Social Security Reform Imperatives in Developing Asia

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Abstract

The main objective of this paper is to discuss broad imperatives for effective social security reform in developing Asia. The current demographic trends strongly suggest that Asia will become old before it becomes rich. It is Asia’s response to managing rapid ageing of its population that will determine how the world copes with this challenge. This paper argues that the objective function of social security for the individual and for the country is multi-dimensional and complex, involving difficult technical and political trade-offs.

In addition, issues involved in transitioning from the current to the reformed system are also politically difficult. Nevertheless, constructing and sustaining adequate social security and social safety net systems are essential for managing the challenges of the 21st century. In the social security reform literature, no single model or framework has emerged. Nevertheless, the World Bank’s five-tier framework may be useful for thinking about social security reform in developing Asia.

This paper suggests that for effective social security reforms in Asia, greater attention should be paid to professionalism, a systemic perspective, transition issues, financial education, pension regulators, and indigenous research capability. Each country however must develop its own strategy for reform which takes into account initial conditions, economic, financial, and fiscal capacities, and political economy. Finally, this paper suggests establishing an Asian forum for dialogue on social security issues and experiences.

JEL Classification: H55, G23, E69.

Key Words: Social Security Reform, Asia, Pension Regulation, Financial Literacy, Provident Funds.
1. Introduction
The main objective of this paper is to discuss broad imperatives for effective social security reform in developing Asia\(^2\). Social security reform has usually been thought of as a major challenge for the Organization for Economic Cooperation and Development (OECD) countries, a group comprising 30 industrial countries. Only two Asian nations, Japan and South Korea, belong to the OECD.

The ageing issues over the next two decades will become a major challenge for Asia (Table 1A). This will particularly be the case for the three Asian countries with the largest populations: China, India and Indonesia. By the year 2050, China will have 432 million, India 330 million, and Indonesia 67 million elderly people (i.e. persons above 60-years of age). The share of the three Asian countries in the global elderly population will increase from 37 percent in 2006 to 42 percent in 2050 (Table 1A).

(Insert Table 1A here)

The median age of the population will significantly rise in all Asian countries, in some such as Japan, Korea and Singapore reaching above 50 by 2050 (Table 1A). The life expectancy will also rise significantly, suggesting that each individual will have to be supported for a much longer period in retirement. Many of the elderly will be female who, as a group, enjoy a longer life expectancy than males. Thus, gender issues are an integral part of social security reform.

For social security, what matters however is life expectancy at age 60, and this is usually higher than that at birth. An individual, who manages to live to age 60, is likely to enjoy a longer life-span than what may be implied by life expectancy at birth. Thus, in India, while life expectancy at birth over the 2005-2010 period is projected to be 63.1 years, life expectancy at age 60 was 16 years for males, and 18 years for females over the 2000-2005 periods (Table 1A and 1B).

(Insert Table 1B here)

\(^2\) Usually defined as all Asian countries that are classified by the World Bank as not high-income.
The above demographic trends have important labor market implications. In countries with a rising economically active age group to total population ratio (such as India, Indonesia, Vietnam, and the Philippines), creation of sustainable and economically productive jobs will need to be given greater weight than simply preserving existing jobs (ILO, 2008; Asher, 2008). For countries with a declining ratio (such as China and Sri Lanka), stress must be placed on increased productivity of workers, and finding ways to take advantage of the demographic complementarities with other countries in Asia and beyond (ILO, 2008).

The rest of the paper is organized as follows. In Section 2, primary objectives of a social security system, and the inevitable trade-offs are discussed. This is followed by a brief examination of the rationale and the relevance of the World Bank’s five-tier framework for thinking about social security reform in developing Asia in Section 3. The last section enumerates the main requirements for effective social security reform in developing Asia.

## 2. Main Objectives and Trade-offs

The main objectives of any social security system, for both individuals and government, are smoothing consumption over lifetime; insurance (particularly against longevity and inflation risks); income redistribution; and poverty relief. However, these have to be traded off against economic growth, labor market efficiency and flexibility, and against other needs like health, education, and infrastructure. Individual fiscal and societal affordability should be kept in mind in reforming social security systems. This implies that benefits promised must evolve over time as affordability grows. The single most important macro-economic variable in providing economic security to both the young and the old is sustained high economic growth (Barr, 2006).

