FINMARK TRUST

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Securing Informal Sector Participation

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FinMark Trust is an independent trust, established by the United Kingdom Department for International Development (DFID) that supports and promotes institutional and organisational development towards the objective of increasing access to financial services by un-serviced and under-serviced consumers across Africa, through both private- and public-sector vehicles. Long-term savings and old age provision forms a key part of FinMark considerations as old age security is an important contributor to the well-being of citizens in these countries.

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1 Introduction

Saving for old age is important. It allows individuals to transfer excess income gained in the wet season of their earning years, if they have excess income, to the corresponding dry times of old age, reducing the corresponding burden on government.

In the last twenty of thirty years, many countries have introduced significant changes to their systems of old age provision. A large proportion of these have closed or scaled down national pension systems that rested in many cases on the foundation of social security taxes, choosing instead to require citizens to direct these contributions to individual accounts in their own names, with benefits directly linked to the contributions paid in.

Nigeria has followed the example of these countries, launching such a system in the last few years. Over 2.8 million contributors were registered by the end of 2007 and total pension fund assets at the same time exceeded US$6 billion in value.[1] Coverage is nevertheless limited largely to Nigerians who are formally employed and is, by the standards of similar systems in other parts of the world, a relatively low proportion of the national population that the United Nations estimates at over 140 million.

This paper looks at how the system might be rendered more effective at expanding covering. With recommendations to this end, it suggests as well that the needs of the poor – and their current methods of preparing for old age – should form a very important part of the policy consideration.

This note has been subject to tight time constraints and should be regarded as a series of thoughts or discussion document rather than a citable paper. It does not include formal referencing but its material is drawn from a wide variety of sources and a significant body of research, which are acknowledged by the author with thanks. FinMark Trust, in particular, has played a significant role in the development of the thinking expressed in this note. Any errors in the writing – facts, inferences or conclusions – are nevertheless the responsibility of the author.

[1] *Presentation by M K Ahmad, Director-General of the National Pensions Commission, to a workshop of the International Organisation of Pension Supervisors, Dakar, Senegal, February 2008*

2 Global context

A number of models or frameworks have been suggested to describe a system of long-term provision for old age.

The World Bank's three-pillar model, later extended to five pillars, is perhaps the best known of these. The Organisation for Economic Co-operation and Development (OECD) stresses the need for simplicity, encapsulating its approach in a two-part model. The International Labour Organisation (ILO), in support of its call for national systems meeting the benefit objectives of Convention 102 of 1952, frequently expresses its views in the form of a multiple tier system.

This section starts the discussion of improving informal coverage in a pension system by proposing that there are broadly six mechanisms for meeting the needs of the elderly residents of a country, social security, pension funds, compulsory individual accounts and three forms of voluntary provision.

If the description that follows appears to lean towards those members of society with lower levels of income, then this may be regarded as a deliberate strategy, for two main reasons.

- A key objective of social protection programs, of which old age provision is one, is to uplift the poor, as encapsulated in the by-line and vision of The World Bank, *"Working for a world free of poverty."*
- Members of the lower socioeconomic strata of society are not homogeneous in their needs or survival strategies, should not be considered as a single group, and should not be expected to respond in the same way to participation incentives.

Government has a fundamental role to play across all of these areas, but its approach should differ according to the objectives of each stream and needs of participants that stand to gain the most from each.

Social security

Provision of benefits to the elderly directly by government is central to the policies in virtually all countries around the world.

This provision takes a variety of forms. It may be a comprehensive system of social security funded directly by contributions. Alternatively, it may be a broad-based social assistance program providing cash benefits to the elderly and supported only by tax revenue. In some cases, limited fiscal resources enable no more than a minimum set of protection to the most needy of elderly citizens, perhaps in the form of a food basket or other tangible benefits.

In all of these instances, the government is directly involved in providing benefits, often through a dedicated social security arm, and in many cases government explicitly bears the costs of providing these benefits, through its tax revenues or external support from donors. Government usually seeks also to ensure that benefits are received by those elderly citizens in greatest need, so there is some form of targeting involved, but this is not always the case. A small group of countries scattered across the world provides a universal pension to all above a stipulated age, sometimes different for men and women, without any form of means testing. There may alternatively be conditions attached to the receipt of benefits, the so-called conditional cash grants system that is the subject of a recent World Bank book.

Unlike all of the categories that follow, the primary motivation or underlying ethos in this case, even in cases of universal pension systems, is redistribution, social protection designed to help the poor.

Occupational pension funds

Employment- or industry-based pension funds play a substantial role in providing income in old age. They do so in most countries, but their influence is generally greatest in developed nations, where they also play a significant part in allocating capital across economies, since they are substantial investors of the accumulated assets of their members.

In many developing countries, occupational pension funds play a large part in old age provision, but with those countries that have higher incidence of poverty and informalization of employment, the corresponding role played by these entities is smaller, because occupational pension funds are built on a formal employment relationship.

