A REVIEW ON THE TYPES OF SAVING INCENTIVES FOR VOLUNTARY PENSION PLANS

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Abstract

Pension is one of the finest social inventions that has ever been made by man. It involves assisting senior citizens who have tirelessly worked for a nation to peacefully enjoy their old age, without worries of ever falling below poverty lines or their standards of living depreciating after they disengaged from active employment. The aim of this article is to review literature on financial incentives that may be used in encouraging people to save in voluntary pension funds.

To achieve our objective, we started off by first the position of voluntary pensions in the three pillars that makes up modern system of pension. This was followed by a discussion on types of pension funds and finally the financial incentives that may be used in encouraging people to save in voluntary pension funds.

We concluded that there are two types of financial incentives that may be used in encouraging people to save in voluntary pension funds. The two incentives are: tax incentives and non-tax incentives.

Key words

Pension incentives, Saving incentives , voluntary pension, pension pillars, pension plans

Introduction

Provision of social security to people who are in need has been part and parcel of mankind since time immemorial. History is littered with situations where people have assisted each other navigate through various challenges associated with stages of human growth and development, i.e. from infancy to late adulthood. The form of social security that has been and continue to be provided to individuals who have reached late adulthood will be of great interest to us in this article. In pre-industrial societies, families played important roles in providing social security to their ageing

populations. Young and able members were expected to feed and protect senior members from various dangers. Emergence of industrialization altered these arrangements and weakened if not severed bonds that existed between family members. Young and able family members no longer lived with their ageing parents but rather moved to urbans centres, far away from their rural homes, to align themselves with the new economic dispensation that came with industrialization. This weakened family bonds, made several people to live miserable lifestyles after disengaging from active work life. Most governments around the world felt that it was unacceptable for their citizens to live in destitution after serving their nations in various capacities. To address this social problem, some governments took the initiative of developing programs so that their senior members would have a continuous stream of income upon retiring from active employment.

The first phase of modern pension system can be traced back to around 1889, when the various German States were being unified by the then Chancellor, Otto von Bismarck. To secure the support of the working class, the Chancellor introduced a compulsory but contributory form of pension system for workers. In this system, workers contributed a certain percentage of their salary to the pension fund. This system assured retirees of sufficient pension benefits in their old age regardless of their levels of skills (Conde-Ruiz & González, 2016). Across the Atlantic Ocean, president Franklin Roosevelt, in the mid-1930s, introduced the idea of the 'New Deal' that saw millions of Americans receive insurance against unemployment and retirement (Bateman, Chomik, & Piggott, 2017).

The 2nd phase of pension scheme development can be traced back to 1942 to a report developed by Sir William Beveridge. The recommendations contained in this report resulted in the formulation of a compulsory national insurance scheme that would provide healthcare, unemployment, and retirement benefits at a flat rate to all British citizens (Farrar, Moizer, & Hyde, 2012; Parker & Ferrie, 2016). The aim of this pension system, commonly referred to as Beveridgean Pension system, was to provide minimum benefits that would protect British citizens from sinking into poverty upon retiring from active employment. Thus, most countries that later adopted this model of pension encouraged their citizens to also save in private pension schemes, because the minimum flat rate benefits provided by this system was not enough in sustaining one's standards of living in old age (Conde-Ruiz & González, 2016).

The 3rd Phase of pension development is linked to 1990 proposal by the World Bank. The World Bank proposed a three-pillar system of pension comprising; State Pension, Occupational Pension and Individual pension schemes (Dong & Sun, 2018).

The ***1st pillar*** of their proposal is synonymously referred to as State Pension or Public pension. It is a type of pension plan where the State passes contributions made by those in active employment to those who have retired. This mode of payment is known as PAYGO and is unfunded type of pension scheme because the State does not engage in the business of investing contributions that it collects from those in active employment. It only facilitates the process of collecting contributions from the young generation and passing it to the retired one. In most countries, regardless of whether one is in formal or self-employment, membership and contribution to this pillar is compulsory.

Types of pension benefits that the State normally distributes to its citizens are old age, disability, and survivor pensions. How the State distributes these pension benefits also varies from one country to another. In some, pension benefits are provided universally to all citizens regardless of their history of contribution while in other benefits are only limited to contributors, excluding survivors of the main contributor. In addition, countries such as Germany, Chile, Canada, and Switzerland have reformed their survivors' pension by introducing the concept of ***pension splitting,*** where divorcing couples equally share benefits, they accrued from their pension scheme while still married. Purpose for the State distributing pension benefits also varies from one country to another. Countries such as United Kingdom, Australia and Ireland distribute their pension benefits at a flat rate with objective of preventing old age poverty while countries such as Germany and France, provide it with objectives of assisting their retirees maintain adequate standards of living that is equivalent to what they had prior to retirement (Claussen, et al. 2012; Laaksonen & Gould, 2015; Hertrich, 2013; Sutcliffe, 2016; Kemp, 2017; Draper, et al. 2014; Fehr & Uhde, 2013; Batty & Hailichova, 2012;).