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3 Longevity risks concerns the probability that accumulated savings and retirement benefits may be inadequate to last until death. Inflation risk concerns the probability that value of retirement benefit may not be protected against inflation during the retirement period.
As social security reform is a process that spans for over a decade or more, it therefore requires a long term focus and appropriate sequencing of reform steps. A social security system usually comprises several components; and in each component there are many provident and pension fund organizations. Initially, pension reformers must seek to reform those areas where seemingly minor reforms could yield disproportionately large benefits, thereby increasing the credibility and acceptability of reforms. Reforms must also be scalable, particularly in countries with large populations such as India and Indonesia. Effective reform also needs to be directed toward better organizational effectiveness and broader system design issues.

**Core Functions:** There are five core functions which any provident or pension fund comprising social security system must perform (Ross, 2004). These are: reliable collection of contributions, taxes and other receipts (including any loan payments in the security systems); payment of benefits for each of the schemes in a timely and correct way; securing financial management and productive investment of provident and pension fund assets; maintaining an effective communication network, including development of accurate data and record keeping mechanisms to support collection, payment and financial activities; and production of financial statements and reports that are tied to providing effective and reliable governance, fiduciary responsibility, transparency, and accountability.

In most developing countries, organizational reforms aimed at performing the above five tasks in a more professional and effective manner are a prerequisite for broader systemic reform, and for contributing to economic development and welfare.

At the systemic level, a well designed social security system should be broad based, i.e. be *adequate* both in terms of coverage and the range of risks covered; *affordable* from individual, business, fiscal, and macroeconomic perspectives; actuarially sound and *sustainable* for over a period of 70 years of more; *robust* so as

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4 It is particularly important to not compare the existing imperfect systems with a reform options based on implicit assumptions of perfect implementation, no political compromises on design and governance, and benign domestic and international economic environment (Diamond, 2004).

5 In many provident and pension fund schemes, a member is permitted to borrow for housing, education or other purposes, but the loan needs to be repaid.
to withstand macroeconomic and other shocks; and provide reasonable levels of post-retirement income\textsuperscript{6} coupled with a safety-net for the elderly poor.

The above implies a fairly complex objective function for a social security system. The society needs to decide through policy makers on the relative weights given to affordability, sustainability, robustness and the level of safety nets. Different societies will make different trade-offs; and the same society may alter the trade-offs at different stages of economic development and demographic situations.

There is a need for political consensus concerning social security reform trade-offs, which universally has not been easy to achieve. Issues in transitioning from the current to the reformed system must be addressed, but this requirement often leads to preference for the status quo. In many countries in developing Asia, there has been a shift in economic paradigm towards greater integration with the world economy, and shifting of the state-market mix in favor of the latter. But this shift has not been adequately reflected in social security reforms in these countries.

**Investment Policies and Performance:** There appear to be two broad views on the objective of investment policies and performance of provident and pension funds. The first argues that publicly managed provident and pension funds, and investment guidelines for non-public funds should take a broader strategic view of national interest in investing the accumulated funds (Charlton and McKinnon, 2001).

The second view holds that these funds are a fiduciary responsibility of the board of trustees of provident and pension funds, in both public and private sectors. The main objective should therefore be to maximize returns for the members, subject to the risk tolerance level set by the relevant authorities (Barr, 2006). The provident and pension fund savings need to be intermediated through the financial and capital markets into productive investments, which have a positive impact on economic efficiency and on the trend rate of economic growth. It is in this context that the role of financial and capital markets becomes important.

