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Effect of Member Income on Additional Voluntary Contributions to Pension Funds in Kenya: Case of Universities in South Eastern

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Abstract: **The focus of this study was to investigate the determinats of additional voluntary contributions to pension funds in Kenya with Specific aim of finding out the effect of member's income to additional voluntary contributions. The population for this study consisted of 859 members of four Universities pension funds in South Eastern Kenya. Questionnaire was used to collect primary data which was analyzed using descriptive statistics. The study found out that Member income affected participation on additional voluntary contributions to pension schemes. The study recommends that the Government should proved incentives in form of tax exemptions on income earned by additional voluntary contributions to pension funds and increase exemption rate of pension contributions from the current maximum of Ksh 20,000 per month to encourage members of the pension schemes to make additional voluntary contributions.**

Keywords: **Additional voluntary contributions, funds, income, pension, schemes, retirement.**

I. INTRODUCTION

The ability to have adequate income for retirement becomes an important consideration in predicting the quality of life after retirement. The measure of adequacy is however not clear cut as there is no "one-size-fits-all" with the perception and reality of adequacy highly dependent on the different individual expenditure needs, behavioral influences and social context (Bajtelsmit, Rappaport, & Foster, 2013). Pensions, which are typically workplace retirement plans, form an important resource often in the form of a regular income stream for retired employees in addition to the government run social security funds whose features differ significantly across countries (Alonso-Ortiz, 2014). Within the Kenyan context these have often been found inadequate in monetary terms to meet the needs after retirement (Walaba, 2014). It therefore becomes necessary for individual workers to consider and plan for additional resources or coping mechanisms that will ensure a comfortable life in retirement.

The earliest retirement benefits schemes to be established in Kenya were insured plans providing guarantees to members on the level of benefits (Angima, 1985). With time the insured plans gave way to DB schemes which guaranteed a pension based on an actuarial formula targeting a replacement ratio. Since then, many schemes converted from DB to DC. In the year 2001, DC schemes constituted 84 percent of all occupational schemes and by 2005 the proportion had risen to 87 percent (Retirement Benefits Authority, 2005). DC plans have become the primary retirement savings vehicle for many employees in Kenya and the DC design continues to grow in importance. A defined benefit plan, most often known as a pension, is a retirement accountfor which your employer ponies up all the money and promises you a set payout when you retire. A defined contribution plan, like a 401(k) or 403(b), requires you to put in your own money, an example being AVCs.

The NSSF is a national scheme, the main objective of which is to provide basic financial security benefits to Kenyans upon retirement. It was set up as a provident fund to provide benefits in the form of lump-sum payments. It works on a contributory basis. There is also the Public Service Pension Scheme (PSPS) that provides benefits for public service

employees (civil servants). This scheme is governed by the Pensions Act and the Public Service Superannuation Scheme Act (No. 8 of 2012). It operates on a non-contributory basis. With the coming into force of the Public Service Superannuation Scheme Act, specifically section 6, the concept of mandatory contributions to a scheme has been introduced to the public service. Every member shall contribute to the PSPS at the rate of 7.5 per cent, which is deducted from his or her monthly pensionable salary, while the government makes a contribution for each member at the rate of at least 15 per cent of the member's monthly pensionable salary. The government is also mandated to take out and maintain a life insurance policy that has disability benefits in favour of every member of the scheme. These policies must be worth a minimum five times the member's annual pensionable emoluments. A member may also make additional voluntary contributions to the scheme, as provided for under section 7 of the Public Service Superannuation Scheme Act (No. 8 of 2012) (Ayugi c., Wanjau E., and Amondi A., 2018).

Additional Voluntary Contributions (AVCs)

AVCs are Additional Voluntary Contributions to a pension account aimed at supplementing a member's retirement benefits within his pension scheme. They allow a member to pay more to build up extra savings for retirement. The returns earned on investment are reinvested over and over, for years. That's why starting to make additional contributions early makes sense; small amounts saved when young can become very large by the time of retire retirement. Many members may not build up enough pension through normal contributions for a variety of reasons; they may have joined the scheme later in their career, had a career break or they plan for early retirement (Kenya Literature Bureau,2018).

