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How the Pension System Responds to Pandemic Shocks: A Case Study of Georgia

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Abstract

The paper focuses on the impact of the pandemic crisis on pension system in Georgia and analyzes the pros and cons of the ongoing pension reforms in the country. Decreased birth rates and increased life expectancy over the next decades will significantly change the picture of the age distribution of the population in many countries. As life expectancy increases and the birth rate decreases, more people retire than are added to the workforce. A change in the demographic picture necessitates fundamental pension reform. At the same time, the world is facing a crisis caused by the COVID-19 pandemic. The future is uncertain, both medically and financially. Despite optimistic forecasts, the second wave of the COVID-19 pandemic has begun in many countries which further increases the degree of uncertainty. Funded pension schemes suffer from the crisis because lower returns diminish their asset values, while low yields on public debt instruments increase the present value of their liabilities. This can generate both explicit fiscal risks—in the case of government guarantees—and implicit fiscal risks through lower private pension benefits or financial strain on the sponsoring employers. Our research is focused on the pension system and its development problems in Georgia, taking into account that since 2019, 1st January, the existing financial, demographic and economic challenges have determined the establishment of a new pension system. Main sources for the research are data gathered from the international organizations and local governmental and statistical data softwares. Our research results show that the pension reform

launched in 2019 in Georgia is a significant step forward in reducing social imbalances and fiscal pressures in the medium / long term. However, for further development, it is important to systematically assess the effectiveness of pension policies, taking into account factors such as changes in demographic structure, expected fiscal spending, the inequality gap and the crisis caused by the COVID-19 pandemic.

Keywords: Pension Reform, Georgia, COVID-19, Pandemic Crisis

Introduction

Very few events have had such an instant and dramatic impact on the world economy and financial fragility as the coronavirus crisis. Following the medical steps, governments are spending billions of dollars now to revive the economy and get it back on track. In the first quarter of 2020, the stimulus packages released in many countries exceeded the percentage ratio of anti-crisis packages to GDP by 10 times or more during the 2008-09 financial crisis. Still, the problems are too many.

For example, according to the rating agency Moody's, the loss of the US public pension system for fiscal year 2020 will be more than 1 trillion USD. Based on the data of Moneyfacts UK Personal Pension Trends Treasury in the UK in the first quarter of 2020, the volume of pension funds decreased by 15.2%, which is the largest rate of decline. However, such a reduction did not occur even during the 2008 crisis. In many countries, it is also a danger that early retirement payments are allowed.

According to the International Monetary Fund forecast, given the current situation, the share of state pensions in the GDP of both developed and emerging economies will increase by 1-2.5% by 2050. Without adjusting taxes and other expenses, this increase will lead to a reduction in public savings. Young people will have to save a lot more in order to have the same pension provision as retirees have today. Increasing private savings for retirement age and ensuring long-term fiscal stability requires a complex and well-planned pension plan. In the case of all other variables being equal, private savings are more likely to increase in countries that have mixed models of the pension system that include beneficiary contributions as well. At the same time, there is a need for financial and labor market reform, which must be carried out in a complex way together with the reform of the pension system.

The economic downturn brought about by the coronavirus pandemic is leading to declining labor demand which, despite governments' efforts to preserve jobs, is translating into not only lower employment rates but also lower activity rates. In particular, older workers—who are more vulnerable to the coronavirus, have reasonably large pension entitlements, and often have a lower likelihood of re-entering employment—may seek to permanently exit

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the labor force and retire. In addition to a potentially higher inflow of pension beneficiaries, governments are introducing tax easements which reduce pension scheme contribution revenues. These developments impact both the sustainability and the adequacy of public pension expenditures, which may reinforce general fiscal pressures arising from the crisis (IMF, 2020).

While the pension systems of the world's developed economies face so many challenges, it is natural, that no easy way awaits Georgia, especially at the initial stage of complex reform. After the literature review and research methodology sections, we will discuss a Georgian pension system in details. At the end of the paper, we will draw some conclusion and recommendation based on the empirical research.

