

Review

Notes on the economics of the 2004 Nigerian pension scheme

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Poor social security arrangement imposes large costs on government and it becomes an attendant economic cost. As a result, large fiscal deficits result along with a high poverty rate. Though, much has been done by the government to address old age poverty and bring dignity to labour for Nigerian workers who (should) deserve to enjoy their retirement, the defined benefit scheme which has been practised over the years has neither help but compels the need for an option in the face of the heavy social and economic costs to both the government and the society. The new pension scheme (Contributory Pension Scheme; CPS) passed under the Pension Reform Act (PRA) 2004 has great benefits for the country's socio-economic wellbeing. This paper takes an overview of the scheme vis-à-vis past schemes with an economic explanation of its impact on the country. The reduced poverty and economic growth, as we will show, are important benefits of the new pension scheme.

Keywords: Nigeria, pension, poverty, retirement savings accounts (RSAs), contributory pension scheme (CPS), pension reform act (PRA).

INTRODUCTION

Since the existence of the Nigerian civil service at independence, the country's public pension system (the defined benefit scheme) has been funded by the government. The private sector, notwithstanding its small size (including the informal sector), also operated a kind of pension, paid as severance bounties to either their apprentices or workers (in the case of the informal sector, the employer sets up a business unit for the severing workers, or gives them some substantial sums of money enough to help them start up a business for a decent livelihood). One peculiarity of the government- or employer-funded pensions is that it is more of a transfer device; the pensions benefits are the 'tax' resources levied on the wages of the workers in the present generation when the retirees' benefits are paid. The amount of these benefits also depend on the grade level of the employees on retirement and is paid monthly.

The Nigerian Pension Reform Act (PRA) 2004 has been described as a beautiful piece of legislation and could be a major step in alleviating poverty in the country.

The clear address of low savings in the country raises hope of effective reduction in old-age poverty as well as reduction in fiscal deficit occasioned by large pensions from government and private sector. Following the burdensome nature of the defined benefit scheme (DBS), the defined contributory scheme was introduced to give better security of post-service life to workers (Lacker, 2006).

The new pension scheme also puts a check on the management of pensions in the country with particular reference to risk-associated problems. As the National Pension Commission (PenCom, 2006) points out, parts of the appeal of the compulsory contributory pension scheme are increased savings, alleviation of old-age poverty, better coverage up to include the informal sector, as well as increased funds in the economy. But then, there are reasons for scepticism about the sustainability of the scheme. It is certain that the scheme will affect the direct savings behaviour of the individuals. It is also notable that the CPS is not taxable neither is it affected by demographic shift

In this paper, the study assesses the economics of the contributory pension scheme for both the individual and the country as a whole. The study pays crucial attention to the analysis of the different types of pensions and

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notes the challenges of the scheme.

CONCEPTUAL ISSUES

Defining pensions

Wikipedia (2007) defines pension as a steady income given to a person, usually after retirement. In a way, it refers to a plan made in the form of a generated annuity to a retired or disabled employee. According to Balogun (2006), it provides post-retirement benefits to employees. And in the words of Ako (2006), a pension system is essentially an income security program which provides benefits to beneficiaries who may be retirees, pensioners or destitute.

So, a pension is created by an employer for the benefits of the employees, and is funded by government, organizations (employers), labour unions or the employees.

Types of pensions

According to Wikipedia (2007), pensions are of different designs, which can be occupational, insurance or annuity-based pension. These are also known as retirement plans, superannuation or pension plans. Retirement plans refer to an arrangement whereby an employer (and also its employees) makes post-retirement income arrangement for its employees after retirement. The pension plans in this case are a form of "deferred compensation". These were common in the United State during the World War II, when there was no increase in workers' pay due to wage freezes. Under these plans are the defined benefits and defined contribution plans.