The retirement planning activity needs to be tied to tangible long term retirement outcomes supported by present day financial savings behavior. This study examined one of such factors that could affect Additional Voluntary Contributions (AVC's) made to boost retirement savings: member's gross income earned from active employment.

Statement of the Problem

In defined-benefit and defined-contribution pensions, governments typically impose ceilings on the income that is subject to contributions, and the same ceiling is typically used in calculating benefits. Since all requirements reduce individual freedom, a ceiling on the contribution requirement limits the impact to what is necessary to prevent old-age poverty and overcome myopia. The ceiling is often set at three to five times the average wage. But governments would still like to provide incentives so that higher income individuals save for consumption smoothing purposes. Governments do this by offering tax advantages for voluntary or supplemental savings. Typically, governments do not tax contributions made to voluntary pension systems or the returns the contributions earn; they tax only the benefits when these are received. However, the evidence generally suggests that higher-income individuals do not increase their savings in order to access these tax-advantaged retirement funds, but merely shift their savings from one instrument to another (Holzmann and Hinz et al. 2005).

Pensioner survey conducted by RBA (2011) showed that 57.2% of pensioners identified pension as the most important source of income during retirement. A further 32.9% of pensioners admitted that pension was their only source of income. It is therefore evident that additional voluntary contributions would enhance retirement benefits to retirees and reduce poverty in old age. According to Olubayi J, (2016), tax reliefs would go a long way in encouraging people to save, however majority of employees will only contribute that which is mandated in their respective organisations despite the fact that there is a lot more that can be beneficial to employees if they were to make the additional voluntary contributions. It against this back ground that this research study was motivated to investagate the effecct of member income to additional voluntary contributions to pension funds in Kenya

Objective

To assess the effect of member income on additional voluntary contributions to pension schemes in kenya

Research Questions

How does member income affect additional voluntary contributions to pension schemes in Kenya?

Scope of the Study

The study covered four University pension funds in South Eastern Kenya, South Eastern Kenya University Pension Scheme, Machakos University pension scheme, Scott University staff provident fund and Daystar University staff provident fund.

II. LITERATURE REVIEW

Life cycle theory

Retirement benefits are intended to safeguard pensioners against shocks during their sunset years. The amount of benefits at retirement depends on many factors such as income, composition of households and age (Paralta, 2010). Modigliani considered savings as one of the most important pillars of the economic system (Modigliani, 1999). According to (Jappelli, 2005) stated that the main drive for saving is to build up resources to be used during retirement. According to Paralta, (2010) there is no certainty that the income after the retirement age will be sufficient to maintain the desired level of consumption, but individuals save a portion of that income in order to increase the allocation of wealth available when they reach retirement.The life cycle model is the most useful framework of studying the link between ageing, consumption and saving (Modigliani and Bromberg, 1954). The main result obtained from this framework is that the consumption is smoothed and the individuals will save in order to transfer purchasing power to the period of the retirement (Freidan and Martin, 2009). While main predictions of the life cycle theory tend to be supported by empirical evidence. The life cycle approach in its simplest version implies that financial life of individuals occurs in three phases after starting a professional activity. In the first phase, each person earns a wage from his or her labor supply and has insufficient income to cover their needs; therefore they become indebted in order to finance their needs of durable goods (furniture, car, etc.), the purchase of a home and the education of their children. In a Impact of accessing benefits before retirement age second phase, they pay off their debts run up in the previous phase and begin a process of accumulation of wealth to be able to finance their retirement period. In a third phase, they use up what they had saved during retirement.

This theory is relevant to the study because it analyses the stages of income expenditure to an employee. It signifies that at the third stage the employee may not save enough for his retirement given the short period remaining to retirement. All factors constant, the higher the income earned from employment, the higher the additional voluntary contributions to pension schemes.

