DO WE NEED A PENSION REFORM?

EPRC
Economic Policy Research Center

2013

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The report was published with the financial support of the Think Tank Fund of the Open Society Foundations within the framework of the Core and Institutional Support to Policy Research Centers program.

KEY FINDINGS

Discussions about the need to introduce a pension scheme, which is different from the effective model of the pension system, have intensified in Georgia in the past few years.

Even though the existing pension scheme is significantly better than the system operating a decade ago, a frequent alteration of it indicates about those shortcomings and inconsistency which are characteristic for this system. At the same time, taking into account developments both inside and outside Georgia as well as expected scenarios of development, a long-term viability of the existing pension model is increasingly questioned.

This is a multifaceted problem which includes difficulties in many directions.

1. This primarily relates to legislative guarantees of ensuring pensions, which are minimal in Georgia. In particular, the source of pensions is the state budget alone and the rights of pensioners are not ensured by any other relevant legislative framework.

2. A constantly increasing pressure on the sector of public finances is a serious shortcoming of the existing model and represents a heavy burden for the state budget.

3. The existing model fails to ensure (because of restricted resources) the adequacy of pensions to changing living standards (constant increase in prices).

4. Aging of population, which is an irreversible worldwide trend, is also observed in Georgia. Consequently, entrusting the tackling of the problem of pensions to the public sector alone leads to a significant increase in state liabilities and contains a threat of a possible failure of the state to fulfill these liabilities.

Thus, the necessity to carry out a pension reform in Georgia is as conspicuous as in many economies of the world (regardless of their level of development and achieved economic welfare).

HISTORY AND DEVELOPMENT

Discussions about the urgency of reforming pension systems started across the world from the mid 1990s. The need to seek such pension schemes that would adequately respond to new challenges of that time emerged because of cardinal changes associated with the increase in world population, aging of population, longer life expectancy, a longer-term change in the proportion between the labor force and pensioners, and the establishment of qualitatively new models of financial and economic relations.

The first paper discussing the importance and seriousness of the problem – "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth"[1] - was published under the aegis of the World Bank in

1 http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1994/09/01/000009265_3970311123336/Rendered/PDF/multi_page.pdf

1994. By publishing this paper, one of the largest international financial institutions confirmed that the problem is rather complex, current or future associated risks are difficult to manage whilst the reformation of existing pension systems is an immediate necessity.

This very publication and the discussions it triggered made it clear that pension systems operating before (and in often cases, operating today) had come to face significant challenges which could not be adequately responded by means of existing pension schemes.

Almost two decades later of the start of those discussions, the situation has further deteriorated. Economic crises of various scales and depths, which have been observed since the mid 1990s, notably worsened the situation of public finances and private pension funds in various countries.

This aggravation coincided with the period when a new and quite voluminous wave of pensioners started entering the world pension systems, thereby requiring substantial financial resources to be ensured with pensions. In this regard, the year 2011 is considered to be a sort of watershed. It is precisely beginning in this year that the first wave of the so called baby boom generation started retiring.

The birth rate reached its peak over the period between 1940s and 1960s. Therefore, this wave of new pensioners is the largest in the history by its scale and at the same time, the most influential (as a rule, pensioners are considered one of the most consistent and active voters and consequently, to win their hearts, governments often take such decisions which bring short term political benefits but are economically unsubstantiated).

As a result, state budgets of almost every developed country are characterized with huge deficit. According to the data of the European Union,[2] as of 2013, the majority of the EU member states fail to observe the "debt ceiling" parameter established by the Maastricht Treaty (under this treaty, a state debt shall not exceed 60% of a country's Gross Domestic Product). In reality, the amount of debt against the GDP comprises 92,2% within the Eurozone.

In contrast to the widespread opinion, this problem is not caused by global or local financial and economic crises alone. According to estimated of the International Monetary Fund (IMF), only 20% of expected increase in domestic state debts in the nearest future will account for financial crisis and recession. The remaining 80% will be accounted for the increase in public funds for covering health care, social and especially, pension liabilities.

For this very reason, when evaluating the existing situation, international scientific sources increasingly use the term "gerontocracy" which reflects the growing influence of elderly on politics.[3]

In such a situation, pension systems face a number of challenges. These challenges are diverse and quite multifaceted, but they still can be grouped following certain logic.

2 http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22072013-AP/EN/2-22072013-AP-EN.PDF
3 http://www.nber.org/papers/w7117.pdf?new_window=1

INCREASE IN LIFE EXPECTANCY OF PEOPLE

Improvements in health care systems, decrease in incurable diseases, increase in the access to new medications and improved treatment technologies have led to a significant increase in life expectancy worldwide.

According to the data of the United Nations Department of Economic and Social Affairs (UN DESA),[4] during the past 30 years (i.e. over the period from between 1980 and 2011), an average life expectancy has increased in countries of all four human development levels:

- *In the countries with very high human development level – from 73,4 years to 80 years*
- *In the countries with high human development level – from 64,8 years to 73,1 years*
- *In the countries with medium human development level – from 61,4 years to 69,7 years*
- *In the countries with low human development level – from 50,1 years to 58,7 years*

As the observation over the period of three decades shows, this is an irreversible trend which indicates about a constant increase in payments for pensions schemes.

UPWARD TENDENCY IN DEMOGRAPHIC PROBLEMS (AGING OF LABOR RESOURCES)

According to the survey, World Population Aging-2009[5], the number of people aged 60 and over, which comprised 11% of the total world population in 2009, will double to 22% by 2050. Thus the number of people aged 60 and over will exceed two billion in the world.[6]

As a result, a significant change in the demographic profile and the age of the world population and consequently, increased pressure thereof on the labor force has become yet another important argument to corroborate the necessity for speeding up the implementation of pension reforms.

4 http://hdrstats.undp.org/en/indicators/69206.html
5 http://www.un.org/esa/population/publications/WPA2009/WPA2009_WorkingPaper.pdf
6 http://www.who.int/ageing/en/

INCREASED DEFICIT OF SOLIDARITY PENSION SYSTEMS (PAY-AS-YOU-GO)

Both above mentioned factors – the aging of population and decrease in the proportion between the labor force and age pensioners – constantly deepen the deficit in pension schemes based on advance payments (Pay-As-You-Go), in which finances for providing pensioners with pensions are ensured by retirement contributions paid by employed workers (through the so-called "solidarity scheme").

