Extending Pension Coverage to the Informal Sector in Africa

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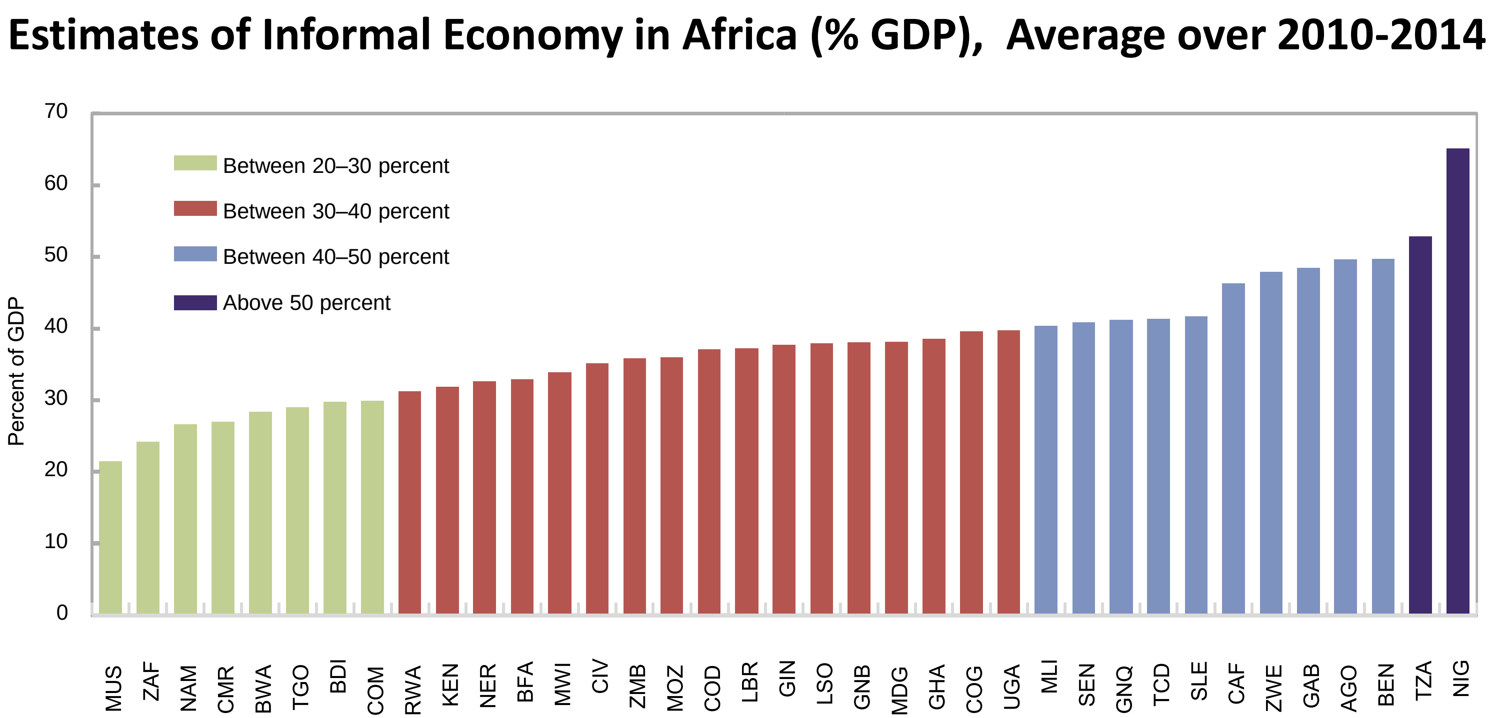
Pensions Core Course

Source: Guven, M. 2019. Extending Pension Coverage to Informal Sector Workers in Africa. World Bank

