THE LONG TERM FINANCIAL SUSTAINABILITY OF THE CIVIL SERVICE PENSION SCHEME IN MALAYSIA

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by

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DEDICATION

I dedicate this thesis to my kids: Nikeisha and Yohann who have been my little ‘travelling companions’ on this journey. Their gentle prodding always gave me hope and endurance to complete this study.

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LIST OF ABBREVIATIONS

DB: Defined Benefit

A pension benefit that is calculated based on the worker's pensionable salary and length of service.

DC: Defined Contribution

A pension where the benefit is determined by the amount of assets accumulated in the fund.

NDC: Notional Defined Contribution Scheme

It is where contributions and interest are recorded as notional with no backing in real assets

KWAP: "Kumpulan Wang Pesaraan" (Retirement Fund Incorporated)

EPF: Employees Provident Fund

GDP : Gross Domestic Product

KEMANPANAN KEWANGAN JANGKA PANJANG SKIM PENCEN PERKHIDMATAN AWAM MALAYSIA

ABSTRAK

Skim Pencen Perkhidmatan Awam merupakan satu skim tanpa sumbangan tetapi dengan ganjaran yang ditetapkan untuk kesemua kakitangan kerajaan yang layak untuk menerima pencen. Di bawah skim ini, kakitangan kerajaan tidak perlu menyumbang ke arah dana pencen dan kesemua kos perbelanjaan pencen adalah ditanggung sepenuhnya oleh kerajaan melalui hasil pendapatan dari cukai. Peningkatan berterusan bilangan kakitangan sektor awam, jangka hayat yang semakin bertambah dan peningkatan faedah persaraan telah mengakibatkan perbelanjaan kerajaan ke atas kos pembiayaan pencen meningkat secara berterusan. Objektif utama penyelidikan ini adalah untuk menilai kelestarian kewangan jangka panjang kerajaan dari segi defisit pencen (nisbah defisit pencen berbanding dengan jumlah gaji) dan jurang kewangan (peratusan defisit pencen berbanding Keluaran Dalam Negara Kasar [KDNK]). Bagi menjayakan penyelidikan ini, satu model khas spesifik kepada sesuatu ekonomi yang membenarkan unjuran pendapatan dan perbelanjaan untuk tempoh masa 75 tahun telah dikaji dengan menggunakan lapan senario yang berbeza. Hasil penyelidikan menunjukkan bahawa tanpa campurtangan dari kerajaan, dana pencen tidak lestari dengan kedua-dua defisit pencen dan jurang kewangan meningkat pada kadar yang meningkat. Masalah ini dapat dibendung sekiranya peningkatan dalam umur persaraan disokong dengan penurunan kadar pengantian, serta peningkatan kadar sumbangan yang boleh menangguhkan peningkatan defisit pencen dan jurang kewangan. Langkah- langkah ini akan membuahkan hasil sekiranya

diperkenalkan secara berperingkat dan hanya melibatkan kakitangan sektor perkhidmatan awam yang baru. Namun begitu, defisit pencen dan jurang kewangan hanya akan dapat diperbaiki sekiranya di samping langkah-langkah yang dicadangkan di atas diambil, saiz sektor perkhidmatan awam dikurangkan dan faedah persaraan skim pencen perkhidmatan awam dikaji semula. Walaubagaimanapun, langkah–langkah ini adalah lebih sukar untuk dilaksanakan.

THE LONG TERM FINANCIAL SUSTAINABILITY OF THE CIVIL SERVICE PENSION SCHEME IN MALAYSIA

ABSTRACT

CSPS is a non-contributory and a defined-benefit pension scheme for all government employees who are eligible for pension. Under this scheme, the employees do not contribute for their pension and all expenditure is borne by the government through tax revenues. With the growing number of public sector employees, their longer life expectancy, and the expanding benefits under the CSPS, spending on pensions has been escalating. The main objective of the study was to assess its financial sustainability in terms of the pension deficit (ratio of pension deficit to total wages) and financial gap (pension deficit as a percentage of GDP). A country specific model that allows the projections of future expenditures and revenues over a period of 75 years was used to undertake this exercise under eight alternative scenarios. The findings indicate that if no intervention is made, the pension fund becomes unsustainable with both the pension deficit and the financial gap increasing at an increasing rate over time. On the other hand, if an increase in retirement age is combined with a reduction in replacement rate, and an increase in contribution rate, the pension scheme becomes more sustainable by delaying the pension deficit and a financial gap over a longer time period. These measures are best introduced in phases and applied only to new civil service recruits. However, the pension deficit and financial gap can only be effectively overcome if, along with the above measures, the size of the civil service is cut and benefits of the pension scheme are substantially modified. These are measures more difficult to implement.