Like the individual account approaches that follow, occupational pension funds exist primarily to facilitate income smoothing, postponing consumption during working age in order to provide for the period of old age. Benefits received are proportional – in some way – to contributions paid, whether the arrangement is defined contribution or defined benefit in design. Redistribution is limited, at best, and coverage is restricted in practice to those working for employers sufficiently large to offer an occupational pension fund, or as members of significant industry groups or professional associations.

Except for provision to its own employees, government's role is usually to regulate the system, establishing an independent supervisory agency to ensure that it operates in the best interest of all participants. It has good financial reasons to do this: failure of the system is likely to result in higher costs to government under its social security commitments.

Mandatory individual accounts

A growing set of countries has introduced a system of compulsory saving in individual accounts. Starting with Chile in the early 1980s and adding a number of Latin American neighbours in the 1990s, the system has also been adopted by a group of Eastern European countries and others, Nigeria, of course, Kazakhstan and Australia, to name a few. With the exception of the last-mentioned, most of these nations would be regarded as middle- or lower-income countries. The majority of them have relatively low levels of government social security provision and at best patchy occupational coverage.

Residents are required to contribute a fixed percentage of their income into the system, receiving pension benefits at retirement – defined contribution in formula – and usually some survivorship and disability cover.

Conceived partly as a means of encouraging participation, on the basis that the direct link between contribution and benefit increases the sense of ownership by participants, individual account systems have, by and large, not resulted in increased levels of coverage, compared with the social security systems that most of them replaced. The main reason for this is that it is not easy for governments to force participation by those who are not formally employed.

The self-employed, rich or poor, also have limited incentives to participate, not least because they are sometimes required to make contributions both as employer and as employee, a burden that they are not always prepared to bear. Members of this group also have a natural incentive to put spare income into their businesses rather than into retirement saving, and tend to regard their investment in themselves as more valuable than a corresponding investment in saving for retirement.

For practical reasons, and to avoid inappropriate distortions to labour markets, the employees of firms with less than a stipulated number of employees are often exempted from participating. The company size threshold in Nigeria is five; it is higher in many other countries. While this is motivated often in the interests of continued development of the small business sector, it limits the reach of the system and the saving mobilised.

National participation rates tend to follow employment patterns quite closely. Latin America's Southern Cone countries, for example, with higher levels of formality of employment, also have higher rates of participation in their pension systems than their Andean counterparts in the north and eastern parts of the continent and the smaller countries of Central America.

As benefits are limited to the accumulation of the contributions of each participant, mandatory individual account systems are not redistributive, though their participants may be supported by some form of government-provided guarantee.

Voluntary supplementary provision

Many mandatory individual account systems also make provision for additional contributions on a voluntary basis, supplementing the accumulation of pension benefits from compulsory participation and making an effort to extend coverage to those not required to contribute under the rules of the mandatory system.

Countries that do not have compulsory individual account systems are also often characterised by systems of voluntary pension saving, usually incentivised by government through tax rebates, with a range of investment options available to participants. The so-called *401k* system in the United States is an example of such a system. South Africa does not mandate participation in a national scheme (yet) but with generous tax incentives achieves relatively high levels of saving in individual account entities called retirement annuities, at least among the wealthy.

Despite the prevalence of tax incentives and the existence of financial service providers in nearly all developed and middle-income countries, voluntary supplementary provision is usually not particularly strong, not least because of the characteristic human tendency to short-sightedness that works against a rational inclination towards long-term saving. This is one of the reasons that so many countries have chosen to mandate retirement saving.

Some countries recognise the practical constraints to mandatory systems and seek instead to encourage participation on a voluntary basis. The Indian pension system seeks to encourage voluntary participation by establishing first the administrative economy of scale through compulsion on federal, state and then municipal employees, a mixed mandatory-voluntary system.

Facilitated additional provision

Tax incentives are a form of facilitation, but may not be particularly effective at encouraging participation by low-income individuals, those characterising the informal sector in many countries, who do not pay tax and are unmoved by the prospect of tax incentives.

A few countries have taken other approaches to these incentives. The Mexican government provides a flat contribution to all contributors in the individual account system. Since it is flat it is relatively more valuable to participants with lower income, adding a higher proportion to their savings, than it is for wealthier participants. While the system itself is not redistributive, based as it is on individual accounts, the method of incentives is, focusing proportionally more on lower income participants.

The government of the Indian state of Rajasthan has agreed to provide similar support to a fledgling system of voluntary contributions run by a private-sector administrator and able to handle very small contribution amounts. Participants in the system are understood to number approximately 100 000 at the time of writing, not bad for a relatively youthful system based on voluntary participation.

Unsupported informal provision

Other methods of preparing for retirement involve private sector providers and government in a number of different ways, but generally to a lesser extent.

