Savings in the absence of functioning property rights[1]

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Abstract

Nigeria is a prime example of a developing country with ill-defined property rights. However, people still manage to save, mostly through traditional and informal means, facilitated by strong family and community institutions. This paper argues that the government should concentrate on strengthening these institutions rather than weakening them by imposing an inappropriate, western-style, formal pensions systems on the country.

Introduction

The economist Hernando De Soto argues that many developing nations' poor economic performance stems from poorly defined property rights. Moreover, attempts to impose Western-style rights will not necessarily succeed unless they enshrine existing social and cultural norms (De Soto (2000)). Nigeria is an example of a country that does not have adequately functioning systems of property rights. In this paper, we examine Nigeria's savings systems – both formal and informal – to examine how society and the government has reacted in attempt to encourage savings in this an environment.

Old-age security in Nigeria is provided by a mixture of Western-style pension schemes and traditional arrangements for old age. The most populous country in Africa with over 130 million inhabitants and more than 250 ethnic groups, Nigeria is still a relatively traditional society in which about 70% of the labour force work in small-scale agriculture. As the country has suffered from political instability and corruption, its formal pension systems often failed to fulfil promises. Thus informal systems operate alongside and complement formal ones.

This article highlights two aspects of old-age security in Nigeria. Firstly it shows why, despite several reforms of formal pension schemes, most people depend on informal structures, which function surprisingly well. These structures possess several advantages over formal arrangements in the socio-economic context of Nigeria. Secondly, it explains the causes of the failure of previous state-operated schemes, and outlines the strengths and weaknesses of the recent reforms that move in the direction of Chilean-style privatised pensions.

Formal pension schemes

Public sector state pension

The first formal pension scheme in Nigeria was inherited from British colonial rule. Originally meant for expatriates, it was later extended to local public sector employees and has been running until the implementation of the 2004 reforms.

Like most public sector pension schemes in the third world, the Nigerian scheme sought to make the public sector an attractive employer. The scheme benefits were quite generous - at least on paper[5]. It was a non-contributory defined-benefit scheme, so that each government allocated tax revenue to the consolidated revenue fund from which pensions would be paid.

In practice, the scheme has been plagued with difficulties. Inflation in Nigeria has been at double-digit rates for decades, eating away the real value of pensions. This problem has been alleviated by periodic readjustments to the benefits, but their real value has been rapidly declining[6] thus benefit levels have been seriously inadequate (Barbone and Sanchez 1999).

The administration of the scheme has been subject to considerable delays, unreliable claim procedures and poor service (Barbone and Sanchez 1999). Lack of accurate record-keeping has both created opportunities for corruption and prolonged periods of non-payment to bona-fide pensioners. Budgetary allocations to the pension fund have often been inadequate and untimely, so that in some cases pensioners never received their benefits.[7]

[5] Retirement age in the scheme was no more than 60 years, or just 35 years in service subject to three months notice. The benefits were good too: in dollar amounts, from the 1980s to the early 1990s the minimum pension was roughly $200 a month, when average GDP per capita was around $300 (Idowu (2006)).
[6] The minimum pension from 1992-2006 has been 4000 nairu a month, but in dollar terms its value has depreciated from over $200 in 1992 to just about $30 by 2006. (Based on Idowu 2006.)
[7] For example, a group of former military men organised a march in the capital, because they had been paid no pensions after 22 years of retirement (BBC News, 18 September 2001, http://news.bbc.co.uk/1/hi/world/africa/1548656.stm). In another case, retired teachers launched a protest after several years of non-payment, because the Lagos state government had seized the 106.7 million nairu

Private sector pensions

The history of state pensions for non-public sector workers in Nigeria is equally patchy. The first scheme, established in 1961, was a provident fund: a type of defined-contribution scheme popular in many African states (Tostensen 2004). It had a very limited coverage only encompassing workers in firms with five or more employees, which in practice comprised just a small proportion of the total labour force.[8]

