

# Collection

## Transferring contributions to individual pension accounts

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**C**ollecting contributions is more complicated in a decentralized pension system, based on individual accounts, than in a public system. Many public plans provide a defined benefit pension based on only a few years' earnings, which limits the need for keeping records of people's earnings and contributions in every year of their working life. And there is usually a choice of pension fund manager with individual accounts.

Collection, record-keeping and transferring contributions to individual accounts has often proved problematic. Some reforms have been delayed or abandoned because of collection problems. Using a series of case studies of Latin American and European countries, this briefing highlights policy choices in operating individual accounts systems.

### Contribution collection problems

Many public pension systems are plagued by poor compliance with contribution requirements. There is usually a mix of different causes. Contribution rates, including levies on both employer and employee, frequently exceed a quarter of gross wages and reach one half in some countries. In addition, complying with contribution requirements can impose a large administrative burden on employers. And high contribution rates, coupled with often weak links between contributions paid and benefits received, can result in poor incentives to comply and even for people to take jobs or firms to hire them.

Poor rates of collection can also result from institutional weaknesses in collection systems. For example, employees of collection agencies are often relatively poorly paid. This can result in recruitment and retention problems, poor qualifications and motivation. It also increases the potential for corruption.

Sometimes there is more than one agency collecting levies on earnings, with social security, personal income taxation and health insurance administered separately. Different agencies often fail to share information, and duplication adds to the public sector's administrative costs and to employers' compliance costs. Some countries lack a unique system of identification numbers for workers and fail to take full advantage of information technology.

These institutional weaknesses can result in poor procedures for enforcing contribution requirements. Effective control systems, for example, should involve pre-defined, automatic 'alarms' as well as administrators' intuition. By comparing indicators for a particular firm over time or against other, similar firms, many deliberate and unintentional errors can be spotted. But this requires effective information technology, qualified and well-motivated staff and transparent application of administrative discretion.

Avoiding these weaknesses in institutions and practices is an important issue in setting up and operating a system for collecting and transferring contributions to individual pension accounts.

### Unified or decentralized collection?

Whether a central clearing house should collect pension contributions or this should be decentralized to individual employers and pension funds is a key policy choice. A centralized system raises another issue. Should pension contribution collection be unified with other levies on earnings, such as payments to unemployment, disability, healthcare funds *etc.* and the personal income tax?

There are two important criteria for judging different options. First, the cost of running the system. Comparisons must count both the public agency's or the pension funds' direct administrative costs and the indirect cost of compliance borne by employers. Secondly, the system's effectiveness. This includes the extent to which people meet the statutory contribution requirement, the speed and accuracy with which accounts are credited and the security of the system.

### Collection costs

Economies of scale are probably fairly important in collecting contributions. Decentralized collection involves duplication, which might be costly. Each pension fund operates its own collection system. And with individual choice of fund, each employer might have to make payments to many different pension providers. But if the banking system has an efficient payment clearing mechanism, the extra costs need not be large. And competition to reduce administrative costs can lead to the development of specialist collection firms able to take advantage of economies of scale.

Unifying contribution and tax collection might also reap some economies of scale, by combining enforcement of the two different levies and reducing the number of payments employers need to make. But employers' compliance costs may not be reduced much if they are levied on different bases. Tax allowances, zero-rate bands and so on often mean people are liable for contributions but not for income tax. Even when there are contribution

floors, they are rarely aligned with tax bands. Income taxes often have a broader base than contributions: including fringe benefits, for example. Units of assessment can also differ: usually individuals for contributions, often couples for income tax. Even periods of assessment can vary. So employers will still have the burden of separate assessments of the two levies, even if the resulting liability is met with a single payment.

### Timing of transfers

Decentralized systems are (in theory at least) quicker at getting contributions to individual accounts. They cut out the 'middle man' or clearing house between employers and funds.

Timeliness of transfers is important when inflation is high. The value of contributions might be eroded before they reach the fund. In all cases, investment returns are lost if contributions are held up.

The loss in a centralized system, of course, depends on the efficiency of the clearing house. But if compensation is made, then individuals' interests are protected. In the United Kingdom, contributions are transferred to individual accounts around a month after the end of the relevant financial year.

### Abuse of funds

Related to the timing issue is the spurious use of pension contribution revenues. Employers, even in the United Kingdom and United States, have often temporarily held onto pension contributions to ease cash-flow problems. This requires rules on the timing of contribution transfers.

Governments, too can be tempted by contribution revenues. And this problem is not confined to countries with poor governance records.

A decentralized system has probably greater risks of employer malpractice, although it can probably better insulate against risk of appropriation by the state. Regardless of who collects contributions, it is essential that the process is transparent.

## Compliance

Ensuring compliance with contribution requirements is relatively automatic if payments pass through a public agency. Pension funds have an incentive to collect contributions due from employers. But it is legally very difficult and probably undesirable to give private sector bodies the same sort of enforcement powers as public agencies, such as tax authorities.

