekly contributions were to be solely allocated to finance retirement pensions. Such organizations repeatedly insist that the present 'welfare gap' – defined as the difference between payments of schemes under the Social Security Account and the revenues received – arises because other payments accruing under a non-pension item, like health or children's allowances, are paid from said account. They also condemn the arbitrary way in which one-off benefits to particular categories of recipients are introduced, often on the eve of a general election. Such ad hoc entitlements are considered both inequitable with regard to would-be beneficiaries, since some who would be eligible may not be informed in time, and to the gainfully occupied who have to support such initiatives.

b) There exist serious doubts regarding the welfare impact of transferring the responsibility to support the pension scheme from the collective – under the PAYG system – to the individual – under a truly funded scheme. The view of a multi-pillar pensions support set up, advocated by the World Bank, is primarily meant to encourage saving, investment and output growth. However, other organisations, like the International Labour Organisation, have grave doubts about the impact such saving format will have on future retirees. With an ageing world, the number of retirees cashing in their past pension entitlement in any one given year may exceed the income available for newcomers in the labour market. The only way such pension titles could materialize is for their price to fall. Retirees will, as a result, collect a lower sum than anticipated. Add to this the additional administration costs, and the expected benefit,

expressed in terms of a pre-determined yield, will not be attained. If, at the same time, interest rates will fall to record a lower inflationary environment, if not an outright deflationary situation as happened in Japan in recent years, then retirees will be even worse off.

c) The attraction of funded pension schemes is critically reliant on several conditions. These are the free movement of capital worldwide in search of the highest attainable rate of return, coupled to sustainable and reasonable rate of global economic growth, an effective supervision of pension funds management and a reliable set up of company accounting. Unless these conditions occur simultaneously, the reallocation of income flows through savings cannot be reasonably guaranteed with the result that the efforts over a lifetime of savings will be dissipated. Would-be beneficiaries could become suddenly exposed to income shortfall at a time when their chances of maintaining employment may be drastically reduced and their basic needs become even more cash demanding. The recent experience of lack of credibility in the system surveying company accounts, as well as the inability of regulators to identify stock market shortcomings, have burnt out billions of would-be pensioners saving. Add to this the fraudulent use of pension funds, or the lack of adequate funding facilities, by some company managers, and the grave exposure of personal borne pension risk will forcefully emerge.

d) Funded pensions are generally complemented by health insurance measures. Hence it is the total cost of health and pension support that has to be accounted for. Personal saving at any time period must account for both apart from supporting other forced saving initiatives like the financing of a mortgage! It is evident that no welfare support initiative can be undertaken without reference to the health of public finances and the rules governing the state's welfare programme.

e) Since 1990, the Maltese government pronounced itself in favour of a welfare support network based on the principles of participation, solidarity, empowerment, subsidiarity and decentralization (Ministry of Social Policy, 1990). This policy document bases greater reliance than hitherto on the principle of self-help. But very little has been done to implement such policy guideline, especially in terms of the financing of welfare measures. There has been the integration of the income tax schedule and the entitlement to children's allowances, where a cut-off income level of Lm10000 was established. But, to date, that has been practically all!

1.6 Fiscal Policy Considerations

- The Ministry of Finance records the income-expenditure flows on a cash flow basis. As yet, it does not complement such accounts with balance sheet and/or intergenerational accounting. This means that while social security contributions and payments in a given year are recorded, the corresponding future

liabilities/commitments that the Maltese government bound itself to remain unknown. Changes in the financing of pensions will have to account for these commitments.

- The government's budget has been in deficit for many years, and it is expected to remain so for the foreseeable future. It is the objective of the Finance department to reduce the structural deficit to around 3% of Gross Domestic Product in a couple of years. Under such financial circumstances, with no budget surplus in view, no fund can be financed without adding further interest rate burden to account for future welfare commitments under the pension scheme. The same consideration applies for any fund that government may deem fit to set up in order to meet eventual future commitments.
- If account is taken of the items of a 'recurrent nature' recorded under the capital budget, like subsidies to pay interest payment due by certain public corporations, then it may be claimed that the government saving tends to zero. With households' saving tending also to zero, the financing of investment will have to rely on the running down of past savings or on international credit, grants or foreign direct investment (FDI).