CHAPTER 1

INTRODUCTION

1.0 Introduction

Civil service pension schemes are separate pension schemes for government employees or the public sector. The civil service pension in Malaysia was founded in Britain in 1810 and government employees were among the first to be covered by the government sponsored schemes (Palacios & Whitehouse, 2006). Many of the British colonies like Malaya (Malaysia, after 1963) inherited its underlying model of generous and non-contributory design (Manaf, 2010; Sujata, 2007). The Civil Service Pension Scheme (CSPS)[1] in Malaysia is a defined benefit (DB) scheme solely for government workers who meet the eligibility criteria and it is currently financed as a "pay as you go scheme" (PAYG) from general revenue although this is expected to change in the near future and be financed from the pension fund called the "Kumpulan Wang Pesaraan" or Retirement Fund Incorporated (KWAP) (KWAP, 2013).

The DB scheme has a benefit structure that depends on final salary and length of service as opposed to a defined contribution (DC) scheme which is solely dependent on contributions and returns on assets accumulated by the fund (Barr & Diamond, 2006; McGilllivary, 2006). PAYG are pensions paid out of current revenue rather than accumulated funds (Barr & Diamond, 2009) while funding refers to setting aside assets for future consumption. Given the experiences of many developed countries

[1] The structure of the CSPS is explained in detail in Chapter 2.

that are facing rising public expenditure as a result of rising life expectancy (Palacios & Whitehouse, 2006; Holzmann & Hinz, 2005, Van der Auwera, 2006) the financial sustainability of defined benefit (DB) schemes is of crucial importance because benefits are dependent on the ability to raise revenues in PAYG schemes, or returns on investment in funded schemes (Barr & Diamond, 2009). As most civil service pension schemes are based on defined benefit, the changing demographic profile and rising fiscal costs have compelled many countries to re-examine their pensions and consider reforms. At present, both developed and developing countries are reforming their civil service pension schemes because of these pressures.

Financial sustainability[2] of a pension scheme refers to its capacity to meet both the short-term and long-term commitments in paying pensions. The short-term commitment refers to the ability to finance the current explicit debt which is paying current pensioners, by taking into account the current assets and liabilities. The long term commitments, also known as implicit debt, refers to the ability to finance future payments of pensions that take into account the future expenditures and revenues (Barr & Diamond, 2009; Holzmann et.al., 2004). In the Malaysian case, the long term sustainability depends on the ability of the pension fund under KWAP to sustain paying out pensions to current and future retirees. The concern here is that the CSPS, without any contribution from the employees, would eventually encounter problems in accumulating financial reserves for investing and may not get the required returns for continuous payment (Lee, 1997). To be financially sustainable means revenues must be sufficient to cover the liabilities. The ability to finance future expenditures will depend on the contribution to the funds, the interest earned on the assets, and the

[2] The concept of financial sustainability is explained and discussed further in Chapter 3.

pension promises to the current and future retirees. A pension fund deficit would mean that the collections in terms of contributions and returns on the fund do not match the payments to pensions. When a pension deficit occurs the pension scheme becomes financially unsustainable and thus creates a pension debt that the government has to finance through its revenue or by raising taxes. This is because the pension system is safeguarded by the Federal Constitution and solvency (assets must equal liabilities) is guaranteed by the government (Lee, 1997). When the pension deficit becomes too large and persists, the entire pension scheme becomes unsustainable and this would require reviewing and changing pension parameters to ensure sustainability.

Forecasting models of future payments and collections into the future enables one to estimate the pension deficit (Becker & Paltsev, 2001). A rising pension deficit over the years would indicate that the fund is inadequate to make payments and possibly not sustainable. A financial gap in the funding is expressed as the pension deficit as a percentage of GDP. This gap will clearly show the amount of pension debt as a share of GDP, the government will need to finance when the pension fund falls short of liabilities (Yi, 2011). Although, the push for reforms may be strong, some considerations have to be given to the multiple objectives[3] of a pension system such as consumption smoothing and as insurance for uncertainty and risks (Barr & Diamond, 2006). Other primary goals like ensuring adequacy, affordability and robustness are also important in the framework for reforms as noted by the World Bank (Holzmann & Hinz, 2005).

[3] The multiple objectives and primary goals are basic concepts of the pension system. They are defined and explained at length in Chapter 3

Many of the reforms are aimed at reducing costs and reducing disparity between public and private pension schemes so as to increase labour mobility between the two sectors (Asher, 2000; Palacios & Whitehouse, 2006). The reforms carried out are both parametric and systemic. The parametric approach focuses on changing the key parameters: like changing the retirement age, increasing contribution, tightening the eligibility criteria and changing the method of indexation to protect against inflation[4] while systemic reform refers to changing the scheme from DB to DC.