Microfinance organisations, in some cases encouraged and supported by government, at least indirectly through facilitating regulation, may require their members to save systematically as a means to pay back their loans and gain access to incrementally larger pools of finance, thus inducing a form of long-term saving. The extent to which the participants are required to demonstrate commitment to the saving varies from country to country and from model to model.

Other organisations have taken a fundamentally different view to the saving-finance balance. They have elected to focus on saving first, requiring members to accumulate a certain specified level of saving before they are permitted to access loans.

In a variation on this, village saving and loans clubs pool savings at the beginning of the year – effectively purchasing shares in a business – and use this capital to lend money to fellow-villagers. Interest rates may appear high to so-called sophisticated investors, but are transparently established by the operation of supply and demand within the village system and are usually significantly lower than in other lending schemes. Shareholders close the business at the end of the year and take out their profit, which they may plough back into the corresponding system for the next year.

Self-help groups often combine saving with other forms of community support and upliftment, and participants are less likely to 'close accounts' at the end of the year, rolling them over instead into a form of longer term saving, later perhaps investing in productive assets.

Governments and large financial institutions may have important parts to play in improving the operation of these community systems, but it is crucial that they consider their role with the utmost sensitivity to the needs of participants. This is the central premise of this note.

3 Two broad approaches

The primary goal of an incentivised or mandated national system of retirement provision is to raise the rate of saving. This should reduce a country's exposure to the vagaries of capital markets but, more important in terms of government's mandate to serve its people, increase the protection that households have against the uncertainty associated with old age.

Part of the policymaker's responsibility is to ensure that the saving takes place in a safe environment. Regulation permits government to enhance the security of these savings. It also gives a means to national leadership to enhance its understanding of the development of the system, the number of citizens participating and the size of asses in the system.

In all countries, however, some economic activity exists 'below the radar screen' that has positive economic value, even if largely unknown to government. Saving may fall into this category, enhancing the security of household finances and protecting against the uncertainty of disaster or the reduced earning potential of old age. The fact that it is hard to measure does not necessarily make such saving activity an inappropriate feature of the economy.

This section is the heart of the paper, asking how the effectiveness of government policy in the long-term saving space might be improved. It seeks to do this in two different ways. First, it considers how the formal system might be expanded to include individuals and groups that are generally difficult to reach, primarily because they are not connected to formal structures. Second, it looks at how saving by informal sector participants might be facilitated, meeting national goals of improved levels of saving for old age.

Expanding the formal-sector system

Individual account systems have not been consistently successful at achieving high levels of coverage. While inclusion has been high in a few countries – Australia provides an outstanding example of very high levels of participation and some of the Latin American and Eastern European countries have done reasonably well – in other jurisdictions, the level of success at drawing citizens into the system as active participants has been relatively poor. Disappointment with coverage levels has characterised many assessments of these systems.

The natural starting point, in response to this, is to ask how the system might be expanded, reaching a higher proportion of the working population. A number of approaches have been tried and these might be arranged under three different headings covering broadly force, incentives and behaviour change.

Push the mandate to participate

The rules of the system could be modified to require participation by a higher proportion of the population. Most systems exclude the employees of small companies – or allow them to participate voluntarily – so one way to enlarge the group of participants is to reduce the company size limit below which employees are not compelled to contribute. Similarly, minimum age limits or minimum earnings levels may be lowered, increasing the pool of potential participants.

Of course, there are trade-offs involved. Company size limits exist with good reason. A system of mandatory saving has labour market impacts that can be most significant at the level of the small- and micro-enterprise: it is more difficult and more expensive to run a start-up operation if it requires compulsory contributions for all employees to a national system. Reducing these limits may induce higher levels of evasion or initiate increased informality of employment. The same concerns would apply to lowering existing age or earnings limits, where there is a strong rationale for these limits in the first place.

Another way to push the mandate to participate is to improve compliance levels. Trade-offs must again be considered. Too often, rules have been written that are idealistic and difficult to enforce. Forcing the self-employed to participate, for example, particularly if they are required to meet contribution obligations as both employer and employee, can be counter-productive, adding again to labour market distortions. The extent to which the 'stick approach' of enforcement could succeed depends on the effectiveness of other state institutions, notably the income tax collection authority. This means that the government objective of improving contributions to the pension system may need to be prioritized behind other more pressing needs, because tighter rules could be rendered ineffective without the appropriate supporting framework.

Policymakers also need to ensure that they define and measure success with care. Experience in Latin America has shown that setting objectives in terms of system registration numbers creates a false sense of achievement, because the consistency with which registered participants actually make their contributions determines the security with which they are able to retire.

Finally, any efforts to broaden the system by expanding the number of participants require concomitant attention to the infrastructure. Registration, contribution collection, database management and payouts are all more difficult for participants that are not as soundly 'plugged in' to the national system. They may not be paying tax. They may not have steady banking access or a reliable postal address. Systems need to be flexible to these challenges. It may be necessary, instead of 'calling the people' to government, to find ways for government to 'go to the people'. Various intermediary models are worth considering and these are discussed in more detail later in this note.