As a result, the change in the demographic picture, which is of irreversible nature, creates a threat that it will become increasingly difficult to ensure the population with pensions through the Pay-As-You-Go system, and over time, this may even become impossible.

Bearing in mind the created crisis, international financial institutions as well as agencies and organizations working on social security issues, recommend that a necessary element – retirement savings – be introduced in the process of reformation of national pension systems.

A years-long debate of the World Bank, the International Labor Organization and the International Social Security Association regarding the adequacy of savings and distributive elements and proportions in the overall provision of pensions finally ended in achieving a political consensus. This consensus was that no universal recipe exists and that each country must choose its own model itself based on national peculiarities, selected economic policy and the level of development.

TYPES OF PENSION MODELS

Various pension models have been applied since the middle of the 20th century. Regardless of some differences between them, all these models may be divided into three groups:

1. A PENSION MODEL BASED ON THE PRINCIPLE OF SOLIDARITY

Under this model, pension outlays are financed through payments (taxes, insurance contributions) made by working population. A direct funding of pensions from the budget by a state is a variety of this model.

In the conditions of inflation and economic growth, a labor reimbursement, as a rule, increases and with it, pension contributions. The indexation of pensions is, traditionally, made on the account of the increase in the total payment made by the working population.

This model, however, is characterized with serious risks. Firstly, along with the aging of the population, the proportion of working population against pensioners significantly changes. As a result, the total pension contributions are no longer sufficient to maintain the level of pensions; indexation is no longer carried out, and the size of a pension against the size of labor reimbursement shrinks, thereby creating a prerequisite for the decrease in pensions.

Moreover, as the experience of many countries show, there is another risk which is of no lesser degree - the political populism of national governments or political groups aspiring to come to power, in which they exploit the pension issue to gain support. As a result, governments often establish pension rates or increase existing pensions without considering sources of long-term financing of these pensions and long-term risks associated with that.

2. A PENSION MODEL BASED ON THE PRINCIPLE OF SAVING

This model envisages an individual nature of accumulating pension with the size of pension depending on the total amount of pension contributions and the success and financial indicators of the investment strategy implemented by the pension funds.

In the conditions where economy grows and financial market is developed, the savings model is characterized with a sustainable increase when the return on investments exceeds the rise in inflation and salaries.

At the same time, the increase in the share of “savings” against the GDP creates strong stimuli for the economic growth.

However, risks associated with pension models based on savings principle are apparent too.

Primarily, a risk is that given the cyclic nature of economy, the growth is not always irreversible. In the condition of economic decline and crises, which have become frequent of late, the accumulated resource may devaluate because of decrease in the price of capital market instruments.

At the same time, participants in the savings pension scheme are much more vulnerable to market risks and inflation.

3. A PENSION MODEL BASED ON MIXED PRINCIPLE.

This model envisages combining certain elements of both solidarity and savings pension schemes. Such an approach partially decreases risks and increases flexibility in determining the size of participation of public and private sectors in ensuring pensions.

The mixed model also makes it possible to distribute risks between pension schemes at times of crisis.

However, this model is also associated with risks. In particular, the problem is the proportion of activity and responsibility of participants in the pension scheme and consequently, the efficiency in determining public costs and private sector contributions.

At the same time, in case of conflict of interests of the state and private sectors, a mixed model decreases the flexibility and efficiency of the pension system.

Based on one of these three principles, various types of pension systems operate in different countries. We will focus on four of them which function, with some variations, in many countries.

NATIONAL MODELS OF ENSURING PENSIONS

A. AMERICAN MODEL

This model is based on personal pension insurance with state and private pension schemes simultaneously operating within its framework.

Of these schemes, a distributive system rests on a standard formula. Pensioners receive monies paid by working population to relevant funds. By recent calculations, the rate of pension contribution comprises 10.7% on average and as a rule, is co-paid by a company and a hired employee in equal amounts.

The savings system rests on investment mechanisms. Pension reserves are invested in securities and credit instruments. The savings system also includes private and public pension programs.

State programs ensure pensions to public servants. Their financial source is annual state contributions and investment revenues of state funds.

Non-public servants accumulate their additional pensions in non-public funds which, most frequently, are set up by place of employment. Moreover, any US citizen has a possibility to open his/her own retirement account in any pension fund and thus, create an additional source of income for ensuring their old age.

Thus, Americans ensure three types of pension: a state, a corporate (resting on labor relations) and an individual.

It is worth noting that such a model operates in several countries of Latin America and Europe too (for example, in Portugal).

B. EUROPEAN (CONTINENTAL) MODEL

This system is primarily based on a three-tier German model; it combines several different systems and vary by tiers depending on the number of insured persons, principle of financing and degree of security.

The first tier involves pensions which are necessary for certain groups of population (employees, public servants, farmers, doctors, lawyers, public notaries, et cetera) (the first tier, as a rule, implies a state pension system based on a solidarity principle; this does not imply guarantying either basic or minimal pension).

The second tier involves pension contributions in addition to liabilities; they are formed upon the initiative of employers. The second tier, as a rule, represents compulsory or voluntary corporate pension schemes (where the obligation of an employer is defined) – this is an additional pension which is actually mandatory and depends on contributions made by employer or in favor of employee.

The third tier involves voluntary individual savings and investments in financial institutions.

It is noteworthy that the need of insurance is defined by the law in pension systems of European countries. Statistically, the distribution mechanism accounts for a larger share.

The size of pension is individual for each insured person and depends on the size of salary and the length of being insured in the system. At the same time, the accumulated resource is subject to permanent indexation.

Pension systems of Europe often receive additional state financing (approximately 20% of the total pension contribution). It is worth noting that the amount of these injections increased in the continental Europe during the period of exacerbation of financial and economic crisis.

C. CHILEAN MODEL

This model entirely rests on principles of guaranteed state payment and compulsory savings insurance of working populations.