Having encountered fiscal stress during times of recession in the 1980s, Malaysia has already initiated several reform measures but the nagging question of sustainability still prevails (Lee, 1997). One of the pressing issues concerning the CSPS in Malaysia is that the fiscal burden of financing this scheme has become significant and may crowd out other expenditures. This is because when pension deficit rises, the amount of government revenue that needs to be allocated for pensions would also rise.

Experiences of reforms in the civil service pension system undertaken by both developed and developing countries are worthy of assessment in order to identify the lessons for Malaysia. Yet, there are very few published studies on the design and the required reforms of the civil service pension scheme in Malaysia as compared to many other countries (Lee, 1997; Ibrahim & Siri, 2012). In contrast, there is a voluminous literature on the Malaysian Employees Provident Fund (EPF), which is a pension scheme for the private sector (for example, Lee, 2001; Narayanan, 2002; Holzmann, 2014).

[4] Pensions can be indexed to inflation or increases in wages. In Malaysia, an annual adjustment of 2 percent is made to account for inflation.

The present study will therefore investigate the issues that accentuate the need for reform and also provide inputs for fine tuning the system.

1.1 Problems in Financial Sustainability of Pension Scheme

There are number of issues in the Malaysian context that pose challenges to the long term financial sustainability of the pension system and consequently underscore the need for reform of the CSPS: the changing demographic structure, the rising size of pension recipients, the widening of pension coverage, the rising pension bill. There are further concerns related to disparities in the obligations and benefits between the CSPS and the EPF (the major pension scheme protecting retired private sector employees), and the institutional capacity to support reform. Each is discussed in turn.

1.1.1 Changing Demography- Increase in Life Expectancy

Increasing life expectancy places additional financial strain on the CSPS. The higher the life expectancy, the longer the payments for pensions from the time of retirement to the time one dies. The difference in life expectancy and the retirement age for Malaysia was considerably high in 2007. The life expectancy at birth in 2007 was 73 whereas the retirement age for government employees was 55. The difference of 18 years was the highest compared to China (13 years) and Thailand (15.6 years) but equaled to that of Singapore (Park & Estrada, 2012: 8-12). Additionally, civil servants tended to have longer life expectancy than the general population, based on evidence from developing countries (Palacios & Whitehouse, 2006). In 2014, with the retirement age raised to 60 and life expectancy at 74, the length in pension payout was reduced to 14 years. Parametric reform such as this in the civil service pension scheme may induce other costs such as rising wage bill along with longer employment years, leading to even higher pensions in the future (Palacios & Whitehouse, 2006). The life expectancy is expected to rise to 80.1 years between 2045 and 2050 (Park & Estrada, 2012) and this also has implications on the cost of financing pensions and the sustainability of the pension system.

1.1.2 Rising Share of Pensioners and the Fiscal Impact

The rising share of pensioners in the population contributes to higher pension costs and thus higher fiscal strain. On average 15,000 to 17,000 employees retire in a year (Sujata, 2007); in addition, the number of dependents[5] has also risen. The initial design of CSPS during British era did not include dependents but over the years the CSPS has evolved to include more recipients (Sujata, 2007).

Table 1.1 indicates that between 2002 and 2014, the number of pensioners grew by 4.12 percent per year while dependents grew at a slower rate of 2 percent per annum. Thus pension recipients as a whole (pensioners and dependents), grew at an annual average rate of 3.4 percent. For the same period, the average growth per annum of tax revenue was 7.5 percent (MOF, various years). In striking contrast, pension payments during this period recorded a growth rate of 9.2 per cent per annum, outstripping the growth of both pension recipients as well as tax revenue. On a per capita basis, too, pension payments registered an annual average growth rate (5.6 percent) that was well

[5] Dependents are widows/ widowers and children or parents of single employees who receive derivative pension.

ahead of the growth of total pension recipients. Clearly, if this trend continues, the CPS scheme will become financially unsustainable[6].