Provide incentives to participate

Instead of seeking to enforce a stronger mandate, government may choose to make it more attractive to participate in the system.

Flexibility of contribution payments is one of the design features that may be considered to make it easier to convince people to participate. While all humans suffer the challenges of myopia – the tendency to avoid short-term loss even for the benefit of long-term gain – those with poorer resources or greater uncertainty of income are less likely to agree to the constraints imposed by a pension system with compulsory contributions. Permitting contributions as and when they can be afforded should increase participation levels at the margin.

Flexibility of access to benefits could also improve the attractiveness of participation. Since a well designed pension system should provide excellent security, cost-efficient administration and generally high investment returns, there is merit in saving into such a system, but the inability to access accumulated resources prior to retirement can quite easily render such an action irrational to those in tenuous financial circumstances.

Policymakers might consider making it easier to draw on accumulated savings to increase the attractiveness of the system to a larger group of potential participants. Early access to parts of the saving would help to allay the fears associated with financial distress in case of dire need and it may also encourage the self-employed, who may regard their businesses as their source of retirement income, to put money aside prudently, protecting them also against the possibility of disaster.

While the need to unlock these savings to meet life-threatening circumstances is often acknowledged, it is tempting to impose rules for withdrawal to ensure that the accumulated wealth is not squandered. This can be expensive and counter-productive. It would be better to define parts of the accumulated saving that may be accessed by participants and parts that are not. Any government co-contribution, for example, could be defined as not accessible prior to retirement. Of the balance, perhaps half might be freely accessible and the balance not, particularly if this mirrors the respective split of contributions of employer and employee.

While penalties for early withdrawal can be difficult to communicate, bonuses for loyalty to the system are more easily understood. Flexibility allows participants to see the value of the system, participate more enthusiastically and make their own assessment of the trade-offs in times of need. Nevertheless, the pitfalls of unnecessary complexity must be guarded against. Clear communication is crucial.

Financial incentives are important as well. Conventional tax incentives probably do not encourage lower income participants, but an explicit government co-contribution may do so. It is puzzling that so many governments require their citizens to participate and are happy to forgo tax revenue – at the average income tax rate of the participant – to encourage their contributions but are not as prepared to pay an explicit amount into the accounts of these participants to provide tangible reward for their partnership in the system.

Incentives need not necessarily be financial. As the state expands its ability to provide services to its people, it may be able to find ways to link accessibility to membership of a system. Such membership would provide certain benefits – faster access to health care or subsidised public transport, for example – but it also permits the establishment of conditions that must be met for the rights of membership to be enjoyed, one of which may be a certain level of participation in the national pension system. While such an approach goes much further than the conditional cash grant systems growing in acceptance in various parts of the world, the principles are similar.

Incentives can also be provided in the design of the system. The easier it is to pay contributions, receive notification of the value of accounts and withdraw any portion that may be accessible before retirement, the greater the chances of participation by those more loosely connected to state structures. The infrastructure of branches provided by a national postal system may be a good place to start. Banks, mobile telephones, microfinance networks and communities themselves may all have some part to play in improving the connectivity of the system, its accessibility to potential participants and the flow of communication back to the people, the most important stakeholders in the system.

Establish a culture of participation

The third broad approach is the most difficult to achieve and probably needs to go hand in hand not only with some of the approaches suggested earlier but also with a substantial and sustained effort at nation-building that cuts across all areas of government and its interaction with its people.

A culture of participation can only be built in an atmosphere of transparent communication together with good levels of understanding of participants. Financial education is a crucial element of this development. A national pension system provides an excellent opportunity for the dissemination of financial education through a wide variety of media. The challenges should not be underestimated, but neither should the benefits.

Can these initiatives work? The Chilean system depends strongly for its success on the participation of the people of that country. Many would describe that system as enormously successful and, to an extent, they are correct. Coverage levels, for example, have been generally high. Not all participants have saved enough, however. More careful scrutiny of the coverage statistics shows that, while registration numbers are high, the corresponding data on contributions is significantly lower, pointing to a disappointing consistency of contribution, the so-called ‘density’ of participation.

A safety net has always been provided in Chile for those unfortunate enough not to achieve satisfactorily high levels of saving but access to this benefit was dependent on 20 years of contributions to the system. Recent research has shown how many participants would fail to achieve this threshold, due mainly to the inconsistency of their working history, hence their earnings. The authorities have introduced a state pension to provide additional protection to its citizens.

The lesson surely is that, while every effort needs to be made to improve the level of compliance of a country’s people to the requirements of its government, failure is possible and additional protection may be required.