In accordance with the rule established by the law, hired employees are subject to mandatory pension insurance and are obliged to contribute 10% of their salaries to a pension fund.

An important element of this model is that the contribution to the pension fund is made not by an employer but by an employee. Then, pension funds invest the mobilized resources but if their investment policy proves unsuccessful, the state assumes the obligation to issue pensions.

At the end of the day, a person who has retired has a choice:

a) to have pension redistributed over the rest of life;
b) to take out the accumulated resource over a certain period of time;
c) to receive accumulated amount at once (this primarily happens in the so-called emergency cases).

D. JAPANESE MODEL

The Japanese system is a two-level system and rests on state social security. Other institutions represent a complement to the state system alone.

The first level involves a basic pension and its size is determined annually in accordance with changes in consumer prices.

Basic pensions are financed by contributions of insured persons, taxes of employers and state donations. Statistically, about one third of basic pension is covered by the state.

However, the size of contributions is individual and is tied to the size of salary. The contribution is jointly paid by an employee and an employer.

A GLOBAL CONTEXT OF PROBLEM

As the population becomes aged, the stability of pension systems in the world, and especially, in European countries weakens. The working population of Europe increasingly retires earlier. In particular, it has been observed that 55% of people of pre-retirement age (from between 55 and 64 years old) has been decreasingly contributing to the economic development of Europe.[7]

Forecasts indicate that the number of those people, who decreasingly contribute to the development of economy, will rise over time.

The number of people aged under five traditionally exceeds that of people older that 65. This situation may change in the foreseeable future because the number of people who are above 65 years of age will increase from current 8% to more than 16% by 2050 whilst the number of up to five-year-old children will decrease form current 9% to 7%.[8]

The highest increase will be seen in the number of people whose age is 80 and over. This tendency is observed in the entire world, but it represents an especially serious problem for Europe where the share of people older than 65 years already comprises 17.8% whilst that of people aged above 85 years stands at 4.9%. By 2040, the share of these categories will increase to 29.1% and 9.3%, respectively.

As a result, risks associated with rising pressure of pension systems on economy, employees and population will constantly increase in the longer term.

The threat is thus absolutely real that the increasing demographic imbalance (the number of pensioners irreversibly rise relative to the labor force) will more and more acutely question the adequacy of state pensions with living standards and will create problems in mobilizing enough resources to state pension systems and ensuring their stability.

Meanwhile, corporate pension funds, with their sustainability becoming way more fragile than it was before due to frequent crises, are also facing challenges which are increasingly difficult to meet.

Retirement age

Aging of population and an irreversible increase in the share of population of retirement age against the total population remain the top problems. Many countries of Europe try to mitigate the pressure caused by this factor by increasing the retirement age (judging by averaged indicators, the increase in the retirement age from 60.5 to 61 years, on average, is already apparent across Europe).

The efficiency of this move is proved by concrete indicators. Countries with a higher retirement age show better indicators in terms of adequacy of state pensions with living standards, sufficiency and stability of resources of state pension systems, and sustainability of corporate pension schemes and are in the lead

7 http://www.imsersomayores.csic.es/documentos/documentos/pensions-barometer-report.pdf
8 http://www.nia.nih.gov/health/publication/why-population-aging-matters-global-perspective/trend-1-aging-population

in overall European ranking by the listed categories. To illustrate the above said, we can cite examples of Denmark (retirement age at 61 years), Great Britain (62.6 years), Sweden (63.7 years), and Ireland (64.1 years).

Outsiders the European ranking by the above listed parameters (adequacy of state pensions with living standards, sufficiency and stability of resources of state pension systems, and sustainability of corporate pension schemes) are those countries which have lower age limit of retirement age, for example, France and Italy. The retirement age in both countries was set at 60 years under the law, though because of various legal exceptions, an actual retirement age comprised 58.8 and 59.8 years, respectively. As a result, the deficit of the French pension system could have increased to 40 or 50 billion euros within a period of 10 years. This nudged the country towards the pension reform (in November 2010, the decision to increase the retirement age to 62 entered into force).

At the same time, a number of countries took a decision to increase the retirement age over a certain period of time or equalize the difference in retirement ages by sexes; for example, in Great Britain, Germany and Denmark (from 67 to 68 years), the Netherlands and Spain (from 65 to 67 years), Hungary (from 62 to 65 years), Greece (from 60 to 65 years for women) and so on and so forth.

In its recommendatory so-called White Paper (White Paper-An Agenda for Adequate, Safe and Sustainable Pensions)[9] the European Commission directly advised the member states to automatically increase the retirement age in proportion to the increase in life expectancy in a country. Moreover, the European Commission called on member states to strictly limit possibilities of early retirement.

The increase of the retirement age, however, will not remove that pressure which the pension sector exerts on public finances and in general, prospects of economic development.

The revision of the retirement age is only part of the solution of the problem. This, of course, partially decreases the amount of public costs, but may trigger a significantly more difficult problem, for example, a decrease in social mobility. This problem has already been faced by many countries across the world. Because of increase in the retirement age, aged employees stay at their jobs longer, thereby impeding younger workers to enter the labor market and establish themselves on it. This problem is clearly seen in many European countries in which the share of unemployment among youth is way higher[10] as compared to that of older people[11] (see details in the table provided below). This is largely conditioned by the fact that the young labor force cannot enter the labor market because it is already saturated with high risk employees.

9 http://europa.eu/rapid/pressReleasesAction. o?reference=MEMO/12/108&format=HTML&aged=0&language=en&guiLanguage=en
10 http://www.oecd-ilibrary.org/employment/youth-unemployment-rate_20752342-table2
11 http://www.oecd-ilibrary.org/sites/factbook-2011-en/07/02/01/index.html?contentType=&itemId=/content/chapter/factbook-2011-64-en&containerItemId=/content/serial/18147364&accessItemIds=&mimeType=text/h

Country	Unemployment-2012 (%)	Unemployment-2012 (15-24 age category) (%)
Spain	25,2	53,2
France	9,9	23,8
Belgium	7,6	19,8
Luxemburg	5,2	18,8
Ireland	15,3	33,0
Italy	10,8	35,3
Sweden	8,1	23,7
Great Britain	8,1	21,0
Turkey	9,4	17,5
USA	8,2	16,2

Source: OECD

Under such conditions, because of existing economic crisis and decrease in labor resources the state pensions are becoming increasingly inadequate with the living standards.