1.7 Summary

Malta's population is growing, ageing and becoming more dependent on future productivity growth for supporting an expanding dependent group, especially in the seventy-five plus age bracket. Commitments exerting pressure on households' saving needs must account for the observed phenomenon that both Maltese households and government record saving ratios that tend to zero. Far off seems to be the households' saving rate of 14% of the nineties.

The present social security contribution system is based on income alone and omits entirely gender considerations. Shifts in pension financing systems must, therefore, account for this condition as well as on the suitability of local regulatory institutions to support large funds, and supervise efficiently and effectively their movement and use. Unless the saving of would-be pensioners is safeguarded, these eventual retirees will end up worse off than at present to the detriment of all concerned.

2. Some Theoretical Observations

Pensions are an instrument by which individuals spread income over the lifecycle. Under the PAYG system, in place in Malta, the pension scheme is regulated and, in part, funded by government. Current workers and employers finance the payments made to pensioners. Employers' social security contributions are labour costs to them. Excluding other employment related benefits, these contributions imply that employers value labour costs at 1.1 (wage bill). If income tax considerations are omitted, employees equate take home pay with 0.9 wages up to any specified capped income level. The Malta Government contributes its share as employer and has to raise resources equal to one half of the combined employee/employer contribution and an equal amount to the resources put in by the self-employed to complement the private sector's contribution. These resources will have to be raised from general taxation.

For the pension budget to balance, $twL = pD$ where t = payroll tax, w = earnings, L = number of workers, p = pensioners' income, and D = number of pensioners. Rearranging, we get $t = pD / wL$

The burden of the pension system rises as the old aged dependency ratio (D/L) increases, or as the benefits become more generous, p/w. Government cannot effectively influence D/L; they can control p/w.

There are several issues related to decisions regarding p/w. One relates to potential trade off between production and distribution – between efficiency and vertical equity;

another refers to equity between the sexes, and a third regards the generation of caring services particularly for an increasing number of the old-old, those persons over seventy-five years.

Under the PAYG model, payments to current pensioners are financed out of contributions of working members. In funded pension schemes, the pension funds are invested in assets and it is the return from these investments that provides for retirement. With the introduction of funded pension schemes, today's young save with the aim of receiving benefits tomorrow; today's retirees receive nothing, because there is no fund to pay them interest.

Under a PAYG, the older generation derives an immediate benefit from the contributions made by the young. Such a system can be considered a 'Pareto improvement' i.e. an increase in one person's welfare without making someone else worse off, as long as the sum of the rates of growth of population and real wages is greater than the rate of interest.

If population falls instead of rises, then real wages growth will have to compensate for such a decline.

Retirement pension schemes can be occupational, usually organised around a workplace or union, or personal arranged directly between the individual and an insurance company or other financial institution. A ***defined benefit*** (DB) scheme pays out according to a formula, generally related to the number of years at work and the salary in the final years of employment. Under a ***defined contribution*** (DC) scheme, individuals receive whatever return has been achieved on the funds invested on their

behalf. Typical occupational pensions tend to be DB, while personal pensions are almost always DC. Both types of schemes involve risks: DB schemes are usually less portable, so that individuals suffer if they switch jobs or if the final salary is low. With DC schemes the level of pensions depends on the position of the stock market.

Government intervention in the pensions market is often justified in terms of securing the purchasing power of pensions by countervailing inflation through cost of living adjustments; individual myopia leading to preference for present consumption rather than future consumption and, as a result, an under-investment in future pension plans; and, the ensuring of equal access to resources for all throughout a person's lifetime.