Table 1.1 Number of Pension Recipients and Expenditure on Pensions

Year	Number of pensioners	Number of dependents	Total recipients	Pension expenditure (million)[1]	Per capita expenditure
2002	263,720	128,545	392,265	5,134	13,088
2003	280,196	131,097	411,293	5,870	14,272
2004	296,966	133,448	430,414	6,060	14,079
2005	291,554	13,4019	425,573	6,809	16,000
2006	309,904	13,7364	447,268	7,008	15,668
2007	330,356	14,0540	470,899	8,251	17,522
2008	346,975	14,3601	490,576	10,022	20,429
2009	356,652	14,6437	503,089	10,146	20,167
2010	372,849	14,,9436	522,285	11,515	22,047
2011	396,528	15,2142	548,670	13,565	24,723
2012	411,729	15,3954	565,683	14,079	24,888
2013	418,940	162,080	581,020	14,842	25,545
2014	445,371	164,178	609,549	16,167[2]	26,523

Sources: JPA, various years [7] ; MOF various years

Note: [1] Includes gratuity payments (or lump sum payments received upon retirement)

[2] Estimate

There are at least two reasons for the rapid growth of pension payments; first, the periodic adjustment upward in pensions not only to account for inflation but also to parallel wage adjustments for the employees. In 2000, a 10 percent increase in salary was given to all employees across the board and following that, another increase was made in 2002. A substantial revision in salary took place in 2007, in which the support group 2[8] (secondary school and lower certificate graduates) received 35 percent increase and the support group 1(diploma and high school graduates) was given 25

[6] A crude elasticity of pension expenditure, with respect to changes in pension recipients ($\%\Delta PE/\%\Delta PR$) for this period has a value of about 3.9 with reference to Table 1.1 over the period, 2002 to 2014 [(16167-5134)/ 5134] /[(9609549-392265)/392265] x 100. This suggests that for every one percent increase in pension recipients during this period, pension payments increased by nearly 3.9 percent.

[7] The data for pensioners and pension recipients between 2002 and 2004 were from JPA annual report 2006; for years 2005 to 2012, the data were from JPA annual report 2012, and data for the period, 2013 to 2014, were from the 2014 annual report. Pension expenditure was obtained from MOF (various years)

[8] Support groups, management group and JUSA are explained in the civil service workforce structure in Chapter 2.

percent increase. The management group and JUSA had 15 percent and 7.5 percent increases, respectively (Manaf, 2010). In 2012, the salaries of all the various groups were increased between 7 to 13 percent (Ahmad et al., 2012). Second, the scope of pension payments has been broadened to include more dependents as mentioned earlier.

The "ultimate fiscal effect will, [of course], depend on government hiring practices" (Palacios and Whitehouse, 2006: 38). In Malaysia, the New Economic Policy (NEP)[9] and subsequent initiatives made the public sector a major avenue to provide employment for the Malays and other *Bumiputra* (Embong, 1996; Khoo, 2005; Menon, 2009; Manaf, 2010; Lau, 2013; Lee, 2012). The employment in the public sector grew at an annual average rate of 4.6 percent from 1971 to 1980[10].

Growth in public sector employment slowed down when privatization was introduced officially in 1983, and the Privatisation Master Plan was unveiled in 1991, as part of the Sixth Malaysia Plan (1991-95)[11]. The slowing down of public sector employment was, however, evident much earlier during the Fifth Plan (1986-90). It persisted through the Sixth, Seventh and Eighth Plan periods (1991-2005). Thus, for the twenty year period, from 1986 to 2005, growth in public sector employment was reduced to a mere 1.2 percent per annum. The privatization policy came about for two reasons; one, the government realized that the burden of financing a large public

[9] NEP was introduced for a 20 year period from 1971 to 1990 and sought to eliminate the identification of race with occupation, and alleviate poverty. Refer to Appendix 3 for changes in ethnic composition in public sector.
[10] All growth rates in this study are continuously compounded rates. The employment growth was computed from the data in Appendix 1.
[11] During the Sixth Plan period (1991-1995) alone, 29 government agencies were privatized and the significant drop in the employment came from the privatization of the Telecommunications Department, National Electricity Board and Post Service Department. (Manaf, 2010)

sector was risky; second, it was one way to ensure *Bumiputera* attainment of 30 percent of economic share in the corporate sector as envisaged under the NEP (Singaravello, 2012).

The employment trend in the public sector began to rise again with the advent of government-linked companies (GLCs) participating in the private sector (Singaravelloo, 2012). The growth in public sector employment recovered under the Ninth Plan (2006-2010) to register an annual average growth rate 3.3 percent. This trend is expected to have continued under the Tenth Plan (2011-2014).

It is therefore clear that the hiring practices in the public sector are influenced by government policies and plans. The hiring decisions in recent years may not add to the current burden of pension spending but will eventually lead to a higher implicit cost through future retirees.

The ratio of civil service employees to population in 2012 indicated that it was the highest for Malaysia (5.0 percent to a population of 28.8 million), when compared to other ASEAN countries like Thailand (3.0 percent of 68 million), Indonesia (1.9 percent of 237.6 million), Philippines (1.5 percent of 92.3 million), Vietnam (2.2 percent of 87.8 million) and Singapore (2.4 percent of 5.2 million) (ASEAN, 2012).

