17 May 2016

Technical Note:
Projecting Alternative Scenarios &
Recommending Reform of the Existing RMI Social Security System

SS Reform

On May 9, 2016, a discussion was held with the RMI President's SS Reform task force. Members in attendance were: Minister of Finance Wase, Minister Muller, Minister Alfred, Minister Kaneko, Senator David Paul and Senator Bruce Bilimon. Discussions were held with the task force on the impact of the various reforms outlined in Bill 43, the former SS reform legislation. A graphical presentation was made in which the impact of the reform on benefits, contributions and fund status could be reviewed. This technical note covers the baseline case of zero reform, followed by a recommended two-phase reform strategy to first stabilize and to then more fully sustain the existing SS system.

Baseline case The baseline case (see Figure 1) indicates projected benefits, contributions and investments on the basis that zero reform is undertaken. The contribution curve grows slowly as the nominal value of wages rises reflecting a slowly growing economy. Benefits rise rapidly reflecting the actuarial projections provided in a previous SS report. As a result of the growing gap between benefits and contributions, there is a need to make large drawdowns from the reserves until 2021, when the fund collapses. From that time forward, the benefit stream converges to the funds available from contributions, and SS members receiving benefits are only

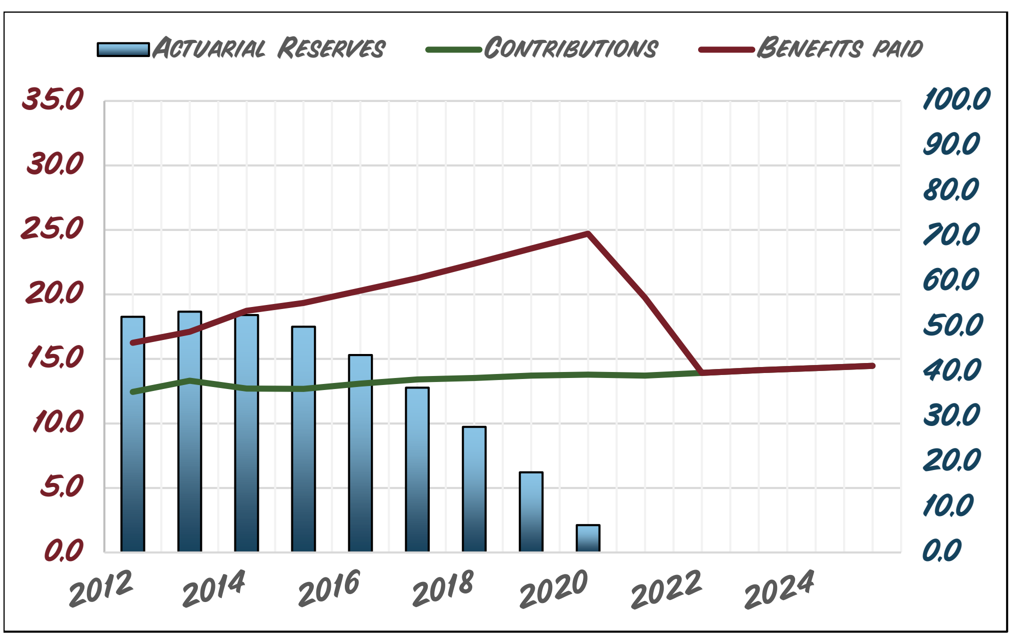

Figure 1 Contributions, benefits and fund status assuming zero reform

paid ¢52 on the dollar. A recipient expecting $200 per month would be reduced to just $104 per month.

Reforms

Bill 43 contained 4 reform major options:

- Increase taxes to 9 percent.
- Increase retirement age to 65.
- Increase the maximum quarterly taxable wage from $5,000 to $7,500.
- Reduce benefits; the bill proposed a 22 percent reduction.

In addition to the Bill 43 proposals, direct contributions by the Nitijela were discussed in the meeting with the SS reform task force. A proposal of a $5 million annual contribution was considered for a 5-year period.

Assumptions

- ***Investment rate of return***: The projections assume that the rate of return on investments under the zero reform scenario is 4.5 percent. This reflects the passive, low-risk nature of the current investment strategy due to the imminent collapse of the fund. Under the reform options it is assumed a more active, higher-risk strategy is adopted and a 6.5 percent return can be achieved.
- ***Use of U.S. life tables***: The actuarial projections are based on U.S. life tables. At birth life expectancy in the U.S. is 79 years while in the RMI it is 71. At age 65, the life expectancy in the U.S. rises to 83; while that in the RMI is not known but is probably in the 75 range. The actuarial projections need to be revised to reflect the differences between U.S. and RMI rates, and presumably the benefit curve would not rise as quickly as currently projected.

