Consultation report

Observations on social security reform in South Africa

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July 2008

1 The observations in this report are principally based on documents and material presented by the Ministry of Social Development to the panel during a consultation that took place from 18 to 20 June 2008. Information acquired during previous missions by panel members was also used.
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1. Introduction

1.1 Limitations, caveats and acknowledgements

This consultation report provides panellists’ observations on the comprehensive social security reform plans of the South Africa Department of Social Development (DSD) that were presented to the panellists during 18-20 June 2008. The reforms are outlined in the discussion document: Creating our Future: Strategic Considerations for a Comprehensive System of Social Security (DSD, June 2008). The report has been compiled by W.R. McGillivray based on submissions and reviews by the panellists, and prepared for distribution by the Social Security Department of the ILO.

The consultation report has to be read bearing in mind that much of the panel’s analysis is based on documentation provided in advance and intensive, albeit brief, consultations over three days. Some of the factual information that was provided to the panel may have been wrongly interpreted by the panellists. This report will not try to repeat or second guess the excellent diagnostic work of the different elements of the existing social security system in South Africa that has been undertaken in recent years by the DSD and others. The preliminary policy recommendations contained in this report should thus be considered as “food for thought” rather than as thoroughly researched policy recommendations. The views expressed by the panellists are personal and do not commit the institutions that they may represent.

In this report social security is defined to be the mechanisms that a society applies to provide income security and access to health care for its members. It includes universal tax-financed income transfer schemes, means-tested tax-financed social assistance schemes, social insurance schemes and employer liability provisions as well as mandatory or voluntary private schemes.

The panel is indebted to the national experts who made presentations and provided valuable insights. This group was led by Selwyn Jehoma, Deputy Director General: Social Security, DSD and included persons shown in the annexed programme of the seminar.

1.2 Context: A sense of urgency

South Africa is probably the country with the most unequal income distributions in the world. The Gini coefficient is in the order of 0.72. Life expectancy and health status varies widely among ethnic groups. There is no agreed poverty line, but depending on the measurement used the poverty headcount varies between 33 and 43 per cent. A cash transfer programme to older people and some children has reduced poverty significantly among some sub-groups. Nevertheless, poverty data show that poverty is a problem of families, notably single parent households with children and households with unemployed household heads. Unemployment remains high; the lower rate (ILO definition) is around 25 per cent while the broader estimate in the order of 43 per cent. Youth unemployment is in excess of 50 per cent. Economic growth in the order of 5 per cent during recent years has not had sizeable employment effects. The recurrent influx of jobseekers – mostly low-skilled workers – discouraged workers, other non-labour-market participants and school

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2 Reform of Retirement Provisions (DSD), Gaps in the System of Comprehensive Social Security and an Assessment of the Policy Options (DSD, 2007), Social or National Health Insurance (McIntyre/van den Heever), Employment, Wages and Social Security (National Treasury, 2007).
leavers has led to a situation where employment gains have not resulted in a reduction in the level of unemployment.

The social situation has two particularly worrying aspects. Firstly, poverty and unemployment are concentrated in the Black community. Secondly, indicators of aggregate poverty levels, aggregate unemployment levels, and inequality figures have worsened since the 1994 democratic change.

High levels of crime, an increasing “brain-drain” migration and recent xenophobic violence signal that there is a need to stabilize society by fostering social peace and inclusion. It is reasonable to assume that these factors curb the country’s growth potential, and in turn sub-optimal economic performance lessens the “economic space” to reduce poverty and unemployment. Current challenges to maintaining living standards – rising food and transportation costs – will aggravate the situation especially for the poorer segment of the population. The poverty reducing “trickle down” effect of economic growth is too slow to provide the relief that the society needs. Rapid reduction of poverty and inequality and addressing alienation from the country and the political and social system among elements of the younger generation, can alleviate some of the country’s security problems and can be an investment in economic growth. The most rapid means of addressing poverty and inequality is through social transfers that demonstrate that the country cares for disadvantaged and excluded persons. While improved social transfers combined with conditionalities or other measures that enhance employment levels will combat poverty and affirm an explicit constitutional right in South Africa, there can be no guarantee that these actions will be successful or pay off in economic terms, or that they will be implemented early enough to realize their full potential. However, the panellists generally saw virtually no alternative strategy.

South Africa has a public expenditure ratio of about 27 per cent of GDP at a per capita GDP level of about US$4,000. The Government presently maintains a budget surplus (that it considers to be non-structural) of about 1 per cent of GDP. Total social expenditure is not recorded through national accounts or a social budget. From International Monetary Fund statistics, many countries at the same level of GDP per capita as South Africa spend more on social transfers. This suggests that there may be fiscal and policy space for enhanced social expenditure in South Africa.

