

# **THE SOCIAL PROTECTION FRAMEWORK**

## **SOME ISSUES IN PENSION REFORM**

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### **I. Introduction**

Income maintenance and social protection well beyond one's working life is essentially a twentieth century phenomena in both industrialized and developing countries. In the industrialized countries, the ideas of Bismark and Beveridge were instrumental in leading to the provisions of retirement incomes for both public and private sector workers. These ideas also spread to the developing world where trade union pressures led to the growth in occupational pension arrangements alongside that of social insurance programmes.

In the English speaking Caribbean social insurance legislation was first enacted almost forty years ago and by now is widespread throughout. Alongside these developments however, there has also been the rise of occupational pensions, private annuities and a variety of retirement savings vehicles. This upsurge in regional activity in the area of retirement savings can be linked to several factors e.g. the view that the *raison d'être* of a pension is to enjoy retirement rather than endure old age; another view that pensions serve important functions such as tax protection, deferred incomes or compulsory employee savings. The growth of the industry in the CARICOM region has resulted in different effects on the economy e.g. the rise of institutional investors, micro-macro linkages, balance of payments effects and the development of the domestic capital market.

Most definitions of a pension include at least one or all of these elements of the function of a pension – income support for the elderly; a payment made because a worker has reached a certain age and no longer participates in the labour force; consumption smoothing over one's lifetime so that some proportion of current consumption is shifted to the future (savings element); deferred income or an insurance against the future; compulsory savings.

Pensions may be defined as "payments made to individuals either because they have reached a certain age and retired from the labour force or from a particular job or simply because they have reached a certain age". Pensions are important because they allow individuals to maintain a standard of living at least equal to that which was achieved during their working life and long after their working life is complete. Pensions systems around the world differ in the manner in which they finance and provide pensions, in respect of whether they are run by the state or the private sector, and whether they specify benefits or contributions. Pensions can be contributory or non-contributory; pensions can also be viewed as a private matter on the basis of property rights and choices made by individuals over their working life (e.g. consumption smoothing this is shifting consumption from working life to retirement) or they can be seen as a collective matter which is determined by public policy which ensures that the welfare of all citizens are taken into account.

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Given the characteristics of pensions as described above, one can identify four distinct types of retirement incomes depending on whether they are funded or not and whether they are driven by individual or collection provision. As described in Table 1 below, Type 1 retirement income is the generic national insurance (NI) programme which is common to most Caribbean countries; Type 2 is typical of many former British colonies and comprises the traditional public sector pay-as-you-go unfunded pension system. Type 3 is a means - tested old age pension (OAP) for persons 65 years and over, while Type 4 includes not only the traditional occupational pension plan, but also annuity type arrangement and individual retirement accounts. Most individuals who work in the public sector would be eligible for Types 1 and 2; individuals who work in the private sector where occupational plans exist can receive Types 1 and 4, but if no plans exist may be eligible for Type 3 after the age of 65. In describing pensions systems, a distinction is usually made between those systems which fix benefits or contributions<sup>1</sup>. Types 1, 2 and 3 are generally DB systems. Type 4 retirement income may contain a mix of DB and DC systems.

**Table 1**  
**Structure of Retirement Incomes**

	<b>Individual/Private Provision</b>	<b>Collective Provision</b>
Contributory	4	1
Non-Contributory	3	2

## II. Pension Systems in CARICOM

What is the nature of retirement incomes in the CARICOM region? Just as described in Table 1, there are three major types and one can identify social insurance programmes as common to the entire region. Social insurance which is represented in the wider Caribbean by NI is characterized by the key factors given in Box I.

Social insurance as represented by National Insurance (NI) in the English speaking Caribbean began in Jamaica (1965), Barbados (1966) and then Trinidad and Tobago (1971) and extended right through the English-speaking Caribbean with that of St. Vincent and the Grenadines (1977) at 15 years of age one of the youngest. The most important NI benefits for which workers are eligible are retirement grants and pensions. The current NI is contributory and mandatory for all employed persons, although in a few countries there is full coverage for the self-employed and the informal sector.

<sup>1</sup> A defined benefits system is structured such that the benefits obtained on retirement are specified in the trust deed and rules. A defined contribution system is one in which the employer and employee contribute a specified proportion of the employee's salary to the pension scheme. Benefits are not guaranteed but depend on the investments made and the rate of return on these investments.

