Adopting Private Pension System in Ethiopia

By

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Abstract

In spite of the case that the paper to some extent touched pension fund reforms in some countries from public managed to fully funded one, the central theme of this paper is to offer background information and analysis for policy dialogue on introducing private pension funds for the other segments of the society employed in the private and informal sectors of the economy. In the face of small government and booming private sector participation in the education and health sector among others, the non-government employees in Ethiopia are estimated to constitute 91 percent of total employment. The establishment would also create a chance for the uncovered public employees as well as those who want to contribute more even side by side with the public pension system where they have membership. The country would benefit from the launching of the system through a more facilitated financial system and hence economic growth. It could also play a decisive role in reducing old age dependency and poverty.

Introduction

Social protection, including safety nets, health insurance and pensions, is a major element in reducing risk for the working poor. Thus, the importance of the economic and social role played by these sectors in domestic economy cannot be denied. Apart from that, they are part of the financial sector of the economy and play a significant role in economic building. A due consideration in this paper will be put on pension funds. Pension is a retirement income, paid for by investments built up during one’s working life.

In recent years a growing number of countries, developing as well as more advanced, have seen rapid growth of pension funds as institutional investors, notably in the wake of pension reform shifting the finance of retirement income from pay-as-you-go to funding. Quite large number of countries has also adopted private pension funds which are fully funded side by side the government sponsored pay-as-you-go system. Private pension system is not operating in Ethiopia and the objective of this short paper is to bring into forth the issue of introducing private pension funds to policy debate. It has also an objective of reminding concerned bodies such as the National Bank of Ethiopia (NBE) and other government offices which bear the responsibility of protecting the gradually increasing private employees in the education, health, industrial, etc sectors from risks related to health and incomes.

Alternative Pension Systems

In performing the financial intermediation function of asset transformation, pension funds are generally intended to fulfill and provide the public with two primary functions: to furnish a saving mechanism and to alleviate poverty among old through provision of income payments on retirement so as to make consumption flows smooth. Efficient pension funds play a pivotal role in financial markets and the economy in general. They are, for example, the largest institutional investors in the OECD area (OECD, 2000), and therefore have a decisive impact on the
The development of the economic infrastructure as well as the financial stability of these countries. Employers, unions, or private individuals can setup pension plans, which acquire funds through contributions paid in by plan’s participants.

Although the purpose of all pension plans is the same, countries provide social security benefits in remarkably diverse ways, reflecting differences in levels of development and historical experience. The differences also reflect political philosophies and cultural differences concerning the role of individual responsibility, family, employers, capital markets, and government. Pension services are provided by at least 172 countries (Turner, 2001; cited in US SSA, 1999). We can, however, aggregate them into two major approaches - the social security and the private pension system. At national level, literatures and country experiences have shown that countries may adopt these approaches independently or jointly. These systems are based on two different financing principles-the former based on the distributive (pay-as-you-go) principle and the latter on cumulative (fully-funded) principle.

The Distributive (Pay-As-You-Go)-hence PAYG- Principle- A PAYGO scheme is a social contract of mandatory inter-temporal intergenerational transfers in which today’s benefits to the old are paid by today’s taxes from the young, relying primarily on a payroll tax. Tomorrow’s benefits to today’s young are to be paid by tomorrow’s taxes from tomorrow’s young. It is backed by an implicit government debt or promise to contributing worker cohorts that they will benefit from future workers contributions once they retire.

The pension system financed by this principle does not own adequate assets. To society, the pension contributions are considered a mandatory social tax other than the best saving facility. As such stimuli are missing, the effectiveness of the distributive system greatly depends on a country’s administrative coercion.