Defined benefit plan

This was the most popular and common type of pension plan practiced in most countries until the 1990s. It is a traditional pension plan which defines a benefit for an employee upon that employee's retirement. The benefit is determined by a formula that incorporates the employee's pay, years of employment, age at retirement or years in service, etc. An example is a flat dollar plan in the US that provides \$100 per month annually for an employee who works in a company; with 30 years of employment, the worker would receive \$1000 per month payable throughout his lifetime. Other examples are final leverage plans where the average salary over the last three or five years of an employee's career determines the pension.

The defined benefit plan is much less portable than the defined contribution plan, due to the difficulty of valuing the transfer value. The plan also pays their accrued benefits as an annuity so the retirees do not bear the investment risk of low returns on contribution or outlive

their retirement income. In this type of pension, the employers bear the investment risk. The cost of the defined benefit plan is not easily calculated, and requires an actuary or actuarial software which is always based on economic and financial assumptions.

Defined contribution plan

A defined contribution plan provides for an individual to account for self, and for benefits based solely on the amount contributed between him and his employer to the account, plus increases on the contribution invested, less administrative or operational deductions (and losses). The contributions under this type of pension plan are paid into the individual account, and invested in the financial markets, with the returns (positive or negative) effected on the person's account. On retirement, the employee's account is credited with all the net retirement benefits, and regular retirement income often generated through the purchase of an annuity. These plans are presently the dominant form of pension schemes in many countries including the US and Nigeria. Examples of the plans include the Individual Retirement Accounts (IRAs) in the US, and Retirement Savings Accounts (RSAs) in Nigeria. In the case of the US, the employee is responsible, to one degree or another for selecting the types of investments toward which the funds in the retirement plans are allocated. The Nigerian contributory pension plans are different, as the directions of investments are determined by the pension fund administrators (PFAs). However, in both, contributions are either wholly paid by the employer or at least, 50 percent matched by the employer.

In a defined contribution plan, investment risk and rewards are directly assumed by each individual (employee) and not by the employer. The cost of this plan is readily calculated but the benefit depends upon the account balance at the time an employee wants to access the funds. In this case therefore, the contribution is known but the benefit is unknown, until calculated. Also, this plan has the advantage of portability unlike the defined benefit which is not portable.

Hybrid and cash balance plans

These plans combine the characteristics and designs of defined benefit and defined contribution plans. They are usually treated as defined benefit plans for tax, accounting and regulatory purposes. Like the defined benefit, investment risk here is borne by the employer, while in the case of the defined contribution designs, benefits are expressed in terms of a notional account balance, and are usually paid as cash balances upon retirement. These features make them more portable than traditional defined benefit plans. An example of the hybrid design

is the cash balance plan where the employee's notional account balance grows by some defined rate of interest.

Funding status of the pension

Financing of pension's forms a critical part of the pension system, and this includes the funding approach the system adopts, the changes in the benefit structure, and the shifts in the age distribution of covered population (Hsiao, 1976).

Unfunded pension

An unfunded pension, which is a feature of the defined benefit plan, is one in which no assets are set aside and the benefits are paid for by the employer. This is characteristic of most government-funded pensions all over the world, with benefits paid directly from current workers' contributions and taxes. This kind is also known as the pay-as-you-go.

Funded pension

A funded pension plan is based on contribution from employers and employees. Some defined benefit plans fall under this form whereby an actuary calculates the contributions that the employers must make to ensure that the pension fund meets future payment obligations. Here also, the investment risk and rewards are borne by the employers. In a case where the plan is not well-funded, the employer may not have the resources to continue funding the plan.

The defined contribution plans are funded (by workers and employers) pension plans as the guarantee made to employees is that some specified (defined) contributions will be made during an individual's working life. But there are other contributory pension plans which are not fully funded and are sometimes referred to as "pay-as-you-go" schemes.