In contrast, the size of corporate pensions increases, though at an insufficient speed. Moreover, the level of their revenues decreases. Nevertheless, this is exactly where the highest potential of increase lies.

Thus, because of exacerbated problems in demographic situation and public finances, pension reforms are still popular in Europe and a key feature of these reforms is a downward trend in the share of solidarity segment. At the same time, the necessity of generating new corporate pension schemes is apparent too.

A clear, though insignificant, change in attitude in Europe can be seen form the increase in the working population's contributions in financing their own pensions – from 40.2% to 41.9%, over the period of one years

At the same time, 10 European countries revised the forecast (in the upward direction) of the participation of population into the formation of their own pensions (only Cyprus proved to be an exception).

Pension expenditures in 27 EU member states comprised 9.1% of the GDP, as of 2010. This indicator will increase to 11.1% by 2040, if pension reforms are not implemented.

According to yet another noteworthy forecast, old age dependency ratio (ratio between the population aged 65 and over with the population aged between 15 and 64 years) in 27 EU member states will increase from the current 25% to 45% by 2040 and further to 53% by 2060.[12]

As a result, domestic debts of the majority of these countries will soar in the decades to come, if they do not undertake urgent measures to optimize pension expenditures.

12 http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde510

By estimates of Standard & Poor's, if governments do not change current pension and other social programs, the costs related to aging of population will push up state debts from 36.1% of the GDP in 2010 to 300% of the GDP by 2050.[13]

These expected risks will most severely damage developing countries and those European states which are in the process of forming their economies. These countries are distinguished for their relatively higher level of social security and fast deterioration of the demographic situation.

A forecast of state debt / GDP ratio in leading countries by 2050 looks as follows: Great Britain – 430% of GDP, Germany - 400%, Italy - 245%, Spain – 445%, Japan - 753% (the highest among 49 countries which were studied).

Against such a backdrop, the implementation of pension reforms is a matter of first urgency in many countries. Therefore, the majority of European countries are in the process of transforming the existing pension systems or even establishing entirely new ones. Examples provided below show how harmful this problem is for countries regardless of their level of development, economy, size of population or any other significant indicators.

MOST RECENT EXAMPLES OF PENSION REFORMS

France (October 2010)

The Senate took a decision on rising the retirement age from 60 to 62 years, substantiating this decision by lower birth rate and longer life expectancy. According to the data of the Organization for Economic Cooperation and Development (OECD), the share of population older than 65 years in France will reach 50% by 2050, doubling from the current 25%, whilst the value of pensions will reach 14.2% of the country's GDP.[14]

This places a huge pressure on the pension system which requires workers to pay from their salaries to ensure pensions to pensioners.

The economic crisis further aggravated already difficult situation because the unemployment rose and the collection of social tax sharply fell. The pension fund deficit exceeded 32 million euros in 2010.

Everyone agrees that the reformation of the pension system is necessary and if corresponding measures are not taken today this will inflict damage on the future generation. Despite a huge resistance, the new law entered into force after the constitutional council of France had confirmed its lawlessness.

13 http://www.apapr.ro/images/stories/materiale/COMUNICATE/2010/2010%2031%20attach.pdf
14 http://www.oecd.org/dataoecd/60/45/47375879.pdf

Estonia (December 2009)

According to the amendment to the pension legislation, the age of retirement which today stands at 60.5 years for women and 63 years for men will first be equalized – 63 years for everyone regardless of sex by 2016, and then will increase to 65 beginning from 2026.

This decision was also based on concrete calculations and forecasts: the ratio between pensioners and workers in Estonia will decrease from current 1:4 to 1:3 by 2030; whilst in 50 years from now, the number of working population will decrease by more than one third, i.e. by 284,000.

A LOCAL CONTEXT OF PROBLEM

One of key declared reasons of reforms implemented in Georgia is the establishment of the liberal economic environment that will be competitive in the world economic space. A reform of the pension system is an integral part of this aim because it is directly linked to that important place and function which the pension system performs in the country's financial and social policy.

Today, Georgia's pension system is divided into two, unequal parts. The main one is the state pension system which rests on the principle of distribution and issues flat-rate pensions from budgetary means.

Non-public pension system has an insignificant market share and due to absence of necessary legislative and other prerequisites is still on the rudimentary level of its development.

At the same time, macroeconomic indicators and dynamic thereof as well as priorities of budgetary policy and demographic changes indicate that the Georgian economy and budget cannot afford the luxury of leaving the coverage of pension liabilities as primarily state function.

As forecasted by the European Bank for Reconstruction and Development (EBRD), the majority of transitional countries will emerge from the crisis at a later stage and start economic growth at a lower speed.[15] Consequently, it is less likely that Georgia achieves such an economic growth which it had in the pre-crisis period (for example, 12.6% growth in 2007). Such a growth is especially unlikely taking into account the decline in investment inflows, exhaustion of donor assistance and low indicator of the private business activity (a substantial part of projects is still implemented by the involvement of the state).

And while the participation of the state in the economic activity of various sectors is high and substantial, the state is actually the only actor in the area of ensuring pensions.

A key challenge to the process of fiscal consolidation in Georgia is the management of pressure of social costs and at the same time, the provision of adequate pension to elderly and adequate social assistance to socially vulnerable people. Pensions represent the largest category of social expenditures, comprising more than half of social spending. According to the World Bank, the pension program will be a heavy burden for the budget until the country's population of the retirement age depends on the basic state pension. In the short-term perspective, the budget will come to face the pressure of social expenditures and therefore, without private pension savings, even the maintenance of existing pension levels will lead the country over time to high budget expenditures. However, according to pre-election promise, the government has increased pensions: on 1 September 2003, the state pension for age pensioners increased to 150 GEL and other pension categories increased too. To cope with these challenges, decision makers have to develop a pension savings scheme or determine financial instruments for the creation of long-term retirement savings.[16]

15 http://www.ebrd.com/downloads/research/REP/REP_January_2012_230112_FINAL_1.pdf
16 World Bank. Georgia Public Expenditure Review. Managing Expenditure Pressures for Sustainability and Growth. 2012. http://www-ds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2012/12/20/000333037_20121220015016/Rendered/PDF/NonAsciiFileName0.pdf

The expenditure side of the 2013 state budget of Georgia exceeds eight billion GEL of which more than 1,146 million GEL is earmarked for covering state pension liabilities,[17] i.e. more than 13% of expenditures (see the table below).