The pension spending for Malaysia was about 1.8 percent of Gross Domestic Product (GDP), 8.5 percent of operating expenditure, and 11.1 percent of tax revenue in 2014[12] (MOF, various years). Comparable figures were 0.5 percent of GDP in

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[12] Refer to Appendix 2 for the changes in spending as a proportion of GDP and revenue.

Indonesia, about 0.8 percent for the Philippines, and about 2 percent for the OECD countries in 2006 (Whitehouse, 2010).

It is evident that Malaysia has a larger public sector and higher pension spending in comparison to Indonesia and the Philippines. When expenditures are rising and revenues are inadequate, reforms to the civil service pension scheme become imperative.

1.1.3 Fiscal Capacity

Barr and Diamond (2009: 16) argue that spending on pensions "must be compatible with a country's ability to finance the consumption of retirees, the investment from which future economic growth derives, and the government's ability to raise revenues." Interestingly, in Malaysia, federal government expenditures, deficit and debt have been rising almost continuously since the 1970s (Narayanan, 2012)[13]. The federal government debt was estimated at 53.2 percent of GDP in 2014 (MOF, 2014). The debt poses a risk to monetary stability and the ability to meet repayment obligations. This, in turn, may be worrisome to foreign investors (Reinhart & Rogoff, 2010). The continuous deficit springs mainly from operating expenditures. The largest component of the operating expenditure consists of emoluments (salary and allowances)[14] paid to government employees; it averages to one quarter or more of the operating expenditures. In 2011, emoluments were about 27.5 percent of operating

[13] Although Malaysia experienced budget deficits from 1971 to 2014, and budget surpluses only between 1993 and 1997, concerns about rising budget deficit were raised only since 2003. Prior to this, the expenditures were seen as a necessity to meet NEP goals.
[14] Emoluments include salary, civil service allowances, housing allowance and cost of living allowance.

expenditure and has been rising over the years - 29.2 percent in 2012, 28.9 percent in 2013 and estimated to be 29.6 percent in 2014 (MOF, various years). The large emolument expenditures are also influenced, as noted before, by rising employment and salary increases in the public sector. Salaries increases are, however, not determined by market forces or productivity. Between 1998 and 2007, for example, national labour productivity grew at a rate of 2.9 percent per year while civil service emoluments grew much faster, at 9.9 percent per annum (Narayanan, 2012). The growth of pensions and gratuities during the same period was 8.5 percent (see Appendix 1). Thus, both the growth of wages and pension payments outpaced productivity growth.

At the macro level also, the fiscal picture continues to raise concerns. Malaysia has not been very successful in balancing expenditures and revenues. Between 2000 and 2007, when the budget deficit was reduced from 5.8 percent to 3.2 percent of GDP, there was no reduction in operating expenditure; instead, development expenditure was cut (Narayanan, 2012). Development expenditure contributes to the productive capacity of the country while operating expenditure finances current consumption. Reflecting on the importance of economic growth and the ability to raise revenue as mentioned by Barr and Diamond (2009), a large spending on pension is not sustainable. In fact, it may be a factor in triggering periods of crisis and inducing governments to impose more taxes or cut expenditures elsewhere (Holzmann & Hinz, 2005). In Malaysia, it is obvious that efforts to raise revenue are being made through the implementation of the goods and services taxes (GST), but not much has been seen in terms of revamping the expenditures on emoluments or pensions or addressing other leakages.

1.1.4 Disparity in Pension Benefits in the Formal Sector

Pensions are as incentives for workers to stay on with the same employer especially in a DB scheme where benefits are based on the final salary (Barr & Diamond, 2006). The disparity in the pension benefits is glaringly in favour of employees in the public sector. The CSPS is a non-contributory, lifelong protection in old age with substantial medical benefits while the Employees Provident Fund (EPF)[15] is savings returned with some interest (Narayanan, 2002). How does this disparity affect the sustainability of the CSPS? The public sector wages are comparable to the private sector in most instances (Manaf, 2010) but wage increments in the former are not linked to productivity, unlike the private sector (Narayanan, 2012). Furthermore, various allowances offered to the public sector employees are exempted from income tax whereas similar allowances received in the private sector are taxable[16]. Given that this offers a clear advantage to public sector employees "any further advantages through [differences in] pension" is "unjustified compensation differential and unnecessarily increase[s] the cost of government" (Palacios & Whitehouse, 2006: 41).

The CSPS covers only 10 percent of the labour force but takes out a large portion of the revenue in pension payments (12.3 percent in 2013), whereas the EPF beneficiaries comprise 50 percent of the labour force (Holzmann, 2014), but are made responsible for their own old age income. The problem of ageing in Malaysia may require more expenditure to be funneled to medical aid for the elderly, in general,

[15] A comparison of the EPF and the CSPS is provided in Chapter 2.
[16] A super scale officer in the government sector could receive various allowances totaling up to RM63, 700 or more per year that would be exempted from income tax. The entire sum will be taxable if it is received by a private sector employee.

making the maintenance of such a wide disparity between public and private sector employees an unduly expensive exercise.

