Designing a Private Sector Pension System in Cambodia

Asian countries including Cambodia will observe some of the fastest population ageing in the world during the next few decades. Currently, for every person in Cambodia over 60 years there are ten people aged 15-60. In 50 years there will only be 2.5 persons for each elderly person. The rising share of elderly people requires an adequate pension system in response.

Currently only civil servants and veterans receive an old age pension, making up about 313,000 pensioners (2015). For the rest of the population of 15 million there is no pension system. Without a pension system population ageing will lead to increased poverty of the elderly and growing financial burdens on the families taking care of the elderly.

The Cambodian context presents many challenges for establishing new pension schemes. There is a high amount of informal employment, short-term formal employment and shifting between formal and informal arrangements. Contributory or employment-based pension schemes thus risk being ineffective. The Cambodian economy also cannot easily absorb a funded pension scheme in which pension contributions are invested in financial instruments.

Group photo taken on the last day of the training workshop

In response to the specific pension challenges in Cambodian, an ILO Actuarial Review recommended a three-tiered pension system for the private sector into which public sector schemes would eventually be transferred. The proposal combines contributory and non-contributory elements and intends to build upon a partially funded defined benefit (DB) scheme (see Box for definitions).

Project Background

On July 9th 2015 the Royal Government of Cambodia (RGC) launched a Technical Working Group (TWG) for the Establishment of a Social Security Development Strategy. The Ministry of Economy and Finance (MEF) hired a consulting firm to develop a framework for the pension system that was meant to serve as the basis for the policy. The consultants recommended a defined contribution (DC) pension system for Cambodia without discussing the pros and cons of various options.

In contrast, the EU-SPS programme (THL-Finland) together with ILO aimed to support an informed dialogue on financially sustainable and socially responsible pension systems. A high level training workshop was organized to strengthen the capacity of the MEF and other Cambodian Government actors around technical aspects of pension systems. Particular time and attention was given to the debate on the conditions and consequences of DC and DB systems and hybrids thereof.

After the workshop MEF requested ILO to carry out an Actuarial Review in order to provide data on the pension systems options. Less technical reports for decision-makers were also produced. The key findings of the ILO Actuarial Review are presented here.

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The Cambodian Context

A pension system will need to be designed for the context of an increasing dependency ratio. The population of Cambodia is expected to continue growing for the next 60 years, while fastest growth will be in the population aged 60 and above (Figure 1). This is due to the combined effects of declined (though still comparatively high) fertility rates and increasing life expectancy. Life expectancy at age 55 was 20 years in 2015, and is expected to rise to 29 years in 2065.

The National Social Security Fund (NSSF) will be responsible for the development of the pension system. **Only 13% of the population are NSSF members, the remaining 87% being effectively informal workers**. NSSF currently provides Employment Injury Insurance (EII) and Health Insurance (HI) for its members. At the moment 71% of NSSF members are women, and the majority of all members are women working in the garment industry. NSSF members are also relatively young, with membership dropping sharply for the group above age 35.

Ways of designing a pension scheme

Pay-as-you-go (PAYG) schemes channel pension contributions directly from current workers to current pensioners. **Funded** schemes invest pension contributions for interest and are intended to reduce pension costs over time.

Defined benefit scheme calculate pensions on the basis of qualifying years (e.g. years in employment) and the insurable earnings (e.g. some measure of salary). The pension formula generally promises an annual pension as a certain percentage of the annual income (called the accrual rate) per contribution year. This formula makes the amount of pension predictable. Contributions are set at a level that makes the scheme overall financially sustainable.

Defined contribution schemes are usually funded schemes in which the returns on invested contributions (positive or negative) are credited to the individual's account. The monthly pension or the lumpsum amount is more unpredictable due to unknown investment returns.

Accruing a sufficient contribution-based pension is challenging due to fragmented time spent in formal employment that contributes to social security.

Workers in the garment sector are mostly employed under fixed duration contracts. In 2006, the average length of fixed duration contracts was one year. In recent years it has been reduced to three months. NSSF data shows that private sector workers move in and out of employment frequently. Moving from the formal sector to the informal sector is also common.