Year	2011	2012	2013
Total expenditure (million GEL)	7 459	7 806	8 748
Pensions (million GEL)	987	1 068	1 146
Share in total budget expenditure (%)	13,23	13,68%	13,1%

Source: Webpage of the Ministry of Finance of Georgia, www.mof.ge

This is a rather high share of total state expenditures but it does not ensure a dignified old age of pensioners, on the one hand, and on the other, deprives the state of a significant source of operational money.

As regards the demographic picture, Georgia is the 164th among 196 countries by the fertility rate. By the indicator of total fertility rate (an average number of children born per woman of the age between 15 and 49 years) the country stands at 1,5 (only 14 countries worldwide have such a low indicator).[18]

The indicator of mortality rate is also rather high among children and mothers. In the group of under 5 years old children, this coefficient comprises 27 deaths per 1,000 live births per year whereas a corresponding indicator in developed countries does not exceed three or four. As regards the maternal mortality, this indicator in Georgia comprises 48 female deaths per 100,000 live births - a high indicator too.

According to the same source, the population of Georgia will decrease by 0.6% over the period between 2010 and 2015. In terms of age of the population, the official statistics evidence that the share of that segment of population who is older than 65 is increasing[19] (see the table below).

Population of Georgia, thousand (2000 – 2013)

Total	<65	65+
4 401	3 841 (87%)	560 (13%)
4 484	3 863 (86%)	620 (14%)

Source: Geostat

17 http://mof.ge/4623
18 http://www.unfpa.org/webdav/site/global/shared/swp/2012/EN_SWOP2012_Report.pdf
19 http://geostat.ge/?action=page&p_id=472&lang=geo

Also statistically proven fact is that the number of labor force decreases in the country (this indicator fell by 118,000 over the period between 2004 and 2012 alone)[20] (see the table below).

Employment and unemployment

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012
Economically active population (workforce), thousand	2041.0	2023.9	2021.8	1965.3	1917.8	1991.8	1944.9	1959.3	2029.1
Employed people, thousand	1783.3	1744.6	1747.3	1704.3	1601.9	1656.1	1628.1	1664.2	1724.0
Unemployed people, thousand	257.6	279.3	274.5	261.0	315.8	335.6	316.9	295.1	305.1
Unemployment rate, %	12.6	13.8	13.6	13.3	16.5	16.9	16.3	15.1	15.0

Source: Geostat

The situation is further aggravated by the intensity of migration processes. Over the period from 1990 to 2006, the difference between the number of persons entering and leaving the country was negative and comprised almost one million persons. At present, as a result of migration caused by ethnic conflicts, only a small number of 105,000 emigrants have the official status of refugees. Because of difficult social and economic factors, up to 800,000 citizens have left the country. The conditions of internally displaced persons are the hardest inside the country. They comprise 6% of the country's population and by the data of 2009 year, made up 260,000 persons.

In general, demographically, the number of pensions is constantly rising. The number of age pensioners has significantly increased during the period of past 12 years (in 2000 – 550,000 with the share in total population at 12.4%, in 2012 – 682,000 with the share in total population at 15.1%). (See the table below).

The number of pensioners (2010 – 2011)

Year	2010	2011	2012
Number of age pensioners	662 288	666 367	682 886
Share of pensioners in total population	14.9%	14.9%	15.1%

Source: Geostat

At the same time, over the period from 1998 to 2012, the number of hired employees, i.e. those taxpayers whose paid taxes must cover pension outlays, decreased from 724,000 to 662,000.

All these data prove once again that the social liabilities of the state are a heavy burden which constantly increases under the system of existing relations and legislative decisions. The amount of monetary resources

20 http://geostat.ge/?action=page&p_id=145&lang=geo

directed towards ensuring pensions increases from year to year; the proof of that is yet another increase in budgetary means earmarked for ensuring pensions topped up from September 2013.

Consequently, monies spent on pensions will increase again, thereby automatically enhancing the pressure on the sector of public finances. As a result, the likelihood that Georgia, alike many European countries, will find itself in a situation when monies to cover liabilities towards age pensioners permanently increase, is high. This poses a threat of crisis emerging in the system of public finances.

Consequently, it is of utmost importance for the state to cooperate with the private sector and distribute risks with all those sectors where this is possible in reality. Thus, the implementation of the pension reform is not only politically and economically expedient but it is the necessity prompted by an extremely grave situation.

Means issued to pensioners today are very small and cannot be even really called pensions; they are more like social allowances. Moreover, they do not actually consider the pension contributions which current pensioners made during their employment; nor do they consider the length of their employment and content of their job (according to most recent data, only 335 pensioners in Georgia receive pensions in accordance with their work experience).[21]

The existing pension system poses many problems to financial sustainability of Georgia and prospects of its development. At the same time, this is not only a current problem but it will remain pressing in many years to come, will permanently worsen and as a result, will significantly impede the economic development of the country and create new social problems.

One should also take into account that positive results of the pension reform will not be immediate but will be felt by the country after a certain period of time, Therefore, it is important that the pension reform starts as soon as possible. Consequently, the need for establishing a real pension system which must be based on the savings scheme is on the agenda now.

In case of retirement savings scheme, people make savings during their employment period and those savings will be used for them after they reach the retirement age. In contrast to distributive scheme, which rests on the principle of solidarity among generations, the retirement savings system implies an individual responsibility in ensuring a dignified old age. It is also worth noting that the retirement savings system is organic for the countries with liberal economy and thus, fully fits into Georgia's context.