### **Box I: Characteristics of Social Insurance**

- pooling of risks, without reference to any health condition of the insured person, to secure almost universal coverage of the population at hazard;
- part or all of the benefits are financed by contributions which are generally related to earnings;
- payments are not made on the basis of "means" tests, but some conditionalities usually apply;
- unlike private insurance, there is no strict actuarial relationship between contributions and benefits received; and
- benefits may be subject to income tax although contributions may be tax deductible.

In some countries there is a system of OAP which exists side by side with the NI system. In Trinidad and Tobago retirement income of the OAP type is now set well above the upper limit of the NI pension following years of upward adjustment through changes in budgetary policy. However, in the 2003/2004 budget the government announced a minimum pension for NI retirees which is equivalent to the OAP but the financing arrangements are not as yet clearly articulated. In Barbados some tinkering with the OAP led to the NI subsidizing the OAP without the resultant contributions from the government. These actions have led to strains in the system which has provided the impetus to calls for reform.

The second most important form of retirement income is the typical public sector pension which embraces the Pay As You Go (PAYG) formula and is widespread throughout the Commonwealth Caribbean. Interestingly enough in Jamaica and Trinidad and Tobago (TT) there are instances in which partial contributions are made e.g. military personnel and Parliamentarians in TT and military personnel in Jamaica. In TT Parliamentarians contribute 5 per cent of their gross income towards a pension.

The third major form of retirement income in the region is that based on private occupational pension plans – Type 4 in Table 1. While these plans may not be common in the ECCU area, they are the norm in Trinidad and Tobago, Jamaica and to a lesser extent Barbados and Guyana. In Guyana for example employees of the majority of private sector and state owned firms contribute towards occupational pension plans which are fully funded and managed by asset management companies. Data for 2000 suggest that there are just over 20 such plans in Guyana. In Trinidad and Tobago the growth of occupational pension arrangement is closely linked to that of trade union activity and the number of such active plans is well over 200. These are managed either by trustees or self administered. Recent estimates suggest that these plans with approximately 44,353 active members have an asset base of just over TT\$13.0 billion.

In addition to these plans, there are a wide variety of savings vehicles – mutual fund products, annuities, individual retirement accounts which are available primarily in TT and Jamaica. These are voluntary in nature and are available for the self employed, individuals or employed persons. In the region therefore, the pension market is divided between the public and private sector with the public sector dominant especially in the OECS region and a mixture of public and private sector arrangements in Trinidad and Tobago and Jamaica.

After more than 60 years of pension management around the world, there has been a groundswell of calls in the 1990's for pension reform. Several different factors have led to initiatives for reform: the ageing of the labour force population in Western Europe and Japan; the growing liabilities of the public sector pay-as-you-go systems in both industrialized and developing countries, lacklustre performance of many social security systems especially in the Caribbean in particular, financial scandals involving many private occupational pension plans.

### **III. Issues in Pension Reform**

Over the last decade much of the literature on the economics of pensions has focussed on pension reform. This discussion has taken place in many industrialised countries but also in the transition economies and in the developing world as well. This has been driven by two main considerations – population ageing and insolvent PAYG systems. World population projections suggest that by 2030 more than 16 per cent of the world's population will be over 60 years and may live much longer than their grandparents. The situation is particularly acute in Western Europe and Japan. The graying of the world implies that some form of financial protection will be needed for these persons who will live for a long time after they exit the work force. A second factor is the existence of a large number of public pension systems in both the industrialized as well as the developing world with large unfunded liabilities which would lead to a significant burden on future generations.

Within the Caribbean region the demographic changes are not as stark as elsewhere but over the next 15-20 years most of the public pension systems will be confronted with fewer workers having to support a growing elderly population. In addition, the financial performance of several of the regional NI systems has been a source of concern and when taken together with the unfunded public sector pensions led to calls for pension reform in the public sector.

In the area of private pension arrangements there have also been similar concerns largely in response to unresolved regulatory issues. Here major issues relate to the treatment of surpluses in fully funded pension plans and the role of trustees. More recently, the ongoing debacle from the corporate failure at Enron and the likely implications for voluntary savings in a particular form in the US will certainly add to the debate. In Latin America, Chile was one of the first (1981) countries to reform its public pension system. The relative success of that model (Box II) which has been adopted with some adjustments by other Latin American countries (Columbia, Mexico) also led to calls for pension reform in the Caribbean and for the adoption of the Chilean model.