Outline

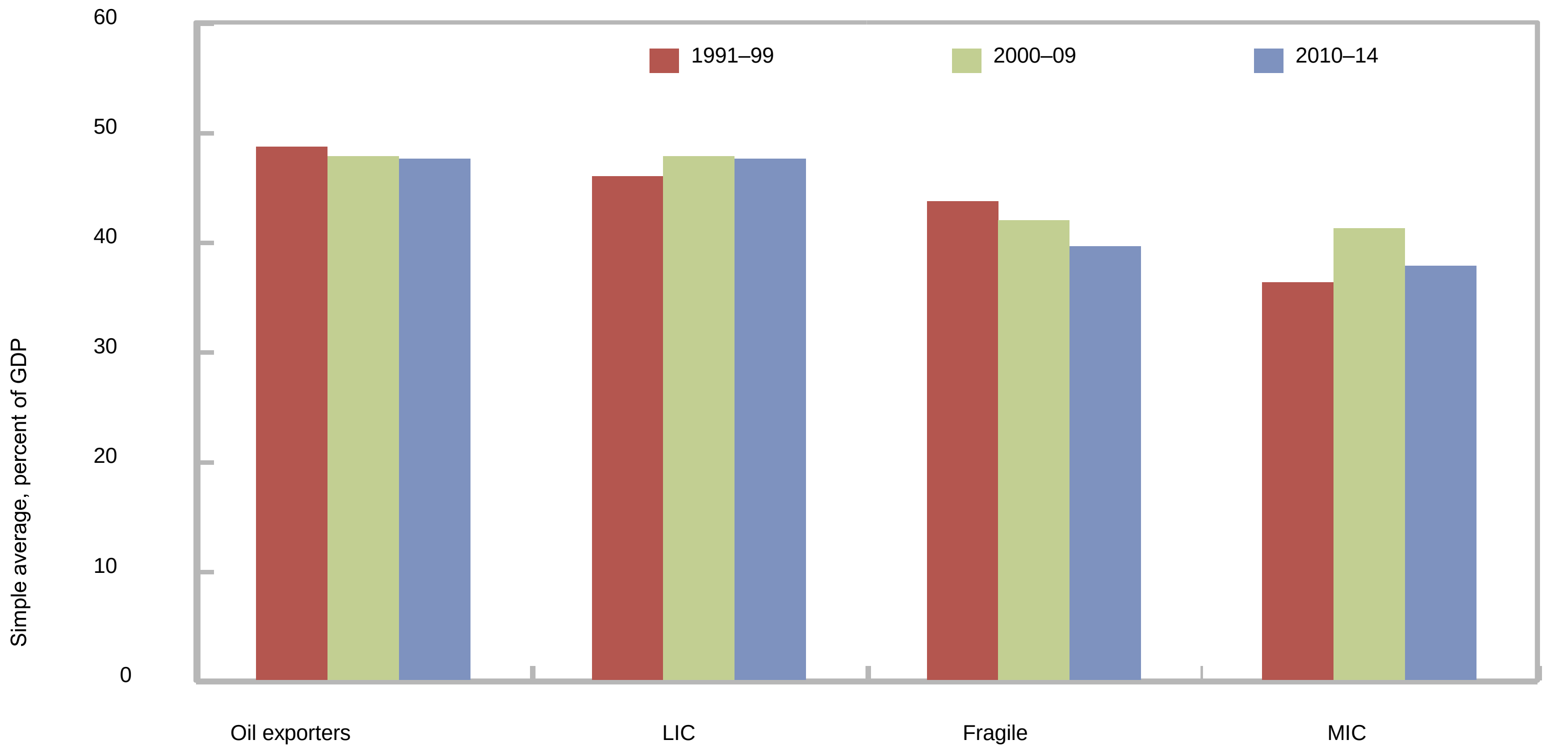
- Size of Informal Economy
- Formal Sector Pension Schemes in Africa
- Characteristics of the Informal Sector
- Broad Principles for Designing Informal Sector Pension Schemes