This disparity also affects the smooth functioning of the labour market by limiting the inter sector mobility of workers. The CSPS's long eligibility (vesting[17]) period restricts the mobility of workers and thus retards the economic flexibility that is necessary for labour adjustments during economic shocks or structural changes. This too adds to the cost of government in maintaining workers until the eligibility period is fulfilled.

1.1.5 Institutional Capacity

One of the key issues of pension reform is the availability of institutional capacity to administer and implement a new scheme. Administrative issues such as the introduction of personal accounts and tracking of contributions require some administrative preparedness (Holzmann & Hinz, 2005). In Malaysia, the government had initiated a pre-funding scheme to ease its burden in the future with the establishment of KWAP. It is clearly outlined in the KWAP annual report of 2013 that this organization is meant to assist the Federal Government in paying the pension liability. The functions of KWAP are clearly stipulated as policy setting for the pension fund, managing the collections of individual contributions, executing and monitoring investments, managing members' accounts and managing financial administration and payments (KWAP, 2013).

[17] One is able to benefit from the pension after fulfilling certain years of service. This is explained further in Chapter 2 for CSPS.

The institutional framework is therefore available to make a shift for public employees towards contributing to the pension fund. The current pre-funding that comes only from the employer may not be sufficient to cope with the increase in the number of retirees. The pension has a statutory claim on government revenue and, as such, it is independent of the economic performance and capacity of the tax payer. Since, in Malaysia, the wages in the public sector is almost comparable to the private sector, some amount of contribution from the employees could enhance the capacity of the fund to finance pension payments in the future.

1.2 Problem Statement

The discussions above suggests that a number of pressures like rising life expectancy, growing number of pension recipients, government employment policies, poor fiscal position, and the disparity in pension benefits that affects labour market efficiency—all add up to a case for civil service pension reform to ensure sustainability of the pension scheme. Many of these issues can be addressed through appropriate reform measures. This provides the motivation for the present study. Its purpose is to examine CSPS and identify the issues that affect its sustainability. It is a normative study that hopes to provide some insights on improving the CSPS.

1.3 Research Questions

More specifically, the study proposes to address the following research questions:

1. Are there factors in the current CSPS that adversely affect its long term sustainability?
2. To what extent is the present scheme of pensions financially sustainable in the long term?
3. How can the system be changed or improved to lower the pension deficit and make it more sustainable?

1.4 Objectives of the Study

Based on the research questions, the main objectives of the study are as follows:

1. To describe the existing CSPS in Malaysia and to identify factors, if any, that is likely to adversely affect its long term financial sustainability.
2. To assess its long run financial sustainability by measuring both the size of the yearly pension deficit and yearly financial gap.
3. To examine measures to reduce the pension deficit and provide recommendations to improve its long term sustainability.

1.5 Significance of the Study

Despite this rising concern regarding the financial sustainability of the CSPS, few studies have examined its structure or discussed the possible consequences. Previous studies on the CSPS have briefly highlighted its rising cost (Lee, 1997) and the impact of increasing retirement age on pension liability from 1991 to 2000 (Ibrahim & Siri, 2012). In short, there is no study that gives a comprehensive review of the civil service pension or that has sought to ascertain the sustainability of the system in the midst of the expected demographic, economic and socio-economic changes. Neither has there been any attempt to estimate the extent of the pension deficit nor how it is likely to grow in the future. This study therefore intends to fill the gap. The evaluation of the current pension system undertaken through this study would hopefully contribute to a better understanding of the CSPS by providing a clearer picture of its current structure, its weaknesses and measures to reduce the financial burden posed by it. It will also identify policies that can improve the financial sustainability of the pension scheme.

1.6 Scope of the Study

This scope of this study is limited to the civil service pension scheme which is one of the two largest old age security schemes in the country; the other is the Employees Provident fund. The former covers the employees of all public sector services while the latter covers largely workers in the private sector. There are other smaller schemes such as the Armed Forces Pension (LTAT) which are not discussed. The Private Retirement Scheme and the Basic State Scheme are also not discussed. The former is akin to a voluntary, individual savings scheme while the latter is still under discussion.

