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Income Inequality: Malaysia Case Study

PROFESSOR GEOFFREY WILLIAMS

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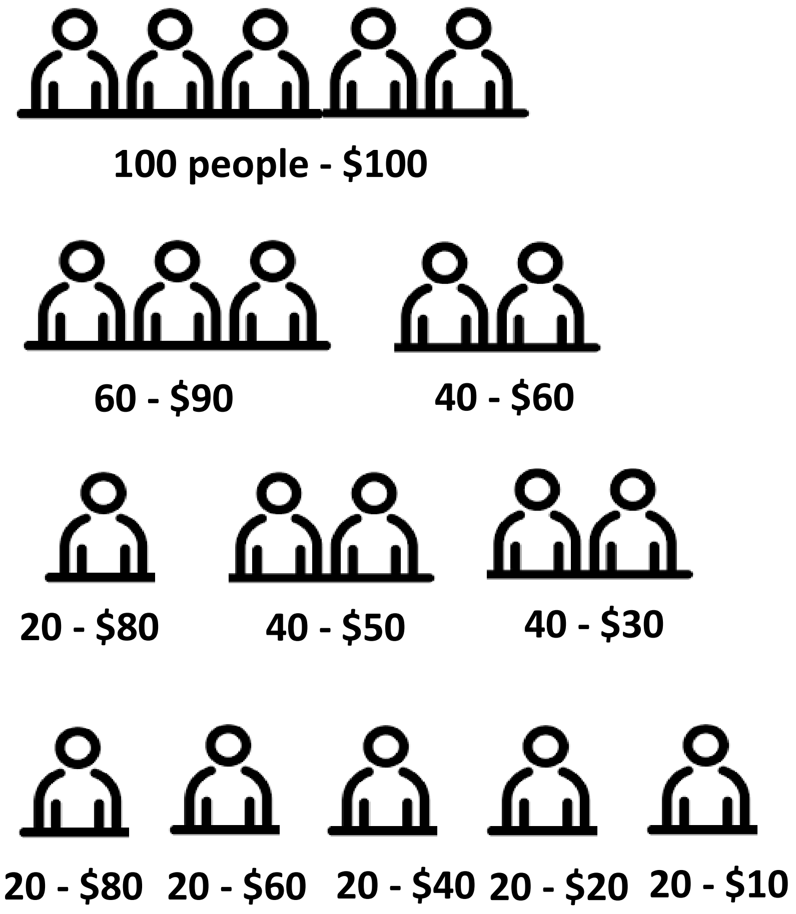
‘THE NEW NARRATIVE : TURNING THE TIDE ON INEQUALITY’

Is inequality inevitable?



Spontaneous inequality

- We often look for **causes of inequality** as arising from **unequal original endowments** or from **socio-political power relations**
- But **inequality can arise from normal human activity**, unforced in day-to-day transactions – **inequality is inevitable and part of the human condition**
- Even if all income was distributed evenly and there was an equitable system of power-relations **we would see inequality**, relative poverty, absolute poverty and abject poverty arising **within a few iterations**
- This then causes power an imbalance of power relations, opportunities and outcomes which leads to **structural inequality and structural poverty** across demographics
- We will **focus on poverty in old age**

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Poverty in old age: Role of pension systems

Basic Definition:	To provide an income (pension) for people who no-longer work (retired)
Functional Definition:	To ensure seniors have a decent standard of living

Economic

- Maintain consumption of the older cohort – consumption smoothing
- Encourages savings through structured funds
- Provides funds for investment and growth
- Minimises labour market distortions

Social

- Provides social equity for the older age cohort
- Reduces the burden on the younger age cohort
- Provides security and peace of mind for the older cohort
- Supports a "social contract" or a "social market economy"

Developmental

- Pension funds become active investors in financial markets
- Pension funds can support structural development
- Provides liquidity for capital markets for financial market development
- Pension funds can promote ESG and responsible management practices

Building a sustainable pension system

World Bank (2008)

- **Adequate** - benefits prevent poverty in old age
- **Affordable** - Is within the financing capacity
- **Sustainable** - Financially sound and maintainable
- **Predictable** - Benefits protected, indexed and risk adjusted
- **Equitable** - Redistribution between lifetime rich and lifetime poor
- **Robust** - Withstands economic, demographic, political or other shocks

OECD (Bi-annual Themes)

