VIEWS 21/23 | 20 OCTOBER 2023

Social Insurance Pension: Saving for retirement collectively

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A version of this article was published in HEAD Foundation's Magazine, THINK on 18th August 2023, titled 'Installing a Pension Floor for All Elders in Malaysia: A Case for Social Insurance Pension'.

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Commemorating Solidarity on Older Persons Day

On October 1st every year, the world commemorates the International Day of Older Persons to recognise the contributions of our senior citizens and raise awareness about the challenges they face. Designated by the United Nation General Assembly in 1990, the theme for this year is "**Fulfilling the Promises of the Universal Declaration of Human Rights for Older Persons: Across Generations**".

The focus on intergenerational solidarity is especially pertinent amid the global demographic shift, characterised by a growing share of the older population relative to their younger counterparts. This transition to an ageing society carries profound implications for the economy, society and the welfare system. One critical challenge is how to equitably allocate resources to ensure that older individuals receive the necessary support without neglecting or overburdening younger generations.

Thus, when formulating social policies, it becomes crucial to highlight an intergenerational perspective that promotes mutual support and protection. This entails the younger generation supporting the older generation, with the expectation that they, in their later years, will, in turn, receive reciprocal care from future generations.

This article will explore how Malaysia can come together to fulfil the promise of ensuring income security for current and future older individuals, as outlined in the Universal Declaration of Human Rights for Older Persons. Old-age income security is a pressing issue that warrants urgent attention, considering the country's rapid population ageing, persistent coverage gap, inadequate benefits, and unsustainable financing.

Rights to income security during old age

The future of a more aged society is nearer than we think. With longer life expectancy and lower fertility rate, Malaysia has transitioned into an "ageing" society in 2020, with 2.3 million or around 7% of its 32.4 million population aged 65 years and older. Indeed, the country is projected to become "aged" in 2045 when the share reaches 14%, and "super-aged" by 2060 when the share reaches 20%[1].

Longevity is to be celebrated but ageing often increases the risk of deteriorating income, health and social support. While ageing is inevitable, the experience varies depending on how well the risks are managed. Multipronged policies must accompany the multifaceted nature of old-age vulnerabilities.

Part of the Universal Declaration of Human Rights is the right to income security, with international standards like the ILO Convention No. 102 delineating nine key branches of social protection—one of them being protection during old age. This can be achieved through a comprehensive old-age retirement system that protects individuals by providing guaranteed income during old age.

However, by international standards[2], Malaysia's current pension provision is still lacking. Not everyone has basic income security that allows a "life in dignity"[3] during old age. Many do not enjoy pension benefits that are at least equivalent to the per capita poverty line income. The pension income received is also inadequate to sustain consumption during periods of income

[1] Unless otherwise stated all demographic statistics are KRI calculations based on the medium fertility variant of the 2019 revision of the United Nations Population Forecast via CEIC (n.d.).

[2] According to international standards, an old-age retirement system should strive to achieve three objectives. First, to provide basic income security that allows for a "life in dignity"; and second, to serve as a consumption smoothing mechanism throughout periods of both high and low income. The fulfilment of the first two objectives is usually assessed by the share of elders drawing pension benefits equivalent to the poverty line per capita (first objective) and benefit level of not lower than 40% of previous earnings (second objective). The third objective typically endeavors to achieve a comfortable living standard beyond the basic and average levels. Source: ILO (2014), KRI (2021)

[3] This means having the minimum income that corresponds to the monetary value of a set of necessary goods and services, national poverty lines, income thresholds for social assistance or other comparable national thresholds. Source: ILO (2014)

fluctuations (such as unemployment or sickness), as many receive pensions lower than the recommended 40% of previous earnings.

Malaysia's multi-tier retirement ecosystem

The pension provision for old age in Malaysia has three components; a tax-funded first tier to ensure a minimum standard of living (e.g. Bantuan Warga Emas), a second tier of mandatory individual accounts that targets income replacement (e.g. Employees Provident Fund, EPF and civil service pension) and a voluntary third tier which is voluntary retirement savings (e.g. Private Retirement Schemes).

Bantuan Warga Emas

Tax-funded pensions that protect against old age poverty are effectively guaranteed to a selected number of elders belonging to two specific groups, with benefits varying between the schemes. The first group includes elders aged 60 and above who are eligible for means-tested assistance under the Bantuan Warga Emas (BWE) scheme. However, the scheme currently only protects 4.2% of elders with a basic income of RM500 monthly as it is limited to those living below the poverty line and without family support.

Civil service pension

On the opposite end, the second group is comprised of more privileged elders who have served the public sector hence are entitled to the civil service pension. The benefits under this scheme range from at least RM950 monthly to 60% of their last-drawn salary.