2. **General observations on the reform process**

2.1 **The existing system and the need for reform**

The existing social security system is fragmented. It consists of tax-financed grant systems (old-age, child support), a social insurance scheme (the Unemployment Insurance Fund (UIF)) providing unemployment benefits and short-term sickness, maternity, death and adoption benefits), private insurance arrangements for pensions and health care, an under-funded public health system, special pensions and health care schemes for public servants, as well as a Road Accident Fund (RAF) and an employer-financed fund for occupational accidents and diseases (COIDA). It performs well in some respects (e.g. the provision of benefits to the unemployed in the formal sector and the delivery of minimum benefits for the elderly to prevent old-age poverty), but fails in other aspects (e.g. the alleviation of poverty among the families with children). The initiative of the DSD to develop and implement a coherent, effective and efficient national social security system that embraces the existing social assistance and social security benefits and seeks to introduce a new social security pension scheme is thus a timely effort that should be accelerated.
2.2 The scheduling of reforms

Since the envisaged reforms touch on the competencies of several government ministries (Labour, Social Development, Health and the Treasury), the UIF and the provinces, rapid progress in implementation of a comprehensive and coherent package of reforms is unlikely. It is therefore desirable to sequence individual components of the reform package without losing sight of the envisaged long-term overall architecture of the national social security system as well as the overall social budget of the reform.

It appears that amendments to the social grant systems both can and should be pursued as a matter of priority. The following sections deal with reforms of individual components of the existing systems. Reforms of the RAF and COIDA are not dealt with in this report.

2.3 The financing of reforms

The DSD estimates the cost of the proposed reforms of the social grant system at R24 billion. The cost of modifications to the grant system is in the same order of magnitude as the expected consolidated national budget surplus in 2010/11.\(^3\) The cost of introducing a new social insurance tier in the pension system could be partially offset for employers by reductions in the private voluntary tier and by a reduction in the UIF contribution rate. A detailed financing plan for reforms to the grant system, the social insurance component of the pension system and a social health insurance scheme should be drawn up in a social budget (see Section 9).

In order to enhance the transparency of social spending in South Africa, a social assistance fund could be set up that would cover some or all of the expenses of the grant system and possibly subsidies for the social health insurance contributions of the poor. The fund could receive income from general revenues and earmarked taxes. One form of earmarked tax is a General Social Security Tax on income which was introduced in France as an expression of social solidarity. It appears that contributions to the UIF can be reduced, and the reduction could be the basis for a general social security tax. An earmarked increase in consumption taxes (either as a whole or partially through taxing only certain goods and services, such as alcohol and tobacco) could be considered. Part of the resources that are presently envisaged for the wage subsidy could be allocated to a social assistance fund. Alternative sources of funds can be identified in the context of a social budgeting exercise.

3. Social assistance reform (other than old-age and disability grants)

The DSD suggests filling in the major gaps in the social grant system by:

(1) Improving support for children and care givers through:

- extending the upper age limit for the child support grant (CSG) from 14 to 18 years (the new entitlement could be made conditional on school attendance or attendance in an occupational training programme);

- gradually increasing the amount of the CSG to the level of “income sufficiency”;

- making the CSG universal (i.e. not subject to a means-test);

- providing designated caregivers of children receiving the CSG with a grant at least at the level of the CSG benefit;

\(^3\) See 2008 Budget Review, p. 46, Table 3.3.
targeting or income-relating of social assistance benefits would be achieved by an income tax “claw back” of payments made to higher-income earners.

(2) Improving income support for unemployed persons not entitled to UIF benefits through providing social assistance grants for unemployed persons related to the proposed monthly unemployment continuation benefit (50 per cent of the minimum wage – see Section 4):

- Unemployed persons aged 19-24: 30 per cent of the continuation benefit (i.e. 15 per cent of the minimum wage)
- Unemployed persons aged 25-59: 20 per cent of the continuation benefit (i.e. 10 per cent of the minimum wage).

Since they would effectively reduce gaps in South Africa’s social assistance provisions the panel supported all the above proposals. The levels of the suggested non-UIF monthly unemployment benefits – 10 per cent or 15 per cent of the minimum wage – are questionable, since it is doubtful that a benefit of R100 to R150 would provide a sufficient incentive for the unemployed, notably the young, to undergo a demanding skill training programme.

A schedule for introduction and improvement of the grants should be determined by a budgeting exercise that would map out a strategy for financing the benefits. The present schedule follows a gradual approach based principally on fiscal prudence. It also envisages the universalization of the old-age grant at a relatively early stage – before the introduction of youth unemployment support – which, though desirable, may not reflect the most urgent need given the relatively extensive coverage of the existing old-age grant system.

The panel advocated, as matter of priority, the early introduction of meaningful child support and caregiver grants and unemployment assistance benefits, combined with a highly visible, well-endowed and carefully monitored public works programme. The benefits and the public works programme could be substantially financed by resources that are presently envisaged for the wage subsidy programme.

Social assistance grants should be increased periodically to reflect increases in the general level of wages or the cost of living. These increases can be measured by an index of average earnings or by an alternative measure of living standards. Over a period of rising real incomes, using a price index will result in a widening gap between the incomes of grant recipients and other sections of the population.

4. Unemployment benefits and the Unemployment Insurance Fund (UIF)

The sole social insurance scheme in South Africa is the Unemployment Insurance Fund. In addition to unemployment insurance benefits, the UIF provides maternity, sickness, adoption and death benefits. Several years ago, the system was virtually bankrupt. Systemic reforms in 2002/03 including the extension of insurance coverage to persons above the contributions ceiling, inclusion of groups of new members and radical and successful administrative reforms turned the financial situation around. This is a unique success story by any international standards.