To be successful, a PAYGO system requires a higher worker to retiree ratio. However, the ratio is shrinking in nearly every country. Thus, to one degree or another, this system is facing financial problems as the system’s structure is overtaken by demographics. In China, currently, there are approximately 6 workers for every retired person. By 2030, there will be only 2.3. In Armenia, by now, there are 4.3 workers for a retiree. But this figure will fall to 3.7 by 2015 and further to 2.9 by 2020(The Central Bank of the Republic of Armenia). Similarly, in the US there were 15 workers to every retiree as recently as 1950. Today there are only 3.3. By 2025, there will be only 2. In Japan and Europe, the problem is even worse (Trustee's Report; cited in Tanner(2001)). Thus, only through the use of market mechanism can countries ensure that they will be able to provide future retirees. Despite the demographic fact and the inherent inefficiency of the public managed vis-à-vis the private one, still some countries provide old-age benefits through a defined benefit social security system as a sole mechanism based on principles of social insurance.

Cumulative (Fully-Funded) Principle- For self-employed individuals or where employees do not have occupational pension schemes, they must establish a private pension scheme. This also applies where individuals are not eligible to join their employer’s pension scheme or want to make additional contributions independent of the employer. Private pension system is an earning related full-funded scheme which forces workers to save part of their wage income for old age. This requires an accumulation of funds today that match expected future liabilities. The contribution of each pensioner is pre-defined but the benefit received by each individual is uncertain. It is uncertain in the sense that it is determined by the investment return on the contributions. The average return on old-age savings (contributions) depends on domestic and international market interest rate and rates of return. Thus, the key issue with private pension
funds revolves around asset management: pension fund managers should try to hold assets with higher expected returns and lower risks through diversification.

The mechanism is that workers contribute some percent of their wages to their own account at a pension fund company, and the latest invest the funds in long-term securities such as bonds, stocks, and long-term mortgages, since benefits paid out of the pension fund each year are highly predictable. Employers may also contribute to employees accounts. Contributions from current workers are invested and used to pay pensions of those same workers upon their retirement. The fund itself carries no additional liability.

Such type of pension system provides, thus, a good saving vehicle for old age. Furthermore, the capital accumulated under the funded part of the system would generate increased productivity and higher wages for the economy, raising the overall rate of return. Private pension plans may be administered by financial organizations such as building societies, banks, life insurance companies, or a pension fund managers. A wide variety of funding arrangements exists, as does the extent to which governments regulate and tax private plans.

**Economic Significance of Private Pension System**

Availability and efficient management of pension plans as per the need of the labor force is increasingly perceived as central to the functioning and healthy development of national economies in the free market system. Recall the self-evident fact that financial system deepening is crucial to the achievement of sustainable economic development.

Introduction of a market-based system for retirement (private pension system) is to provide for the security and protection of individual workers (weather government, private, or self-employed) within the context of financial sustainable system. Moreover, its development in developing countries is of great relevance in that a good sum of the labor force is private or self-employed. As Turnham indicated it, in developing countries, available estimates of informal-sector employment in urban areas vary between an average of 30 percent for a sample of relatively high-income countries and 50 percent for a sample of low-income countries (Corsetti & Schmid-Hebble, 1995). More realistically, as Turner (2001) put it, in Sub-Saharan Africa, nearly 75 percent of the labor force works outside the formal economy, often in subsistence agriculture. On average, social security programs in Africa cover only 10 percent of workers (Turner, 2001). Most workers not covered relay on extended families for support when they can no longer work. Such dependence on extended family is no more working as socioeconomic as well as demographic problems are widening in poor African families. Lack of alternative social insurance mechanisms would widen the incidence of old age poverty.

The new system could raise national saving rate and encourage the development of national capital markets. It also eliminates factor market distortions, increasing long-term growth and welfare levels. In addition, the system may also affect growth through efficiency improvements in both financial and labor markets. The potential efficiency gains are derived from incentives to liberalize financial markets or to reduce the magnitude of financial repression. Pension funds, the argument goes, provide particularly valuable financial resources in the process of reforming domestic markets, both because of their magnitude and their encouragement of the development of the long-term investment instruments. Efficiency gains in the labor markets work through changes in labor supply and resource allocation decisions in response to new incentives in product and factor markets.
A system of individually owned, privately invested retirement accounts would accelerate the move to a shareholder based economy and can promote full participation by workers. Since every worker would have an individual pension account, every worker would have the opportunity to own stocks. Even the poorest worker would become a shareholder and owner of factor of production and, consequently, could grow much more attached to the free market and to a free society. This has the effect of reducing class conflicts, which in turn has a role of promoting political stability, in a way improving the workings and coverage of the financial sector.