For a pension system reform to be planned and implemented successfully in Georgia, it is necessary to formulate key goals and directions of the reform, define terms and costs of its implementation as well as results in both shorter and longer term perspectives.

In this regard, it is crucial to analyze international experience, especially, to study pensions systems and success stories of those countries which are close to Georgia by various indicators (development level, economic structure, population size, et cetera) and consider the possibility of importing them. Moreover, it

21 http://ssa.gov.ge/index.php?lang_id=&sec_id=628

is necessary to take into account the practice of those countries which may starkly differ from the starting position of Georgia, but have significant innovations and successes in operating pension systems (for example, the USA, France, Chile, Latvia, Kazakhstan).

The study of international experience will allow us to better analyze problems in Georgia's pension system and ways of solving them. This analysis must result in developing an adequate model of reforming the system, which will establish a savings principle, increase the role of private pension schemes and enable to reconsider the place and share of the state pension system anew.

At the same time, it is important to have a deep understanding of all those problems which will emerge in the process of pension system reform (terms and costs of implementation, minimizing risks of transitional period, instruments of investing means accumulated in pension funds and their proper management and supervision, et cetera).

At the same time, it is necessary to outline and communicate to public all those positive results which the development of non-public pension system will bring to not only the Georgian pension system but the economy as a whole. This implies the emergence of new financial and investment resources as well as increase in and long term availability of these resources.

POSSIBLE SOLUTION

Given the change in demographic picture, one should expect that the issue of current pension system will be soon put on the agenda. According to effective legislation, the retirement age for men is set at 65 whilst that of women at 60.

The tendency having outlined in many European countries show that increasingly more countries reject the practice of establishing difference in retirement ages by sex. This is justified by the necessity to eliminate discrimination, on the one hand, and on the other, by the fact that women, traditionally, live longer than men (these indicators in Georgia are similar to the world trend: according to the United Nations Population Fund (UNFPA), the life expectancy in Georgia is 71 years among males and 77 among females. Over the period from 2005 to 2010, an average life expectancy increased from 73,96 to 74,43 years).

At the same time, one can see a tendency in many European countries of revising that retirement age - 65 years - which is considered a norm. Over time, the number of those countries which increase this age limit will rise: for example, in its most recent report, The Moment of Truth,[22] the US Commission on Fiscal Responsibility and Reform has already made a recommendation about a three-stage increase of the established normal retirement age in accordance with the increase in life expectancy and the defined schedule, in the long term perspective (see the table below).

US plan on the increase of retirement age

Year	Established retirement age
2027	67
2050	68
2075	69

Source: the Commission on Fiscal Responsibility and Reform

The retirement age will increase from 65 to 67 in Germany over the period from 2012 to 2019,[23] whilst in the Netherlands this will happen till 2025; Iceland has also embarked the same path. The retirement age of males will increase form 65 to 66 in Great Britain until 2016, whilst that of females from 60 to 65.[24]

In Japan, a possibility of raising the retirement age form 65 to 70 was considered as early as in 200 by the government of Prime Minister Yoshiro Mori, although, at the end of the day, another model was chosen. In 2004, the Japanese government adopted a package of pension reform laws which raised the retirement age from 60 to 69 for those citizens who are obliged to pay contributions to the pension fund. Moreover, it adopted a legislative norm obliging citizens of Japan to pay this contribution even after reaching the age of 70 years, if they continue working.[25]

22 http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf
23 http://ec.europa.eu/economy_finance/publications/publication14992_en.pdf
24 http://cdn.hm-treasury.gov.uk/autumn_statement.pdf
25 http://siteresources.worldbank.org/SOCIALPROTECTION/Resources/SP-Discussion-papers/Pensions-DP/0541.pdf

It is noteworthy that in OECD member states women retire at an earlier age (61,7 years) than men (63,1 years). At the same time, the life expectancy among females is longer (85 years, on average) than among males (81,4 years, on average). Consequently, in OECD member states, women receive pensions during 23,3 years whilst men during 18,3 years.[26]

Besides, many countries (especially, European), along with establishing a minimal retirement age, set additional requirements necessary for issuing full pensions. For example, in France, the so-called Fillon law[27] (named after the initiator of this law, François Fillon, the then Minister of Social Affairs and later, Prime Minister of France from 2007 to 2012), which entered into force in 2003, requires that to receive a full pension, a person must have reached 60 years of age and had the total work experience of at least 160 quarters (40 years) (under the 2010 reform, these requirements have changed into 62 years and 164 quarters).[28]

The same law determined that if the total work experience was less than the established duration (160 quarters), the amount of pension would decrease by 1.25% per lacking quarter or the amount of such quarters until a person turn 65 years old (the lesser value is chosen). However, this "penalizing" coefficient must not in total exceed 25% of the basic pension.

At the same time, the law included an incentive according to which a pensioner would receive a 3% addition on each year worked in excess of 160 quarters or after the age of 65 years. This value, however, must not exceed the total of 15% of the basic pension.

Increase or equalization of the retirement age will be a rather difficult process in Georgia because that is related to significant political and social risks.

This process will be difficult firstly because the expectation in the country is contrary – of decreasing the retirement age for citizens to receive pension at an earlier age. This reality is conditioned by high unemployment in Georgia and acute social problems with a large part of population lacking stable incomes and more or less stable social guarantees. Against this backdrop, a 150 lari worth pension (as of September 2013), received by each and every pensioner, somewhat mitigates the grave social situation (especially, in regions).

Moreover, the rise in the retirement age will adversely affect the degree of popularity of the political force which will take this decision and hence, its political future. Consequently, these circumstances will become significant impediments for taking a decision.

Despite these risks, the revision of the retirement age in Georgia seems to be inevitable. In this regard, there are numerous examples of countries dealing with this problem in a relatively painless manner through scheduling this process and minimizing risks.

26 http://epp.eurostat.ec.europa.eu/portal/page/portal/employment_social_policy_equality/omc_social_inclusion_and_social_protection/pension_strand
27 http://fr.wikipedia.org/wiki/Loi_Fillon_(retraites)
28 http://www.eurofound.europa.eu/eiro/2008/07/articles/fr0807019i.htm

However, as the international experience also shows, tackling the problem of pensions is not only limited to the change in the retirement age. The primary problem is the institutional transformation of the system and its development which requires a longer-term and more difficult work.