The ***2nd Pillar*** proposed by the World Bank is known as Occupational Pension (The World Bank, 1994). It is a type of pension plan that is normally provided by employers to their employees with objective of enabling them to maintain their standards of living in their retirement periods. In some countries, it is mandatory for employers to provides this type of pension to their employees while in others it is optional. In countries where it is optional, employers provide it for purpose of

maintaining some of their highly skilled and experienced employees from moving to other firms. They achieve this by inserting non- forfeiture clauses in employment contracts they give their employees. Thus, employees with such contracts stand to lose their benefits should they terminate their employment contracts prematurely before retirement age (Hertrich, 2013; Bossler, 2015; Arnold & Jijiie, 2019; Mešťan, et al. 2020).

There are three models that are normally used in providing occupational pension: substitutive, mixed, and parallel models. In substitutive model, public pension system is entirely phased out and is replaced by a private system of pension. Chile is one of the countries in the world that has adopted this model. In mixed model of pension, the amount of pension benefits in public pension plans is greatly reduced and the difference is topped up by benefits obtained from private pension plans. For instance, Japan uses a mixed model where it has two tiers of pension. In the 1st tier which they call National Pension (NP), all residents aged between 20-59 years are compulsorily covered by State pension. NP provides cover to self-employed, farmers, students, unemployed, and their dependents. In the 2nd tier, all employees in private sector are compulsorily covered by occupation pension scheme which they call Employee Pension Insurance (EPI) while those working in the public sector or state agencies are covered by Mutual Aid Association (MAA) (Murata & Chen, 2013; Okumura & Usui, 2014). In parallel models of pension, participants are given a lee way of choosing between a public or private pension system. It is up to individuals to decide where they want to save for their pension. This model is practiced in countries such as United Kingdom and Sweden (Lurie, 2018).

Occupational pension is a type of funded pension plan where workers save for their own benefits. In Sweden, there are occupational pension companies that manage contributions on behalf of employers. These companies in turn pay retirees pension benefits as either life annuity or fixed term payment. It is the pensioner who decides the format of receiving pension benefits. In the former payment option, the retiree receives pension benefits up to the point of death while in the latter payment option, pension benefit is paid to a defined period but if death comes before that period, pension payment is also stopped (Hagen, 2015).

The *3rd Pillar* is usually referred to as individual pension scheme. It is type of scheme where individuals voluntarily set a aside certain amount of money in their accounts for use during retirement period (Pilková & Mikuš, 2020; Simonovits, 2018). State pensions wholly depends on

PAYGO systems which makes them unstainable with large generosity. They just serve the purpose of keeping retirees out of poverty. Thus, voluntary pension plans come handy in assisting retirees smoothen their consumption behaviours. In this system, participants are encouraged to save, without withdrawing until they reach retirement age, through incentives such as subsidies and tax allowances.

Pension plans and funds

Pension plans are 'organized investment programs designed for providing income after retirement from active employment'. They may be sponsored by individuals or employers, for civil servants the sponsor may be the government (Batten, 2020). There are two types of pension funds that may be used for purpose of retirement saving: Defined Benefits (DB) and Defined Contribution (DC). DB refers to a type of pension plan that specifies upfront to an employee specific pension benefits they stand to get upon retirement from his/her employer. In most case DB is normally based on a percentage of employees' salaries. On the other hand, Defined contributions is a type of pension plan that is normally based on the amounts that employees contribute to their pension accounts.

Contributions to pension schemes are usually either mandatory or voluntary. Mandatory contributions are mostly associated with public pension schemes, 1st pillar, while voluntary contributions are mostly associated with private pension schemes that is, 2nd and 3rd Pillars. Compulsory contribution is usually necessary for public pension schemes, because they aid in protecting citizens who engage in myopic behaviours from old age negative financial consequences for failing to save. On the contrary, people also need to be induced so that they can voluntarily save for their old age. The best way to induce people to save in voluntary schemes is through pension incentives (Vittas, 2002).