Size of informal economy in Africa is large



Source: IMF 2017

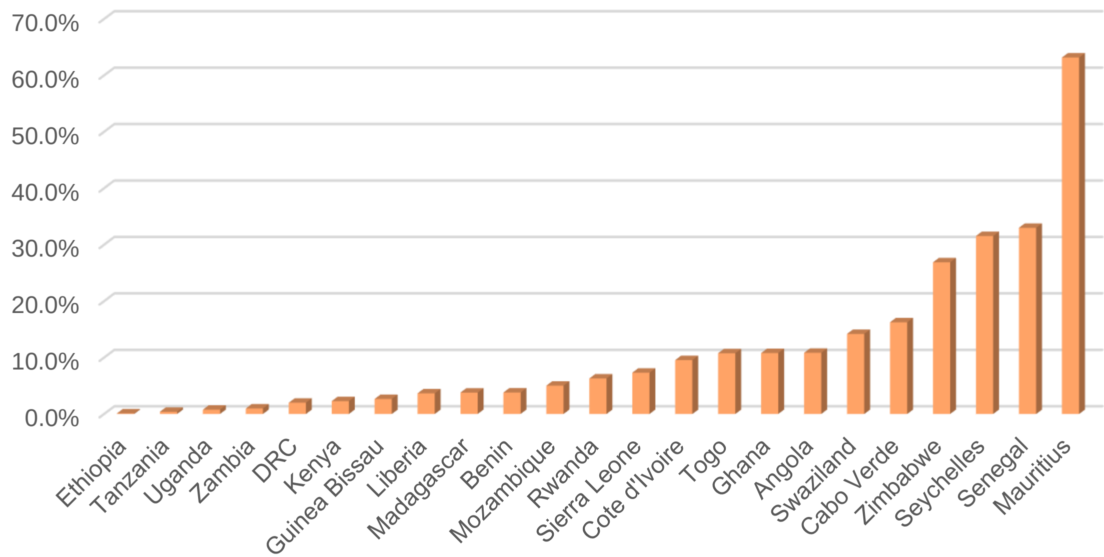
Size of informal sector employment in the region is not expected to change for many years to come



Source: IMF 2017

Coverage of formal sector pension schemes has been persistently low

Coverage of Contributory Private Sector Schemes, % of Population Ages 60+



Source: World Bank pension database

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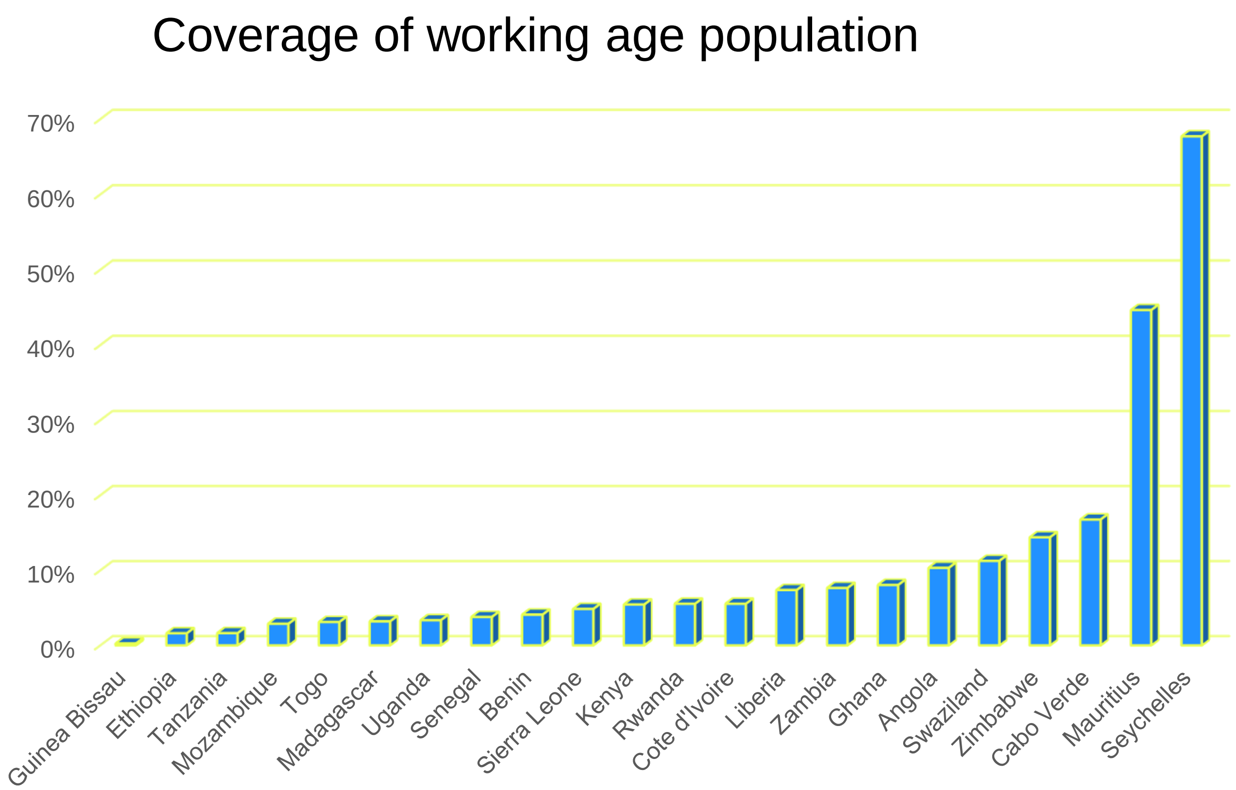
Coverage of working age population is low meaning low elderly coverage will not change in the foreseeable future