\textsuperscript{6}Pension experts generally recommend a replacement rate, i.e. ratio of retirement income to pre-retirement income, of between 66 to 75 percent, adjusted for both longevity and inflation risks. Some countries index pensions to wages to enable retirees to participate in increased productivity of the nation.
The two views are not necessarily mutually exclusive. In many Asian countries, qualitative and quantitative expansion of physical infrastructure is of high priority. The provident and pension balances could be used to partly finance such expansion, provided appropriate financial instruments (such as infrastructure, municipal and corporate bonds) are developed, and the decisions to invest are based under sound corporate governance and regulatory principles and practices. So the focus should be not on whether these funds are invested in infrastructure, but on the quality of the decisions and policy regulatory environments under which such investments are made.

3. The World Bank’s Five-Tier Framework
There has been considerable debate and experience with social security reform, but no single idea, system or model has emerged even among Asian countries. There has however been appreciation that from a practical policy point of view, a multi-tier framework is better able to address various social security risks than reliance on a single-tier. The World Bank’s earlier report (World Bank, 1994) suggested a three pillar/tier framework, but accumulated evidence and re-thinking has led the Bank to suggest a five pillar/tier framework (Table 2) (Holzmann and Hinz, 2005).

(Insert Table 2 here)

The five-tier framework recognizes that different target groups require different combinations of pillars; and that basic pension or at least social assistance financed from general budgetary revenues (Pillar Zero) is essential for the lifetime poor. This group may constitute as high as 30 percent of the total labor force in some developing countries, such as India and Indonesia.

It also recognizes that a mixture of defined benefit (DB) and defined contribution (DC) schemes, with varying degrees of social risk pooling, is desirable. Under the Defined Benefit (DB) method, benefits to be provided to members are defined, and contributions are left undefined. The pension plan sponsor (employer, government, etc.) bears the investment and other risks. DB-type voluntary occupational pension plans are usually not portable (for example, when a person changes jobs), thereby affecting labor mobility between employers and sectors. This
is also the case with the civil service DB pensions. In mandated social insurance systems, society as a whole bears the risks, and the portability issue is not relevant.

In a DC scheme, contributions are defined but the final pension benefits are left undefined. It is the individual members which bear the investment risk during their working life and when accumulated balances are converted into a regular income stream at the time of retirement through annuities or programmed withdrawals. A DC scheme is disadvantageous to those with irregular employment.

It also recognizes that private management, investment allocation among a wide variety of physical and financial asset classes, and international diversification may not be suitable for all countries. There is also less insistence on private management of pension assets, and recognition that accumulation of large assets is not always optimal.

The role of family, community, physical assets (such as housing), and labor market activity after retirement (Pillar 4) also receive emphasis. The contextual aspects of each country must be given substantive consideration in provident and pension fund design and governance. Mainstreaming micro-pensions may also be useful for reaching certain sections of the labor force.

The World Bank’s multi pillar-pension taxonomy provides a framework for thinking about pension reform and it should not be regarded as a blueprint. In the pension reform literature, Chile’s mandatory savings, individual-account based, privately managed model for providing retirement financing has received considerable attention. Chile’s strong economic growth, healthy balance of payments, fiscal accounts, and demonstrated competence to deliver public services, effectively are requisite pre-conditions for success of such an approach (Asher and Vasudevan, 2008).

Recently, recognizing the limitations of the single-tier approach, Chile has passed legislation strengthening the zero pillar termed social security pension to be financed from budgetary revenue (Asher and Vasudevan, 2008). The policymakers in Chile plan to construct a multi-tier pension framework (Kay and Sinha, 2007).
4. Imperatives for Effective Social Security Reform

Many of the requirements for effective social security reform in developing Asia are implicit in the discussion in the previous sections. This section however enumerates the key requirements. Each country will need to devise its own strategies for reform to suit the initial conditions, economic, fiscal and institutional capacities, and political economy of its country. Constructing and sustaining robust social security systems and safety nets is an urgent necessity requiring considerable expertise, sustained focus, and political consensus on a new social contract which is consistent with demographic trends, stakeholder expectations, and institutional, financial and economic capacities, and the needs of the 21st century. The above requires rethinking existing ideas and practices about social security and not decisions taken in an atmosphere of crisis (Hoskins, 2008).