Pension Incentives

Public pension, unfunded scheme, faces a myriad of challenges in meeting its objectives to the retirees. One of these challenges is populist politics where some politicians arbitrary increases its generosity, for purpose of gaining political mileages, without addressing how the extra generosity will be financed. The longevity has also brought another challenge to public pension system where the ratio of workers in active employment to those in retirement has been on the decline in most

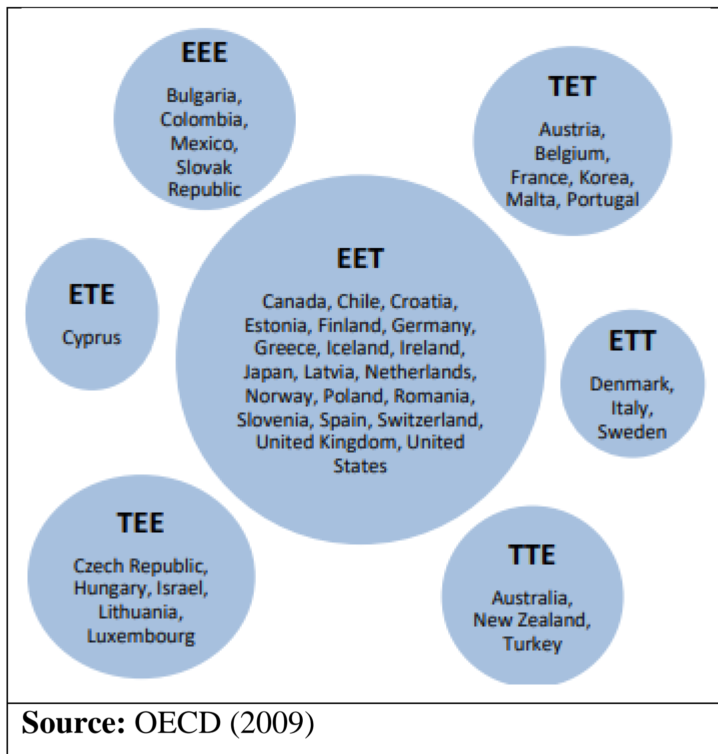
countries. This decline has made pay as go system unsustainable in disbursing pension benefits to the retirees. To address this challenge, most governments have resorted to encouraging their citizens, by use of financial incentives, to save in funded pension schemes (Carbonnier, et al. 2014). There are two types of financial incentives that are normally used in encouraging people to save: Tax incentives and non-Tax incentives.

a) Tax incentives

Tax incentive where individuals are given tax allowances in order for them to save more resources for their retirement. They are indirect forms of subsidies provided through tax code for workers who save for retirement in funded pension schemes. They work by either 'promoting total savings or changing compositions of wealth portfolios' and discouraging people from making premature withdrawals (Ayuso et al. 2019).

There are seven taxation regimes that various countries use in inducing their citizens to save. The seven taxation regimes are EET, TEE, ETE, TET, TTE, ETT and EEE, where E denotes points of tax exemption or Relief while T denoting points of Taxation. For instance, in the Taxation regime EET, the government exempts both pension contributions and incomes from capital funds from being subjected to taxation but subjects pension benefits to taxation upon withdrawal from the account. In the case of TEE, the government subjects pension contributions to taxation while exempting incomes accumulated from capital and withdrawal of pension benefits. Under TTE, all sources of savings are taxed (i.e., contributions and incomes accumulated from capita) while pension benefits are not taxed at the point of withdrawal. In the last regime, EEE both sources of incomes for voluntary pension and pension benefits are not subjected to taxation (Caminada & Goudswaard, 2008; Romaniuk, 2013; OECD, 2019; Király & Simonovits, 2019; Marcinkiewicz, 2019; Kopinec, Dobrovolská, Matyšák, & Holonič, 2017)).

Figure 1: Taxation Regimes



Source: OECD (2009)

According to Vittas, (March 2002), TEE regimes are suitable for compulsory pension schemes while EET regimes are suitable for voluntary pension schemes.

b) Non-Tax incentives

There are two forms of non-tax financial incentives that may be used in encouraging eligible people to save in private pension schemes**: i) Matching contributions**, is a type of incentive that is normally ingrained in pension schemes where either the employer or the government adds certain amount money to employee's retirement savings account. This is usually done in relation to amount of money employees have saved in their retirement account up to a certain fixed percentage. ii) **Pension saving subsidies**, is another form of non-tax incentive that is used by most governments to encourage specific group people, such low-income earners, or the entire population to save for their retirement days. Pension subsidies are normally given in the form tax credits, flat rate benefits, and/or tax deduction.

Conclusions

Pensions benefits play important roles in either protecting retirees from falling below poverty lines or assisting them main standards of living they had prior to their retirements. Contributions to

pension schemes may either be mandatory or on voluntary basis. In mandatory type of contributions, people have no alternatives but to remit certain amount of money to the fund. Unlike mandatory contribution, voluntary type of contributions requires people to be encouraged. In our review, we conclude that there are two types of financial incentives that may be used in encouraging people to save in their pension funds. The two incentives are tax incentives and non-tax incentives.

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