These arguments call for some form of government intervention but not necessarily the implementation of a tax-financed pension system. Depending on the degree of openness of the capital market and the investment opportunities in the country of origin, a portfolio of inflation-linked bonds could countervail inflation. Similarly, mandatory 'minimum' private pension plans could countervail individual myopia and bring about access to resources throughout one's lifetime.

One may also consider arguments related to horizontal equity particularly between sexes. Women tended either not to work outside the home and hence do not earn an income on which they could pay social security contributions, or they could be concentrated in low-pay jobs and, as a result, become entitled to lower retirement pensions. Against this, it may be argued that women live longer than men, but they do not pay premiums that reflect this longer life span.

With an increasingly ageing population, resulting in higher dependency ratio, ***D/L***, under a PAYG scheme, either the benefits enjoyed by pensioners fall, or the tax burden of workers increases, or productivity will have to grow at higher rates than that attained to date so that the domestic value added rises at above trend level. Therefore, the choice of a pension support system ideally has to consider the impact the system will have on personal (household) saving. Prima facie, it may appear that a funding system that consolidates saving could lead to higher capital accumulation and economic growth.

In a world populated by individuals with finite lifetimes, savings perform two functions: for individuals they allocate consumption across time; for society they provide the means to build the capital stock. These functions need not mesh. In equilibrium, the capital stock may be too low, compared to the level which maximizes per capita consumption; or it may be too high, with consumption below its maximum because too much of each year's production is devoted to maintaining the existing capital/ labour ratio. In this case, a lower investment may be a good thing if there are diminishing returns to capital. In an ageing population, it would be optimal for capital accumulation to decrease.

However there is no solid evidence that a PAYG system leads to the generation of a lower capital stock. Besides, there is always the burden associated with a transition from one form, PAYG, to another, funded scheme. Workers

caught in the transition period will have to continue to pay, through their taxes, for the benefits enjoyed by retirees under the PAYG scheme while saving for their own pension. What happens to the composition of aggregate household demand and investment in these circumstances will be time specific, i.e. it will depend on the impact on the expenditure on the consumption of domestically produced goods and services, the resultant stimulus (positive or/and negative) to investment, and the way in which savings are translated into productive capital assets.

If life lengthens, and working life and productivity do not rise, then the goods and services produced will have to be extended over a longer period; consumption per head will fall. There are no magic solutions to the social and economic issues that arise from an ageing population.

3. Policy Considerations

There are several matters that demand scrutiny, given that no simple ready-made solution exists to the ageing phenomenon and the re-scheduling of resources over a lifetime that go with it. These are examined briefly below.

Risks and Regulators

State PAYG welfare support systems place the onus of safeguarding the value of pensions on governments. A switch to occupational or personal portable pension schemes transfers that responsibility on companies, individuals and fund managers. Since governments in the western world, Malta included, are not expected to give up their responsibilities assumed gradually over the past century, there has still to be a firm commitment by the State to continue supporting welfare programmes, pensions included. In the end, however, governments' abilities to meet their pronounced social commitments are bounded by their success in raising tax revenues, which, in turn, are the product of the tax regimes and economic output. Besides, payments have to be collected in time and in volumes due, while effective controls are also carried out on expenditures. In the case of the welfare system, this implies curbing abuses and exercising cost-effectiveness throughout.

A PAYG system has to ensure the collection of payments due and the control of social fraud. Failure to do so will jeopardize not only the welfare of the present beneficiaries hence frustrating the objective of income redistribution as spelled out at law. It also risks affecting negatively the efficiency objective by distorting the propensity to work and save especially for employees engaged in activities 'on the brink' of the welfare/market systems. The abuse of the social security systems could push workers underground. Instead of being a safety net to support people in need, the social security system could become a disincentive to work.