Literature overview

Several studies have been done on income and savings but none has been carried out in Kenya in relation to the determinants of AVCs in pension funds. For example Loayza and Shankar (2000) confirmed that savings are positive related with per capita income in India by using co-integration approach. Ozean et al (2003) found that income levels positively affect the savings of people in Turkey. The life cycle theory also describes the positive relation between per capita income and savings. Agrawal (2001) empirically proved this relation in developing countries. These studies dwelt on the effect of income on savings but did not emphasis on saving for retirement. This study investigated the role of member income on AVCs of pension funds. Members of pension scheme, who made additional voluntary contributions into the fund, retire with a higher benefit in comparison to those who do not make any additional voluntary contribution RBA (2011). The study failed to show the determinants of AVCs in pension funds.

Conceptual Framework

Figure 1 conseptualizes how the independent variable member income influences dependent variable (AVCs).

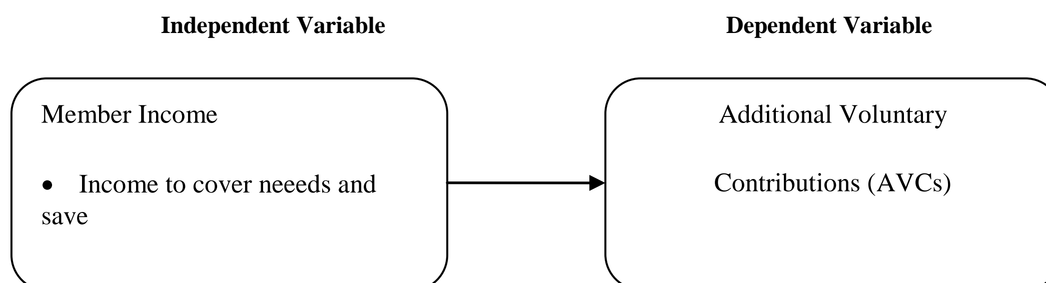

Figure 1: Conceptual framework

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Empirical review

Gallego and Butelmann (2001) estimated the determinants of voluntary saving in Chile. The authors carried out a multivariate analysis for which they used microeconomic information from two cross sections (1988 and 1996-1997). Their results support the idea that savings are linked to the accumulation of assets to soften consumption over time, and the theories of the life cycle and permanent income. This is because over 60% of the variation in the savings rate is explained by age and transitory household income. In addition, they found that wealth, human capital, and the size and composition of the household determine people's decision to save. Finally, they obtain evidence that institutional aspects such as access to credit and the pension saving system would have effects on saving according to the macroeconomic context. Medrano (2007) investigated the determinants for participation in the pension system under various scenarios, for which she estimated the sensitivity of contributors to legislative changes to the pension system. She found that the increase of benefits increases participation in the system. However, when these benefits mean greater costs, the final effect will depend on relative effects; while the reduction of fees, the incorporation of multi-funds increase participation, unemployment insurance did not have an effect. Based on the survey of consumer finances, Avery and Kennickell (1987) indicated that in the United States, families with higher real income and families that received support or large gifts, which is an alternative definition of transitory income, experienced a higher level of savings. In addition to permanent and transitory income components, the rate of growth in income is used as an additional explanatory variable in empirical savings studies. Increased growth rates in income are also expected to have a positive effect on household savings. Collins (1990) for example, found that income growth would increase savings especially if it were concentrated in higher saving households. In this study all three definitions of income, namely, permanent income, transitory income, and growth rate of income, were used as explanatory variable. Kenya's Vision 2030 (strategic plan to achieve key economic milestones by 2030) documents pension provision as an important pillar to achieving economic growth and faster development of the financial markets. In the long term therefore, the population should be empowered to make financial decisions which will in turn contribute to reduction in old age poverty as the population will be empowered to make rational financial decisions for their interests in both the short term and the long term (Kafele, 2010).