Professionalism: It is imperative that the five core functions of provident and pension funds identified in Section 1 must be done with greater professionalism than has been the case so far in many Asian countries. This, in conjunction with strong regulation, would enable the Asian countries to provide much higher levels of pension benefits from lower contribution rates than is the case now. The focus of these organizations should be on providing benefits to their members, which are commensurate with the contribution rates and the transactions costs of administration and compliance.

Some Asian countries, such as Indonesia, have high administrative and compliance costs. They have not been able to undertake record keeping and management information system tasks adequately, even for a relatively small proportion of the labor force comprising formal sector workers. Their plans to sharply expand the coverage to include informal sector workers may therefore be severely undermined by their inadequate record-keeping capabilities.

Investment policies and performance also remains a challenge in Asia. Limitations of domestic financial and capital markets, legal restrictions on international diversification (e.g. Malaysia, Indonesia, Sri Lanka, and India), and relatively low importance given to fiduciary responsibilities (which require maximizing returns of provident and pension fund balances for the benefit of the members) have contributed to this outcome.
As pre-funding arrangements, through retirement savings or accumulation of reserves, become increasingly common (pension assets are expected to grow significantly in Asian countries), development of domestic financial and capital markets has become essential. Provident and pension funds will need to be increasingly comfortable with sophisticated investment strategies using diverse asset classes (e.g. debt, equity, real estate and currencies) and diverse players (such as hedge funds, private equity investors and sovereign wealth funds).

Modernizing investment regulations and greater importance to governance structures of provident and pension funds are therefore needed in many Asian countries.

**Systemic Perspective:** There are three aspects of this perspective that needs to be addressed. The *first aspect* involves complimentary reforms in other areas such as labor markets, fiscal policy and financial and capital markets are essential for effective for social security reform.

Effective social security reform is greatly facilitated by sustainable macro-economic policies which lead to high and stable growth whose benefits are distributed widely. This is because the single most important variable for the economic security of both the young and the old is the long term trend of economic growth. The labor market regulations and functioning must provide an appropriate balance between creating new jobs and preserving existing jobs. High employment is negatively correlated with poverty, and therefore creating economically viable and sustainable jobs is essential.

Civil service pension reform should form a part of the fiscal policy reforms. These should be based on the full cost (including unfunded liabilities) of pension (and health) benefits being provided to the civil servants; and to improve the delivery of government services (including social assistance or social pensions for the elderly). Without full and explicit costing of civil service benefits, it would be difficult to allocate society’s resources devoted to the elderly equitably, and efficiently. In many countries, without civil service pension (and healthcare) reforms too large a share of
national income devoted to all elderly will accrue to civil servants. This creates intra-generational inequities, and may strain social cohesion.

Financial and capital market reform is essential as the demand for quality investments by provident and pension funds should be matched by the corresponding supply of financial assets, based on both debt and equity. Unlocking the value of state enterprises through partial or full divestments will be an important avenue in many Asian countries for increasing the supply of such assets.

The second aspect of the systemic perspective concerns the multi-tier framework to provide social security. While such a framework may have theoretical limitations (Diamond, 2004), it is essential for managing risks of financing old age in any realistic political economy setting, particularly in Asia.

The relative weight of each tier however may vary from country to country. Initial conditions would have an important bearing on these weights. Thus, China, the Philippines, Thailand and Vietnam have pension (and health) systems based on social insurance principles (though coverage of population in each country is far from being universal). Malaysia has primarily relied on a single tier of mandatory savings, which is also used for housing and healthcare. Countries also need to expand their social assistance programs, and introduce social insurance and solidarity principles into their pensions systems.

These countries need to consider building other tiers, particularly social assistance (or social pension) type programs financed from the budget, and individual retirement savings (Palacios and Sluchynsky, 2006). Several Asian countries such as China, Thailand and the Philippines have however found it difficult to implement individual retirement accounts, whether mandatory or on a voluntary basis. Developing robust annuity markets, which are particularly important for defined contribution pension systems, has been a major challenge for many Asian countries (Asher, 2008).