A Two-Phase Reform Strategy

It is recommended that a two-phase reform strategy is considered:

Phase 1: The first phase would entail adopting the first 3 measures proposed under Bill 43: increase tax rates to 8 percent in FY2017 and 9 percent in FY2019, increase retirement age to 65, and raise maximum quarterly taxable wage to $7,500. Further an annual contribution of $5 million from the Nitijela would assist in maintaining fund levels. These phase 1 measures can be implemented relatively easily as specified in the prior Bill 43 and are likely to meet with less political opposition than cutting benefits. These measures are arguably less likely to put the vulnerable and low income groups into severe financial distress. Meetings with the chamber of commerce during the recent Article IV IMF consultations indicated that the private sector was aware that radical action is needed to save the SS system and that increases in taxes were unavoidable and necessary (attendance at the meeting was limited and may not reflect that of the whole private sector). Nearly all senators have expressed concerns over reducing benefits. Phase 1 reforms could be enacted quickly during the August session of the Nitijela.

The stabilizing impact of the Phase 1 reforms is shown in Figure 2. Collapse of the actuarial reserve fund is averted during the period, but the system is not sustainable in the longer-term. The delayed, but projected eventual fund collapse remains highly probable. The five-year

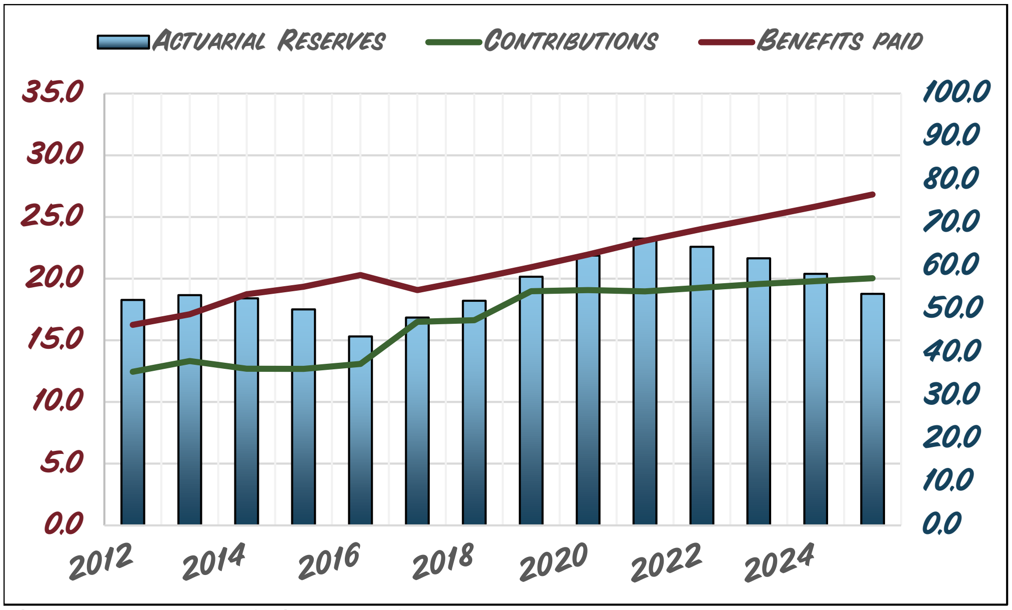

Figure 2 Impact of Phase 1 reforms

Nitijela contribution effort helps to improve the fund status and the reforms bring the benefit and contributions curves into closer proximity.

Phase 2: the second Phase would entail a reduction in benefits of an amount to be specified to ensure full sustainability of the SS system. However, an across the board cut is not recommended. Vulnerable and low income groups should be protected and any reduction in benefits should target the better off sections of the community. Further, reforms on the benefit side should take the opportunity to restructure the SS system, and this would likely entail a series of public hearings. Lastly, the projections and assumptions presented in these recommendations should be rerun with the latest information available at the time of enactment.

The impact of a 10 percent cut in benefits from FY2018 onwards is examined in Figure 3. The 10 percent cut should only be considered indicative and a final reduction in rates should only be chosen after all information is updated. However, the implementation of the 10 percent cut indicates that the funds status is sustainable over the medium-term, although the diverging nature of the benefit and contribution streams suggests that problems lie in the future. Once the projections are based on RMI life expectancies and all streams are re-estimated a more precise adjustment on the benefit side can be established. However, the dynamic nature of the system suggests that no "once and for all" set of reforms exists, and adjustments every 5-10 years are likely to be necessary.