Besides, policy makers should ensure that no benefits are added to the social security programmes, to which retirement pension entitlement belongs, without feasibility studies on the sustainability of the particular service, per se, and of the entire social support mechanism. The total amount of resources available for such purpose is already high. It is close to sixty percent of government's recurrent expenditure in Malta in 2003.

For pension schemes run by companies, it has to be ascertained that adequate provisions are in place to ensure the long run viability of such schemes, especially if medical insurance is also borne, in part or in whole, by the company. The necessary safeguards have to be in place in case of voluntary liquidation. The Western world is facing an uneasy industrial environment and labour unrest because of rising costs and loss of competitiveness for companies following increases in premiums on medical insurance, plunging profits, rising unemployment and threatening future pensions! Companies may accept lower profits to plough resources into their pension funds. But if

employers wind up those funds, the schemes will be unable to pay more than a fraction of the benefits due to future retirees.

The same argument may be made for personal pension schemes. Recent experience with 'misselling' of funds in the U.K., following the launching of high-income bond funds in the height of the bull market, is an eye-opener. Some funds are reaching maturity with devastating losses. (Vide *Financial Times Fund Management*, 3 February 2003: 1) Besides, some of Europe's best-known financial services companies are running high numbers of unprofitable UK retail funds. It is estimated that the UK's retail fund management industry, one of Europe's biggest, wastes up to 700 million pounds a year running 'sub-scale' uneconomic funds. (Vide *Financial Times Fund Management*, 14 April 2003:1) Pension funds are asking members to agree to sharp rises in pension contributions: in one instance, ABP, Europe's biggest pension fund for about one million people working in the government and education across the Netherlands, recommended that premiums will rise from 15.3% to 19%. (Vide *Financial Times Fund Management*, 14 April 2003: 2)

Safeguarding hard earned savings is no mean task for financial regulators and financial institutions. Huge resources may be lost overnight plunging many close to the poverty threshold, whether they are retired or still at work. There is at present an estimated 129bn euro gap between the pension liabilities of British companies and the assets available to meet them. Closer home, it has to be recalled that around one fourth of Maltese households, single or couple, with at least one head aged sixty-five are deemed to be poverty prone.

At the same time the purchasing power of pension income has also to be considered. Regulators responsible for consumer affairs, in general, and services for the elderly, in particular, have an important role to fulfill in this regard. The formal sector for services for the elderly in bound to increase; such services do not come cheap when compared to the subsidized services in government and Church homes and to the zero-price provided by family members in the past. Hence when people are made to pay, especially if they are running down their past savings in the absence of knowledge about their life expectancy and state of health, they expect to receive a fair deal in terms of quality of service and price.

Income Creation, Capital Growth and the Labour Market

Sustainable income growth depends on total factor productivity, on the ability of a people to organise production in such a way as to utilise existing resources better thereby increasing value added as a result. Additions to manpower and the capital stock, if integrated effectively in the production process, will boost output even more.

Economic growth is a complex phenomenon that is, as yet, not very well understood especially in terms of the role social conditions have in such a process. There are several forces at work both inherent to the economy and

outside it that at any one time may act as catalysts of change and innovation leading to higher output per employee. The social security and social welfare system forms part of this growth matrix in which both efficiency and equity appear. These two policy criteria have to be accounted for particularly in a small community. There cannot be a widening of income differentials for too long without inducing social unease if not outright unrest.

The Maltese economy is passing through a critical economic phase. For the first time in many years trade is being opened following the removal of protective tariffs. At the same time, support for ailing industry through direct cash handouts or subsidised inputs are being restricted to a specified time frame after which they will be completely withdrawn. Besides, more state industries will be privatised, in part or in entirety. The implications for security of job tenure, training, output and profits are many and not necessarily predictable.

From an economic or efficiency point of view, this may be a laudable objective that has to be pursued with consistency. But it has to be recalled that this fairly massive economic restructuring exercise will take place with the projected increase in the number of persons aged sixty years and over occurring between this year and the year 2025. The emerging demand for labour schedule will be directly related to the demand for the product sold. In the past, labour demand was in part conditioned by government's willingness to support an ailing industry through protective legislation or cash handouts. This will no longer be the case.