Source: World Bank pension database

Africa is a young continent, but the share of the elderly in the population will rise

Existing pension scheme requirements in Africa

- Formal employee-employer contract
- Long term, relatively stable jobs with stable income
- Regular (monthly) contributions on the basis of salary/wage
  - In many cases contribution rates are a high percentage of salary in Africa
- In most cases eligibility requirements are on the basis of a defined benefit formula
  - years of contributions, accrual rate, etc.

→ Existing pension schemes are not responding to the needs of the informal sector

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Increasing number of countries are looking at ways to extend pension coverage to informal sector

- Coverage of contributory pension systems remain limited to the formal sector
- Several high-middle income countries extended coverage through social pensions but at a high cost
- Informal sector is large in Africa
  - Informal jobs comprise more than 90% of total employment in some countries
- Most countries in Africa are likely to have large informal sectors for many years to come

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Informal sector is heterogeneous

- Informal sector is diverse
  - Employs a wide range of individuals
  - Small farmers, street vendors, small traders, porters, casual laborers, and artisans are all part of the informal sector
  - More women (74%) in informal employment than men (61%) in the region
- Self employed is a predominant characteristic
  - represents 70 percent of informal employment (outside agriculture) in Africa-if South Africa is excluded, the share is about 80 percent
- For some staying informal is a choice
  - To hide transaction information to save on taxes
  - To avoid requirements on the number of employees to save on social security contributions
  - to avoid labor regulations

Not all workers in the informal sector are poor. Indeed, some informal sector workers are able to save.

Informal sector workers may not have regular incomes or savings

- Self-employed earnings
  - typically irregular and often unpredictable
  - making financial planning a challenge
- Wage-employed
  - typically have low incomes
  - their employment is irregular
  - Therefore their incomes are also irregular
  - Agricultural sector rely on seasonal incomes
- Africans rely on informal mechanisms for savings
  - about 60 percent of adults save
  - only 16 percent of these people use a financial institution to do so
  - others rely on less secure methods, such as stuffing cash under a mattress
  - informal savings club (70 million unbanked adults use informal groups to save)

→ **share of the population that saves for old age is low in the region (about 10 % but varies across countries)**

Informal workers are more susceptible to short-term shocks

- Idiosyncratic shocks -Health-related may have a significant impact
- leading to reduced food expenditures
- obligation to tap into savings if available

- Covariate shocks -floods and drought, may have a significant impact on the agricultural sector

- Cannot implement common coping strategies in the absence of
- access to formal social protection
- formal financial institutions
- savings and physical assets that can be used as collateral,

  - **more vulnerable to shocks because of their generally lower incomes, lack of social protection, and limited savings available for coping**
  - **lack of access to financing and credit leads to loans at higher interest rates, compromising future incomes with irreversible consequences**.

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Individuals in the informal sector are difficult to reach

- In rural areas, most employment is in agriculture, which is characterized by informality
  - outreach is a major challenge for service and social safety net providers.

- Large share of the economic activity in most African cities takes place on the streets
  - while formal services are close to workers, outreach may still be complicated
  - individuals may not have stable jobs,
  - may change jobs and locations frequently, and may lack appropriate documentation.
  - often do not own property and may have found shelter in locations without formal addresses, which makes contacting them difficult.

In both urban and rural areas, outreach to the informal sector is a challenge

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Informal sector workers are organized

- large number of informal sector workers are members of worker associations
- they are typically organized around particular trades or activities to protect the rights of informal sector workers,
- provide training to members to improve their productivity, and help in finding financing, typically from microfinance institutions .
- The associations may be represented at all levels of administrative infrastructure in the country and therefore have the ability to conduct outreach and communication as well as act as trusted sources of information for members documentation.