1.7 Organization of Study

The study is organized as follows: Chapter 1 provided the background to the research topic, identified the research questions, the objectives and the significance of the research. Chapter 2 provides a description of the CSPS from its origins and traces the changes it has undergone to evolve into its present form. It also discusses the disparity in pension provisions in the formal sector by comparing both EPF and CSPS. Chapter 3 reviews the literatures and provides explanations to the various concepts, the models of pension systems and compares reforms in other Asian countries and United Kingdom. The implications for Malaysia's CSPS reforms are also highlighted. Chapter 4 presents the framework and model that is used to evaluate the sustainability of the current pension system. Chapter 5 discusses the results, and the final chapter looks into the policy implications of the findings and suggests recommendations for reforms.

CHAPTER 2

MALAYSIAN CIVIL SERVICE PENSION SCHEME (CSPS)

2.0 Introduction

This chapter gives an overview of the pension design in Malaysia and traces the evolution the Civil Service Pension Scheme (CSPS). It highlights the changes that have taken place and the changes that failed to take off. It also discusses the disparity between the private sector pension scheme and the CSPS.

2.1 Pension System Design in Malaysia

The pension system design refers to the basic structure of the pension system and its characteristics. It shows how the system fits into the multi-pillar framework of the World Bank and to what extent it is integrated with the other pension systems in the country (Pallares-Miralles, Romero and Whitehouse, 2012)

2.1.1 Pension System Design against the World Bank Framework

Table 2.1 gives an illustration of the overall social security framework in Malaysia set against the World Bank pillars. The World Bank multi-pillar model is designed to meet the needs of various target groups, including the lifetime poor, informal sector workers and workers covered by formal pensions. The diversity provides more flexibility in meeting the needs of the various groups and is also able to cope better against demographic, economic and political risks. The five pillars are:

2.1.1(a) A Non- Contributory or "Zero Pillar"

This pillar is financed by the government with the objective of alleviating poverty. It is a minimal provision for the elderly to ensure that those with low lifetime income and those who participated marginally in the formal economy are given basic protection. This scheme is highly dependent on budgetary resources. In Malaysia, the zero-pillar is fragmented and is based on a case- to- case basis. Malaysia does not have a universal pension for the elderly.

2.1.1(b) A Mandatory "First Pillar"

The objective of this pillar is to smoothen out consumption by replacing some of the income previously earned prior to retirement, and to alleviate poverty. This pillar is aimed at meeting the risks of uncertainties in life expectancy. It can either be financed through a 'pay as you go' scheme, or be fully funded. But it is subject to demographic or political risks. It is a public pension plan, either with a defined benefit (DB) or defined contribution (DC), or a Notional Defined Contribution Scheme (NDC). It is based on contribution and linked to earnings. The CSPS fits Pillar 1 of the World Bank model that is mandated and financed from public revenue and provides benefits for old age, disability, and derivative pension. It covers about 10 percent of the labour force (cited in Holzmann, 2014), comprising of employees of the Federal and State governments, statutory and local authorities, attorney general's office, and police and military personnel who have served for more than 21 years.

2.1.1(c) A Mandatory "Second Pillar"

This pillar is also aimed at consumption smoothening and alleviating poverty in old age. It can either be a DB or a DC scheme. It is more of an occupational plan. The Employees Provident Fund (EPF) is a mandatory old age retirement fund for the private sector, with both employees and employers contributing to the fund. The LTAT (Armed Forces Fund) is a DC scheme for military personnel below officers' level, with both employer and employee contributing to the fund.

2.1.1(d) A Voluntary "Third Pillar"

It is meant for consumption smoothening for both the formal and informal sectors. It can be carried out as an occupational or personal plan. Participation is on a voluntary basis and the source of funding is from personal contribution. The Private Retirement Scheme (PRC), set up in 2012, acts as a voluntary scheme to help address the needs of an ageing population in the future.

Table 2.1 Social Protection Programmes in Malaysia Compared against the World Bank Pillars

World Bank Pillar	Social Protection in Malaysia
Zero Pillar	
Elderly Poverty Protection	No universal protection for the poor
Target Group : Lifetime poor, informal and formal sector	Those with no source of income or no financial support from family
Characteristics: Basic' or 'Social Pension' or 'Social Assistance'; Universal of means tested	Old Age Assistance: RM300 monthly cash benefit Protection at Home Care: Rumah Seri Kenangan
Funding: Budget/ general revenue	Determined by the Department of Social Welfare, Ministry of Women, Family and Community Development
1st Pillar	
Elderly poverty protection and consumption smoothing	CSPS
Target Group: Formal Group	For pensionable public sector employees only
Characteristics: Public pension plan, publicly managed, defined benefit or notional defined contribution Mandated	Life-long pension payment with defined benefits, disability pension, gratuity, derivatives pension
Funding: Contributions, and perhaps with financial reserves	No contribution from employees Financed from tax revenue (budget) Administered by Public Service and Post Service Department and KWAP
2nd Pillar	
Consumption smoothing and elderly poverty protection through minimum pension	EPF and LTAT
Target: Formal sector Mandated	EPF for private sector employees LTAT for armed forces of other ranks
Characteristics: Occupational or personal pension plans, fully funded defined benefit or fully funded defined contribution	EPF : contributed by both employer and employees LTAT: contributed by both employer and employees
Funding: Financial assets	Both are funded