### **Box II: Pension Reform in Chile**

In 1981 Chile pioneered a new concept of pension reform that has influenced pension reform in the Latin American region. Chile substituted an old system based on the PAYG method with one based on defined contributions. The system involves the introduction of individual retirement accounts with the employee contributing 13.1 per cent of his salary, 10 per cent of which was for old age with the remainder to finance disability, survivors' benefits (60.8 per cent) and the administrative charges (averaging over 2.2 per cent). Individuals may choose to make voluntary contributions greater than the mandatory 10 per cent to increase their personal capitalization to finance early retirement. Benefits are not defined but are determined on the basis of the net value of the contributions plus their investment yield. Retirement age is set at 60 years for women and 65 years for men. The funds are privately managed by pension fund administrators (AFP) and individuals can move around from one administrator to another. The state regulates the AFPs and guarantees a minimum investment yield or minimum pension in case of bankruptcy.

### **Philosophical Issues**

Discussions in respect of pension reform have tended to focus on the so-called pillar approach whose origin derives from the World Bank's study *On Averting The Old Age Crisis, 1983*. Much of the discussion which followed this seminal work has resulted in some consensus on the three pillars or tiers, although there are some deviations in respect of how the tiers should be provided.

The debate on pension reform can be considered from two different philosophical approaches to developing an ideal type pension system with universal application. These approaches have been developed independently of each other by the ILO and the World Bank. Both have identified three pillars in the ideal pension system – hence the terminology 'multipillar pension systems'. The first pillar is set at a basic level of welfare; the second is viewed as the core of the pension system and provides fundamental benefits while the third pillar is considered to be supplementary and/or voluntary. However, both the ILO and the World Bank differ in approach as to whether the pillars should be mandatory or voluntary; whether there should be defined benefits or defined contribution systems, whether they should be fully funded and privately or publicly managed.

While some commentators have defined pillars in different ways, in describing any pension system it is useful to identify characteristics such as, coverage, benefits, contribution, funding, management and ownership. Following the World Bank's proposals the first pillar is described as a large mandatory public or semi-public system which can be fully funded or partially funded and in which a 'defined benefit' formula determines benefits. A second pillar should consist of a fully funded 'defined contribution' system in which benefits are not defined but will depend on the assets in the individual's account at retirement. This pillar has as

its goals, insurance and savings, unlike the first pillar whose goals are insurance and redistribution. This pillar should be mandatory and in the form of an individual savings plan administered by the private sector but state regulated. The third pillar should comprise a government regulated voluntary or privately managed fund which could be used to supplement pillars 1 and 2. The World Bank suggests that countries could choose Pillars 1 and 2 or some blend of both systems.

Under the ILO's approach the first and third pillars are relatively similar. The first pillar is mandatory and based on the PAYG system, provides a universal subsistence pension based on need, which is state administered. The third pillar falls within our Type 1 arrangement, it is voluntary and is state regulated, fully funded and is generally of the 'defined contribution' type. The ILO's second pillar however differs substantially from the World Bank's second pillar in that for the ILO the pillar is mandatory, provides 'defined benefits', is administered by social insurance and is funded therefore by insured contributions and employers clearly along the lines of the current NIS.

Within the Caribbean region when pension reform is considered some advocates have interpreted this to mean that the social security systems should be privatized and any reforms undertaken be along the Chilean lines which have been deemed to be extremely successful. This view is also philosophically close to that of the World Bank which has rejected what has been called the 'principle of solidarity' in favour of the 'survival of the strongest'. In the Bank's view the focus should be on the individual maximising his own interests in free and efficient markets. Nonetheless, several critics in the region (Theodore: 1998; Alleyne: 1998) have reacted strongly to that position and suggest that we cannot afford to adopt that 'extreme' philosophical position. Instead, pension reform should take into consideration those cultural and moral values which make Caribbean societies what they are. Pensions should be viewed as a collective matter which touches on the welfare of the elderly and must be determined by public policy (Theodore 1998). If we accept this argument in principle, how then should we address pension reform in the region?