- 2005 - Conceptual framework
- 2007 - Private pensions
- 2009 - Economic crises
- 2011 - Adequacy vs sustainability
- 2013 - Housing, financial wealth and public services
- 2015 - Incomplete careers
- 2017 - Flexible retirement
- 2019 - Non-standard work
- 2020 - Impact of Covid-19

WEF (2017)

- Increasing life expectancies and lower birth rates
- Lack of easy access to pensions
- Inadequate savings rates
- Long term low growth environment
- Low levels of financial literacy
- High degree of individual responsibility to manage pension

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Robert Holzmann, Richard Paul Hinz and Mark Dorfman, PENSION SYSTEMS AND REFORM CONCEPTUAL FRAMEWORK, World Bank (June 2008)
Pensions at a Glance - PUBLIC POLICIES ACROSS OECD COUNTRIES, OECD, (Bi-annual 2005-2019)
Case Studies in Retirement System Reform, World Economic Forum (May 2017)

A comprehensive pension model

World Bank (2008-2020)

- **Zero Pillar**
  - Non-contributory social assistance financed by the state, fiscal conditions permitting
- **First Pillar**
  - Mandatory with contributions linked to earnings and objective of replacing some portion of lifetime pre-retirement income
- **Second Pillar**
  - Mandatory defined contribution plan with independent investment management
- **Third Pillar**
  - Voluntary taking many forms (e.g. individual savings; employer sponsored; defined benefit or defined contribution)
- **Fourth Pillar**
  - Informal support (such as family), other formal social programs (such as health care or housing), and other individual assets (such as home ownership and reverse mortgages).

OECD (2005-2020)

- **First Tier - Mandatory, Universal, Redistributive**
  - Social protection
  - Targeted to restrict costs
  - Residence-based Basic Pension
  - Contributions-based Basic Pension
  - Minimum
- **Second Tier - Mandatory, Earnings-related**
  - Public - Defined Benefits, Funded Defined Contributions, Notional Defined Contributions, Points
  - Private - Defined Benefits, Funded Defined Contributions
- **Third Tier - Voluntary, Earnings-related**
  - Private - Defined Benefits, Defined Contributions

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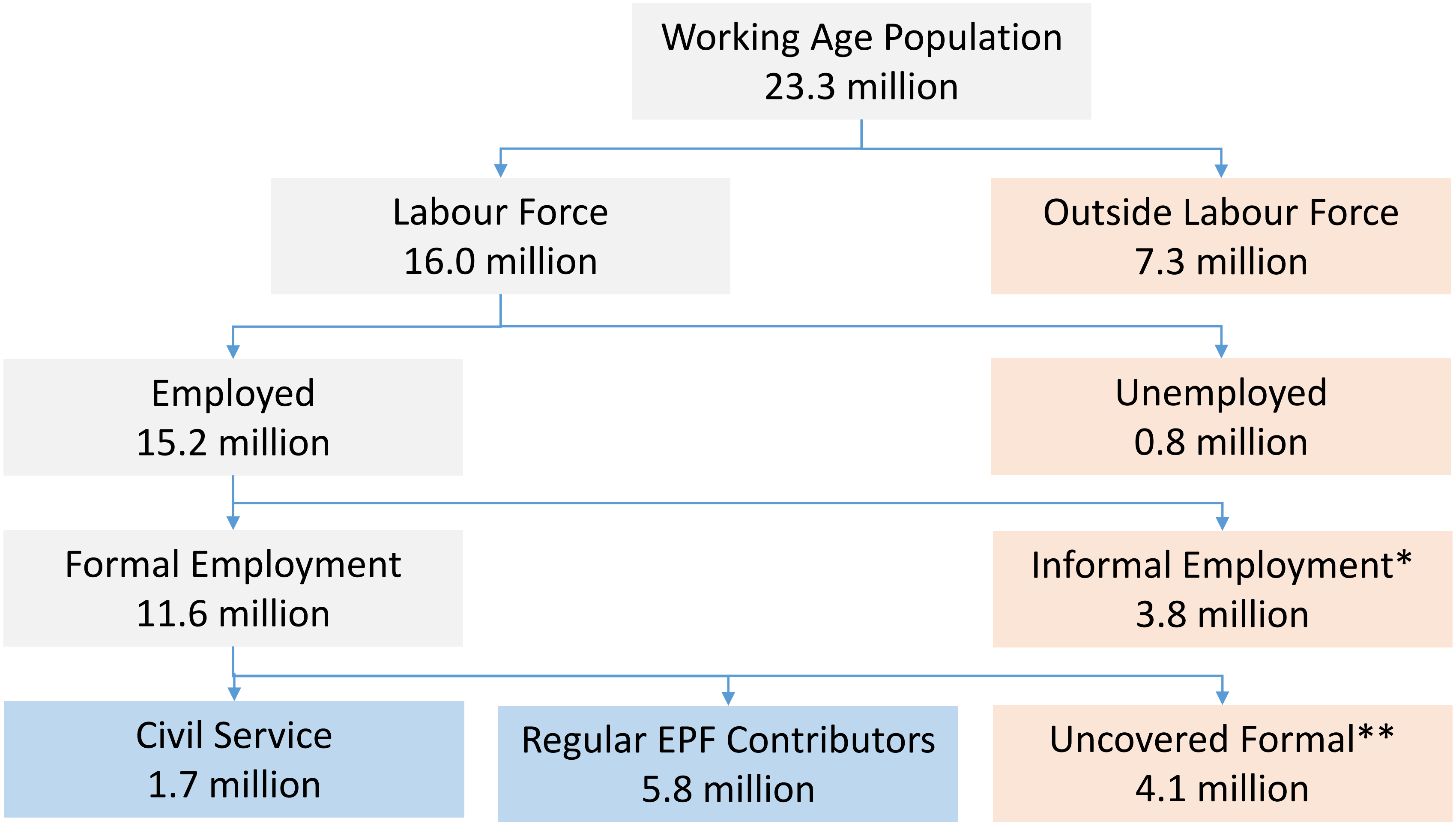
85% of Malaysians face old-age poverty