Facilitating saving in the informal system

The second broad approach to improving national long-term saving is to support the development of the informal system. As a substantial proportion of Africa’s people survive through informal means, such an approach is simply essential. Even so, it may rest uneasily with government organisations that, with the best motives in mind, would like to understand the financial activities of their citizens, not least to build the regulatory infrastructure that protects and supports the products and services that are used.

Though the informal sector is, almost by definition, difficult to reach, government may have a significant role to play in its development.

A small set of examples illustrates the point.

- Research that facilitates the development of financial markets to enhance the extent to which low-income citizens are able to make good use of them may be encouraged, part-funded or undertaken by government or a related state entity.
- Market facilitation investment may follow from this research. Colombia's *Banca de las Oportunidades* (Opportunity Bank) is a government-established program that seeks, through research and facilitation, to enhance access to financial services, particularly for lower income households, in an effort to promote development while enhancing social equity. Nigeria has made progress with its Microfinance Operational Guidelines and Policy paper, its recognition of community banks and their conversion to microfinance banks.
- Investment in telephonic infrastructure, or a policy that encourages private sector development of that infrastructure, directly benefits the level of access of lower income citizens to financial services, as banking and telephony grow inextricably closer together.
- State grants, where provided, should be given in such a way that the potential for recipients to access good financial products is maximized, for example, by opening a bank account for recipients that do not have access to banking and by developing a range of contact points for withdrawing (and using) grant money.
- Government could consider a flexible regulatory infrastructure for banks and insurers that permits the development of non-bank deposit-taking institutions and quasi-insurers with less onerous supervisory burdens. This should stimulate the development of products and services that are more beneficial to the poor, the majority of whom exist in the informal sector. South Africa is in the process of developing a second tier regulatory infrastructure for microinsurance.

As a start, governments need to understand the needs of its citizens and the manner in which central institutions may be able to assist them.

These are examples from across the financial services section. The discussion that follows focuses on long-term saving.

Recognise that long-term saving is not always rational

A study of the attitudes of low-income South Africans to long-term saving – a summary of the study is included as annexure to this note – shows a number of important hurdles that needed to be overcome before embarking on a formal saving program:

- **Short-sightedness**. While the large majority of people of all socio-economic backgrounds suffer a tendency to overstate the importance of the short-term at the cost of actions to benefit the long-term, those with shorter expectation of life – generally with lower levels of income – are more likely to do so. As no more than half of 20-year-old South Africans are expected to reach 65 and the prognosis for poorer citizens is worse than for the population as a whole, the decision not to save for retirement, particularly if access to savings prior to retirement is limited, has a very strong rational foundation.

- **Affordability**. Disciplined saving of a fixed proportion of income is more difficult for lower income individuals than for their wealthier counterparts, not necessarily because that proportion may mean more to them, but because this group of people tends to suffer much greater volatility of income and outgo. It is more difficult for the poor to insure (or self-insure) against catastrophe and much more difficult to manage volatility if a fixed proportion of income is being directed to another goal.
- **Community**. The research found strong evidence of mutual protection within communities, with individuals both giving and receiving remittances in the course of a year. A program of disciplined saving, while good for the individual, may not be as helpful to the community.
- **State provision**. The means test of the old age grant in South Africa tends to reduce the marginal propensity to save. Individuals interviewed were not always sure how the means test worked, but they were aware of its existence and were nervous about accumulating too much in assets themselves, in case it reduced their access to a state grant.
- **Alternatives**. With considerable sophistication evident in their thinking, despite their low income levels, many of those interviewed explained how education – whether or not they expected their children to look after them in the years ahead – and housing took precedence over formal saving. Bricks in the yard, for example, were regarded as more tangible than a bank statement, for they hold the promise of a roof overhead, improved social esteem, and, importantly, an income-bearing asset.
- **Unattractiveness of formal products**. The large majority of formal-sector bank, insurance or investment products designed to accommodate long-term saving were described as inflexible, intangible and inappropriate to need.

The implications of this research for policy are significant. A policy of compulsory saving may not be appropriate at all levels of society. Savings needs to be defined more broadly. Rather than imposing (often rather complex) financial products on individuals, ways should be found to allow the accumulation of appropriate assets, at an appropriate pace, and matching real needs. Finally, policy needs to be holistic.

But the most important lesson for those involved in the research was this: we need to work harder to understand the needs of the people that we seek to serve.

Communities have other ways of meeting goals

Remittances form a very important part of the global financial system and governments should do everything they can to facilitate the smooth operation and low cost of money transfers like these. Nevertheless concerns across the world, that the family structure is no longer providing the support to the elderly that it used to appear to be valid. Mobility is improving and, with it, urbanisation and cross-border movement. The social obligations of family seem to be fading.

Communities support one another through catastrophe, often literally by sharing, more commonly by forming clubs or groups intended to provide a combination of saving, usually rather short-term in nature, and insurance, most frequently to cover some or all of the costs associated with a funeral. Research across the continent confirms that individuals are willing to contribute a relatively high proportion of their income to save in communities schemes, though generally not on a long-term basis.