#### **IV. Pension Reform in the CARICOM Region**

At the macro level there are two overriding issues in pension reform – regulation and governance. In respect of regulations there is one view that the sector is not appropriately regulated because there are no over-arching pensions regulator/regulations at the national level in any jurisdiction. Calls for a single regulator are somewhat premature given the deficiencies in both the public and private pension systems throughout the region. As a start therefore, it may be more appropriate to tidy up individual segments (public and private) before any such vision is articulated at the national level.

Against such a background therefore, one can now address pension reform in the region and this can be done in distinct phases, the most important of which is the reform of the NI system. The problems may differ from one jurisdiction to the next but in the main these relate to governance, where there are two outstanding issues – investment policy and the independence of the Board of the NI system. Reform here is critical as the investment policy determines rates of return and in the longer term the value of the pension that the individual receives.

In considering the NI system there are many similarities and differences in respect of investment strategy throughout the region. Good governance suggests that these systems should each have an Investment Committee that determines the parameters for successful strategies in each country. Typically these committees are tripartite in nature and reflect the composition of the NI Board - business, labour government. While the composition of the Board and the investment policy of the system may appear to be independent, in reality in the region there has been a marked tendency towards investment in government securities. Indeed some analysts have suggested that in several jurisdictions the public sector views these funds as ready sources of budgetary finance.

What is the extent of the regional experience? The evidence suggests that once the Investment Committee is established a set of rules, restrictions and mandates may govern or limit the investment choices. Campbell (1995) noted that in Belize the scope of the Investment Committee, which hitherto had been responsible for all investment decisions, was amended in 1986 so that the Committee became an advisory body to the Board of Directors on investment matters. By 1992 however the Board had established a subsidiary company with responsibility for managing housing investment for the Board.

In TT for example, quantitative limits are set on equity investment by the local NIB and this must not exceed 25 per cent of total funds without explicit approval from the Ministry of Finance. This approach is consistent with international experience whereby explicit restrictions or implicit mandates are given to Boards to pursue developmental objectives in the area of housing, health and education. During the boom years, the mandate was given to the NIB to provide mortgage financing for first time homeowners at interest rates well below private sector agencies. This policy led to a skewing of the investment portfolio such that mortgages which had accounted for 4 per cent of the portfolio in 1972/73 peaked at 63.5 per cent by 1985/86. The manner in which the policy was implemented, the subsequent recession and collapse of the real estate mortgage market contributed to the low rate of return on investments for the NIB in the 1980's.

In some instances restrictions have been used to force NI systems to lend money to the quasi public sector entities either directly or indirectly. In the latter scenario the approach taken is usually in the form of private placements for public sector bonds or by simply requiring that a proportion of government bonds be held in the institution's portfolio to reinforce safety considerations. In some countries however government securities may be the most dominant type of security given the thinness of the capital market and relatively limited investment opportunities.

It is also important to note that all the NI systems in CARICOM were established over a period of fixed exchange rate regimes and exchange controls. In this environment it would be the rule rather than the exception to prohibit investments outside the home country. As far as this writer is aware only five jurisdictions in (The Bahamas, Barbados, Montserrat, Guyana and Trinidad and Tobago) allow for investments of NI reserves outside of their home countries. In the case of Montserrat for example, however, foreign securities represented just over one half of the portfolio. This appeared to be a deliberate policy choice of the institution. Government paper was more important in some countries (Grenada) than in others. For the ECCU sub region government paper and commercial bank deposits are the two most important financial instruments in these economies. In the larger CARICOM economies by contrast, mortgages also play an important role and as already mentioned accounted for well over 50 per cent of the portfolio in the 1980's.



### Size of Private and Public Funds

As Table 2 suggests, the value of the investment portfolio for the NI systems in the region amounted to just over US\$3,000 million at the end of 2000. In Barbados and the East Caribbean Currency Union (ECCU) area the portfolios account for well over 20 per cent of GDP but this is substantially smaller than in Trinidad and Tobago (TT) where the retirement income market has other important players. Indeed in TT the single largest investment portfolio is that of the self administered group of occupational pension plans which accounts for more than one half of all institutional investments. (TT\$7,000 million)