The scheme now has about 7.2 million contributors (including domestic workers). Annually the UIF pays benefits to about 420,000 unemployed persons, 30,000 sick persons and 96,000 women on maternity leave, and it pays about 24,000 death benefits. In 2006/07 the UIF had expenditures of about R2.7 billion and an excess of contributions over
expenditures of about R6 billion. Recent surpluses have resulted in the UIF holding reserves of about R21 billion at the end of 2007.\(^4\)

The UIF reserve has reached a level of about seven times its annual expenditure. This is several times higher than is required for a reasonable and prudent reserve. Social insurance schemes such as the UIF are risk pooling and redistributive mechanisms, not capital accumulation schemes. Unemployment and short-term cash benefits require only contingency reserves. A contingency reserve should have sufficient funds to meet expenditures in order to provide time for a scheme to adjust its contribution rate and/or benefit levels in the event of adverse experience, for example, unexpectedly high unemployment benefits resulting from a rapid economic downturn. A contingency reserve level of about one year’s expected annual expenditure is generally regarded as appropriate.

The UIF pays benefits to about ten per cent of the approximately four million unemployed persons in South Africa. However, its reserves effectively take about R18 billion away from possible redistributive measures which could be introduced to alleviate hardship due to unemployment not covered by the UIF or caused by other contingencies.

The UIF recognises that there is a need to improve its coverage and concurs with the DSD that a number of improvements can be made. Measures suggested include:

- increasing the maximum number of benefit days the unemployment benefit is payable from 236 to 300;
- de-linking the benefit entitlement in the different benefit categories (for example, allowing women to receive the maximum number of daily unemployment benefit payments after having received the maternity benefit);
- improving the malfunctioning placement service and developing effective active labour market services (e.g. demand-oriented training and retraining services);
- extending for an unlimited period the payment of a continuation benefit of 50 per cent of the minimum wage (i.e. a monthly benefit of around R500) to beneficiaries who have exhausted their normal unemployment benefit entitlements, subject to their being available for work and following required measures to qualify for the benefit (e.g. participation in skills assessment and training programmes);
- increasing the lower limit of the graduated benefit replacement rates (presently 38 to 70 per cent) to 45 per cent;
- inclusion of self-employed persons and civil servants.

The panel agreed in principle with the above measures subject to the following qualifications:

- The period of payment of the continuation benefit should be limited in order to avoid creating dependency. This should not create hardship if a social assistance benefit for unemployed persons is introduced (see Section 3).
- The development of an effective active labour market policy is a matter of urgency. The services can be made available to the wider group of unemployed persons, with the cost of services to the uninsured reimbursed by the state.
- To avoid manipulation of the scheme, self-employed persons cannot be covered for unemployment benefits.

\(^4\) Of the R21 billion, about R15 billion is invested in government bonds.
• The inclusion of civil servants is a matter of national solidarity.

• In the short- to medium-term, the above measures will not reduce the reserves of the UIF to the level of one times expected annual expenditure. Thus, for a number of years, it is possible to reduce the contribution rate. This would free funds for financing urgently needed social assistance benefits.

Providing social assistance benefits for the uninsured unemployed is a high priority. It may be observed that introducing a rural employment guarantee scheme (such as has been introduced in India) that provides one person per household with 100 days of employment per year paid at the minimum wage, would probably cost in the order of R6,000 per annum per recipient. This means the annual surplus of the UIF alone could finance such a scheme for about one million youths. Furthermore, the part of the wage subsidy that is not earmarked to offset the introduction of a new social insurance scheme could be used to finance such a system, which would have a much more tangible outcome in terms of reducing unemployment. It was pointed out, however, that implementation of a 100 day employment guarantee scheme would not be an appropriate alternative to the proposed social assistance grants for unemployed persons (see Section 3).

5. Pension reform

The panel fully supports the principles of statutory national pension schemes: universality, equity, pooling of risks, mandatory participation, administrative efficiency and solidarity, as well as the objectives of adequacy, affordability, benefit predictability and financial sustainability.

With respect to the predictability of benefits, ILO Convention No. 102 requires a minimum replacement rate of 40 per cent (of the last or a defined reference wage) for old-age pensions after 30 years of contributions. This benchmark sets a minimum target level of income people need for planning their retirement. Whether the benchmark is achieved depends on the mechanism used to provide pensions and how investment, demographic and other risks are handled.

The DSD suggests a national pension system with the following components:

Tier 1: Flat-rate universal pension grant of approximately R940 per month (in 2008 terms) financed by general revenues. There would be no means-testing. This is a modification of the existing old-age and invalidity grant system whereby it is incorporated as a component of the statutory national pension scheme.

Tier 2: Contributory pension scheme with two components:

  Tier 2a: Defined benefit (DB) scheme – covering persons with annual incomes under R75,000, a contribution rate of 15 per cent and a pension benefit accrual rate of about 1.5 per cent per year of contributions.

  Tier 2b: Defined contribution (DC) individual savings scheme – covering persons with annual incomes between R75,000 and R750,000 and a contribution rate of 15 per cent.