Should it be cause for concern that long-term saving is not the norm? For a number of the reasons identified in the South African study, saving for the distant future is not always rational, so difficulty finding these types of arrangements should not be a great surprise.

Nevertheless, longer term saving exists at grass-roots level.

- Indian women have developed a culture of saving in gold, gradually accumulating what small amounts they can gather together until they have sufficient to change it into an item of gold, often jewellery, which they purchase from their local jeweller. This practice has been taken one step further: instead of converting the cash to gold, the jeweller writes a promissory note, acting as informal deposit-taker.
- Village savings and loans schemes in India and Africa, notably in the countries of the Sahara, mobilise saving by putting it to work, lending to fellow-villagers at a rate appropriate to make a reasonable profit each year, which is often then rolled over into the new year of operations. Those who work with these groups suggest that, perhaps paradoxically, they operate most successfully in conditions of poor literacy – they use a very simple record-keeping system understood by all members – and in areas isolated from developed financial services and infrastructure, since they are mutually self-sustaining and built on the foundation of trust.
- Self-help groups exist in a number of forms, but have in common the bringing together of poor people – usually women – for mutual support, practical advice and a commitment to uplifting themselves and their families through saving, growing crops or vegetables, and in some instances obtaining or granting loans. These groups provide encouraging examples of long-term provision that may not necessarily be focused on retirement, but gives the opportunity for a more comfortable period of old age.

Policymakers seeking to improve the long-term position of their people in such a variety of conditions face many challenges.

Government support: bringing the formal and informal together

Two principles should underpin any government efforts to bring together the structures developed for the formal economy with the vast need in its informal counterpart:

- to ensure that the development of government policy is coherent across areas of responsibility, working consistently to meet the most important needs most effectively, and
- to make every effort to understand and prioritize the needs of those that the policymaker seeks to assist and serve.

Both of these are enormously challenging. Through parliamentary and inter-ministerial structures, most governments make a serious attempt at meeting the first imperative but too often fail in efforts to achieve the second.

Understanding the needs of the people is surely the foundation to all policy, but it requires an extremely dedicated commitment to research that includes not merely the gathering of information but a disciplined enquiry into the currents underlying that data.

An analogy in banking may help. FinScope is a consumer perception study run by FinMark Trust that looks at people's interaction with and engagement in, the financial sector. It runs in a number of countries, all but one in Africa, and has reached its seventh iteration in South Africa. The headline figure in that country is that use of bank accounts is increasing. More valuable than this, however, is the set of reasons for not having a bank account and the corresponding lists for those who were previously banked against those who have never had a bank account. Even better is a breakdown of these figures by geographical region and socio-economic group. This information helps policymakers interested in improving the reach of banking services to understand why people are electing not to use banks and where more attention needs to be laid in the pursuit of a policy objective.

In the area of financial education, measuring people's knowledge of financial services terminology is helpful, particularly when the same data is available by education level, but it is even more useful to understand people's *desired* financial knowledge. The success of financial education initiatives is likely to be greatest where it matches the perceived need.

Banking access and financial education are both linked to the success of a national saving initiative, mandatory or not. Policymakers should seek to understand their citizens' perceptions of long-term saving rather than taking it as read that, since it is broadly rational to engage in income smoothing, everybody will seek to do so given the opportunity. Government is in a position to play a strong role in facilitating such research.

This then facilitates the development of coherent policy. By way of summary, some of the areas in which policy can improve the opportunities for long-term saving are:

- sound banking and insurances environment with a sensible balance between prudential regulation and opportunities for innovation at the customer level;
- good investment in telephony infrastructure to improve the opportunity for technological innovation in banking, insurance and saving, that could expand the reach of these products and reduce their costs; and,
- a sensitive appreciation that communities often engage in strong, coherent and secure methods to improve financial standing.

Though there may be ways to facilitate these systems, for example through permitting microfinance institutions to collect pension contributions and pay out benefits, care needs to be taken to understand what works in these systems and how central involvement might change their dynamics.

4 Closing comments

In recent years, the informal sector in Africa has been celebrated for its ability to generate employment, income and skills outside of the regulatory framework of the state. Much of this optimism has been fed by the rapid expansion of the informal economy as the state and formal enterprises fail to adjust rapidly to the structural adjustment policies of the 1980s. Thus, rather than the informal sector playing its previous supplementary role in the provision of employment and welfare, it is now expected to be the primary medium for sustaining the livelihoods of millions of people who have been retrenched from their jobs, or whose incomes are no longer sufficient to support basic needs. (Meagher & Yunusa, 1996)[2]

Informality of employment is an established feature of working patterns on the African continent, rapidly growing in some regions.

Even if, as economists suggest, this represents at least partly a natural response to the failure of formal sector enterprises and the state to 'adjust to the structural adjustment policies of the 1980s', it may have created a generation of do-it-yourself Africans with little connection either to formal-sector employers or to the governments that serve them.