If we consider the BWE recipients and civil service pensioners as old-age pension beneficiaries, currently only 24% of the elders in Malaysia receive periodic old-age benefits. This means only one in four elders in Malaysia are protected from old age risk, lower than the world average of one in two[4].

Employees Provident Fund

Meanwhile, workers in the private sector are required to build their retirement savings under the Employee Provident Fund (EPF). These are made via mandatory contributions by their employers as well as deductions from their own monthly salaries[5]. However, EPF members are not considered to be pension beneficiaries due to the individual nature of these accounts and the opportunity for lump sum withdrawals[6].

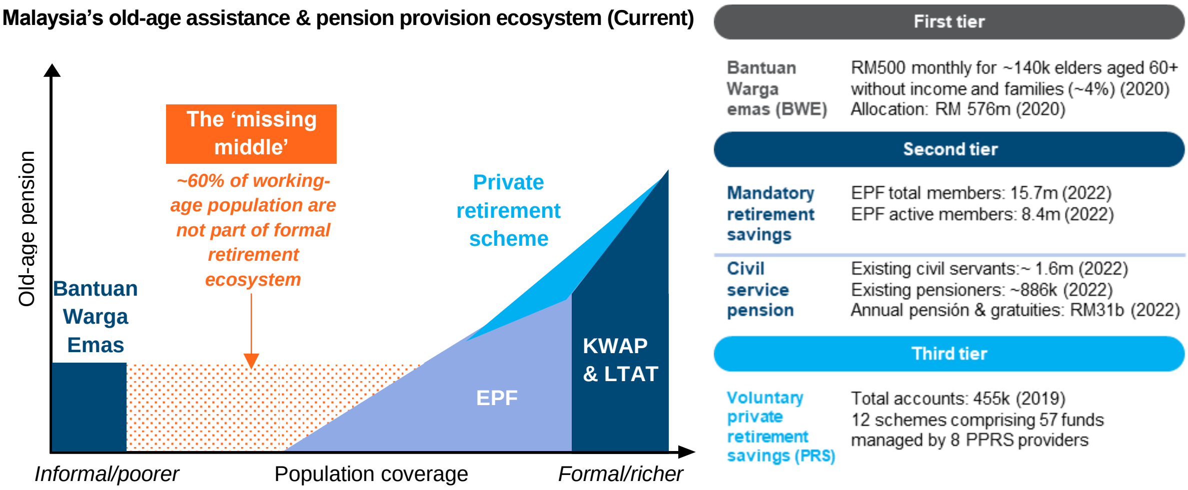
While the EPF scheme is meant to accumulate savings for retirement, the breadth and depth of the coverage have not been adequate. In 2020, more than half of EPF members aged 54 had less than RM50,000[7] in their accounts. This falls far short of the target set in 2019 of RM240,000 in savings by age 55, which would provide RM1,000 a month for 20 years of retirement—in line

[4] This is based on an unweighted average of old-age effective coverage from 180 countries reported. Source: ILO (2017)
[5] However, EPF members are not considered as pension beneficiaries due to the individual-account and lump-sum withdrawals arrangement.
[6] The total periodical and monthly EPF withdrawals have been negligible, reported to be 796 in 2017 and just 579 in 2019. Source: EPF (various years)
[7] EPF via Malaysiakini (2020)

with Malaysia's life expectancy[8]. Even then, this rate is far below the estimated monthly expenses of RM 2,450 necessary for a senior citizen to maintain a decent living standard. On top of this, inadequate savings were reduced by RM145 billion via four COVID-19 withdrawal schemes in 2021 and 2022[9].

The 'missing middle' of the formal retirement arrangement

Figure 1: Multi-tier retirement ecosystem in Malaysia



Note: The EPF (Employee Provident Fund) is the mandatory retirement savings fund for private sector workers in Malaysia, The LTAT (Lembaga Tabung Angkatan Tentera) is a statutory body providing retirement savings scheme for officers and members of other ranks of the Malaysian Armed Forces and the volunteer forces; KWAP (Kumpulan Wang Awam Diperbadankan) is Malaysia's civil service pension fund; JPA (Jabatan Perkhidmatan Awam) is the Public Service Department; PRS refers to Private Retirement Scheme

Source: Adapted from Knox-Vydmanov (2021), OECD (2015) for illustration purpose [LHS], SC (2020), JPA(2022), World Bank (n.d.), EPF (n.d.), Berita Harian (2022), MalaysiaKini (2021) [RHS]

Notably, the sparse provision has resulted in a significant gap known as the "missing middle" (see Figure 1). These are individuals who are not part of the mandatory retirement schemes while simultaneously do not qualify for old-age assistance or are a part of the civil service pension. It is estimated that in 2019 about 60% of working-age individuals[10] in Malaysia were outside the formal retirement arrangements.