Tier 3: Supplementary voluntary savings possibly subsidized by tax credits.
5.1 **Tier 1: Old-age and disability grants**

The universalization of the old-age and invalidity grants and the envisaged benefit levels are supported by the panel. They are crucial tools in the continuing battle to avoid poverty in old age and during invalidity. When there is a high income threshold for a means-test which results in most persons qualifying for the benefit, the cost of administering the means-test can be higher than the savings made by means-testing. Since the present income threshold for the means-test is relatively high and population coverage of the grant is wide, it is desirable to abolish the means-test.

When there is an income threshold for contributions, there may be questions of equity between persons whose earnings were below the threshold and consequently did not contribute, and those who contributed since their earnings were slightly higher than the threshold. Persons with relatively low contributions might not receive any (or only a small) additional benefit, compared to others who did not contribute. An equitable approach is to levy contributions only on earnings above the threshold.

5.2 **Tier 2**

The panel recommends that the DSD consider national pension scheme design issues including the following before formulating a specific proposal for Tier 2 and seeking a national consensus:

The principal retirement benefit should be a pension:

- It may be necessary also to provide a modest lump sum at retirement (particularly for low-income earners).
- Drawdowns of retirement benefits before retirement should be limited. Contingencies which create the need for such drawdowns should be met by other benefits.
- Disability and survivors’ pensions should be related to the retirement pension in payment or accrued pension rights.

Tier 2 should provide retirement benefits based on earnings up to a ceiling:

- The ceiling should be set at a level to include all the earnings of, say, 80 per cent of the insured persons.
- The ceiling should be adjusted annually to take into account increases in average earnings.

All income earners, including civil servants, should participate in the Tier 2 scheme:

- Including all income earners in the national pension scheme gives effect to the principles of universality, risk-pooling and solidarity.
- There should be no exemptions (e.g. for alternative schemes which have benefits equal to or better than the statutory scheme). The Tier 2 scheme would be “carved out” of existing occupational schemes.
- Existing schemes would provide supplementary benefits by applying accrual rates in excess of the statutory scheme accrual rate and for earnings above the statutory scheme earnings ceiling.
A target Tier 2 replacement rate for a full-career participant should be set (e.g. an accrual rate of 1 per cent per year would produce a 40 per cent replacement rate after 40 years of contributions):

- Earnings for the calculation of pension should be career average adjusted earnings (i.e. earnings adjusted annually according to the increase in average wages).
- There is no reason to limit participation to persons over age 25 (especially if Tier 2 is a DC scheme).
- A replacement rate under 50 per cent leaves room for Tier 3 voluntary occupational and personal pensions to top up the statutory benefit.

A Tier 2 contribution rate of 15 per cent has been mentioned:

- A possible 15 per cent increase in labour costs is not insignificant and, to the extent that the cost falls directly or indirectly on employers, has potentially serious implications for employment in a situation where there is already a severe unemployment problem.
- A 15 per cent contribution rate will generate funds for investment which are apt to exceed the capacity of the domestic capital market to absorb and could have an effect on interest rates and asset values.
- Foreign investment is an alternative, but this is unpopular; funds withheld from consumption should be used to build South Africa.

Retirement age for males has been reduced to the female retirement age of 60. This will create problems in the future:

- It is simple to reduce retirement age, but extremely difficult to develop the consensus and political will to increase it, and any increases must generally be phased in over extended periods.
- Retirement age should be increased to maintain a constant ratio of expected period in retirement to expected contributory period.
- Provision for an automatic increase in the retirement age as life expectancy at retirement age increases could be legislated.

Tax relief may not encourage persons to opt for voluntary (e.g. occupational) retirement schemes, but it would be inequitable to tax these schemes on a TTT basis: 5

- Acceptable alternatives are EET (i.e. tax deferral) or TTE. Under the EET system, the personal income tax payable on the pension is generally at a lower rate than the tax relief on the contributions and investment income.
- Ceilings can be applied to any tax relief arrangements.

The structure of a national pensions system for South Africa, consisting of a basic Tier 1 flat rate universal pension, a social insurance (DB) Tier 2a and a voluntary private insurance (DC) Tier 3 was supported by the majority of the international panel. One

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5 TTT means that contributions, investment income, and benefits are subject to income tax. EET (exempted, exempted, taxed) means that contributions and investment income of reserves are exempted from income tax, while benefits are taxed.
member suggested a structural modification to Tier 2 which is set out in Section 5.2.2 as Option 2.

The panel made a number of specific comments on the design of Tier 2. Suggested modifications and alternative options are outlined below. Option 1 refers to Tier 2a, a DB scheme operated by a government agency. Option 2 discusses Tier 2b, a mandatory DC scheme operated by private sector managers.

5.2.1 Tier 2 Option 1: Defined benefit scheme

The Tier 2 scheme could consist of only a social insurance DB scheme (i.e. only Tier 2a) with a 1 per cent (or slightly lower) accrual rate for retirement pensions and include the risk benefits (invalidity and survivors’ pensions). The ceiling on insurable earnings would be set at 2.5 times average annual earnings (i.e. R75,000 per annum according to information provided to the panel). The reference wage would be calculated on a career average adjusted earnings basis using revalued annual earnings. Benefits in payment would be indexed to take into account inflation since they were awarded.

