

# A review of *babatunde alayande*'s "funded pension, financial sector development and economic growth in nigeria"

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**ABSTRACT:** Based for the most part on the inadequacies of the defined benefit scheme (DBS) more because of the DBS' financial unsustainability and lack of capacity to enhance and entrench economic growth, *Babatunde Alayande*'s article analyzes the behavior of both the DBS and the contributory pension scheme (CPS) in the context of the Nigerian economy, and the country's strong desire for funds and investments towards development. The article emphasized the influence of funded pension (as a savings stock) in spurring financial growth and enhancing development project financing. In sum, pension reform is identified as crucial because of its economic effects considering the link between contributions and benefits, pension funds contribution to financial markets development, and the efficiency of the public finance system.

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## INTRODUCTION

The main contribution of *Babatunde Alayande*'s paper titled "Funded Pension, Financial Sector Development and Economic Growth in Nigeria" is to develop new evidence that helps understand the critical role of funded pension in financial sector development and by extension, in economic growth with particular reference to Nigeria. In the review of the paper, this article emphasized why that objective is a worthy one considering the chains of impacts and benefits the funded pension brings to the economic development of Nigeria.

Social security system all over the world has become a dynamic tool in addressing socio-economic challenges. While the tackling of poverty have become a challenge from the point of view on the younger generation, the focus has rather now been cast on addressing old age poverty. Amid the quest for addressing development inequality is the need to cash-in on the multiplier effects this noble policy could have on the larger economy. And since the passage of the Pension Reform Act (PRA) in Nigeria in 2004, research in this area has mushroomed. Such studies on the movement of funds in the economy and how the funds from pension savings could be moved to the deficit side of the economy. Poor social security structure imposes large costs on government and an attendant economic cost. Consequently, large fiscal deficits are experienced along with a high poverty rate. Much has though been done by the government to address old age poverty and bring dignity to labour for Nigerian workers who deserved to enjoy their retirement; the Pay-As-You-Go (PAYG) scheme has left so little impact to desire.

With the 2004 PRA was the evolvement of the fully funded contributory pension scheme (CPS) with great benefits for the country's socio-economic wellbeing. This, along with the concerns on its

financial sustainability and the quest to chart development pathways in addressing the poverty challenges faced at the old age period led to the PRA 2004.

A major problem of the PAYG is that it creates capital flight that could have been available for other uses like funding developmental projects, retirees do not have direct access to benefits and idle funds that could go into the capital market for economic use are not made available.

## **1. NIGERIA'S PENSION REFORM: FROM THE PAYG TO THE CPS**

Nigeria has overtime operated the defined benefit scheme (DBS, also referred to as the unfunded or PAYG) which for the civil service, funding is the responsibility of the government. The private sector, notwithstanding its small size (including the informal sector), also operated a variant of pension, paid as severance benefits to either their apprentices or workers.<sup>1</sup> One peculiarity of the government- or employer-funded pensions is that it is more of a transfer device; the pensions are the resources levied on the wages of the workers from the retirees' generation. The benefits also depend on the grade level on retirement which is paid monthly.

The clear address of low savings in the CPS 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 CPS was introduced to give better security of post-service life to workers (see 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 the informal sector, and increased funds in the economy. But then, there are reasons for skepticism about the sustainability of the scheme.

The DBS was introduced into Nigeria before the independence by the British colonial government with the aim of providing post-retirement security to the British working in the country. From the first pension scheme legislated as the Pension Ordinance of 1951, to the National Provident Fund (NPF) scheme of 1961, which took care of the private sector, several others have followed thereafter: the Pension Act No. 102 of 1979, the Armed Forces Pension Act No. 103 of 1979, the Police and Other Government Agencies Pension Act No. 75 of 1987, the Local Government Pension Edict of 1987 and the National Social Insurance Trust Fund (NSITF) scheme of Decree No. 73 of 1993, which replaced the NPF scheme penultimate 1st July 1994 and involved the private sector, made provision for loss of income in old age, invalidity or death.

Before the introduction of the 2004 Pension Reform Act (PRA), most private sector organizations just like their public sector counterparts operated the DBS, and in such a way that the final entitlements were calculated on the employees' length of service and terminal remuneration. In the public sector, the DBS has been poorly-funded and ill-managed more because it relied on budgetary allocations, which have been inadequate. This situation led to over ₦2 trillion (Nigerian naira) in public pension deficit as at 2004 in view of the fact that the proportion of pensions payable to salaries also increased from 16.7 percent to 30 percent between the years 1995 and 1999 (Guardian,

<sup>1</sup> In the case of the informal sector, the employer sets up a business outfit for the severing workers, or gives them large sums to start a business.

2007). The administration of the scheme was altogether weak, while inefficiency and lack of transparency characterized its overall management.