Changes in the labour supply, both in terms of numbers and skills distributions, will influence the future growth path of the economy. Additional welfare costs to companies and employees will affect directly either unit costs and competition, or unit profits. Unless, therefore, adequate measures are taken to adapt the labour supply to the envisaged demand through immigration and/or retraining and, at the same time contain unit labour costs problems are bound to emerge for locating plant in the Maltese Islands. Negotiators in labour relations have to learn how to improve the offer for workers by exchanging financial improvements in the aggregate pay packet in part with lifetime training.

Changes in the system of welfare funding will have to be considered in this context. Recent collective agreements in certain industries have tried to extend the list of non-wage income sources to medical insurance. If one accounts for paid leave, national holidays, social security contributions and other benefits, like subsidised transport and canteens, the aggregated unit labour costs rise to about 20% - 30% of basic earnings. Any additional costs will have to follow productivity changes, which are not infinite at any one-time period under an existing set up of capital per employee.

The Exchange Rate Regime

Up to now, Maltese trade was carried under an exchange rate regime that sets the value of the Malta Lira in real

time via a basket of currencies. An eventual replacement of the Lira with the euro will usher in a new factor in the trade equation in addition to the liberalised economic environment that developed in recent years. The euro is a floating currency whose value is determined on the international foreign exchange markets conditioned by various factors in the euro zone and in the other trade areas whose currencies are considered for exchange.

Adopting this currency will bring about two realities. Firstly, the domestic prices will automatically become international; there will not be the need to translate domestic prices into foreign prices and vice versa. For unit prices to remain internationally competitive, now that these become the internationally quoted prices without the 'assistance' of an intermediate 'translator', very close consideration will have to be given to domestic costs, including the impact of any imported inflation. Discipline in cost control and an evolved system of accounting become a must.

Secondly, the Monetary Authorities that oversee the value of the Malta Lira will no longer be the Central Bank of Malta but the European Central Bank. The former used to evaluate the optimality of the Lira in relation to the economic and financial conditions prevailing in Malta; the latter judge the suitability of the euro in relation to the entire EU economic zone. Therefore any appreciation of 'domestic' (that is, in the Maltese Islands) unit costs of production cannot be counterbalanced by a decision to devalue the Lira, which will be no more! It is important to recall this condition seeing that the competitive gains from the devaluation of the Lira in November 1992 were dissipated within a few years as a result of inappropriate labour market decisions. The unit cost gain and its erosion over time is illustrated in Annex 4 through a Unit Labour Cost Index for the years 1990 to 1995. (An explanation of this index is given in Delia, 2002:215-244.)

Any policy measure that enhances competition and streamlines the production of goods and services will be welcome. It is in everyone's interest to synchronise inputs as effectively as possible. But this change may not be readily achieved. Difficulties could arise for psychological reasons: several productive sectors have been operating under 'artificial price structures', insulated by protective practices for many years. Operators adapt, but sometimes with a lag. Difficulties could arise because of lack of managerial expertise to face an open trade environment. Again, adaptation should follow, how fast will depend on the quality of leadership that permeates the respective productive sectors. In the presence of, what may be termed, 'institutional fatigue' the adaptation period will be longer than desired.

Productivity considerations will become paramount especially in the know of an eventual decline in the working age population as defined today. A shift towards higher value added production is necessary in order to support a rate of growth in real wages that, in turn, can generate savings and revenue for the state to finance the commitments entered as of today with regard to future pension liabilities. This shift is also necessary in order to countervail any strengthening of the foreign exchange currency whose value will no longer be subject to 'local' control.