Challenges of pensions plans

Pension schemes are faced with a lot of funding difficulties. Whether fully funded or not, there is always a difficulty arising in the chain of operations though when not well-funded poses greater problems. The different forms of the defined benefit and contributory pension plans seem to bear much unmanageable risks for both employers and employees. The defined benefit plan bears more liability problems. For example, the Pension Benefit Guaranty Corporation (PBGC) in US which as a government agency covers about 44 million workers and retirees participating in over 30,000 private-sector defined benefit pension plans but whose future liabilities to

retirees are not totally covered by premiums from insurance companies except there is a taxpayer bailout (Lacker, 2006). PBGC's deficit by 2006 was estimated at around US \$23 billion since 70% of all the claims incurred by the agency since more than 30 years ago are covered by insurance.

Population ageing is another challenge posed to the pensions schemes. Reduced birth rates have brought about an increased life expectancy which increases the number of older people. There is then a change in the demographic structure of the population and poses serious threats to the ability of future generations to finance public pension programs on a pay-as-you-go basis without tax (Wikipedia, 2007; Morris, 1976).

Large pensions liabilities have the capability therefore of negatively affecting economies of countries unless there is a reform or taxes are imposed to cover up as a bailout. And such reform measures have been based on the increase in retirement age. Canada, Japan, UK, and Australia are critical examples of top-heavy old-age population with difficulties in financing pensions due to demographic shift, and have to open up their borders to immigration.

NIGERIAN PENSIONS SYSTEM

The phenomenal economic progress in Nigeria within the last five years has been unprecedented. Reforms have virtually served the key to this growth. The deregulation of the telecoms industry, privatization of hotels and some public utilities, and reforms in the public service has brought the country's economic potentials to the fore. And the reform of the pension system in the country is expected not only to erase old-age poverty but also provides funds needed in the economy.

Prior to the passage of the PRA 2004 into law by the national assembly, the country (and principally the public sector and a few private firms) operated the defined benefit or 'pay-as-you-go' scheme which was funded primarily from budgetary allocations and ate deep into company's treasuries. Countries like the US and Brazil with large populations have experienced huge problems in meeting up with the liabilities of ill-funded pensions, and so have embraced the reform of their social securities.

The defined benefit pension plan financed through the taxes of the present generation of workers, adjusted at intervals to ensure availability of funds to meet up with the obligations of benefits payment (Dalang, 2006). The pre-reform era in the public sector shows that the scheme was poorly funded due to inadequate budgetary allocations and thus makes it unsustainable with outstanding deficits estimated at over N2 trillion by 2004 (Balogun, 2006). The benefits of retirees were also not paid as at when due, poor management of the scheme, lack of transparency and non-coverage of many private and informal sectors employees.

Table 1. Outlay of employee-employer contributions to pension funds by sector.

Sector	Employee	Employer
Federal public service (including the FCT)	Minimum of 7.5% contribution	Minimum of 7.5% contribution
Military	Minimum of 2.5% contribution	Minimum of 12.5 %contribution
Others (particularly the private sector and other state & local governments)	Minimum of 7.5% contribution	Minimum of 7.5 %contribution

Source: Pencom (2005).

In order to correct the problems created by the defined benefit scheme, government hence, embraced a scheme that will provide benefits capable of reversing the country's high old-age poverty rate in order to positively affect the country's social and economic structures, withstand economic, political and demographic shocks as well as be sustainable. The PRA 2004 therefore brought about the adoption of the compulsory contributory pension scheme (CCPS) with the National Pension Commission (PenCom) as the regulatory agency.

The new pension scheme represents a systemic reform as a total shift from the defined benefit scheme to a defined contributory scheme. The mode of contribution as presented in Table 1 is summarized as follows:

- i) For the private and public sectors, employees and employers contribute at least 7.5% each of basic salary, housing and transport allowances up to a minimum of 15% monthly.
- ii) In the case of military, employer contributes a minimum of 12.5% of basic salary, housing and transport allowances while employees contribute a minimum of 2.5%.
- iii) Additional voluntary contributions can be made into the RSAs by employees. Such contributions not withdrawn within 5 years are tax free. The CPS itself is tax free.
- iv) Employers may take up the sole responsibility of pensions contribution.
- v) In addition to the contribution, every employer must maintain life insurance policy in favour of each employee up to a minimum of 3 times the annual total emolument of employee.
- vi) Contributory rates may over time be reviewed upwards upon an agreement between employer and employee, which are notified to PenCom.
- vii) Withdrawal from the RSA is either upon retirement or on attainment of age 50, or whichever comes first.