Of possible three-pillar pension system, only two pillars are operational in Georgia today. The first pillar – a component of state pensions – entirely covers the current pensions of the country's population. As regards the third pillar - voluntary retirement savings – this component is actually in a static condition and develops at an insignificant speed: according to the data of three quarters of 2011, pension schemes established by only three insurance companies operates in Georgia and the indicators of their performance are very modest[29] (see the table below).

Performance indicators of pension schemes operating in Georgia

Pension schemes	2010	2011	2012
Amount of contributions (GEL)	2 393 288	2 117 817	2 407 256
Number of contracts (unit)	11664	11 735	11 802
Number of participants (person)	16 879	17 343	18 397
Withdrawn means (GEL)	1 200 623	1 116 177	990 468
Reserves (GEL)	7 915 350	9 478 392	11 289 694
Investment revenues (GEL)	775 049	944 253	1 006 177

Source: National Bank of Georgia

In a situation when the first pillar of the pension system (a state pension) may face deficit and crisis over time, whilst the third pillar (voluntary retirement savings) does not grow at a desired speed, it seems proper to think about the introduction of the second pillar – forced retirement savings.

In its essence, this approach is a measure of coercive nature, but, at the same time, creates necessary preconditions for ensuring a better old age to quite a large group of people.

In this regard, the most acceptable model, regardless of shortcomings detected in it and problems created by the economic crisis, is still the Chilean pension model.

It is noteworthy that the social security system which also included Pay-As-You-Go pension system, was in effect since 1920 in Chile (in Georgia, as in part of the Soviet Union, this pension system became effective since the 1920s, though the Law on State Pensions was adopted in 1956). However, within 50 years of its enactment, by 1973, this system was almost bankrupt even though 73% of Chilean workers honestly paid the imposed tax.

Dodging pension contributions became a frequent occasion because hired employees did not see connection between contributions they paid and symbolic amounts paid as pensions.

29 http://nbg.gov.ge/index.php?m=493

The system was saved from a total fiasco by the 1980 reform which was launched during the rule of the President Augusto Pinochet and which replaced the distributive pension scheme with the gradual retirement savings model. Every person getting involved in the retirement savings scheme receives a personal account where contributions made by him/her are accumulated. These contributions are invested in various projects by private pension funds and they generate returns which, together with retirement contributions, are paid back to a person after he/she retires.

The transfer onto a savings model in Chile took several years. Young citizens were required to become participants in the retirement savings scheme. Those workers who had already paid their contributions to the distributive pension system were allowed to make a choice between the two models.

Those who opted for the distributive pension system receive basic state pensions. Those who decided to move to savings scheme, received government bonds compensating earlier contributions (these bonds have a flat rate of 4% benefit and when the holder of these bonds retires, the state buys the bonds out).

During the implementation of this reform, more than 90% of the population migrated from the old to the new pension system; this was mainly caused because of the 40-50% increase in pensions and almost halving of insurance payments (from the initial 19% to 10%, whilst in case of life and disability insurance – to 13%).

In parallel, a basic state pension continues to exist, which is ensured from the retirement reserve fund (this fund receives around 0.5% of the GDP from the state budget annually).

It is noteworthy that in 2008, during the rule of President Michelle Bachelet, the effective model of the Chilean pension system experienced several important changes following the recommendation of the World Bank.[30] In particular, the analysis of the operation of the pension system revealed two serious problems: the coverage of population and high administrative costs. It transpired that the pension system still did not reach many people whilst accumulating monies by means of pension funds cost quite expensive and making retirement savings there loses sense for low income workers.

At the same time, frequent crises increased the number of those people who cannot finance their pensions because of lack of regular sources of income. As a result, many people fail to reach a mandatory minimum of 20 years of paying contributions which is necessary to receive a minimal pension.

Considering these circumstances, the World Bank drew up a recommendation for a notion of minimal pension and social security being entirely abolished and instead, a mechanism of response to risks being introduced, which will be financed from collected VAT taxes.

As a result, a minimal pension and social security was replaced by a solidarity pension system financed from taxes. Every citizen older than 65 years of age, who has lived in Chile for a minimum of 20 years and has not accumulated a minimal amount of pension, has the right to join the solidarity pension system.

30 http://www.safp.cl/573/articles-3832_recurso_1.pdf

At the same time, the legislation extended the list of those sectors and projects in which pension funds are allowed to invest (in order to ensure higher returns).

And finally, during the transitional period, which will last until 2015, every self-employed must be involved in the pension system.

After the departure of the left-wing President Bachelet, the government of current right-wing President of Chile, Sebastián Piñera, has continued the implementation of this reform, in other words, despite ideological differences, the legacy and irreversibility of reform is guaranteed.

It must be said that the Chilean model has already been imported in a number of countries and the monitoring on those countries also provides interesting and noteworthy information.

In the former Soviet space, Kazakhstan used the analogous model to reform its pension system. With the law on Provision of Pensions, adopted in 1997, legislative and economic framework was created for the establishment of a new retirement savings system and a gradual refusal of the old solidarity system.

The transfer from one system to another has been carried out gradually and according to preliminary estimates, this transfer will be completed by 2038 or 2040.

According to current data, 12 pension funds operate in Kazakhstan at present; the number of participants in private person schemes has exceeded 8,1 million people whilst the total assets of pension funds comprise 17 billion USD.[31]

Apart from being a necessity, the implementation of the pension reform will create favorable conditions for the development of a number of beneficial tendencies for the country's economy.

First, in the sector of ensuring pensions, the basis for the public private partnership will be created. The state will have a possibility to gradually diversify risks with the help of private sector and to decrease an increasing pressure of the social security system on the sector of public finances.