Literature Review

It is necessary to understand the economic channels through which COVID-19 pandemic shocks act in various areas. There are three main channels for transmitting shocks (Carlsson-Szlezak *et al.*, 2020; Carlsson-Szlezak *et al.*, 2020b): (1) A radical reduction in the consumption of goods and services; (2) Indirect impact through financial markets and their impact on the real economy; (3) Delivery. Since COVID-19 causes many delays, this translates into a negative impact on the supply chain, on demand for employment, which in the long term is followed by a steady rise in unemployment. The employment market is directly related to the sustainability of pension schemes. In addition, modern economy is a complex connection of employees, companies, suppliers, consumers, and financial intermediaries. As a result of this, the effects of the virus will be even deeper and more severe, and 50% of the working-age population will find it difficult to keep a job or find a new job (Gourinchas, 2020).

Economic and financial crisis has a very big impact on pension systems. The last financial crisis has affected European pensions in both the short and long term. Members of funded pension systems nearing retirement experienced a sharp contraction in pension wealth as equity markets fell. Market turmoil has damaged public trust in such schemes and has caused employers to revise their pension obligations. Countries running funded schemes based on a share of mandatory contributions are faced with rising transition costs as unemployment rises and tax bases shrink (Casey, 2012). Some authors discussed the positive effects of diversification for pension systems during and after the financial crisis. The differences in the rates of return in different stock exchanges, in both the short and the long term, are significant. Thus, this supports the implementation of geographic diversification (Chybalski, 2011). The experience shows us that regardless of whether a country relies more heavily on an unfunded pay-as-you-go state pension system or funded private pensions (whether defined benefit or defined

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contribution), the crisis has an adverse effect everywhere (Eich, 2009). The crisis of 2008/09 has impacted both funded and unfunded pensions. Unfunded pensions have been affected in pretty much the same order of magnitude as funded schemes. The percentage loss varies a great deal across member states and averages around 5 to 15 percent across the EU27. The symmetric reaction to a financial and economic crisis strengthens the view that mixed multi-pillar systems of funded and unfunded elements are risk-minimizing (Börsch-Supan, 2010).

Research Methodology

During the research process, empirical research method was used. The empirical evidences are gathered using research, data analysis, and international organizations' reports and literature review methods. Stages of the research include:

1. ***Formulation of the Problem***

Any economic-financial crisis, in particular, raises the issue of pension funds planning, that are unstable to financial and economic shocks. The crisis caused by COVID-19 is no exception. Our research is focused on the pension system and its development problems in Georgia, taking into account that since 2019, 1st January, the existing financial, demographic, and economic challenges have determined the establishment of a new pension system in Georgia.

2. ***Gathering of Primary Data***

Main sources for the research are data gathered from the international organizations and local governmental and statistical data softwares: World bank, International Monetary Fund, International Labor Organization, National Bank of Georgia, Pension Agency of Georgia, Ministry of Finance of Georgia, Ministry of Economy and Sustainable Development of Georgia, and National Statistical Office of Georgia. We also used reports from financial institutions and different kind of articles on the web.

3. **Conducting Data Analysis and Framing the Results**

Data analysis is done empirically and quantitatively. After gathering the primary data mentioned in setion 2, we found out how the crisis impact pension systems in general and what condition does Georgian pension sysem has during the reform and COVID 19 panedmic crisis. The current crisis influences pension schemes through a number of channels, we identified these channels and based on the analysis of statistical data collected during the research, we determined the approximate course of development of pension systems in the short and medium term.

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4. **Making Conclusions**

The last step for our research is making conclusions and suggestions due to pension system reform and its conditions for the near future in Georgia.

Ongoing Pension Reform and its Callanges in Georgia

Unlike developed countries, where the three-pillar pension system was widely used for a long time, pension reform in developing countries began in the 1980s and continues to this day. It should be noted that the main wave of pension reform in Eastern European countries took place in 1998-2006. Georgia joined their ranks in 2019. At this stage, the reform of the capital market and the pension system is in an active phase in the country. In the wake of this process, the country will have to deal with the crisis in the coming years.

The pension system based on the principle of generational solidarity in Georgia until 2019 could not provide pensioners with an adequate pension. The pre-reform replacement rate in the country was 19.1%, which was significantly lower than in other countries. The average replacement rate is around 40% in the region, 63% in the countries of Economic Cooperation and Development Organization (OECD), and 78% in the EU. The amount of the replacement rate 19.1% means that the income of a middle-income citizen of Georgia after retirement is reduced by 5 times. Therefore, this means that the low replacement rate is a significant source of public injustice. At the same time, as in many countries, the number of pensioners in Georgia is growing steadily, which will put even greater pressure on the pension system in the future (see Figure 1 and Figure 2). According to the UN Population Demographic Survey, the Old-age dependency ratio in Georgia will reach 24% in 2020. Hence, this may reach 53% by 2100, considering the average birth rate. The latter means that for every 100 people between the ages of 15-64, there will be 53 people of retirement age (>=65) (i.e., for every 3 citizens, there will be 1 retiree).