The aims of the CCPS according to PenCom (2006) are as follows:

- i) To ensure that all retirees are paid their full benefits as at when due
- ii) To encourage savings especially among the poor

iii) To make uniform rules, regulations and standards in the administration of retirement benefits in the public and private sectors

iv) To establish a sustainable pension system that puts employees in charge of their RSAs, enhance the mobility of labour, but also minimize incentives for early retirement

v) To ensure transparency and efficiency in the management of the pension funds

vi) To promote a wider coverage of pensions payments, down to the informal sector.

The scheme's guidelines are delicately crafted to control and regulate risks. The institutional framework has the PenCom, PFA, closed pension fund administrator (CPFA) and pension fund custodian (PFC) as operators. PenCom is a regulatory agency established to ensure that pension funds are safe through the issuance of guidelines and regulations for licensing, approving, regulating and monitoring the management and investment activities of PFAs and PFCs. The body also resolves complaints investigated, serves as watchdog and makes sure that pensions businesses are carried out with minimum exposure to fraud and risk, which also requires the use of approved risk-rating agencies to determine the viability of the investment instruments being used. The PFAs on the other hand are limited liability companies licensed by PenCom to manage pension funds by opening a RSA for each employee invest and manage the funds and assets in accordance with the provisions of the PRA 2004. The CPFA refers to a private organisation or public agency with self-existing, self-funded and well-managed scheme, which wishes to manage its own pension funds in accordance with Section 39 of PRA 2004 and item 415 of PenCom guidelines, would be licensed as such, and assumes that same status as the PFA. The PFC must be a bank licensed by PenCom to hold pension fund assets on behalf of the PFA.

The aforementioned chain of responsibilities is a risk control strategy aimed at protecting contributors' pension funds while also ensuring maximum returns on their investments. And because investments are exposed to different types of risks, there is need to gauge up strategies to mitigate against the effects. Employees (who

Table 2. Asset Management Limits and Performance Guidelines for PFAs and PFCs.

Asset class	Maximum investment as percent of pension funds assets	Per Issuer	Per Issue
Federal Government (FG) Securities/Bonds	100	Maximum of 100% of total issue of FG bonds	No limit
State Government (SG) Securities	20	Maximum of 2% of pension funds assets in one SG	Maximum of 2% of anyone (SG) issue
Corporate Bonds/Debts (Including REITS, MBS)*	30	Maximum of 2.5% of all issues by one corporate organisation	Maximum of 2.5% of anyone issue
Money Market Instruments	25	Maximum of 1% of pension funds assets in all instruments issued by one bank	Not applicable
Ordinary Shares	25	Maximum of 1% of pension funds assets in one corporate	Maximum of 1% of issued capital
Open-Ended and Closed-Ended Funds	5	Maximum of 0.5% of pension funds assets to one issuer	Maximum of 0.5% of any open, closed or hybrid fund issued

Source: PenCom (2005)

*REITS, Real estate investment trusts; MBS, mortgage-backed securities.

are the RSAs holders) are only interested in the returns on their pension funds which are invested and the soundness of the PFAs and PFCs. The PRA 2004 provides the guidelines with regards the control and management of these risks (Table 2 for the investment guidelines set by PenCom).