**Table 2**

#### Value of Investment Portfolios for Selected NI Systems - 1990 and 2000

	1990		2000 <sup>e</sup>	
	\$M	% GDP	\$M	% GDP
Barbados (\$B)	513	14.9	1,100	22.1
Belize (\$Be)	76	11.2	214	18.1
ECCU (\$EC)	547	14.4	1,553	26.4
Guyana (\$G)	1,640	10.5	13,000	10.7
Trinidad and Tobago (\$TT)	2,067	9.8	4,900	9.7

E - estimate

Source: Osborne (2001) and authors' calculations

### Rates of Return

Table 3 below contains selected data on rates of return for some four NI portfolios over the last three decades. In the first two decades of their existence real rates of return for the sample tended to be negative especially during the 1970's and early 1980's. Over these years there was an inflationary environment worldwide following the oil shocks of the 1970's and many institutions may have been forced to hold low yielding government paper. In addition, the structure of the portfolios and lack of investment autonomy contributed to results such as these. These rates of return compared favourably to commercial bank deposit rates and yields on treasury bills and in TT for example real rates of return have been positive and well above commercial bank deposit rates and the return on loans. In some years the return may have been lower than that which obtained in the treasury-bill market, while the more positive results may also have reflected a change in philosophy by the NIB.

The disappointing results of the late 1980's together with a rethinking of investment rationale led to a change in focus at the start of the 1990's, and use of the ILO's general principles governing the investment of social security funds. These principles were as follows: - safety, liquidity, yield and social and economic utility and suggested a movement away from those investments whose values would be maintained during periods of inflation e.g. real assets (equities, property).

The 1980's experience of the TT NIB had dictated a retreat from investments in mortgage such that by 2000 mortgages accounted for 5.3 per cent of the portfolio compared with 7.2 per cent in the previous year. Over the longer term however social security systems need to balance considerations of safety with the maintenance of real values of their assets.

**Table 3**  
**Average Real Yields For Selected NI Systems**  
(%)

	1974-1982 (Avg.)	1983-1991 (Avg.)	1992-2000 (Avg.)
Barbados	-5.7	4.9	5.8*
Guyana	-5.6	-13.7	12.24*
Jamaica	-7.8	- 4.5	n.a.
Trinidad and Tobago	-5.6	- 2.3	4.2

Source: La Foucade (1995) Theodore and La Foucade (1998), and author's calculations

\*Data for 1992 for Guyana and 1992-1994 for Barbados

In summary therefore, pension reform in the region needs to build on the good experiences of the already existing NI systems and in particular improve on the level of governance. This would involve ensuring that the composition of the Boards is indeed tripartite in nature and that the Chairman of the Board is independent. The Board must set investment policy within the sphere of the mandates/guidelines issued with an emphasis on maintaining positive real rates of return. This will ensure that the pool of savings grows overtime. This allows pension benefits to be guaranteed and maximised without the need to increase contributions in an ad hoc manner.

So far the discussion has focused on governance and in particular, rates of return given their importance in maintaining the real value of a pension. However, a second element of the reform effort is related to the ageing of the labour force. The "old age crisis" is still some way off in the region, although there are estimates that suggest that Barbados will get there ahead of the rest of the region. This window of opportunity will allow policymakers time to tinker with the raising of the age for retirement. About four decades ago for example, labour force participation rates indicated that workers remained in the labour force until age 65, but this trend was reversed in the 1970's and 1980's. Data for the CARICOM region suggest that if NI systems are to remain viable and solvent, in the longer-term, the mandatory retirement age should be raised to 63 or 65 years. Recently in Barbados changes were made along these lines.

An important element of the NI reform effort must take cognisance of the relationship between the OAP and NI pensions. In some jurisdictions the OAP is partly funded from contributions to the NI, while in at least one other, up to fairly recently the pension OAP was greater than the NI pension. Micro reforms suggest a move towards a minimum pension received by all persons of pensionable age and thereby reduce any incentives there may be to stop contributing towards the mandatory NI. Reforms which are built along these lines should get the region closer to an ideal basic pillar.

The second phase of pension reform must address the unfunded liabilities of the typical public sector PAYG system. It is well known that the transition costs to move from an unfunded system to a funded one over a period of time are extremely high and several studies for developed countries suggested that this can be achieved successfully over a 15-20 year period. The situation is further complicated by what should be the appropriate treatment of current members of public sector system as there are legal as well as financial issues. In TT for example, constitutional amendments are needed before any contributory pension plan for public sector workers is set in train. The pension reform process has commenced but achieving consensus on this issue will be long and painful. Whatever choice is made is dependent on the state of the country's public finances over time and in a broader context how well the economy performs.