A DB scheme has predictable replacement rates and thus enables personal financial planning. After 30 years of contribution, a pension formula that guarantees 1 per cent of the reference wage per year of contribution would, along with Tier 1, lead to a total replacement rate for the average earner approximately at the 40% level set out in ILO Convention No. 102. After 40 years of contribution, the replacement rate would be around 50%.

A statutory DB national pension scheme would be partially funded. The ultimate guarantor of the benefits is the Government. The initial contribution rate can be set taking into account the capacity of contributors to contribute, and the amount of reserves which will be accumulated and the possibility of investing the reserves productively. Subsequently, depending on the initial contribution rate, the rate may have to be increased periodically according to a benchmark which triggers an increase. A 40 per cent replacement rate after 40 years of contributions could be financed with a contribution rate much lower than 15 per cent.

A partially funded Tier 2 DB scheme would also allow:

• redistribution through the benefit formula or contribution rate (a progressive contribution rate structure is preferable to a wage subsidy);
• payment of risk benefits (disability and survivors’ pensions) by the scheme;
• crediting of insurance periods for periods of sickness, maternity, caring (which will become more important in South Africa in the coming years) and unemployment;
• “grandmothering/fathering” in older workers without having to wait decades before the first full pensions are paid;
• diversification of risks among a flat rate Tier 1, DB Tier 2a and voluntary DC Tier 3.

The Tier 2 DB scheme would be operated by a government agency. A Tier 2 DC scheme would be operated by competing private sector managers. It is not clear what advantage there is in having a DC scheme and private managers given the following considerations:

• Competition among private DC scheme managers is largely illusory. Rather, private investment institutions could be contracted to invest tranches of the reserve funds accumulated by a partially funded DB scheme. This would create real competition.
• Private DC scheme managers typically have much higher expense ratios (including commissions, profits) than a well-managed publicly administered DB scheme where the expenses should be under 5 per cent of contribution income.

• Risk benefits (payable in the event of disability or death) must be financed separately in a DC scheme.

• A DC scheme requires contributors to make important decisions about financial products for which they are totally unqualified, and they are often influenced by advisers who have a pecuniary interest in their decisions.

• Annuitization of DC balances at retirement to produce a lifetime stream of periodic payments has been a problem for DC schemes. Also, unless the provider(s) of annuities have access to indexed bonds (almost exclusively issued by the Government), pensions cannot be adjusted to automatically take into account inflation. If indexed bonds are available there is no point in pretending to have competition among annuity providers.

Mandatory membership of DC schemes requires that a stringent and effective regulatory authority must be set up. When contributions are mandated, regulation must be stronger than for voluntary schemes, since the Government has an implicit obligation for the performance of the mandatory DC scheme. The cost of regulation is ultimately borne by scheme members in the form of lower pensions.

If there is some form of government guarantee of pensions, the Government might just as well operate a DB scheme.

5.2.2 Tier 2 Option 2: Mandatory defined contribution scheme

It is not clear why Tier 2 should have both a mandatory social insurance programme (Tier 2a) and a mandatory fully funded defined contribution component (Tier 2b). Such a combined programme will require additional contributions and (if successful) imply substantial transfers across the life cycle from working age to old age.

Existing defined contribution pension funds in South Africa suffer – to a greater or lesser extent – from problems of excessive fragmentation and high administrative costs which reduce the effective return to participants. Much of the potential return to the more diversified portfolio that can be offered by such a scheme relative to a traditional “pay-as-you-go” scheme is therefore eroded and not available to plan participants in the form of higher pensions.

If a policy of mandatory defined contribution pension coverage is implemented – whether to supplement Tier 2 earnings-related coverage or as an alternative to that programme – then the structure of the DC component must be thought through carefully. In particular it should avoid the pitfalls of excessive administrative charges, fragmentation of funds and over-complexity of investment choices that might arise in such circumstances.

One strength of a proposal for a mandatory tier of this kind – especially if backed up by the possibility of public contributions in the form of individual tax reliefs (up to some ceiling) and, possibly, supplementary contributions for low earners, is that the sheer size of the potential flow of investments gives the Government some bargaining power vis-à-vis private providers. Mandatory DC plans open up a whole new market to private providers, and it is important that the Government exploits its role in the process to maximize social welfare rather than simply the profitability of providers. This bargaining power should make it easier for the relevant government department to negotiate on issues such as capping administrative charges, limiting complexity and exploiting the economies of scale in investment arising from a limited number of providers.
One model of such a structure would be for the Government to act as a “clearing house” in collecting mandatory contributions from employers (as with a standard public programme) and then transferring these contributions to nominated providers. This saves on the administrative and marketing costs that arise when individual providers seek to negotiate contracts with individual contributors. The Government could establish an open tendering process by which a limited number of established private pension providers (which could be from the South African market or indeed external providers with international experience of similar arrangements) were invited to manage the investment funds arising from these contributions. Contributors could choose which of (say) the four or five providers approved by the Government would manage their contributions; the Government itself could be a default provider in the form of investing the proceeds in government securities.