Additional Considerations

Double Dipping During the task force meeting Minister Wase indicated the concern that some retired SS members are receiving benefits although they are still working. Adjustment to the SS system could be made to limit "double dipping" during the Phase 2 reforms.

Defined Contribution Schemes Senator David Paul indicated the possible introduction of a voluntary defined contribution scheme. This would not replace the SS system but provide a

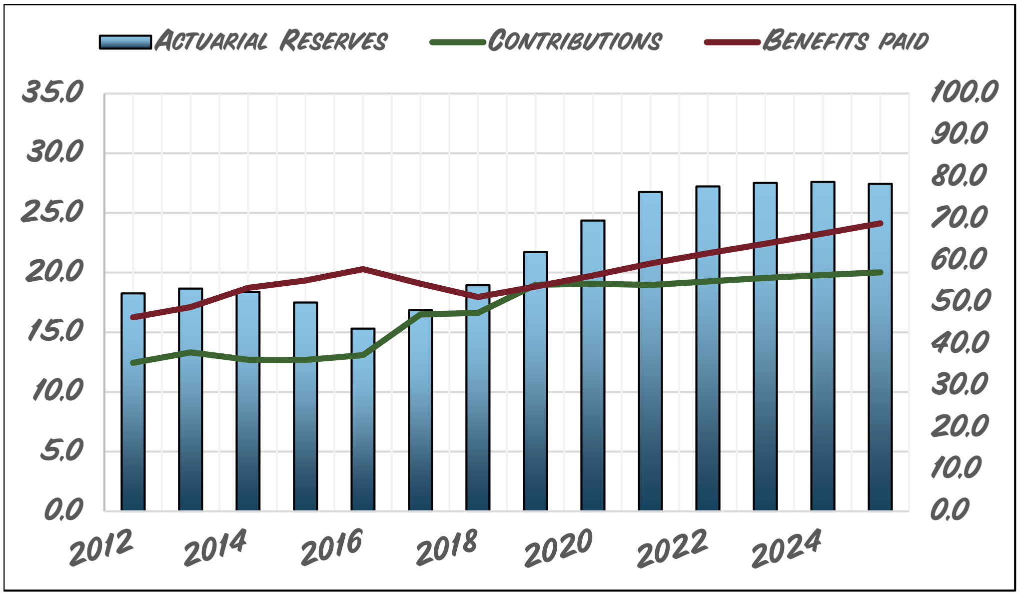

Figure 3 Impact of Stage 1 and 2 reforms

complementary pension plan, for those interested but presumably higher income earners. This is worth considering, but it would not be a replacement for the existing SS system. None of the IMF representatives or investment advisors at the SS workshop favored DC over DB systems to replace the existing scheme. DC schemes also do not achieve the important redistribution and social protection afforded through the existing SS system.

Alternative Investment Strategies the potential to invest SS resources in higher yielding domestic investments was also raised. However, it was pointed out that while the current SS investments in BOMI have provided a good yield in recent years, the investments must be considered risky and illiquid. Investment in marketable financial instruments in the domestic economy are largely nonexistent. Investments in the local economy would be more appropriately achieved through a venture capital fund, not a suitable vehicle for public investment in a SS scheme.

Conclusion

This SS reform technical note suggests that the Bill 43 reforms should be considered as a two-phase process. Action to save the system is required immediately, and the Phase 1 reforms can be enacted quickly during the August session of the Nitijela. This will place the system on a sounder position going forward. The Phase-2 reforms and adjustments on the benefit side can be undertaken after the impact of a full one-year period under the Phase 1 reforms, and perhaps as late as four years from now in the year 2020. Even the one-year delay will allow for wider public debate, for a vulnerability assessment to be undertaken, and for a more accurate determination of the needed level of benefit cuts and incidence of such cuts to be determined based on timely data and RMI-specific life tables.

This note recommends reforming the existing defined benefit SS system, which has many desirable attributes, most importantly serving as a safety net for vulnerable and low income groups as the system was designed to do. The other SS systems in Micronesia in the FSM and

Palau have also undergone threat of collapse, but have been reformed and are now on a sustainable path. Reform of the existing system in the RMI can achieve a similar result without the need for a radical redesign.