Can benefit from associations for outreach

Building blocks of an informal sector pension scheme

Financial Inclusion

- Overall improvement on financial inclusion
- Share of adults with accounts through financial institutions and mobile money providers increase from 23% to 43% from 2011-2017
- Africa is global leader in mobile money

Identification Systems

- Correctly identify individuals
- Verify and track contributions
- Establish ownership of pension benefits
- Countries in the region are increasingly investing in identification systems

Voluntary scheme is more realistic

➢ **Not realistic to mandate due to:**

incomes

- some informal sector workers may have sufficient incomes to defer consumption and save for old age
- others face competing demands on their incomes (e.g buying food, paying for children's education, caring for family members, housing, health care costs)
- if a scheme is designed as mandatory, some informal sector workers may not be able to contribute when these pressing and frequent demands arise

challenges in implementing efficiently

- informal sector workers are typically spread widely around a country, including in rural areas,
- Difficult to reach leaving a gap in coverage if mandatory

Defined contribution scheme is more suitable

- **Defined benefit schemes**
- Promises a pension based on a pre-determined formula
- Benefit formula is based on earnings history, years of contributions, accrual rate, etc.
- More suitable for the formal sector
  - clear employee-employer relationship
  - predefined contributions made based on regular earnings
- **Defined contribution schemes**
- pensions are based on accumulated contributions and investment income, net of expenses
- More intuitive as pension to be paid out is a direct result of the savings that have been accumulated----mimics bank savings accounts
- Relatively easier to build trust ---- participants can see savings they have
- can be crafted so as not to require the regular payment of predetermined contribution---participants may make contributions at any time

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Need to be flexible on level of contributions and frequency of payments

- **Informal sector workers do not have regular incomes**
  - Seasonal workers, irregular employment & income
  - Short term liquidity needs
  - payment of contributions at least once a year
  - More frequent payments (e.g. weekly) should be allowed
  - a minimum payment to be viable
  - Mobile money can be used for easy payments

Make it easy to save!!!

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Efficient management of savings & administration

➢ Management of Savings

- Investment policy for optimal returns and to minimize asset management costs
- Professional management of pension savings
- Centralized custodian and fund management services

➢ Administration

- Minimize operational costs
- Central administration platform
  - Avoids fragmentation
  - Contributes to sustainability & robustness of the scheme
- Identity of administrator depends on country context
- Could be formal sector pension administrator, private sector operator
- Appropriate capacity
- Important to separate existing formal sector scheme and informal sector scheme
- investment of reserves can be together to achieve critical mass to reduce asset management costs

Particularly important as relatively small savings are involved

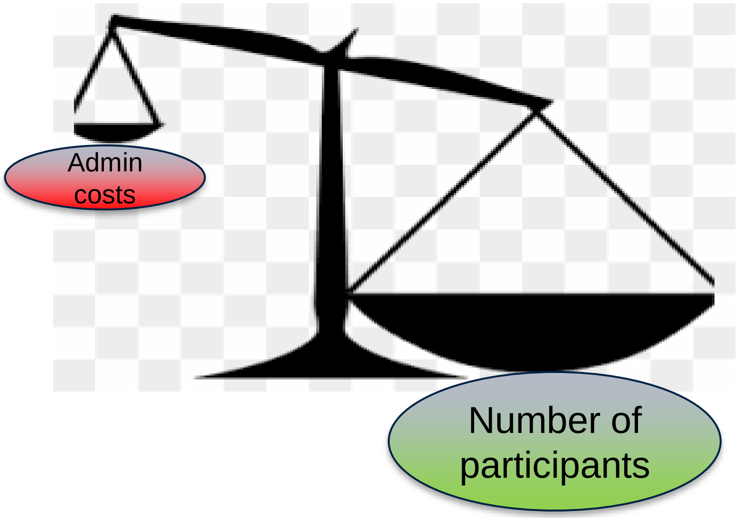
Important to build public confidence and trust to encourage contributions

Allows for relatively better benefits in old age

Reaching scale is critical

- **For viability of the scheme and providing relatively better benefits in old age**