In the context of the above-stated problems was the adoption of the CPS contained in the PRA. Part of the objectives is the reduction in old-age and contagious poverty, with further benefits of contributing to the country's social and economic development through the funds saved. And to make it sustainable, it was made compulsory for all organizations with at least five employees, and the National Pension Commission (PenCom) as the regulatory body. A retirement savings account (RSA) is opened by every employee with a pension fund administrator (PFA) of choice which serves as the point of transaction, and a contributor can only transfer to another PFA not more than once in a year during a „window“ period. So, the scheme allows for the mobility of labour without necessarily affecting the contribution of the employee. Withdrawal from the RSA is subject to the person attaining age 50 and

(i.) the employee is retired from active service having been appropriately medically certified as unable to function or work anymore,

(ii.) the employee retires in accordance with the terms and conditions of his employment.

On retirement or attaining the age of 50 years, or whichever is later, a RSA holder will utilize the balance standing to his credit to purchase an annuity from a life insurance company with programmed monthly or quarterly payments calculated on the basis of an expected life span, provided that the balance left after the withdrawal of the lump sum is sufficient to procure an annuity or fund programmed withdrawals that will produce an amount not less than 50 percent of his annual remuneration as at the date of his retirement.

**Table 1. Outlay of employee-employer contributions to pension funds by labour sector under the PRA 2004**

	<b>Sector</b>	<b>Employee</b>	<b>Employer</b>
<b>1.</b>	Federal Public Service (Including the Federal Capital Territory [FCT])	Minimum of 7.5 Percent Contribution	Minimum of 7.5 percent contribution
<b>2.</b>	Military	Minimum of 2.5 Percent Contribution	Minimum of 12.5 Percent Contribution
<b>3.</b>	Others (Particularly the Private Sector and Other State & Local Governments)	Minimum of 7.5 Percent Contribution	Minimum of 7.5 Percent Contribution

Source: PenCom (2006)

The PRA also provide avenue for voluntary contribution to the scheme which is taxable at the point of withdrawal before five years from the date it commenced, while the CPS is not taxable whatsoever. The quota of contribution by both the employer and the employee under this scheme is such that the employer makes at least 50 percent of the contribution (i.e. 7.5 of the employee's basic salary, transport and housing allowances) as a reward for the employee's service to the employer or his organization (see Table 1). The minimum contribution into the RSA is 15 percent of basic salary, housing and transport allowances which can be reviewed upward upon an agreement by both the employee and the employer. While in the case of the military, the employer contributes 12.5 percent and the military personnel 2.5 percent compared with other labour sectors which have a 50-50 percent contribution between the employer and the employee except where the employer opts to make the larger or entire contribution.

## 2. NIGERIAN PENSION REFORM AND THE FINANCIAL SECTOR DEVELOPMENT STRATEGY

While reduced poverty and economic growth are the louisiest benefits of the fully funded scheme, other interwoven gains exist that bring multiplier effects into the economy. The financial system is one major area the CPS is expected to impact.

A simplistic application of the conventional new school shows that funded pension enhance economic growth as evident in the Pareto efficient test where unfunded pension creates economic distortions and welfare inequality is thereafter created (see Breyer, 1990 and Homburg, 1990). The CPS can thus eliminate the deficit burden imposed on it by the unfunded defined benefit scheme through a shift in the economy's inter-temporal budget constraints and go ahead to positively impact the people's welfare (see Homburg, 1990). According to Holzmann (1996) and Beck and Levine (2004), the CPS can enhance labour dynamics to improve productivity and thus, a higher economic performance, with resulting benefits of a deepened financial sector market and better resource allocation.

Regression technique was adopted and so the Granger Causality was applied to test the impact of funded pension on the financial market. The result was positive as confirmed by theory that the CPS as a funded scheme increases financial market development and enhance economic growth. Herein, it was also found that economic growth also spurs the growth of the funded pension scheme.

## 3. CONCLUSION

This article examines the reasoning behind the reform of the Nigerian pension system from PAYG to the CPS using *Alayande's* article as the mirror. His analysis was built upon the conventional neoclassical argument, wherein he noted that funded pension results in multiplier effects for the economy with welfare benefits, financial markets development and economic growth among others as income growth, streaming in as interwoven gains. The results from the Granger Causality test also show that these are true.

One of the strengths from *Alayande's* article is that he was able to demonstrate practically (empirically with figures, so to say), the benefits that Nigeria stands to reap from the CPS, having broken away from the PAYG which left with it corruption, unfunded and non-payment of pensions, fiscal challenges to the government and poverty. What stands beyond dispute is that the funded pension is an active and well-structured type of savings which goes on to affect the financial market positively and thus spur economic growth. Thus the transition from the PAYG to the CPS system is a right step that holds multiple benefits in fiscal discipline, economic growth and financial sector deepening.

Not many people actually appreciate the CPS which is why even private sector workers are less-concerned whether their employers are remitting their contributions or not. *Alayande's* article will be important reading note, and will make an excellent foundational resource for the development of learning resources in pensions, as well as for policymakers and further research.

## 4. ACKNOWLEDGMENT

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