The main constraints arise due to limited investment instruments to manage longevity and inflation risks during the payout phase. Uncertainties about longevity trends are also a constraining factor, as these lead to conservative pricing of annuities,
making them unattractive in comparison to other investments (and in some cases unaffordable, creating adverse selection problems). Therefore, greater attention will have to be given to the payout phase, including phased withdrawals, with some social risk pooling in the form of above-market interest rates, financed from the budget.

Lower fertility rates, urbanization, changing values and expectations of both the young and the old are significantly increasing the need for more formal pension systems in Asia, consistent with the experiences of current industrialized countries who faced these trends earlier. Nevertheless, public policies in Asia should continue to promote traditional family oriented values and allocate requisite resources and energies towards this goal. This is unlikely to reverse the trend towards more formal pension systems but it may reduce the rate of transition, and somewhat reduce the scope of the formal systems.

The five pillar framework of the World Bank (Table 2) also recognizes the importance of personal savings, home ownership, investing in human capital, including for children, and opportunities for participating in livelihood activities in old age as integral elements of any pension system. If their importance is reflected in tax, regulatory and government expenditure allocation decisions, the fourth tier can play a useful supplementary role in addressing pension challenges. In some countries with well-developed micro-finance institutions, micro-pensions could also play a useful role.

It is important that policy makers enable households to utilize all the tiers, albeit to a varying extent, to obtain the required replacement rate for financial security in retirement. While the precise share cannot be prescribed a priori, both the policy makers and the households must consciously strive to make full use of all five tiers.

Regardless of whether social security systems of a country is primarily based on social insurance and social solidarity principles or on individual and family responsibility, a significant proportion of retirement financing needs in the 21st century will have to be met from individual savings (Spivak, 2008). This strongly suggests that social norms and financial regulation should be so structured in a way that does not undermine thrift and saving habits. The credit culture must be kept in
reasonable check lest it undermine household saving which is the main component of national saving in countries such as India. It is also essential that the responsibilities of families and immediate communities taking care of the elderly are not too rapidly substituted by the state. This will require nurturing appropriate social norms and regulations.

The third aspect of the systemic perspective concerns public policies in Asia need to consider pension and health care financing arrangements in an integrated manner. In high-income Asian countries such as Korea and Japan, long term care is already an important health financing issue. A significant proportion of individuals above 80 years of age have difficulty performing daily functions. With decreased fertility and greater mobility, health care givers for the aged have become scarce. Developing Asian countries such as China, India and Thailand also will also have to address the challenge of long-term care.

Transition Issues: Transition issues in reforming the pension system should be given much greater consideration than has been the case in many Asian countries. These involve not just technical aspects, such as treatment of accumulated pension rights, but also the issues concerning perceptions of fairness and legitimacy of pension reform. Unless these less tangible issues are addressed satisfactorily, the pension reform process may not yield desired results (for example, by adversely impacting compliance levels).

Pension Regulator: Regulation is a public good which the government has the responsibility to provide. There is a strong case for a dedicated pension regulator in developing Asia. Its main functions should be to ensure professionalism in performing core functions, ensuring systemic perspective (to consider all 5 tiers in an integrated manner), to develop pensions industry and promote financial education (Asher and Nandy, 2006).

Financial Education: Asian countries need to make much more systematic efforts in promoting financial education. Such education is needed at all levels, general public, officials and trustees of provident and pension fund organizations, those involved in
designing, marketing and advising of pension products, media and the policymakers. National campaigns for enhancing financial literacy will be needed.

**Indigenous Research Capability:** The countries in Asia need to substantially enhance their capacity to undertake rigorous empirical evidence based policy-relevant research on pensions and healthcare issues. This will require considerable strengthening of the existing database on morbidity and mortality patterns; and behavior of individuals and firms concerning saving, and retirement. The challenges of ageing in Asia are too immense and complex to delay building such capacity, and not adopting a mind-set which translates research findings into timely policy measures. Asian countries may benefit from studying the experiences of the OECD countries, such as Sweden and Germany, and of Chile’s experience in encouraging a culture of solid analytical, policy-oriented indigenous research on pension issues and making available a robust database to undertake such research.