Table 2.1. Continued

3rd Pillar	
Consumption smoothing	Private Retirement Scheme (PRS)
Target group: lifetime poor, Formal and informal sector (emphasis on formal and informal) Voluntary	On voluntary basis
Characteristics: Occupational or personal pension plans, partially or fully funded defined benefit or funded defined contribution	Contributory
Funding: Financial assets	Funded
4th Pillar	
Elderly poverty protection and consumption smoothing (emphasis on lifetime poor and informal sector but also includes formal sector)	Individual savings and insurance Individuals and family members Tithing through Islamic institutions e.g. Department of Islamic Development Malaysia (JAKIM) for needy Muslims
Target group: Lifetime poor both formal and informal sector	Lifetime poor from formal and informal sector
Characteristics: voluntary or access to informal support (e.g. family support) or formal social programs)	Individuals and family members Tithing through Islamic Institutions: Zakat for needy Muslims by Department of Islamic Development Malaysia (JAKIM)
Funding: Individual savings and insurance	Savings, insurance or family member or Zakat.

Sources: Sim and Hamid (2010), Holzmann et.al (2008), Holzmann (2014), KWAP (2013)

Note: Zakat is compulsory for all Muslims and as such some hold the view that Zakat does not fit into the 4th Pillar which is voluntary but rather it is similar to Zero Pillar which is universal for all Muslims.

2.1.1(e) A Voluntary "Fourth Pillar"

This is an informal support aimed at elderly poverty protection and consumption smoothing on voluntary basis.

In the Malaysian case, at least in terms of coverage and intention, the zero, third and fourth pillars have not fully met the aspirations behind the World Bank framework. The implementation of the first and second pillars, on the other hand, merits revaluation to make them more sustainable. The focus of this study is on how to ensure the sustainability of the first pillar.

2.2 Malaysian Civil Service Structure

The Malaysian Civil Service in Malaysia consists of both Federal and State level employees, and can be traced back to the British influence in Malaysia through more than 100 years of administrative rule from 1824 to 1957 (Manaf, 2010). The Federal level consists of ministries and departments while the state level comprises local government and local administrators. The employees can be divided into 2 categories: (i) managerial and professional and (ii) support groups. The following table briefly describes the structure of the civil service workforce.

Table 2.2 Civil Service Workforce Structure

Categories	Group	Qualification
Managerial and Professional	Premier Civil Service (JUSA- Jawatan Utama Sektor Awam)	Promoted from professional and managerial group
	Professional and management (service officers)	University Degree
Support Groups	Support group 1	College diploma and high school degree
	Support Group 2	Secondary school cert and lower school cert

Source: Manaf (2010)

Notes: The Premier Civil service category includes the rank of 'Tulus'.

The public service encompasses the (i) judicial and legal services (ii) the police force (iii) education service (iv) armed forces (v) public service of states (vi) the joint public service (Federal and State), and (vii) general public service of the Federation. The bulk of the employees are from the support groups, comprising almost 70.3 percent of employees, followed by the professional and management staff who account for 28.2 percent, with the remaining 1.5 percent being made up of those in the 'super scales' or JUSA category (JPA, 2012).

The recruitment quotas for the administrative elite were introduced in 1952 and have continued till the present. As such, the Malaysian Civil service has majority of Malays (Manaf, 2010). Even more Malays occupy the higher level positions of the civil service after the NEP (New Economic Policy) was introduced in 1970 (Khoo, 2005). By mid- 2005, Malays accounted for about 77 percent of the civil service (CPPS, 2006). The proportion has remained largely at that level and includes places reserved in the civil service for other indigenous groups from Sabah and Sarawak. Malays and these groups are collectively termed the '*Bumiputera*'.

The Public Service Department (JPA) is the main agency for human resources in the public sector and it is under the purview of the Prime Minister's Department. The selection and recruitment in the public sector is carried out by the Public Service Commission (PSC). The National Institute for Public Administration (INTAN), founded in 1972, is responsible for the training and development of the public sector employees.

In 1992, a 'performance based reward system', the National Remuneration Scheme (NRS), was introduced. The salary structure was known as the Matrix Salary Schedule and applied to all, except JUSA. It allowed three movements of salary scales— horizontal, vertical or diagonal. Those whose performance did not qualify