Approved providers would have to satisfy stringent conditions concerning ceilings on administrative charges, transparency of portfolios and reporting arrangements, and easy access to information and advice for members. To keep administrative costs under reasonable control, the range of investment options offered by these companies to contributors should be decided in advance by the Government and kept to a strictly limited number of alternatives (e.g. 100 per cent bonds, 25 per cent equities + 75 per cent bonds, 50 per cent equities + 50 per cent bonds). Experiments undertaken in conjunction with the introduction of the new Personal Accounts in the UK suggest that potential contributors find it difficult to make choices beyond four or five portfolio options and that their choices are highly influenced by whatever “default option” is offered as the portfolio that will be assigned if the contributor does not make an “active” choice. The role of the Government in this process should also permit it to rule out what it considers “anti-social” investment strategies and to pursue its own social goals in deciding on approved investment strategies. Care should, however, be taken in ensuring that the pursuit of social goals does not outweigh the provision of satisfactory returns to contributors which, after all, is the primary object of the reform.

With such a scheme in place, the residual role for Tier 3 investment in discretionary pension funds is that it permits certain groups in the population – particularly those with surplus investment funds – to invest in portfolios which may diverge from the limited choice envisaged for the Tier 2b. The extent and diversity of these arrangements would then depend on the success of the Tier 2b pension investments. One could envisage a successful Tier 2b as leaving only a residual role for discretionary investments with the inevitable attrition of much of the existing, fragmentary, multiplicity of pension schemes. Indeed the nominated Tier 2b providers might have a dominant market position in Tier 3 as well as the Tier 2b, which re-emphasizes the need for effective regulation and control of the private pension sector. On the other hand, if returns earned in Tier 2b were relatively modest (due, for example, to the Government and contributors choosing rather conservative investment strategies) then the scope for a large Tier 3 would be greater. Either way, effective regulation of the private pension industry must extend to Tier 3.

5.3 Tier 3

Tier 3 would comprise voluntary private and personal pension schemes that would largely consist of existing occupational schemes. Occupational schemes would have to be modified depending on the form of the Tier 2 scheme which they would supplement. Regulation of Tier 3 schemes should be strengthened.
6. Health care

6.1 The need for change

The case for change in health care financing in South Africa through the introduction of mandatory social health insurance is both strong and urgent. Despite discussion of various proposals, there does not appear to be a clear proposal that could now be submitted for consultation and discussion with stakeholders and high level decision-makers.

The case for change should also be considered in the light of the lack of achievement of the Millennium Development Goals (MDGs) for health in the last decade, and the stagnation and even deterioration in mortality rates, as noted in the DSD document Creating our Future: Strategic Considerations for a Comprehensive System of Social Security (Chapter 4: Context for Social Security Reform, Socioeconomic context, p. 13).

The mechanisms to reach the suggested change could be accelerated by stressing several issues, in addition to the noted problems and cost escalation in the voluntary medical insurance system and public-private mix of providers. These issues are:

- Inequity in access to health care, with the majority low-income population seeking and receiving less care than the minority high-income population.
- Differences in health indicators across population sectors (e.g. by income levels, urban and rural residence, insured persons in private schemes and the rest of the urban population).
- The lack of comprehensive health care benefits in the existing private medical insurance schemes and failure of these schemes to introduce health promotion and preventive services.
- The failure of the substantial revenue generated through the medical insurance schemes to contribute to improvement in health and health care services throughout the country.

6.2 Principles of mandatory social health insurance

From the outset, the principle of universality should be stressed in the change in health care financing, mainly through the introduction of a mandatory social health insurance system with affordable levels of contribution and social assistance for those who cannot contribute. Universality is not likely to be achieved immediately and may take up to a decade. The process will require:

- Legislation of a mandatory social health insurance system for all economic sectors, including both public and private sector employees and their dependents, as well as the self-employed and informal economy workers and their dependents.
- Adjustment of the Government Employees Medical Service (GEMS) to the design of the new mandatory system.
- The sharing of contribution payment between employers and employees for the employed population as a percentage of salary, with appropriate ceilings.
- Appropriate mechanisms to facilitate registration and contribution collection from persons in the informal economy and consideration of state subsidies for the low-income families in this population to replace employer participation.
• Mandatory social health insurance for all the contributing sectors, without exemption of persons covered by existing private health insurance schemes.

• Coverage of the indigent and non-economically active population with the same entitlement to benefits as the contributing population, and the cost covered by the state budget, and through the same system.

• Coverage of a package of health insurance benefits which includes both ambulatory and in-patient care, with primary health care in the community and home, specialist care covered as ambulatory and in-patient benefits, and covering an appropriate defined range of technology and pharmaceutical drugs and medical supplies.

• A defined allocation of health insurance revenues for health promotion and prevention at the individual and population levels in addition to government funding of preventive services.

• Provider-payment systems which are not volume based, that is, moving from fee-for-service to capitation fees or a combination of provider-payment mechanisms with the necessary quality assurance mechanisms to assure appropriate health care.

• Provider-payment mechanisms which are identical for all categories of providers for essential health insurance benefits.

• Appropriate legislation and regulatory tools to implement and enforce all of the above, and covering all aspects of contributory and non-contributory membership, benefits, provider contracts and payment, as well as governance and management structures.