III. RESEARCH METHODOLOGY

The design of this research was a descriptive research survey. A descriptive research survey seeks to obtain information that describes existing phenomena by asking individuals about their perceptions, attitude, behaviour or values. The sample of the study was drawn from all 859 members of the four university pension funds. 10% of these members were randomly selected to respond to the questions in the questionnaires. The names of the active members in each University were numbered from 1 to 281,292,23 and 263 respectively and the desired sample of 85 respondents was randomly drawn. According to Mugenda and Mugenda (2003) ,10% is adequate sample for a study. Therefore 10% sample size was adequate for this study. The questionnaires were administered using drop and pick method. Descriptive statistics such as percentages and frequency distribution were used to analyze the data. Data presentation was done by the use of pie charts, bar charts and graphs, percentages and frequency tables. This ensured that the gathered information was clearly understood.

IV. DATA ANALYSIS AND RESEARCH FINDINGS

Member Income and AVC

The objective sought to assess the role of member income on AVCs. The study used members monthly gross income in Kenya shillings. The fundings indicate that there is an inverse relationship between the respondents monthly gross income and participation in AVCs as illastrated in Figure 2. Figure 2 shows that out of 11 respondents who made AVCs, 7 (63.6 %) earned between Kshs 20,000-60,000, 2 (18.2%) earned between Ksh 60,001-100,000 while 2 (18.2 %) earned between Ksh 100,001 and above. This clearly shows that those who are in the lowest earning brackets, seemed to participate in AVCs more than those on higher earning brackets. This contradicted the findings of Kennickell (1987) study that concluded that families with higher real income experienced a higher level of savings.This could be attributed to the fact that those who earned less contributed less to the pension funds and also the employers portion which matches that of the employee tends to be less and therefore the need to make AVCs to enhance retirement benefits as opposed to those who earned more and contributed more into the pension fund in form of compulsory contributions.

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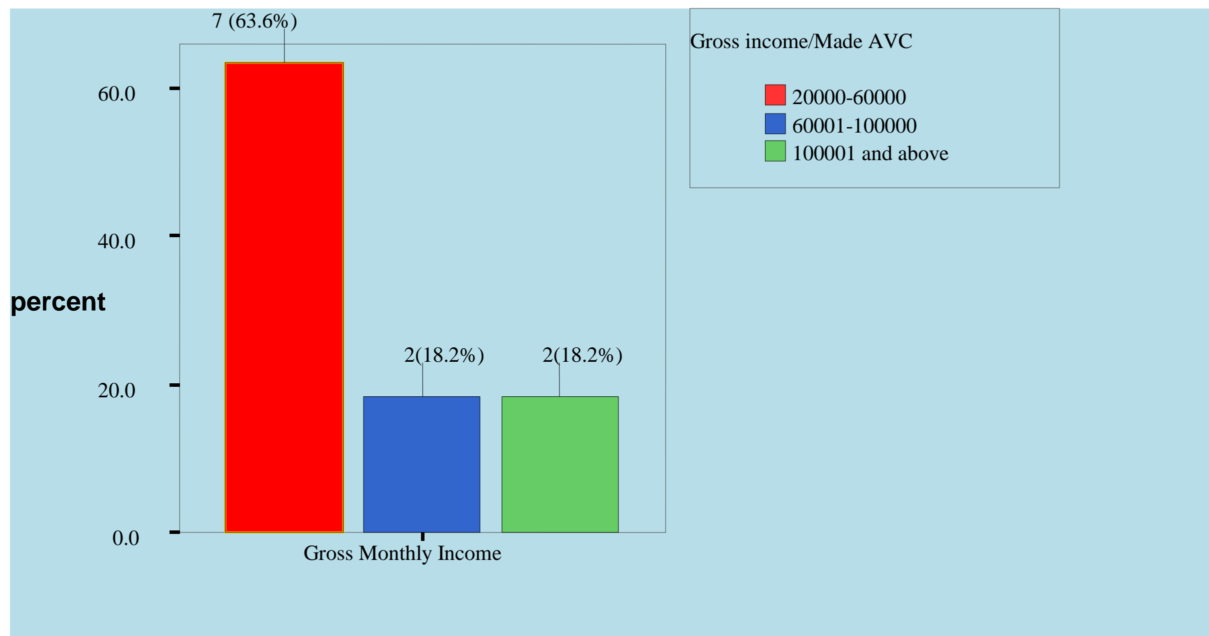