Some of the investment and risk management guidelines as provided by PenCom and the PRA are as follows:

- i) Employees shall have freedom of choice of which PFAs to choose, and changeable as she/he may wishes.
- ii) There is a separation of the roles of funds custody from investment management
- iii) A statutory reserve shall be maintained by the PFAs.
- iv) The appointment of officers: compliance officers and other top executives shall follow PenCom guidelines.
- v) Pension fund assets shall not be invested in the shares or any other securities issued by the PFAs and PFCs, or such assets sold to their shareholders, directors, affiliates, employees, spouses or related people.
- vi) Pension assets cannot be used as loans, credits or collaterals by PFAs.
- vii) A PFA shall establish a risk management committee at the board level to determine the risk profile of their investment portfolios and the levels of reserves to cover the risk of the investment portfolios, draws up adjustment programmes in case of deviation, and advise the PFA in maintaining adequate internal control procedures.

viii) The PFA shall establish single investment fund for all contributions made to it, that is, all contributions shall be made in a similar manner and in a single fund as against having multiple funds (products) with different characteristics for contributors.

ix) With regards integrity and transparency of investments made by the PFAs, they shall establish authorized markets for trading in pension fund assets, and the securities include ordinary shares of companies quoted on the Nigerian Stock Exchange (NSE), government bonds, open- and closed-ended investment funds, as well as money market investments on the money market electronic platform.

x) Investment instruments, and companies invested in must have a minimum of a "BBB" rating from at least two rating agencies, and the firms being invested in must have at least a "A" rating from two or more rating agencies, while the securities to be purchased must be listed on a recognized stock exchange with "AAA" rating from at least two rating agencies. All these ensure high quality investments made by the PFAs.

The economic environment of pensions

The economic sensitivity of pensions is multifarious. It has positive effects on both the micro-and macro-economic levels. The first concern is in alleviating old-age poverty, and the second, as a resource, providing funds

to oil the economy. The motivation of this research has been to assess the impacts inherent therein on the economic situation of the country.

The contributory pension scheme holds a lot of advantages for both workers and the nation as a whole. For the government, pensions as an overhead cost have always resulted in fiscal imbalance. The Guardian (2007) reporting the excitement of Nigeria's former finance minister in 2007, Nenadi Usman, on the pension funds accumulated said the new pension scheme will help correct the fiscal imbalance as the pension overhead costs overshoots the salaries of workers in the public service.

In the poverty alleviation aspect of the scheme, it serves as a means of saving for the future, therefore, contributing to national savings and generating liabilities thus stimulating funds transfer from the surplus to the deficit units. Since savings are important for capital formation and thus economic growth, the scheme makes capital available for small and large enterprises to expand or start and thus, provides employment opportunities and thus income, encourage savings and investment which goes on to affect the economy positively.

In addition to the poverty reduction effects, the pension funds invested in assets will provide a better hedge of workers' savings against inflation, while also enhancing capital market development with positive externalities to include a competitive and more efficient financial market.

CONCLUDING REMARKS

The paper has reviewed two basic issues on the new contributory pension scheme in Nigeria: the legal and institutional framework, as well as the implications of the scheme to the country. More importantly, we consider the economics of the scheme with reference to both the micro- and macro-economic effects on the country.

Overall, this study discovers that the previous pension scheme (the defined benefit plan) is faced with a lots of problems ranging from corruption and funds misappropriation, unpaid pensions which resulted in huge liabilities in the private and public institutions, large fiscal deficits, and poverty at the receiving end. It does not also encourage savings by workers. Reflecting on the types of pensions available, we acknowledge the CPS as a better pension scheme the country can adopt to alleviate old age poverty. And in a very mobile labour economy like Nigeria, it makes so much sense.

Pension funds form a significant part of an economy, especially in supplying funds to the capital market. At the end of March 2007, pension funds in Nigeria according to the Guardian (2007) grew up to ₦600 billion following the introduction of the CPS.

One major challenge of the CPS is its workability at the small private organizations and informal sector. A monitoring team may be needed to enforce adherence while the role of public education highlighting both employer- and employee-benefits cannot be over-emphasized. The labour and trade unions may also need to perform some roles here in pressurizing government at the various levels and organizations concerned to implement the scheme. But then, considering the subsisting problems especially in risk management and control of pension funds, sound supervisory oversight is indispensable.

More research is still expected to be carried out on the CPS, using Nigerian indices across a wide range of sectors and jobs, especially with regards service delivery, the investment strategies and returns, pension funds security and benefits adequacy. This will ensure that the primary objectives of the scheme are achieved.

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