Finally, consideration could be given to establishing a forum in Asia to discuss social security issues. Such a forum should bring together not only public officials, but also other stakeholders such as trade unions, employer organizations, academics, researchers, and pension industry representatives.

Meeting the imperatives of social security reform will be a major challenge for developing Asia, requiring not only high technical and governance capacities, but also vision and leadership. This challenge however must be met if developing Asia is to increase its role and standing in global affairs.
### Table 1A: Demographic Indicators in Selected Asian Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Population (millions)</th>
<th>Average annual rate of change of population</th>
<th>Total Fertility Rate (TFR)</th>
<th>Median Age</th>
<th>Life Expectancy at Birth</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>6671.2</td>
<td>9191.3</td>
<td>1.17</td>
<td>0.36</td>
<td>2.6</td>
</tr>
<tr>
<td>China</td>
<td>1328.6</td>
<td>1408.8</td>
<td>0.58</td>
<td>-0.32</td>
<td>1.7</td>
</tr>
<tr>
<td>India</td>
<td>1103.4</td>
<td>1592.7</td>
<td>1.55</td>
<td>0.30</td>
<td>3.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>231.6</td>
<td>296.9</td>
<td>1.16</td>
<td>0.10</td>
<td>2.2</td>
</tr>
<tr>
<td>Korea</td>
<td>48.2</td>
<td>42.3</td>
<td>0.33</td>
<td>-0.89</td>
<td>1.2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>26.6</td>
<td>39.6</td>
<td>1.69</td>
<td>0.41</td>
<td>2.6</td>
</tr>
<tr>
<td>Philippines</td>
<td>87.9</td>
<td>140.5</td>
<td>1.90</td>
<td>0.50</td>
<td>3.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>4.4</td>
<td>5.0</td>
<td>1.19</td>
<td>-0.38</td>
<td>1.2</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>19.7</td>
<td>18.7</td>
<td>0.47</td>
<td>-0.55</td>
<td>1.9</td>
</tr>
<tr>
<td>Thailand</td>
<td>63.9</td>
<td>67.4</td>
<td>0.66</td>
<td>-0.27</td>
<td>1.8</td>
</tr>
<tr>
<td>Vietnam</td>
<td>87.4</td>
<td>120.0</td>
<td>1.32</td>
<td>0.21</td>
<td>2.1</td>
</tr>
</tbody>
</table>

### Table 1B: Demographic Indicators in Selected Asian Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Life Expectancy at age 60, 2000-2005</th>
<th>Percentage of total population aged 60 and above Medium Variant</th>
<th>Population aged 60 and above (millions) Medium Variant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Men</td>
<td>Women</td>
<td>2005</td>
</tr>
<tr>
<td>World</td>
<td>N.A.</td>
<td>N.A.</td>
<td>10.3</td>
</tr>
<tr>
<td>China</td>
<td>20</td>
<td>17</td>
<td>11.0</td>
</tr>
<tr>
<td>India</td>
<td>16</td>
<td>18</td>
<td>8.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>18</td>
<td>16</td>
<td>8.3</td>
</tr>
<tr>
<td>Korea</td>
<td>23</td>
<td>18</td>
<td>13.7</td>
</tr>
<tr>
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<td>6.7</td>
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<tr>
<td>Philippines</td>
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<tr>
<td>Thailand</td>
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<td>17</td>
<td>11.3</td>
</tr>
<tr>
<td>Vietnam</td>
<td>20</td>
<td>18</td>
<td>7.6</td>
</tr>
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<table>
<thead>
<tr>
<th>Pillar</th>
<th>Target Groups</th>
<th>Main criteria</th>
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</thead>
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<tr>
<td></td>
<td>Lifetime poor</td>
<td>Informal sector</td>
</tr>
<tr>
<td>0</td>
<td>X</td>
<td>x</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>4</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

*Note: The size of x or X characterizes the importance of each pillar for each target group.*

*Source: Holzmann and Hinz (2005).*
References