Figure 2: Gross monthly Income and AVC

On further Interrogation on the reason for not making AVCs, the 40 respondents who did not make AVCs attributed their failure to Insufficient income and lack of information on AVCs as shown on Figure 3. The study reaveled that out of all the 51 respondents 40 of them did not participate in AVC of the 40 respondents who had not made AVCs, 29 (57%) of them attributed insufficient gross monthly income as the reason for not making AVC while 11 (21.5%) attributed it to lack of information on AVC. This can be attributed to financial commitements that weigh down on monthly income of most respondents and hence non participation. Lack of information on AVCs can be explained by lack of adequate information and training of members by RBA and Boards of trustees on the importance of AVCs.

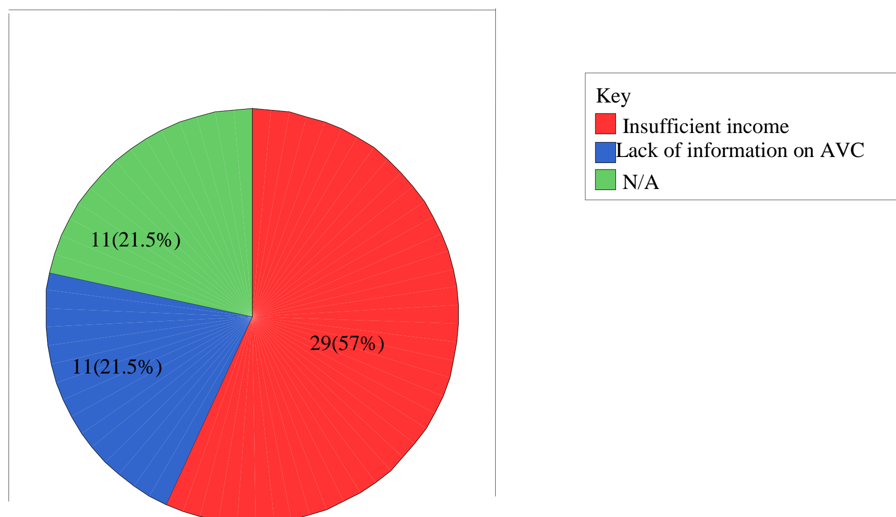

Figure 3: Reasons for not making AVC

V. SUMMARY, CONCLUSION AND RECOMMENDATION

Summary

This study found out that the out of 51 respondents 11(21.6%) respondents made AVCs while 40(78.4%) did not. Out of the 11 respondents who had made AVCs 9(81.8 %) males while 2(18.8%) of females members made AVCs. The study established that there is an inverse ralationship between member income and AVC since those who earned less seemed to

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participate in AVCs more than those whose income was more. The study further revealed that 57% of the respondents attributed insufficient gross incomeas the reason for not participating in AVCs while 21.5% attributed it to lack of information on AVCs.

Conclusion

Arising from the foregoing summary of findings, the study concluded that member gross monthly income played an inverse role on AVCs since those who earned less participated more in AVCs than those who earned more. The study further revealed that insufficient of income and lack of information on AVCs were the reasons for not participating in AVCs.

Recommendations

The government should provide incentives that encourage savings for retirement in form of tax exemptions on income earned by AVCs for pension funds. The government should increase exemption rate of pension contributions from the current Ksh 20,000 per month to encourage members of the pension schemes to make AVCs.

Suggestions for further study

A study can also be conducted on other pension schemes. A similar study can be conducted with broader objectives on AVCs as a vehicle of mobilizing savings into pension funds to enhancement of retirement benefits.

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