Generally, international experience has revealed the advantages of cumulative pension system (the Central Bank of the Republic of Armenia):

- Development of financial market by creating long-term savings in the economy; increase in national savings, hence additional investments and stimulation of the economic growth;
- Create effectiveness, generate products of high quality, and better customer service due to high competition among managers and political neutrality;
- Independent of the demographic situation; and
- Freedom to choose: a pensioner will himself/herself determine how to deal with personal pension savings; the amounts of pensions are determined only by personal pension contributions and investment income.

Pension system is one of the strategically important areas in the state policy, and therefore like other financial institutions, it requires ongoing control through an authorized body to ensure their soundness and safeguard the interest of affiliate workers. Such a body shall be responsible for regulation and control over the activities of the private pension funds, including administrators’ activity. According to international experience, proper control is a key factor, and shall incorporate:

- Ongoing off-site and on-site supervision;
- Capability of early recognition and prevention of problems;
- Imposition of fines and penalties;
- Ability to revoke the license; and
- Require compliance with and administration of professional integrity for staff and management.

For private pension funds to be sufficiently reliable to mandate that workers’ savings be deposited with them, certain minimum conditions have to be met. A growing literature analyses these threshold conditions. Vittas (1998 and 2000) argued that the slow build up of (private) pension funds gives the adopting country time to implement the infrastructure of more efficient capital markets, and to encourage the development of an adequate supply of private securities. Vittas(1998) put three necessary conditions for the success of the new system are conditions relating exclusively to the political will and technical capacity to guard and manage the accumulated assets: 1) a political commitment to macroeconomic price stability and sound fiscal policies—long term financing will be unattractive if there is too much instability, 2) a political commitment to the effectiveness of an independent regulatory and supervisory body, and 3) the existence of well capitalized banks and insurance companies to offer asset management and administrative services (although these need not be domestic institutions). E Philip Davis (2005) added a fourth condition for the success of private pension funds: pension funds must not be unduly constrained in their investment choices nor driven by political as opposed to economic imperatives.
The Case of Ethiopia

Like many other developing countries of the world, safety nets, pension systems, and public transfers are not adequately developed in Ethiopia. There is lack of well-developed formal social assistance programs for the population. The population instead has to relay on traditional practices including within and across family and community transfers. Family members are taken care of by other family members during their old age, sickness and unemployment. This system, however, is faced with increasing level of problems due to economic as well as social shocks. The pressure on the independents is even worsened with HIV/AIDS and other health problems. All this implies increased government responsibility in providing some social security services unless it furnishes adequately favorable environment for the private sector to play its own role. Lack of such programs can lead to increased incidence of poverty.

As it was indicated at the beginning, the emphasis of the paper is on security system. The prevailing type of security system in Ethiopia is the government sponsored Social Security system. The history of the formal social security system in Ethiopia dates back to the formulation of the Pension and Social Security Authority (PSSA) in 1963 (Public Service Pension Proclamation N. 209/1963). This decree covered only the military and civil service workers. For these groups, the pension scheme was funded by a mandatory contribution. The PSSA administers four pension scheme namely: old age pension, invalidity pension, sickness benefits/pension and work injury pension. To maintain international standard and to benefit from international experience, the SSA become an affiliate member of the International Social Security Association (ISSA) in 1985. In the SSA scheme, normal retirement age is 60 years for both males and females and the scheme is applicable on any type of work. Minimum years of service to qualify for pension entitlement are 10 years. It is estimated that the population over 60 years of age in Ethiopia was 4.5 percent of the total in 1990; it is expected to fall to 3.9 in 2020 and rise afterwards to 4.2, 6.8 and 15.1 per cent in 2030, 2050 and 2075, respectively. The dependency ratio (population over 60/ population 20-59) was 11.5 per cent in 1990 and is expected to increase in the future.