State-managed private sector pensions in many African countries have performed so badly that the funds have effectively been appropriated by governments (McGillivray (1998)). The Nigerian provident fund did not fare much better (NSITF 2002). Rampant inflation eroded much of the value of the savings, resulting in inadequate pensions, and restrictions on investment policy did not favour efficient management of the fund. Employers were not eager to comply with their legal obligations, and the corruption prevalent in the country resulted in widespread evasion, under-reporting or delays as well as failures to make contributions (McGillivray 2000).[9]

Because of such problems, the provident fund was converted into a pay-as-you-go defined-benefit scheme in 1994, called the Nigeria Social Insurance Trust Fund (NSITF). It had the same, rather limited coverage, and the original required total contribution rate was 7.5% of basic earnings.[10] Retirement was permitted at age 60, and beneficiaries could choose between annuities and a lump sum grant. Many beneficiaries preferred a lump sum, which they used to start up a business, build a house or purchase other illiquid assets (Barbone and Sanchez (1999)).

Converting a fully-funded defined-contribution scheme into a PAYGO defined-benefit scheme can be politically very advantageous, because it can create a short term cost

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allocated by the federal government for the purpose of paying the pensions of retired teachers (http://allafrica.com/stories/200606201019.html).

[8] For example, in 1990 only about 2.4% of the total labour force contributed to formal pension schemes in Nigeria (Barbone and Sanchez 1999).

[9] In itself this may not be such a bad thing. Given the appalling administration of the scheme, evasion may actually have been the most prudent course of action for both employers and employees.

[10] Contributions were separated into 2.5% by the employee and 5.0% by the employer. From 2001 onwards these were raised into 3.5.% and 6.5% respectively, resulting in a total contribution rate of 10.0% (NSITF 2002).

saving by using the accumulated funds in the transition to fund benefits (Tostensen (2004))[11]. Indeed, the NSITF performed better than the earlier savings scheme: pensions were mostly paid on time and contribution rates were higher. However, many people were still reluctant to participate because of the poor credibility of the government in financial affairs. The significance of the scheme was limited given that the great majority of Nigerian workers still have no formal pension arrangements.

2004 reforms: privatised contributory pensions

The current president has implemented several reforms to privatise and deregulate the economy. One of these is the 2004 Pension Reform Act, which institutes a Chilean-style privatised pension system, a fully-funded contributory scheme with individual Retirement Savings Accounts.[12] The total contribution rate is 15% of basic salary, and the scheme encompasses both public sector employees and private sector workers in firms with five or more employees. This reform seeks to deal with the accumulated pension debt and to put formal pension arrangements in Nigeria on a firm footing.

The reforms have been impressive. The new Contributory Pension Scheme is flexible in that beneficiaries can withdraw funds from age 50 onwards and choose among various options (monthly or quarterly withdrawals, an annuity purchased from a life insurance company, or a lump sum grant). The personal retirement accounts are portable, which enhances labour mobility. They are not managed by a government agency but are instead privately managed by a Pension Fund Administrator (PFA) chosen by the contributor, and the assets are held by a Pension Asset Custodian (PAC). Thus the administration of the funds is expected to be both more efficient and less prone to fraud. The scheme is also likely to encourage capital accumulation.

There are various checks and balances in place. The overall scheme is supervised and regulated by the National Pension Commission (NPC), an independent body created for this purpose. PFAs and PACs have distinct roles, so that the PFA does not have direct

[11] Proposals by many trade organisations and think tanks, now partially accepted by the UK government make the same mistake with UK pensions – though without affecting accumulated funds. Abolishing contracting out of the UK state second pension increases government revenue to spend on current pensions but reduces the extent to which funds are being put aside for future pensions.