So in a decentralized system, there needs to be regular, detailed reports of the flow of contributions which must be audited by some kind of supervisory agency. Fund managers might be required to report any evidence of non-compliance to the supervisors. But effective supervision still adds to the complexity and cost of running the contribution system. Also, rates of compliance might be lower.

Cross checking tax and contribution information can help with enforcement of both levies. This is possible with two separate agencies, but considerably easier with a single authority with unified technology and procedures.

## Collection in practice

Different countries' collection regimes vary, illustrating many of the policy issues.

Chile's pension funds are responsible for collecting contributions from their members. Employers deduct contributions from wages and send contributions to each worker's choice of fund monthly. The government retains ultimate enforcement powers, but pension funds can sue employers for unpaid contributions.

Mandatory individual pension accounts were introduced in Chile in 1980-81. Public pensions in the new system are limited to 'recognition bonds', covering rights accrued in the old regime, and the minimum pension guarantee. Both are one-off transfers from the government to the pension fund. The case for decentralized contribution collection is stronger when the government has such a restricted role in the pension system after reform.

## Argentina

Argentina's new pension system, in contrast, retained a larger role for public pensions. All workers covered by the new regime will continue to receive some state benefits, the so-called 'first pillar'.

Pension contribution collection in Argentina is centralized in the tax authority, along with health, other welfare contributions and taxes. Employers make monthly payments and reports, either directly to the tax agency or through a financial institution. In turn, the tax authorities transfer contributions to pension fund managers within 48 hours.

## Chile and Argentina compared

Comparing the Chilean and Argentine collection systems, Chile appears to achieve higher compliance rates. But this, in part, is because Argentina requires the self-employed to make pension contributions. Chile does not. The self-employed have higher rates of evasion of all kinds of statutory levies: income taxes as well as welfare contributions. So the narrower net of compulsory coverage means Chile is likely to show better rates of compliance than Argentina. Also, Chile has a stronger tradition of tax compliance. It is difficult to judge whether it is these factors or the structure of the system which delivers better collection rates.

Argentina's collection system also seems to be more expensive. But again there are problems with the data. Chile's pension funds tend to collect contributions through affiliated banks, so it is not possible to separate collection from other costs. And the Argentine tax authority has a broader range of duties.

Centralization of collection in Argentina began before the pension reform. A unified social security contribution, replacing separate payments to many different funds, was introduced in 1992. A private consortium ran collection in the new pension system, introduced in 1994. In 1998 responsibility was transferred to the tax authority.

## Sweden

Other countries share this trend to centralization. Responsibility for contribution collection in Sweden was gradually transferred from the social security to the tax agency between 1975 and 1985. Contributions to individual accounts (introduced more recently) will also be collected centrally.

## United Kingdom

The United Kingdom shifted responsibility for social security contribution collection to the tax agency in 1998, although the latter had long collected 95 per cent of contributions. The tax agency transfers contributions to pension funds for people covered by individual accounts.

But around twice as many people are members of employer-based schemes as there are in individual accounts. These so-called occupational plans are mainly defined benefit, but defined contribution schemes are becoming increasingly important. In both types, employers are responsible for paying their own and their employees' contributions into the fund. But a separate supervisory agency is responsible for ensuring these payments are made. And problems with payment of contributions in practice make up the bulk of the agency's work.

## Poland

Poland will also have single clearing house for collection, which will transfer pension contributions to people's choice of fund. But this will be the social security agency, and collection will remain completely separate from tax administration. This decision is partly attributable to a desire to mitigate the social security agency's opposition to reform by offering it a major role in the new pension system. But the agency's head has recently been forced out because of failures in the collection and transfer system.

## Hungary

Hungary has decentralized collection. Employers make payments directly to pension funds, which they must also report to the pension fund supervisory agency. The separation of social security contribution and tax collection, enforced by the constitutional court, is designed to protect privacy.

The United Kingdom also used to prevent information sharing between different government agencies for privacy reasons. But recent legislation to allow cross-checks between taxes, benefits and contributions did not meet with much opposition. The contrast with Hungary perhaps reflects the latter's experience of state abuse of comprehensive personal information.

## Further reading

Rofman, R. and Demarco, G. (1999), 'Collecting and transferring pension contributions', Pension Reform Primer series, Social Protection Discussion Paper no. 9007, World Bank.  
World Bank (1999), 'Protecting funded pensions and building confidence in the system', Pension Reform Primer briefing, World Bank.

## Conclusions and recommendations

- operational issues—collecting contributions, keeping records and transferring payments to pension funds—have seriously delayed some pension reforms
- some systems operate a central clearing house to collect mandatory contributions and transfer them to individuals' chosen funds
- pension funds collect contributions directly from employers in other regimes
- centralized systems, taking advantage of economies of scale, are probably cheaper in general
- but competition between pension funds, using banks' payment clearing systems and institutional failures in public agencies can offset this disadvantage
- centralized systems can also enforce contribution requirements more easily
- there are also cost and compliance advantages to combining pension contribution collection with other contributions and personal income taxes