Around **16 million people** of working age have **no formal pension cover**

This is **69% of the working age population**

EPF estimate that **73% of their active members** have inadequate cover

Taken together **around 87% of the working age population** have inadequate cover

3.6 million people over 60 years old **estimated 2.6 million inadequate cover**

Department of Statistics, Malaysia (DOSM): Labour Market Review, First Quarter 2021, Malaysian Bureau of Labour Statistics; Media Statement: Statistics of Labour Force, Malaysia, May 2021; Current Population Estimates, Malaysia, 2021, 15, July 2021; *Informal Employment (estimate) covers agriculture, own account workers, family business workers and others; **Uncovered Formal covers foreign, workers, interns and other casual workers

Saving more and working longer

Age (Years Old)	Working Life (To 60 years)	RM240,000 (RM1,000 per month) RM Monthly	% Wages Median	Average	RM648,000 (RM2,700 per month) RM Monthly	% Wages Median	Average	RM540,000 (RM4,500 per month) RM Monthly	% Wages Median	Average
20	40	500	24%	17%	1,350	65%	46%	1,125	55%	38%
30	30	667	32%	23%	1,800	87%	61%	1,500	73%	51%
40	20	1,000	48%	34%	2,700	131%	92%	2,250	109%	77%
50	10	2,000	97%	68%	5,400	262%	184%	4,500	218%	153%

Retirement Age	Extra Work (Years)	Retirement Years	Extra Monthly Pension Median Wage (RM)	Average Wage (RM)
65	5	15	165	235
67	7	13	266	379
70	10	10	495	704

- Only those at the **early stages of their working life** aiming for the **lowest threshold of retirement** adequacy can save enough
- **Working longer** adds **virtually nothing** to retirement income

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An example of a comprehensive pension scheme

	Pension Type	Objective	Target Income	Target Group	Funding
Level 1	Universal Basic Pension	Minimum basic and decent income for the older cohort	Universal Basic Income / Living Wage income*	All population working and non-working	Non-contributory, contributory, social top-up, investment income from public investment funds
Level 2	Replacement Income Pension	Replace part of early-life income	Percentage of median/average income**	All income earners from whatever source	Income-related shared contributions (employer/employee), investment income from public investment funds
Level 3	Desired Income Pension	Target a desired older-life income and lifestyle	Higher rate lifestyle-based older-life income	Higher income earners	Higher tax-free contributions and savings in public or private funds
Level 4	Non-pension Income Alternative	To incentivise income-earners in older-life	Lifestyle and choice-based older-life income	Older cohort who want to continue to work or earn	Any form of housing, rental, financial, investment or work-based income and social or family help will enjoy tax incentives

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*Bank Negara suggest a Living Wage is RM2,700 per month for an individual or RM4,500 for a couple without children in Kuala Lumpur. Estimates for a UBI have not been made formally but suggestions are RM1,000-1,500 per household depending on size.