Most of these individuals would have to rely on personal savings and assets, or intra-generational family transfers to sustain themselves after retirement. However, declining fertility rates, shrinking household size[11], lower prevalence of multi-generational households[12], as well as rising

[8] EPF Basic Savings target by age 55 was revised from RM 120,000 in 2008, RM 196,800 in 2014, RM 228,000 in 2017 and RM 240,000 in 2019. Source: EPF (n.d.-a)
[9] New Straits Times (2023)
[10] KRI (2021), pp 92
[11] Household size shrunk from 4.3 in 2005 to 3.9 in 2019. The declining pattern is observed in both rural and urban areas. Source: DOS via CEIC (n.d.)
[12] The proportion of three-generation households declined from 41.1% in 2004 to 30.7% in 2016. Source: World Bank (2020)

living costs and household debt[13] indicate a future where old-age income security would depend less on family transfers.

Public discourse has centred around two sets of options to address the long-standing issues of poor coverage and adequacy. The first option proposes to improve the mechanisms within the EPF, while the second suggests broadening the coverage and possibly deepening the benefits of the means-tested BWE programme. These two solutions are not mutually exclusive and are often complementary. See Box 1 for a discussion on these two sets of options.

Box 1: Comparison of Potential Solutions

EPF-centred solutions

The EPF-centred solutions consist of three parametric changes to the existing scheme to help members with lower incomes:

1. **Deepening progressive contribution** by *increasing the employer's contribution* for local workers with a monthly salary of below RM5,000 from 13% to 15%;
2. **Introducing progressive dividends** by applying *higher dividend rates* for members with *lower savings*;
3. **Increasing contribution period up to 65** with a *higher statutory minimum retirement age* from 60 to 65.

We conducted a hypothetical simulation model to assess the effectiveness of each proposal and found that raising the retirement age would have the greatest impact on improving members' savings. Doing so is expected to ensure that 82.2% of elders enrolled in the EPF retirement scheme would have enough savings to avoid poverty.

However, while raising the statutory retirement age can potentially address the gap, it is important to recognise that not all elders can continue to work due to various factors (e.g. education, health, etc). Additionally, the main concern is that these proposals are not enough to yield significant results to widen the coverage and deepen savings as about 20% of members would still live below the poverty line, let alone those outside of the EPF scheme.

[13] Household debt as percentage of nominal GDP has increased from its all-time low of 60.4% in 2008 to 93.3% in 2020. Source: BNM via World Bank (n.d.-b)

BWE-centred solutions

Alternatively, the introduction of a universal social pension in Malaysia has been proposed to overcome coverage challenges faced under the EPF schemes, particularly informal and unpaid work. As mentioned earlier, currently, tax-funded social pensions in Malaysia are limited to poor older individuals without income or family support and pensionable civil employees. The proposal is to expand the BWE to establish a pension floor where all eligible individuals will receive regular old-age benefits, typically pegged at the poverty line.

However, expanding BWE to universal coverage, even at a minimum benefit level, is a significant leap, with cost implications posing the greatest hindrance. The estimated universal social pension expenditure share of 1.5% of GDP (RM24 billion) is significant, especially when it is nearly 50 times higher compared to the existing share for BWE allocation of 0.038% of GDP (RM0.5 billion)[14]. Undeniably, a social pension that is universal and fully tax-funded is the most ideal, but it remains the exception to the rule. The delivery of tax-funded social pensions varies widely globally, underscoring the fiscal constraints faced by governments.

Social Insurance Pension: Pooling longevity risk and saving collectively

Given the challenges and limitations of other options, we deem introducing a life annuity scheme under the social insurance pension (SIP) model as an enduring approach to achieving full coverage for basic income during old age. This scheme guarantees a lifetime stream of income via an annuity—a series of periodic payments—in exchange for a premium. It is based on the principles of solidarity and collective financing, must be operationalised by an institution with a public mandate, and should not be confused with private insurance.

In general, a social insurance pension provides old-age benefits to individuals who have met the qualifying age and the minimum contribution period, which can vary between 10 and 35 years. Compulsory contributions are made during working years and are usually funded from a percentage of earned income. Like other schemes, the operational details vary from country to country, but it is worth noting that most social insurance schemes are a hybrid of defined benefits and defined contribution schemes where one's entitlement depends on one's contribution[15].

[14] KRI (2021)
[15] As the name suggest, defined-benefit schemes are those where benefits of the schemes are predetermined, while in defined contribution schemes, the contribution rates are predetermined.

What would a social insurance pension model look like for Malaysia?

Key features of a life annuity under SIP include **monthly disbursements** instead of annually, **a single rate** for both men and women, and **pension benefits that increase annually** to account for inflation.

Assuming the scheme is launched in 2025, preliminary estimates indicate that a 24-year-old would contribute RM53 per month for 36 years to receive a monthly annuity equivalent to the future value of the poverty line per capita for a lifetime starting from the age of 60[16]. Upon reaching the age of 60, these individuals will receive a future value of RM1,346 monthly (instead of RM600 in 2020).