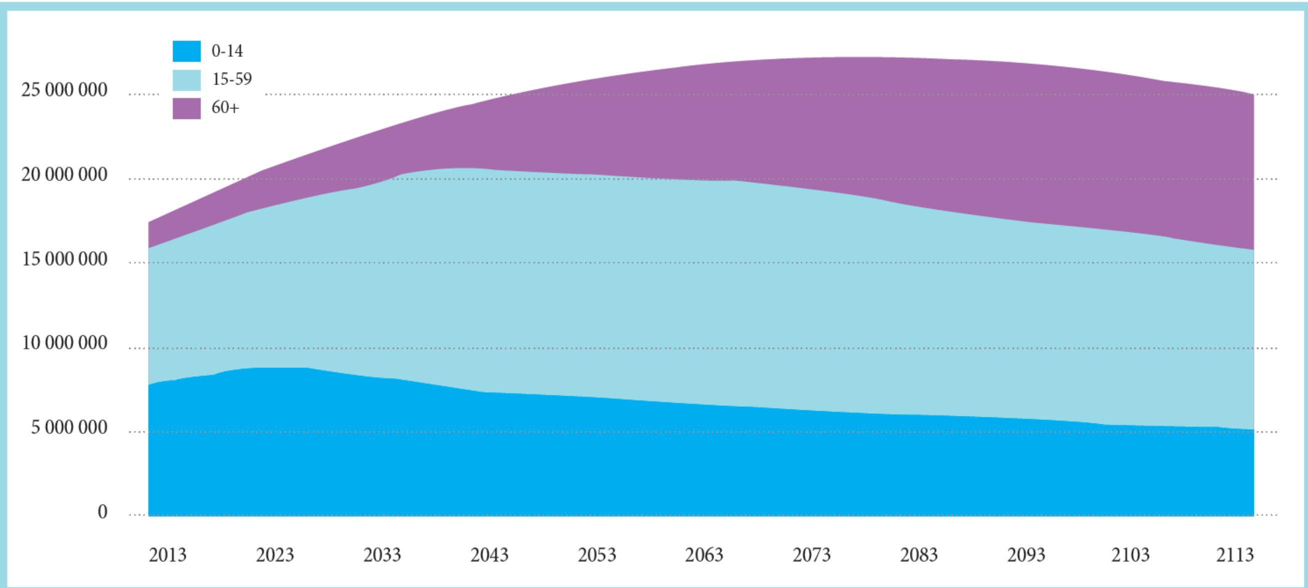

Figure 1: The (projected) numbers of different age groups in Cambodia 2013-2113. Source: ILO (2018) "National Social Security Fund: An adequate and sustainable pension scheme for the private sector"

Workers over 40 years old are far more likely to be in the informal sector. One reason for this could be that garment manufacturers are less willing to hire older people. Some workers may also not wish to continue in this strenuous industry far away from their families and with little opportunities for advancement.

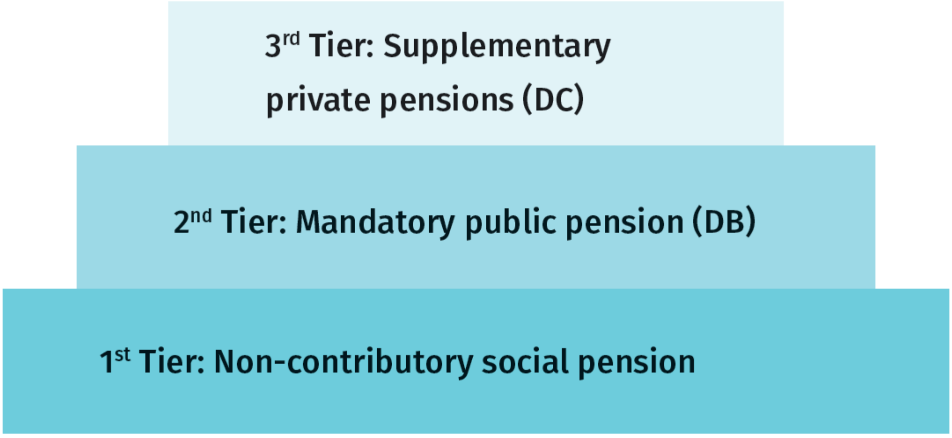

Figure 2: The three-tiered pension system as proposed by ILO (2018)

In 2015, NSSF members made contributions only for an average of 60 per cent of the year or 7.2 months. Therefore even the core of the formal sector is actually informally employed for nearly half of the year. In the years 2010 and 2011 the time spent making contributions was around half of the year.

Pension system recommended by the Actuarial Review

The ILO Actuarial Review highlighted the following aspects that the private sector pension system should include to minimize risks in Cambodia:

- **The eligibility period needs to be short enough** so that workers can accumulate a pension despite fragmented periods in formal employment.
- **The amount of pension needs to be high enough** to maintain incentive to contribute to the scheme.
- **Pensions should be tied to career salary** and indexed to price level.
- **The accrual rate should be higher during the beginning of the career** since that is when workers are most likely in formal employment.

The specific proposal is a three-tier private sector pension system with a contributory DB scheme at its core (see Figure 2). Multiple tiers allow addressing multiple challenges and increase overall system resilience to specific disturbances. The accrual rate for the contributory tier would be 1,75% during the first 15 years of contributions and 1,25% thereafter. Retirement age would be 60.

The first tier is a non-contributory social pension for everyone paid from general Government revenues. The non-contributory tier compensates for the fact that short duration contracts and time spent in informal work disadvantage contributory schemes. Its effect is redistribution toward those with atypical careers. The size of the pension should be indexed to price level but not tied to the minimum wage as this could make the minimum pension vulnerable to being reduced too low.