6.3 Prerequisites to assure effectiveness of a mandatory health insurance scheme

The development of private health care in South Africa has not followed a national health system development plan but rather has followed economic opportunities in a for-profit service industry. The majority of the population will remain dependent on the public health care system, which needs to be strengthened as part of the process of the introduction of health insurance. Several activities or interventions are suggested to reach this stage:

• Allocation of additional resources from the state budget for necessary improvements in infrastructure, including equipment, in public health centres and hospitals.

• Review of the system of provincial level allocations for health care to assure improvement in recruitment and a stable supply of all resources, particularly human resources.

• Development of national and provincial plans for the establishment, licensing and continued accreditation of all levels of health care facilities (including health centres, specialty clinics, diagnostic facilities and hospitals).

• Strengthening of the management and financial accounting functions of providers, particularly the public hospitals at all levels, to enable the retention of revenue from health insurance at the provider level, rather than the current transfer of user charges to the provincial health departments. With appropriate guidelines, this process should lead to financial autonomy of providers.

• The extension of coverage to persons in the informal economy may involve a number of alternatives, from the development of capacity in a state health insurance system to
cover this population, to contracts with associations or cooperatives to operate as satellite schemes. Care should be taken to develop regulations for the extension of coverage to this population, in order to avoid the establishment of a wide variety of unregulated community-based initiatives.

• If user-fees in public hospitals are eliminated, then mechanisms will be needed to encourage membership in the mandatory health insurance scheme. The implementation of mandatory social health insurance should result in providers being financially compensated for health care provided to all population groups.

6.4 **Regulation of existing structures**

The current voluntary health insurance coverage involves a large number of medical insurance schemes which are statutorily non-profit entities served by commercial agencies to handle the contracting with and payment to for-profit providers of medical services. While some proposals for regulation have been made, it is suggested first to develop criteria for the accreditation of the agencies, and to define the government authorities responsible for each group (e.g. medical insurance schemes, commercial agencies, private health providers) as part of the regulatory reform process.

6.5 **Role of the existing private health insurance schemes and providers**

The role of the existing medical insurance schemes has to be clarified as a first stage in development of a proposal. It would be unfortunate if 14 years after the democratic change in South Africa, a two-tier system were developed; leaving the higher income population covered by the existing private structures and a new public system for the low-income and indigent population. The existing schemes could play an important role in insuring benefits beyond essential health care on a voluntary basis, and could facilitate the provision of non-essential services, including direct access to specialists without referral and private in-patient accommodation. The expertise of the larger existing schemes should be tapped to assist in the development of the mandatory social health insurance system.

Private hospitals would gain from contracting with the mandatory insurance scheme to cover defined populations under the same provider-payment conditions, and this could increase their current low occupancy rates without major cost increases. At the same time, the private providers would be able to charge for non-essential services, such as private accommodation, directly to the patients or through the voluntary insurance component.

6.6 **The development process for a mandatory health insurance scheme**

Following the vast amount of research and work already done, it should be possible to develop a sound proposal within two to three months. The proposal could be in the format of a master plan for mandatory social health insurance for South Africa, developed by a task force including representatives of the agencies which participated in the seminar organized by the DSD. Assistance could be given by providing examples and an outline for a master plan.

The master plan should be a document for review and consultation and then be submitted for approval to the highest level authorities, along with appropriate orientation on the principles of social health insurance and the multiple objectives of the proposed changes in health care financing in South Africa.
In parallel with the master plan, a plan for the legislative and regulatory tools required for mandatory social health insurance should be prepared by the same task force but with the assistance of individuals familiar with the Constitution and legislative tools required for such mandatory systems for social services. This plan would help to provide a realistic time-frame for the development of the health insurance system.

Much of the ground work has already been done, and the suggested documents could be drafted within a short time.

7. **Wage subsidies**

The Treasury has suggested that the introduction of a contributory social insurance scheme should be eased by wage subsidies for low-income workers. The wage subsidies would be paid to employers, and were expected to serve a dual purpose: firstly, to offset workers’ social insurance contributions, and secondly, to create incentives for employers to hire low-skilled workers. The panel considered that reduced contribution rates for low-income workers would be a better and simpler alternative. Under a defined-benefit pension scheme these subsidies could be financed by the community of contributors on a solidarity basis without any subsidy from the Treasury.

The amount of the wage subsidy that exceeds the amount needed to offset the social insurance contributions would be a subsidy for low-skilled labour. Given the low amount of monthly subsidy a low-skilled worker would receive (possibly in the order of R100 per month), the panel questioned whether the subsidy would be a sufficient incentive to significantly increase employment of low-skilled workers. Rather, there is risk that this subsidy would lead to considerable dead-weight losses and embody a hidden tax relief for employers.

8. **Institutional reform, governance and administration**

It was suggested by the panel that:

- It should be recognized and accepted that existing social security institutions are unlikely to be replaced or amalgamated. The focus should be on rationalizing social security programmes and introducing new ones in order ultimately to produce a coherent (non-duplicative) and comprehensive system of statutory social security protection.
- Receiving two benefits due to the occurrence of one contingency ("double dipping") should not be possible.
- The regulation of voluntary occupational (and personal) pension schemes must be strengthened. (See publications and activities of the International Organization of Pension Supervisors (IOPS) and the Financial Affairs Division, Directorate for Financial and Enterprise Affairs, Organization for Economic Co-operation and Development OECD.)
- A system of specialized social security tribunals should be set up to deal with appeals against decisions made on a claim for a benefit or other matters. (See the systems in the UK and Germany.)
- It is desirable that any social security scheme be simple to understand. Complex schemes may (theoretically) produce better protection, but if the scheme is not understood by those it is designed to protect, it will not be appreciated. A simple
scheme facilitates simple and efficient administration by the social security institution(s).