- It is critical for these schemes to reach scale to be successful
- Central administration would help reach scale
  - Administration and asset management costs decline with scale
  - Fragmentation risks viability
- Need to carry out an analysis of:
  - Savings ability in the country
  - Viable size of the scheme



Incentives to Reach Scale

- **Combination of long & short-term savings accounts**
- Short term access to savings help build trust
- Short term access help in time of shocks
- Can be used as collateral for financial transitions
- **Fiscal incentives**
  - Matching contributions
  - Free insurance
- **Integration/bundling with other services**
  - Health insurance
  - Priority access to financing through MFIs
    - short-term savings accounts could be used as collateral
- **Other behavioral nudges**

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Communication, outreach, financial education help reach scale

- **Design/implement a communication strategy**
- Raising awareness, building confidence
- Propagating a proper understanding of a pension scheme
- Pension will depend on what they contribute
  - May not be at the level of a formal sector pension scheme but workers will be better of in old age compared to had they not save at all
- Pension scheme rules
- **Financial Education**
- Needed given relatively low education levels in the informal sector
- Necessary to promote informed decisions

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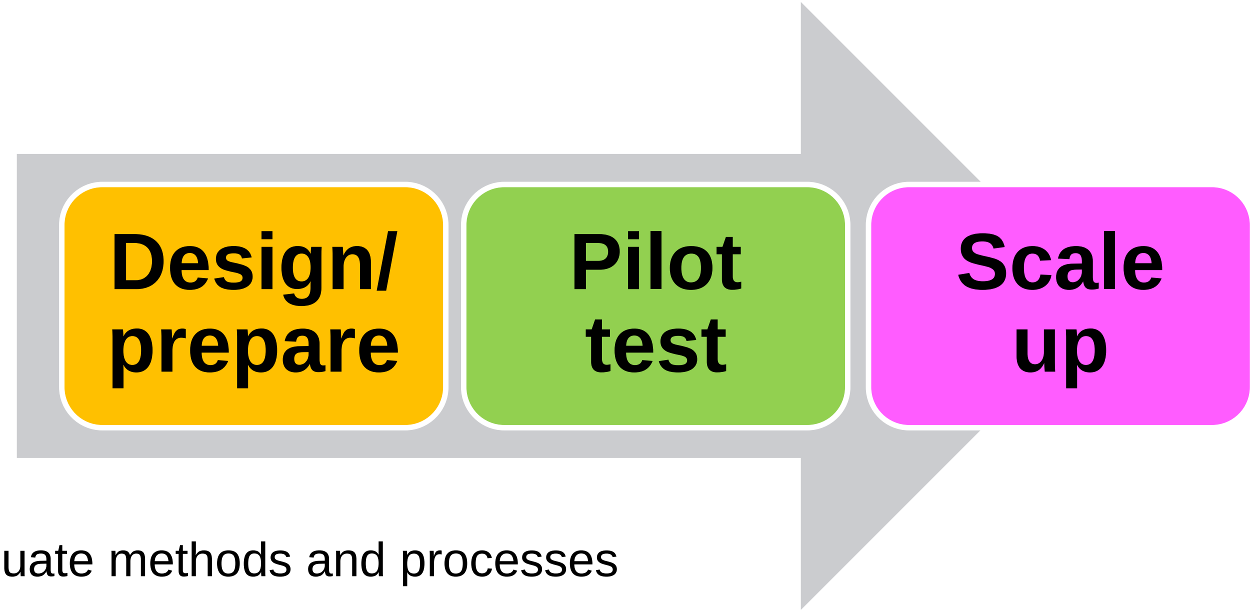
Pay-out phase

- **Plan for pay-out phase at the outset**
  - Pension benefit: linked to contributions plus investment returns minus admin costs
  - Payout options:
    - lump-sum payment---might be spent quickly
    - term annuities (5 or 10 years or more)---encouraged
    - Could consider a social pension beyond the end of term annuity depending on resources available
    - Benefit level maximum at the poverty line and link the benefit increase to inflation
    - This social pension will cost less than that would be provided at earlier ages

Pilot test before national scale up



- evaluate methods and processes
- behavioral nudges
- the role of various stakeholders
- synergies with other products

lessons learned through pilot testing should inform national design and implementation arrangements