This makes the roll-out of centralised programs challenging, particularly those that require an active decision of citizens to participate, even more when such participation involves a financial contribution with pay-off only in the distant future.

Mandatory national saving systems fall into this category. Since the infrastructure that might enable coercion by African policymakers does not, in the majority of cases, extend deep into the employment- and community structures of working age citizens, *incentives* to participate may prove to be more important and more effective than a *mandate*. Government embarking on such a program effectively have a product to sell, and may need to work hard to sell it.

Building on the foundation established by the level of participation and assets accumulated to date, greater attention may need to be given to understanding, with deep sensitivity, the needs of Nigerian citizens in order to determine whether the system might be modified to meet these needs more effectively.

The stakes are enormous. Africa watches with great interest.

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[2] *Meagher, K & Yunusa, M (1996) Passing the Buck: Structural Adjustment and the Nigerian Urban Informal Sector, United Nations Research Institute for Social Development, Discussion Paper 75, May*

Annexure

Savings study summary

The article reproduced below is the full text of a FinMark Brief summarising a study of the attitudes of low-income South Africans to long-term saving.

FinMark Trust

MAKING FINANCIAL MARKETS WORK FOR THE POOR

South African Savings Institute

Brief

Old-age savings by low-income South Africans

Background

South Africa is reforming the systems through which it takes care of its elderly and destitute and encourages its residents to prepare for their old age. These reforms will have far-reaching consequences for many people, making it difficult to overstate the care with which this exercise should be approached.

FinMark Trust is dedicated to finding ways to make financial provision more accessible to the poor, whether this is provided by the private or public sector. With this in mind, together with the South African Savings Institute, FinMark Trust initiated a study to understand better whether and how poor people in South Africa make financial provision for their old age. Genesis Analytics carried out the research.

The aim of the research was to understand the ways poor people provide for their old age and to identify the policy priorities needed to meet their needs more effectively.

Some insights

The most important insights from the research are summarised below:

Low-income people save little for retirement: According to FinScope™ South Africa 2005*, around one-third of the working-age members of LSM1-5* save at all, but only 5% of them say that they actually save for retirement (see graph overleaf). A proportion of this group is likely to save because their employer requires them to do so, which means that few people in this socio-economic group save voluntarily for their retirement.

The state old-age grant is the most important source of income of the elderly poor: FinScope™ South Africa 2006 reports that 89% of age sixty and older members of the LSM1-5 group receive their income from the grant. The remaining 11% say that they receive most of their income from family and friends, or simply have no income. Of this 11%, very few have any form of employment-based or personal pension saving.

Significantly fewer South Africans will reach retirement age: The statistical life expectancy of 20-year olds has fallen dramatically. At the time of the democratic transition in 1994, 20-year-old women could expect to live, on average, to 71 and men to 63. In 2007, the life expectancy for 20-year-old women is well below 60, and for men below 55. This is reflected in the attitudes that working-age people have towards preparing for retirement.

The already low employment rates among low-income people fall off rapidly from age 45: General Household Survey data shows employment levels among the LSM1-5 group at around two-thirds for people in their late 40s. This falls to around 60% in their early 50s and less than 50% in the five years up to age 60. Those who describe themselves as "economically inactive" correspondingly rise from 15% in their late 40s to 40% when they are 10 years older. These unemployment rates exacerbate the low marginal propensity to save for the medium to long term.

The incomes of working-age people in the group are lower than the corresponding income for retired people: Average personal income in every category from LSM1 to LSM5 is lower for working-age members than for their retired counterparts. This accentuates the low potential for working-age members of the LSM1-5 group to save. If the state old-age grant is considered an adequate income for retirees, by definition the incomes of those still working in LSM1-5 must be inadequate even for basic needs and therefore a fragile basis for long-term savings activity. It also undermines the traditional intergenerational contract, under which parents educate their children at least partly to enhance the ability of these children later to sustain their parents in their old age.

** FinScope™ is a nationally representative study that benchmarks the use of, and access to, financial services. See www.finscopeafrica.com.*

**Living Standard Measure (LSM) is a system of categorisation used in South Africa to provide differentiated socio-economic*

FinMark Trust is a Johannesburg-based, independent think-tank promoting financial inclusion in Africa. In practice this means supporting institutional and organisational development to increase access to financial services by the unbanked and underbanked of Africa.

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The South African Savings Institute (SASI) is an independent non-profit organisation dedicated to developing a robust culture of saving in South Africa.