**In 2019 DOSM estimated mean income in Malaysia was RM7,901 while Malaysia's median income was RM5,873. Replacement targets are typically between 30-70% of income which would be RM2,370-RM5,530 for average income and RM1,761-RM4,111 for median income replacement

Financing a Universal Basic Pension

	Total Costs			% Government Spending			National Pension Fund (RM bn)			Tax on T20 Households		
	RM1,000	RM2,000	RM2,700	RM1,000	RM2,000	RM2,700	RM1,000	RM2,000	RM2,700	RM1,000	RM2,000	RM2,700
B10	2.2	4.3	5.8	0.7%	1.3%	1.8%	43	86	117	0.8%	1.6%	2.2%
B40	8.6	17.3	23.3	2.6%	5.2%	7.0%	173	346	467	3.3%	6.6%	8.9%
B70	15.1	30.2	40.8	4.6%	9.1%	12.3%	302	605	816	5.8%	11.5%	15.5%
Porfolio Financing (33% each source)												
B10	0.7	1.4	1.9	0.2%	0.4%	0.6%	14	29	39	0.3%	0.5%	0.7%
B40	2.9	5.8	7.8	0.9%	1.7%	2.3%	58	115	156	1.1%	2.2%	3.0%
B70	5.0	10.1	13.6	1.5%	3.0%	4.1%	101	202	272	1.9%	3.8%	5.2%

- A modest **UBP can cost as little as 0.7%** of government spending
- For a generous UBP **financing across a portfolio of options** is perfectly feasible
- A radical solution could fund a UBP by **pooling existing government pension funds** (RM1.2 trillion)
- A 5% return would yield RM60 billion which could cover a **living wage pension for 70% of retirees**

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*Bank Negara suggest a Living Wage is RM2,700 per month for an individual or RM4,500 for a couple without children in Kuala Lumpur.
**In 2020 DOSM estimated mean wage in Malaysia was RM2,933 while Malaysia's median wage was RM2,062.

Challenges and opportunities in Malaysia

Challenges:

- It may be impossible for many Malaysians to replenish their EPF Account 1 funds over their remaining work-life
- Based on growth projections (World Bank: high income but lower growth) and distribution it may be impossible for many Malaysians to save enough ever
- The future of work and gig-economy makes work and income more precarious for many people
- The 4IR and automation replaces jobs and reduces value-added from work
- An aging population puts greater emphasis on the need for reform of pensions

Opportunities:

- Total pension funds are large across national pension schemes
- Returns on funds have been well managed, strategic asset allocations are sound and inflows and outflows are manageable
- Alternative development models are available so that high income with slower growth is not inevitable
- Future of work and 4IR options can be managed with alternative outcomes
- High quality fund managers and strategy teams are already considering reform options
- There is still plenty of time for reforms provided a start is made now

Key success factors in pension reform

- **Aims and structure**
  - Pension coverage is universal – even for new forms of work and those that do not work
  - Benefits prevent age-related poverty
  - The system design is open, transparent and efficient
  - There is an adequate savings rate which does not deplete consumption
  - Government or social pension support is available
  - Home ownership and other sources of wealth and income are accounted for effectively
- **Sustainability and management:**
  - There is an effective investment strategy for the fund including growth assets
  - Total assets are sufficient and risk-secure
  - The economic environment supports growth and development
  - The pension system fully accounts for predictable demographic change
- **Integrity and governance:**
  - Regulations are credible, accountable and transparent
  - Member protection is enshrined in law,
  - The highest governance standards are applied,
  - Member communications are clear, regular and timely
  - Operating costs and margins for private pensions are not excessive
- **Additional factors:**
  - Access to public an private schemes is open and encouraged – even for self-employed
  - Pension funds support economic and financial market development, including ESG
  - A balance is struck between employee-employer-government contributions
  - Adequacy and sustainability does not force higher savings or longer working lives
  - Transfer and penalty costs for private pensions are not excessive

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THANK YOU
Q&A

Email: **geoffrey.williams@must.edu.my**

geoffrey.williams@williams.com.my

Mobile/WhatsApp: **011 1327 1518**

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