Moreover, since only government employees are covered by the pension scheme, large portion of the eligible age population is excluded. The total number of beneficiaries as of 1998 was 439,363 (Melaku Don, 1998). Given this limited coverage, broad-based reduction of old age poverty is not possible. Moreover, the implied saving mobilization role of such financial institution cannot be realized. When we examine the structure of the labor force in Ethiopia, the majority of the employed population (91 percent- excluding unpaid family workers) works for either the informal sector, the private sector or is self-employed (CSA, 1999). These employees fail to have access to pension services and thus are vulnerable for income instability especially in their old age. There are also a reasonable amount of public employees with no possibilities for pension services so as to make consumption flows somehow smoother in their old ages.

Moreover, the majority of public as well as non-public employees who are denied access to government sponsored pension system lack access to provident funds. Provident funds in this country are usually employer sponsored where both employers and employees contribute some amount (some percentage of their salaries, for workers). It is different and less important than pensions in that while provident funds are to be paid as a lump sum benefits to workers upon their leave from their employment either as a retiree or even in their working ages, pension funds are to be paid to members at their retirement in the form of monthly settlements so as to make consumption flows smooth while income flows are, strictly speaking, declining. Moreover, while public and private pension schemes generally offer survivors benefits as an annuity, provident funds usually only provide a lump sum benefit. Lump sum benefits typically provided...
by provident funds do not protect against the risk of a retired person outliving his or her income. These problems are largely acknowledged by countries and most countries have been replacing it with the fully funded private pension system.

Apart from the poverty-reducing role of pension funds during the old age and disability times, one should notice their role in furnishing another avenue for financial sector development and widening financial product ranges. This might in turn impact long-term investment and economic growth of the country. Studies and mere observation reviles that there should be extended efforts to expand financial intermediaries and products so as to make the country beneficial from the sector.

The financial system in Ethiopia is very fragmented and there are particularly no well-established investment opportunities for pension funds. One can identify at global level four asset classes that could help bridge the gap between the supply and demand for long term funds that could be raised by pension funds: securitized bonds, mortgage securities, infrastructure finance bonds, and collateralized loan obligations. The newly flourishing real estate industry and the ongoing infrastructure works in Ethiopia usually require huge sum of long-term finance. The fear for lack of investment opportunities for funds raised by the private pension funds can be dropped to lower level if the funds can be used to finance the real estate industry and infrastructure development activities in the country. Moreover we should believe that new instruments may bring new opportunities.

**Conclusion**

In Ethiopia, unlike other developed countries and countries in transition, the public pension system is not endangered with demographic factors--retiring baby boomers, shrinking working age populations and lengthening lifespan. The problem is lack of coverage. As is shown in the paper, a large proportion of the country’s labor force work for the non-government sector and lacks access to public pension benefits. Thus, there should be another institution standing for the benefits of this group of the society. More importantly, too, the adoption of fully funded pension scheme is crucial for the mobilization of funds (capital) and efficient allocation of credit. Thus, they should be viewed as catalysts to develop the financial sector of the county. They would lead the sector to institutional investors in financial assets. Therefore, responsible government bodies should draw appropriate rules, policies and guidelines for the introduction of the scheme in Ethiopia. Any such move to introduce a complementary pension system will be rewarded by stabilized society, expanded financial system, and growing economy.

Nevertheless, it should be born in mind that the structure and limitations of the existing financial system (like lack of a menu of long-term saving instruments and capital markets) and other institutional inefficiencies, provide important constraints on the prospectus for successfully implementing private pension systems. Thus, a high degree of commitment is required from concerned entities in this regard. Once a point about private pension schemes is raised so as to make it subject of policy debate, all requirements, ownership structure, and administrative, regulatory and supervision issues are left for further study and empirical examination.

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June 2009