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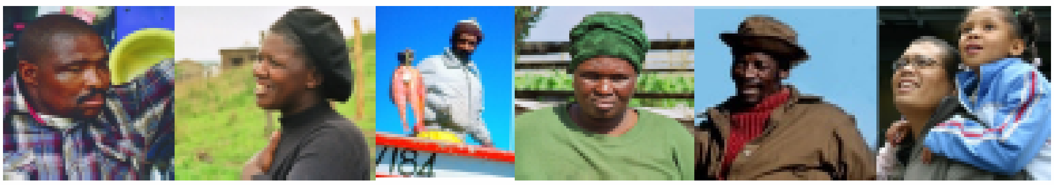


Context is important: elderly South Africans enjoy a means-tested grant, currently at a level of R1 010 (US$120 approximately), generous in comparison with the average earnings of the recipients.

Hurdles to saving

Low-income people face a number of hurdles in trying to save.

Short-sightedness: People of all socio-economic classes suffer a short-sightedness that makes it difficult to give up present consumption to save for a long-term future. As lifespan is positively correlated to socio-economic status, lower-income people may be even less inclined to save for their old age.

Affordability: Lower-income people are more exposed to risks and less able to manage them, either through insurance or spare resources to overcome these setbacks. Informal insurance arrangements tend to use up excess cash, as many in this group readily contribute to the immediate needs of their neighbours knowing that they are likely to benefit similarly when beset by difficulty.

State provision and the means test. While the state old-age pension should not reduce the marginal propensity to save, the means test on the state grant almost certainly does. Working-age people with poor means are likely not to save if the means test reduces the likelihood of receiving state benefits.

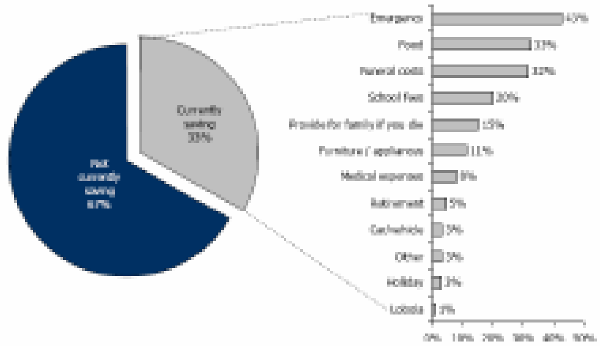
Priority of alternative mechanisms: People interviewed for the research highlighted competing forms of saving, notably education and housing. While some see educating children as an obligation, others regard it as a way to provide for an uncertain future by equipping children with the power to work and earn. Less ambiguous was the message on housing. Most people see this as a valuable, tangible and even flexible means of providing for an uncertain long-term future.

Inappropriateness of many formal products: The research suggests that, with these hurdles in mind, it should not be a surprise that the take-up of existing long-term savings products such as endowments is low. They generally do not provide the flexibility to put periodically available disposable income away or to access significant parts of the accumulated saving in the event of emergency.

Bricks and books

To summarise: lower-income people do not save for the long-term because they do not see it as a priority and cannot easily afford to forego present consumption. They prefer to prioritise tangible long-term objectives like piece-meal housing development and educating their children. They are discouraged by the disincentive of the means test and find the available products expensive, inflexible and unwieldy.

Savings activity and reason for savings: LSM 1 - 5



Source: The savings market for the poor (based on FinScope™ 2006) Eighty20, 2007

Policy considerations

The research has a number of implications. First, the means test needs to be dismantled or significantly modified as it removes the motivation that this large but economically marginal group may have to prepare more actively for an uncertain future.

Second, a policy of compulsory saving may be misplaced, even if it applied only to the formally employed people in this group and were supported by explicit cash incentives of one type or another. If the state old-age pension is considered an appropriate income for retirees, why should we expect people of working age, who earn less, to part with income that is meeting basic needs? Incomes in LSM1-5 do not seem to deliver much more than a hand-to-mouth existence and the burden of mandatory saving might be intolerable. It would remove assets from the community as a whole, undermining the informal insurance arrangements that may keep many people afloat in times of difficulty.

Third, we need to define savings more broadly. The conventional cash-based definition, as understood by the financial industry in terms of contributions to a policy, unit trust or government vehicle, seems to resonate little with poorer people who value more tangible savings. Perhaps contributions to the cost of educating children or developing housing could be considered part of the formal saving effort and even receive a form of government subsidy. If a house is regarded by many lower-income people as a good investment for the future and therefore part of a rational saving strategy – something that is not questioned in the higher income population segments – perhaps policymakers and private sector providers could be brought around to this perspective as well.

Fourth, policy must be holistic. As difficult as it may be, the many strands of government efforts to improve the long-term position of lower-income people must be considered together.

The information in this brief is extracted from the report ***Old-age saving by low-income South Africans***, compiled for FinMark Trust and the South African Savings Institute by Genesis Analytics, available at www.finmarktrust.org.za

Comments on the findings of this study are welcome and should be directed to Rob Rusconi, technical advisor to FinMark Trust, at rob@trsconsulting.co.za

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Copies of this brief and of the full research report, may be obtained from the web site of FinMark Trust, www.finmarktrust.org.za.