- Collection of contributions to all social security programmes along with income tax can reduce collection costs and is a sound approach, provided:
  - The tax collection agency is efficient, and able and motivated to collect contributions on earnings between the social security schemes’ contribution threshold(s) and ceiling(s), and to perform social security verification, oversight and enforcement functions.
  - The tax collection agency transmits data on contributors and contributions to each social security scheme administration promptly.
  - The tax collection agency has the legal right, personnel and motivation to enforce social security contribution conditions.

- A common threshold and ceiling for contributions to all social security schemes would simplify contribution collection and employers’ compliance. Thresholds and ceilings should be adjusted annually to take into account increases in average earnings.

- A centralized agency to maintain basic data on scheme members is a sound approach, but each scheme still needs its own specific data (e.g. for claims adjudication, actuarial valuations, etc).

- Each scheme should adjudicate and pay its own benefits. Offices comprising all government operations (e.g. social security schemes, vehicle licenses, business licences, etc) are a modern approach (“one-stop-shops”) and should be used to provide information and advice to social security scheme members.

9. **By way of conclusion: Further technical work is needed**

The panel concluded that social security reform in South Africa should move forward based on a set of principles and priorities. The key principles are:

- Keep it simple.
- Do no harm; ensure that reforms are, and are perceived to be, equitable.
- Do what can be done quickly.
- Take time to ponder what requires longer-term planning.

Social security reforms which would help to stabilize South African society should have first priority. Improvements to the social assistance grant system will have an immediate effect on poverty and inequality, and can be undertaken immediately. They can be financed in the short term from the current surplus, transitional borrowing at a modest level and/or a reduction in tax credits for voluntary occupational or private pensions and health insurance. In the medium term the increased resources can be financed by borrowing from the pension scheme until such time as the tax to GDP ratio is increased by appropriate measures, or increasing growth creates the necessary fiscal space. The establishment of a social assistance fund (to finance the grant system) in parallel with a social insurance fund (to finance social insurance pensions) and a possible national health insurance fund would create a transparent financial structure of the overall social security system.
To create maximum “buy-in” and wide acceptance of reforms, institutional upheavals should be minimized. While existing institutions may be assigned new or additional tasks in a comprehensive reformed system of social security protection, major reforms of the institutions themselves would result in a political cost that should be avoided in a situation where broad consensus is necessary. The functional part of the private pension and health insurance schemes should be maintained, and these schemes should be given space and roles so that they can maximize their social utility and minimize potential discontent.

Establishing or reform of social insurance pension and health insurance schemes is a longer-term undertaking. The full effects of the schemes are evident only after years – in the case of a pension scheme, after generations – and the analysis requires extensive statistics. Much groundwork to set up these schemes has already been done, and the preparation of the suggested documents should be possible within a short time. Through the seminar organized by the Department of Social Development in June 2008, the major stakeholders have been identified and have demonstrated their willingness to participate in the process.

After the endorsement of mandatory social health insurance by the ANC in November 2007, it is important that this process moves ahead as soon as possible to take full advantage of the current political commitment. The process should first focus on the major equity, health status and health system issues, and then on the financial aspects and institutional elements. The proposal should be kept as simple as possible and provide a rational time-frame for the required changes, drafting and passing of legislation and the extension of coverage to the entire population to reach universal coverage.

Reforms of important societal institutions like social insurance and social assistance schemes must be based on the greatest possible transparency and full information to the public on the expected long-term development of contribution and tax rates and levels of benefits. Based on complete information, an informed policy debate on the pros and cons of alternative solutions can take place and be brought to a consensual conclusion. Full disclosure of all information and assumptions can result in a robust consensus in an interest ridden policy area like pension reform. The process will take time but such an approach can create national ownership and consensus and avoid subsequent governments reopening the reform package, thereby creating uncertainty.

The ILO is available to support the process by providing the Government and social partners with a structural financial analysis of the social security systems, including the pension systems, on the basis of demographic, economic and labour market scenarios that are provided by a tripartite working group. The outcome of this analysis would be a projection of the social budget of South Africa which would provide a sound basis for discussion of different options. The analysis could be established under the guidance of a multi-party steering group (including representatives from concerned government agencies, employers, workers and civil society) which would help to set the assumptions and identify design alternatives that then can be tested to assess their social desirability and fiscal feasibility.

The members of the panel and the International Poverty Centre are ready to support aspects of the reform process through individual or collective inputs.

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6 A social budget model would encompass all branches of social insurance, the health insurance scheme, and the social assistance schemes as well as the government budget in order to model the financial and fiscal relationships and impacts of the overall social security system.
# ANNEX

## INTERNATIONAL EXPERT PANEL SEMINAR ON SOCIAL SECURITY REFORM

### PROGRAMME

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