Anomalies in Present Welfare Legislation, Data Bases and a Comprehensive Social Welfare Policy

But independent of the above considerations there are three issues that demand attention. First, the legislation and complementary administrative decisions related to implementation is often the subject of complaints. There are anomalous situations that pensioners' representative in Malta, for example, keep pointing out. Irrespective of what happens to the financing of pensions in the future, such possible legal and administrative shortcomings have to be attended to for the sake of equity and fairness.

Secondly, there cannot be an informed policy formation unless the data bases on which such policy is based are not reliable. Three data sets demand constant surveillance. These refer to income distribution, household saving and the labour supply. They are three elements on which a realistic and equitable social welfare programme comprising transfer of money and services can be devised and implemented. Suffice to point out that up to now family members supported their elderly relatives at no cost to the State. As families get smaller, and both husband and wife find remunerative employment, this zero-price support system for the elderly will have to be replaced by fee-paying market activity. Earnings from work will exceed the income generated as an allowance paid to carers in order to encourage them to look after their elderly relatives; this income differential may well encourage family members to take up a job and pay for the services that their elderly relatives need.

In turn, this transfer of caring for the elderly has two important effects: it substitutes an income-in-kind commodity with a fee-paying service, and it tops up local value added or the Gross Domestic Product (GDP). Home help provided by relatives is not recorded in the GDP – allowances for carers are transfers and not wages. But fee-paying services are recorded and, thus, they boost up total and per capita income. For a member of the European Union, any activity that enhances the GDP will impact on that member's net fiscal contribution vis-a –vis the Union. More than care and inter-generational support are involved in such a move!

The third issue refers to policy. There has to be a clearly defined and integrated social welfare and social security policy, now that the generation of employment is seen dependent more than ever before on market forces. The security of tenure that is generally correlated with public sector employment is becoming more bounded as the privatization programme continues: fewer economic activities will operate in non-profit environment with the result that a greater number of workers will see their jobs dependent on sales. Such changes in the labour market imply a critical evaluation of the entire family/personal income and consumption support programme. The success in generating future wealth and in setting up an effective

person-directed income/services distribution network rests on such an evaluation. The network of support providing services will include the state, profit-seeking private enterprise and non-profit organisations.

In addition, gender considerations will have to be addressed. Maltese labout law discriminates in favour of female early retirement. However, Malta's membership of the European Union will activate the equity at work priniciple pronounced by article 119 of the Treaty of Rome an Directive 86/378/EEC that imports the equal treatment principle with occupational pension schemes. Conformity with this principle will define the labour and pension beneficiary configuration in the future. Any changes in the retiring age limit, for example, will have to apply to all workers. (Deliam 2002: 134-135)

4. A Concluding Remark

Demographic ageing has been described as a process which is "the least doubted, the best measured, the most regular in its effects and the easiest to forecast well ahead as well as the most influential". (Tout, 1989:17) This may be true. But the many ramifications into aggregate and sectoral production, individual and market demand composition, capital and foreign exchange movements, and regulation are very complex, very much doubted and not-very-readily measured.

The same applies for the pension question. While actuarially it is easy to derive the periodic contribution to attain a predicted sum of money, n years from a given date, at predetermined rates of inflation and yields on investment, yet it remains unknown whether the future retiree is able to raise the resources in time and whether the assumptions will actually come about. That conclusion is left for time to decide. The under-capitalisation of pension plans in Britain and in the United States of America that is apparent at present came about because actuaries persisted in working out capital requirements on relatively presumed high rates of return. These returns were not attained with the result that the capital accumulated over time fell short of the sums projected.

In addition, it has to be constantly recalled that pensions and the provision of services to the elderly are only one component of a series of income and service flows that, altogether, contribute to a person's welfare over a lifetime. Hence they cannot be discussed is isolation. In economic jargon, a dynamic general equilibrium scenario will have to be envisaged, described and tested; this is not an easy task. But at stake are human welfare, personal happiness and social cohesion.