[12] See the Nigerian government document *The Obasanjo Reforms: The Contributory Pension Scheme* (2004). http://www.nigeria.gov.ng/THE%20OBASANJO%20REFORMS%20-%20PENSION%20SCHEME%20(2).pdf.

access to the funds, whereas the PAC cannot make investment decisions without the approval of the PFA. PACs must issue a guarantee for the full value of the assets in its charge, and PFAs are required to employ a compliance officer and to report their operations to the NPC.

The new scheme faces several potential problems. Firstly, its coverage is as narrow as that of the previous schemes, so it will only have a limited relevance in supplying old-age security to the population of Nigeria. Secondly, there is the question of whether the checks and balances are sufficient to eliminate fraud given that corruption is a major problem in both the public and private sectors. Thirdly, the system is likely to create substantial administrative and regulative overheads leading to wasted resources.

There is a lack of suitable markets and assets to invest in, which may result in poor investments or artificial market bubbles. And finally, one must ask whether a system of compulsory pension provision is such a good idea, as it institutionalises a particular form of retirement provision and forces people to allocate savings to an inflexible, long-term savings vehicle that may not suit individual needs (Booth and Cooper 2005). Forcing people to save 15% of their salary in pensions may be a gross misallocation of resources, saving for retirement is not really a priority in a country where life expectancy is 43[13] [14], whereas many people may urgently need such funds at earlier stages in their lives due to illness, unemployment or other financial difficulties or to pay school fees. Given the choice, people might well prefer to look after themselves in retirement (if they live that long) in some other way such as through a combination of family support, part-time work and smaller savings. This leads on to a wider discussion of these issues.

Informal old-age security

Formal pension schemes in Nigerian have performed poorly in the past, often providing unreliable and inadequate support. The great majority of Nigerians are entirely outside formal arrangements: these include the self-employed, those working for small companies or larger companies that fail to comply, and the roughly 70% of the labour force who work

[13] www.unicef.org
[14] The Chilean system (with which the Nigerian system has certain features in common) has a compulsory contribution rate of 10%, in a country where life expectancy is 76 (www.earthresources.wri.org)

in agriculture. Even if the 2004 reforms are successful, most people will have to rely on other means to provide for their old age. The question is how, if at all, they do this.

One may question whether Western-style pensions are the right kind of institution in present-day Nigeria. Most people need some form of security against loss of income, but the inability to earn money for most individuals in Nigeria is more likely to be due to illness, unemployment or a multitude of other shocks rather than be due to old age. Pensions by definition only provide old-age benefits. Given the administrative, informational and agency costs of formal pension systems, they are unlikely be an efficient solution to the problem of old age for most people in Nigeria.

Family support: informal PAYGO

Traditionally, the most important source of old-age support has been the extended family, both in Africa and in many other poorer countries. Although the trend in Nigeria is towards less traditional values and an emphasis on the nuclear family, most people continue to feel responsible for supporting their parents and other family members when they grow older (Okoye 2005).[15] Urban-dwellers often intend to return to their rural hometowns, where the cost of living is cheaper, when they retire, and many allocate funds to building homes there for themselves and their parents.

Family support can be described as a type of private and informal pay-as-you-go arrangement: each earning generation supports the previous one, and the cost of raising and educating children is seen as an investment in old-age security. Many Nigerians regard old-age support and other help in times of need as the most important benefits of having children (Isiugo-Abanihe (1994))[16]

The familial nature of the support has several advantages: it has a very wide coverage and is rarely subject to fraud; there are no bureaucratic and administrative costs; much of the

[15] 95.5% of the respondents in a survey in Nigeria said that children have a special responsibility to look after their parents, while 69.4% thought that anyone who cannot take care of his parents is irresponsible; 80.6% also said they would not mind living in the same house with their parents when they grown old (Okoye 2005).