Modelled costs to Government begin at around one percent of GDP at the beginning of the scheme, but can be reduced. **Medium and long term costs can be reduced by integrating part of the first tier to the contributory second tier**. 30 years of service would be required receive one’s first tier pension completely from the second tier contributory scheme. Those with fewer years in service would have their first tier pension paid for in part by the first tier. Those with zero years in service would receive the full first tier pension entirely from the Government. As the second tier grows it covers a larger portion of first tier costs. The ILO projected that first tier costs on the Government could fall to about 0.6 percent of GDP by 2100.

The second tier is a contributory DB scheme that will at first only cover a small portion of the population. The Review recommends systemically expanding the role of the second tier, which requires formalizing employment overall. The second tier should begin as a PAYG scheme and introduce funding gradually to press costs down. Introducing full funding immediately would lead to high costs early on, since contributions need to cover both current pensions and fund accumulation. Gradually increasing pension fund funding also gives time for financial markets to grow in Cambodia. A partially funded contributory pension scheme that gradually increases the role of funding is also how the Finnish mandatory DB pension scheme has developed.

The third tier is an optional funded DC scheme. Its purpose would be to allow individuals to increase their replacement ratios (the ratio of pension to salary). Opting for the third tier is an expense that requires a certain income level and would therefore not realistically cover everyone. Implementation of the third tier would also have to wait until sufficient pension investment opportunities exist in Cambodia. Another reason for not basing the pension system on a DC model is that it would risk leaving replacement ratios low if incomes continue rising quickly. Further, DC schemes offer no guarantee of minimum pension and do not provide security against invalidity or a shift to the informal sector.

Benefits of a non-contributory scheme

The Government of Cambodia is planning to introduce a DB pension scheme for the private sector in 2019. However, as of January 2019 a non-contributory social pension was not mentioned in the draft pension act which proceeds to parliament after a review process. EU-SPS and ILO recommend that the passed act mention the possibility of a social pension so that future pilots will be easier to introduce. Below are highlighted various benefits that a Government-financed minimum pension would bring despite its associated costs.

Even if optional contributions in the DB scheme were opened to informal workers too, several barriers to their participation exist. Often informal workers do not trust the government, have imperfect information, short time horizons, and may simply not afford to contribute. The majority of the population will therefore not be covered by a solely contributory scheme and are not likely to join at large scale and will not be covered by a solely contributory scheme.

Some argue that the Government could subsidize the contributory scheme so that its high benefits incentivize membership of informal workers. This approach simultaneously introduces Government costs to the scheme while not addressing the underlying problem of widespread non-coverage. The subsidies may need to be very high to incentivize informal workers despite their circumstances. By contrast, a non-contributory scheme covers everybody by design. **It is reasonable to expect a universal non-contributory minimum pension to cost about the same (or less) as a subsidized contributory scheme that only covers a minority of the population.** In addition, non-contributory schemes in fact serve the formally employed too by providing a safety net in the very common case of formal employment ending or fragmenting before retirement age.

A minimum social pension scheme is easier to administer than a social assistance scheme targeting the elderly. There is also a better chance to reduce exclusions. Combining social pension with second tier pension guarantees that there will be no person who would get social pension on false grounds.

A minimum social pension can benefit families and increase incomes in the wider community. Low-income families risk falling into poverty themselves if they need to take care of the financial needs of an elderly. Securing a minimum pension to all is thus not an issue limited to the elderly themselves but reduces strain on all associated low-income families. Sharing incomes within families is also a far less predictable form of "security" than a Government provided pension. Family incomes likely come from short term or other wise insecure employment. These employment incomes could be undermined by injury or illness. Securing a minimum pension that is not susceptible to sudden changes creates predictability that cannot be achieved by other means and allows families to lead more economically empowered lives. Secure household finances in turn can be precondition for seeking training or beginning small-scale enterprise.

The money spent on minimum social pension is not wasted. It continues circulating in the economy bringing incomes to other members of the community (the so-called multiplier effect). Raising the incomes of all elderly and by extension their families benefits local enterprise through increased expendable incomes. In general, non-contributory benefits are a reasonable approach to stimulating economic activity. The Government may then tax these increased incomes in any way it deems appropriate and redirect spending as the needs of Cambodians change. Instead of framing minimum social assistance as a drain on limited resources, it is better viewed as an enabler of a basic level of consumption that brings economic security to the receiver, their family, and their wider community, thereby creating the conditions for prosperity.

EU-SPS: co-operation with 11 countries and regional organizations in Africa and Asia

The EU Social Protection Systems (EU-SPS) Initiative supports national, regional and international expert institutions in 11 mainly low income countries in their efforts to develop inclusive and sustainable social protection (SP) systems.

Partner countries:
Cambodia, Ethiopia, Indonesia, Kyrgyz Republic, Malawi, Mozambique, Namibia, Tanzania, Togo, Vietnam and Zambia.

Funding:
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OECD Development Centre and Government of Finland's National Institute for Health and Welfare (THL). The four-year initiative was launched in 2015. Germany joined the initiative in 2016, with parallel funding through GIZ on behalf of BMZ.

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