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Annex 1

At-risk-of-poverty rate by household type (percent) Malta 2000

Total	14.9
1 person household (Total)	24.5
1 person household (Male)	16.7
1 person household (Female)	28.0
1 person household, under 30 years	33.8
1 person household, 30-64 years	23.1
1 person household, 65+ years	25.3
2 adults, no dependent children (at least one person aged 65+years)	24.6
2 adults, no dependent children (both less than 65 years old)	11.1
Other household with no dependent children	4.5
Single parent household with at least one dependent child	55.1
2 adults 1 dependent child	12.7
2 adults 2 dependent children	15.9
2 adults 3+ dependent children	28.5
Other households with dependent children	8.3

Source: National Statistics Office, 2002: Table 38

Annex 2

Annual Premiums yielding Lm33 in real terms per week after n years, for three scenarios, for a Male retiring at age 60 and 65

Males at 60

Scenarios		A	B	C
Number of years				
5	Lm	3392.698	4167.047	4665.736
10		1533.719	2033.206	2304.762
15		921.630	1322.479	1517.923
20		621.160	967.529	1124.618
25		445.225	754.890	888.726
30		331.441	613.407	731.541
35		253.053	512.582	619.331
40		196.675	437.168	535.230
45		154.857	378.695	469.869

Males at 65

Scenarios		A	B	C
Number of years				
5	Lm	2908.027	3509.092	3979.598
10		1314.616	1712.173	1965.827
15		789.969	1113.666	1965.827
20		532.424	814.762	959.233
25		381.622	635.698	758.032
30		284.092	516.553	623.961
35		216.903	431.648	528.253
40		168.578	368.142	456.520
45		132.735	318.902	400.771
50		105.536	279.646	356.211

Scenario A: a situation where inflation is 2% per annum, investment yields 6% per annum, giving a yield gap of 4%.

Scenario B: a situation where inflation is 3% per annum, investment yields 4% per annum, giving a yield gap of 1%.

Scenario C: a situation where inflation is 3.5% per annum, investment yields 4%, giving a yield gap of 0.5%.

Source: Delia, E. P, 1993:Table 4.

Annex 3

Annual Contribution by Males and Females, aged 20 and 40 years, to yield Lm33 in real terms after n years: Retiring age at 60 years and 65 years

Males

Scenarios:		A	B	C
Retiring Age: 60 years				
Age: 20years	Lm	196.66	437.17	535.25
40 years		621.16	967.52	1124.62
Retiring Age: 65 years				
Age: 20 years		132.73	318.90	400.77
40 years		381.62	635.69	758.03

Females

Retiring Age: 60 years			
Age: 20 years	221.26	518.13	646.74
40 years	698.81	1146.70	1358.91
Retiring Age: 65 years			
Age: 20 years	150.67	390.91	486.65
40 years	433.19	779.24	920.47

Note: Scenarios A, B, and C as per Annex 2.

Source: Delia, E. P, 1993: Table 5

Annex 4

Unit Labour Cost Index for the Manufacturing Industry

	(1)	(2)	(3)	(4)	(5)	(6)
Year	MHLC	RVA	Lm/$	(1)x(3)	ULC	ULCI
				$	(4)/(2)	1990=100
1990	Lm1.67	Lm1.53	3.1527	5.2650	3.4412	100.00
1991	1.79	1.56	3.1002	5.5494	3.5573	103.37
1992	1.85	1.54	3.1462	5.8205	3.7795	109.95
1993	2.02	1.57	2.6171	5.2865	3.3672	97.85
1994	2.11	1.61	2.6486	5.5885	3.4711	100.87
1995	2.27	1.63	2.8333	6.4361	3.9485	114.66

Notes:

MHLC = Mean Hour Labour Compensation

RVA = Real Value Added per Man-hour

ULC = Unit Labour Cost

ULCI = Unit Labour Cost Index

Source: Delia, E.P., 1998: Table 4.2