The SIP annuity will also increase annually at a fixed rate of 2% to account for inflation. It only offers a basic annuity scheme that covers the risk of longevity, and no compensation is given when the recipient dies as the annuity is not inheritable by surviving dependents. The scheme must also go through a periodic assessment to ensure the contribution rate can meet the potential increase of benefit expenditure, which will lead to higher premiums in the future.

To avoid additional costs to workers and employers, it is proposed that a percentage of EPF contribution is ring-fenced and channeled to build this collective fund. The government also plays an additional role in ensuring the continuity of contribution for individuals without regular incomes, such as homemakers, unemployed individuals, and self-employed individuals with low and irregular wages.

Once the desired coverage is achieved, the SIP can potentially provide the necessary pension floor to close the gap for the 60% without formal retirement arrangements. The benefit or annuity set at the poverty line per capita of RM600 is considered to be sufficiently high to cover basic needs during old age while at the same time sufficiently low to still encourage individuals to continue contributing to their existing retirement savings.

This proposed SIP route is expected to cost much less at 0.06% of GDP (RM1.8 billion) than the 1.48% of GDP (RM28.8 billion) it would cost to directly provide the universal tax-funded social pension for all elders (see Figure 2 and 3). Based on our estimations, the large cost difference still holds even if we compare the annual cost of paying the premium today (0.09% of GDP) versus the cost of paying social pension tomorrow (0.3% of GDP) for the same age cohort.

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[16] This is based on an expected investment return or interest rate of 4%.

Figure 1: Estimated investment, by scheme (RM), 2025-2060

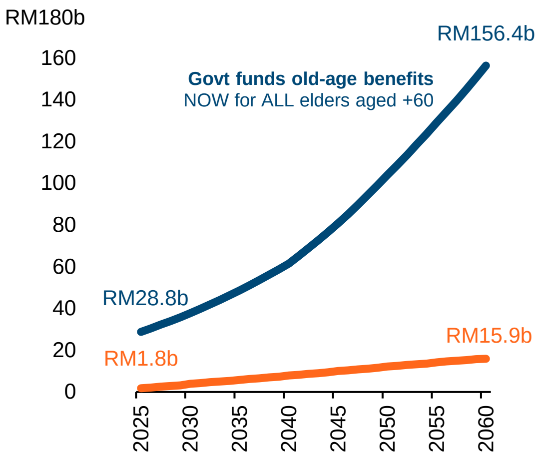
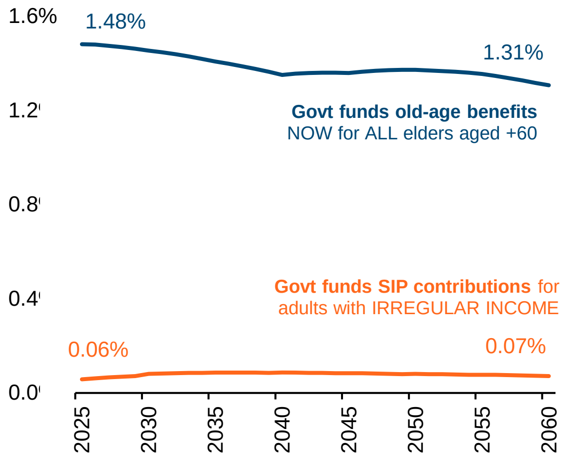


Figure 2: Estimated investment, by scheme (% of GDP), 2025-2060



Source: KRI (2021)

Concluding Remarks

Solidarity is an integral value of social protection. This value is reflected in the framework of Social Insurance Pension such as the solidarity between;

- men and women (e.g. single rate between men and women despite different expected life expectancies);
- the rich and the poor (e.g. each individual is entitled to the same minimum pension irrespective of the amount of contribution);
- those within and outside of the labour force (e.g. coverage includes those who do valuable unpaid work such as homemakers); and
- between generations (e.g. benefits to be paid to current claimants are raised from the current working population).

The existing coverage and inadequacy gaps cannot be addressed solely through small, incremental fixes to the current system, but instead require major reforms. Ultimately, we need to consider moving towards a model as the current one that primarily relies on individuals' efforts has proven to be inadequate. The proposed SIP is a model where we can minimise our individual risks and maximise our collective benefits. By sharing the longevity risk and building a collective fund together, the scheme can help provide a sustainable and equitable pension floor that ensures old age-income security for all Malaysians.

Undeniably, the downside of establishing this collective fund is that we won't see immediate results. The fund needs time to grow, and it will be a slow process as we are planting the seeds. Malaysia still has a window of opportunity to proactively prepare for an ageing population. While the fruit of SIP may only be seen long into the future, the seeds of change have to be sown today. We must act now.

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