[16] 24.0% of men and 29.4% of women said providing supporting for parents in old age is the most important benefit of having children. The other major benefit was of course that children are a source of fulfilment, joy and pride (25.1% and 22.7%). It is noteworthy that women see family support as particularly important, which is consistent with the fact that elderly widows tend to be the economically most vulnerable members of the society (Abahine 1994).

support comes in the form of housing and other basic needs, which can be provided more efficiently in the community; the provision of information is better, which reduces problems of abuse; and harmful incentives are minimised, so that there are no institutional retirement ages but elderly people can contribute by doing whatever they can, such as working in the house and looking after grandchildren. Moreover, familial support in times of need is not limited to old age, but also helps in cases of unemployment and illness. In this respect, informal support is much more efficient than formalised unemployment and disability benefits, which tend to have numerous loopholes and encourage passivity.

Of course, the extended family is not going to solve all the problems of old age. Weakening family ties may undermine this source of support, and in any case it carries high risks: children may fall ill, they may fail to find suitable employment, and some parents will not have children. However the main constraint of family-based support in Africa is that there is just so little income to spare, and this is due to decades of instability and bad economic policies, rather than limitations of kinship-based arrangements. (Tostensen (2004)). The values and social norms are there, but people need more opportunity to create wealth and save. Even in this background, though, in difficult circumstances, families behave rationally in a way the combines self interest with the promotion of wider family and community ties. For example, it is common for parents to pay school fees, or even university fees, to raise the productive potential of their children – both to help their children but also to raise the level of security in old age.

Roscas: saving together

One of the challenges in developing countries is indeed how to accumulate wealth. This is made easier by one of the most widespread financial institutions in the developing world, most commonly known as Roscas (rotating savings and credit associations). These are a type of informal mutual-help society that comes in many forms but has a simple basic principle: members pay fixed sums periodically into a common pool, which is distributed to individuals at fixed intervals either randomly or following some pre-determined rule. According to Bouman (1995), between 50% and 95% of the adult population participated in Roscas in across Africa at that time.

Some economists have modelled Roscas in terms of efficiency in acquiring lumpy durable goods (Besley et al. 1993). Others have rationalised them as commitment devices: obligations towards other members make it easier to resist short-termism (Gugerty 2000, Anderson and Baland 2002) as well as external social pressures that demand more immediate redistribution (Amber and Treich 2003). One form of Rosca will accumulate the savings of a number of individuals and then allocate a substantial part of the pool by lottery or in rotation to one individual. That individual may use the proceeds to buy a kiosk, farm animals or equipment and so on. As such Roscas help to overcome the problems of accumulating wealth in situations where there are no active securities markets allowing the divisibility of property rights over investments. Clearly Roscas are mainly a capital accumulation device, not a source of social security. However, in helping people to purchase durable consumer goods and capital goods, Roscas facilitate the accumulation of wealth, which will function as a buffer in times of hardship due to illness, unemployment or old age.

The popularity of Roscas testifies to their success in gaining high compliance rates in environments where formal financial institutions rarely succeed. Members of Roscas are well known to each other, and the small-scale nature of Roscas facilitates their dynamism in adapting to changing circumstances. It is worth noting that these informal arrangements thrive in environments where legal systems are inefficient and formal contracts practically unenforceable.

Conclusion

Nigeria has had a rough history in terms of its state pension systems, and most people are still outside the existing schemes. The 2004 reforms show some positive developments, but will not make a big difference to the old-age security of most Nigerians. Most people still depend largely or entirely on informal structures ranging from family-based support to savings schemes such as Roscas.

The situation in Nigeria highlights the importance of the informal system, which works for the majority of the population in a way which formal state-operated systems are unlikely to in the foreseeable future. Most apparent weaknesses of the informal system are mainly due to people being too poor to save adequately. A more substantial weakness is that their small size and locality does not allow diversification of risk, and systems can be undermined by localised disaster.

However, future reforms should neither underestimate the potential of informal structures, nor undermine them by imposing an inappropriate formal system on the country. Instead, they should aim to support and formalise traditional arrangements in ways that reinforce their basic role while helping where the informal structures fail.

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