### **Box III: Reform of Private Sector Pensions**

Several analysts believe that the solution to the problems of public sector pensions can be found by substitution for private sector arrangements. However, there are several possible areas of reform which may be needed with private pensions. While the Chilean model may have been hailed as a success, critical assessments have thrown up weaknesses in the system e.g. *45 per cent of the labour force do not contribute on a permanent basis to the pensions*. More recently however corporate governance issues have been raised in respect of the management of private sector plans in at least two countries. The current ongoing shocks resulting from the bankruptcy of the US based Enron Corporation may well lead in the longer term to regulatory reform in respect of 401 (k) retirement plans to protect pensioners from corporate failure. It is to be noted however that these issues are not new as can be seen from the experience of the Mirror Group of Newspapers (MGN) in the United Kingdom (UK).

In late 1991 the debacle which followed the death of Robert Maxwell also led to pension reform in the UK. A month after his death, the Serious Fraud Office in the UK began to investigate how the pension schemes of the Mirror Group of Newspapers (MGN) and Maxwell Communications Corporation (MCC) both public companies had incurred losses on loans of £400 million to his private companies. Investigations revealed that the pension funds had lent shares to the private companies which had initially put up the collateral. But Robert Maxwell began to sell the collateral in mid-1991 to prop up his business interests which were close to bankruptcy. At the end of 1991 estimates suggested that the MGN pension fund which had been valued at £520 million with a surplus of £150 million now had assets of £170 million and liabilities of £370 million. These developments took place against a background of already mounting concerns about the pension industry (how should surpluses be treated, should there be contribution holidays) and by June 1992 the Goode Pension Law Review Committee was established. Two of its major recommendations which were adopted into law were the introduction of a pensions regulator and a compensation scheme financed by a levy on all occupational pension schemes (Blake 1997).

Some analysts suggest that the best solution to NI problems should be to place these funds in the private sector, however, a close examination of occupational pension arrangements reveal that there are several regulatory issues which must

be addressed: - the treatment of surpluses, portability, merging of individual plans. The most vexing issue here however is that of ownership of the surplus. The question as to whether ownership of the surplus should belong to the employer or the employees (e.g. where a plan has been wound up) has been the subject of litigation in TT. In one instance a contribution holiday for employers and employees occurred when one company was sold to a foreign entity. Some commentators suggested that this issue is best left to the courts rather than the regulators, however, if left unresolved occurrences such as are described in Box III may become the norm. In Trinidad and Tobago current legislation does not allow for portability of benefits from one occupational plan to another or even for moving from the public (unfunded) to the private sector (funded). The reform effort here should be focussed on dealing with these micro issues.

The fourth phase must consider how to improve the voluntary component of savings for retirement e.g. mutual funds, annuities. In some economies this can be done by way of fiscal policy and in this regard tax incentives to stimulate savings, have a role to play. Their design however must take into account the costs of the incentives to the central government. Alongside these developments will be the need to improve the legislative and regulatory framework for these kinds of private pension arrangements especially in the area of mutual funds. Here the choice may be between a "*draconian*" regulatory regime, which gives a great degree of control over private plans to government or at the other extreme guiding principles are set out and monitored from time to time by the supervisory authorities. No one ideal type is recommended here; instead the maturity of the systems may determine where a country may choose to be on the continuum.

## **Conclusion**

Pension reform worldwide has been driven by the old age crisis and the fiscal pressures stemming from unfunded public sector pension systems. While the CARICOM region still has some time to put its house in order in respect of population pressures, the major focus of the reform effort should be improvement in governance in respect of NI pension. A well functioning NI system throughout CARICOM will be a sound basic pillar as the region gropes towards the CSME. Occupational pension plans are more common in the larger economies and here reform elements are closely connected to the regulatory environment in the immediate short term and over the medium term may be dealt with within the framework of over arching pension legislation. Finally, the third-pillar or voluntary component should be encouraged for all workers during their productive life. This should ensure that at retirement, incomes remain above that basic minimum threshold.

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