Enactment of private schemes and transfer onto the retirement savings model, as a rule, is primarily facilitated by creating tax incentives. During a short period (2004) Georgia also set a precedent of tax incentives for facilitating non-public retirement savings (when an employer could enter a contribution of an employee to a private pension fund as an expenditure in its books), but the new Tax Code abolished this benefit. Nevertheless, this several-month-long operation of this norm proved sufficient to boost interest towards pension schemes.

Naturally, at the initial stage, the establishment of mechanisms facilitating private pension schemes will decrease those revenues which are collected under the existing tax regime. However, in the long term perspective, this will encourage the operation of pension schemes and the emergence of institutional

31 http://www.afk.kz/index.php/en/pension-sector?start=22

investors of a new type – private pension funds which will ensure an additional economic activity and, consequently, payment of taxes.

It should be noted however that in those countries, where pension reforms were implemented, this undertaking enjoyed a substantial support, including financial support, from international financial organization[32] (see the table below).

World Bank's financial support provided to various countries during the implementation of pension reforms

Country	Amount (mln GEL)
Brazil	1 326
Mexico	604
Argentina	481
Peru	363
Kazakhstan	324
Russia	288
Turkey	198
Uruguay	149
Ukraine	147

Source: World Bank

Such assistance is necessary for an institutional support of reforming system. This implies, for example, the establishment of the system for registering individual accounts; at the same time, it is necessary to take into account some decrease in tax revenues too caused by considering a certain proportion of pension contributions in the existing tax structure (at the same time, if reform determines obligations of employers, this will increase a tax burden on the business sector).

We deem it worthwhile to consider those features of the Chilean pension model, which ensure the compensation of contributions that were paid to budget in the pre-reform period in a certain form (for example, in the form of vouchers) as well as the intensification of the practice of life and disability insurance.

Both the former and latter practice is acceptable in Georgia. On the one hand, the introduction of such type of vouchers will be a possibility of creating new securities which will benefit the country's securities market and will introduce a new instrument there (Chile's "pension" voucher generates 4% annual benefit which exceeds the cost of government bonds of many countries).

The increase in the demand for life and disability insurance will help decrease risks, on the one hand, whilst on the other, generate and establish this type of products of the insurance market.

Yet another characteristic of the Chilean model lies in those innovations which were introduced to it following the 2008 legislative amendments. Firstly, we mean the requirement of the amendment to extend pension schemes to self-employed people in the following years.

32 http://www.worldbank.org/ieg/pensions/documents/pensions_evaluation.pdf

One of main factors cited as something impeding the pension reform in Georgia is the low number of employees hired under formal contracts and a very high share of self-employed in total labor force[33] (see the table below).

Economically active population of Georgia (2012)

Workforce	Number (thousand)
Total	2 029
Employed	1 724
Hired	662
Self-employed	1 054
Unidentified	7.4
Unemployed	305

Source: Geostat

The number of self-employed comprises more than half of economically active population. Consequently, involving them into a pension scheme will be a significant step forward.

No less important factor is the creation of a possibility to mobilize new financial resources via pension funds and invest them. As the world experience shows, this facilitates the intensification of economic activity and ensures higher retirement savings than it is possible in the case of operating the state pension scheme.

It is noteworthy that Georgia has the lowest position by the savings indication – only 1% of the country's population has corresponding asset.[34]

At the same time, the government also acknowledges the necessity of increasing savings. The pre-election program of the Georgian Dream emphasized the need of establishing the retirement savings system.

Savings (including increase in retirement savings) traditionally create new financial resources for economic development and decrease dependence on financial resources from abroad.

At the same time, underdeveloped capital markets are one of main impeding factors today for the introduction of retirement savings system; in case of the reform, saving will start immediately but investing pension savings is quite problematic if relevant instruments are not developed in the country – in certain cases this may even cause outflow of investment resources form the country. In this regard, it is necessary to determine and clearly define the role of asset management companies in the system.

For a successful implementation of the pension reform, it is necessary to consider peculiarities of Georgia's economy and demography. For example, as it is well know, remittances to family members by the Georgian

33 http://geostat.ge/?action=page&p_id=145&lang=geo
34 http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2012/04/19/000158349_20120419083611/Rendered/PDF/WPS6025.pdf

diaspora have a serious financial and social connotation in our reality. Consequently, a thorough study of the issue of a possible involvement of diaspora in this system may prove very interesting.

Moreover, various international financial institutions and separate national governments have a rather high level of qualification and expertise in regards with the implementation of pension reform. This provides a possibility to thoroughly study endemic risks, find a model which maximally fits with the specifics of the country and exclude all reform-related risks during the implementation of the reform in Georgia.

CONCLUSIONS AND RECOMMENDATIONS

Dynamic of the country's public finances, the change in demographic picture of the country's population, the situation with employment and expected changes in endogenous or exogenous factors put the necessity of the reformation of current pension scheme on the agenda.

Attempts to modify the current model do not meet the challenges which are apparent and make the existing retirement system increasingly inadequate to the realities of life.

The operating pension system is, in essence, an instrument of social assistance which mitigates the situation of only vulnerable pensioners but fails to satisfy basic living requirements.
Consequently, a whole set of steps must be taken to turn a pension system into an effective mechanism, to involve private initiative and to avoid it being left as a responsibility of inflexible state machinery alone.

To achieve these changes it is necessary to consider and implement the following recommendations:

- Taking political and legislative decisions for the enactment of the second pillar of the pension system (mandatory retirement savings);
- Formulating transparent and understandable rules of game for establishing and operating pension funds and asset management companies in the country and strictly supervising their activities and minimizing expected risks;
- Identifying problems expected in the transitional period as well as measures for minimizing risks;
- Identifying sources of financing the cost of transitional period;
- Determining possibilities of retiring, using savings and managing and moving individual accounts;
- Setting and legalizing a minimum state pension and the guarantees for the use thereof;
- Revising a minimal retirement age towards a possible increase or equalizing the difference by sexes;
- Determining possibilities of early retirement in a strict and substantiated way;
- Forming a complex pension system for citizens with various incomes;
- Identifying directions for investing pension assets whilst taking into account the fact that the securities market is at the rudimentary level of its development in Georgia;
- Enacting the practice of ensuring pension contributions;
- Studying possibilities of involving Georgian diaspora in a new system.

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