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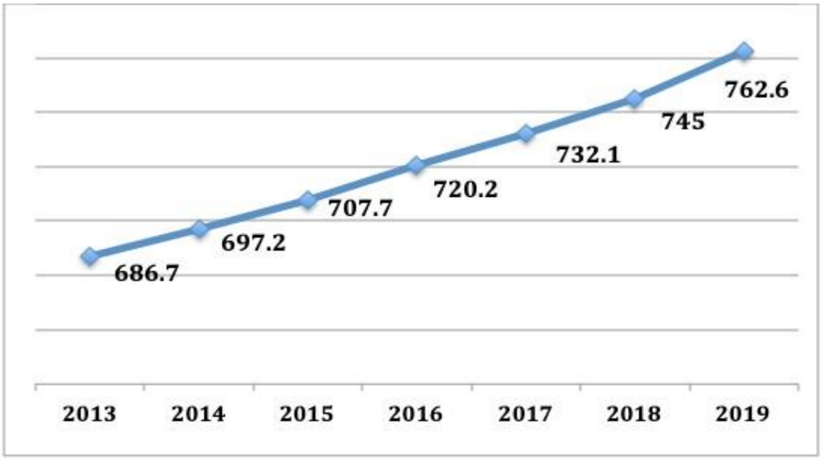
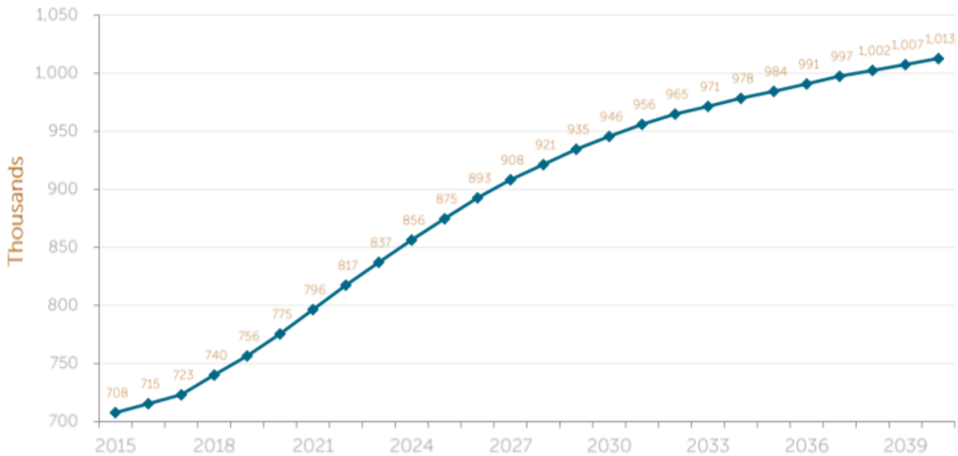
Figure 1. *Retiree in Georgia (retired age), thousand*



Source: National Statistics Office of Georgia

This trend is likely to continue. In 2015, the number of old-age pension recipients was 707.709. As shown in Figure 2, it is estimated to increase by 34% in the next 15 years and will reach 950,000 by 2030, meaning that the elderly will make up over a quarter of the total population.

Figure 2. *Growth Dynamic for Social Pension Recipients for Georgia (2015-2060).*



Source: Ministry of Economy and Sustainable Development of Georgia

Under such conditions, the existence of a social pension system alone cannot ensure an effective response to demographic change and an adequate level of retirement income. Thus, the accumulative pension system was launched in Georgia on January 1, 2019. Involvement in pension reform has become mandatory for all employees under 60 (in the case of women up to 55). The reform is voluntary for all self-employed persons and those

 ISSN: 1857-7881 (Print) e - ISSN 1857-7431

employees who have completed 60 years before the entry into force of the law (55 years for women). Also, 3 months after the implementation of the reform, employed citizens who were 40 years old before the law came into force could leave the system voluntarily. The employee, the employer, and the state make a contribution of 2 percent of the tax-free amount of each employee's salary to the individual pension account of the scheme participant. As for the self-employed, their contributions makes up 4% of their own income, to which is added a 2 percent contribution of taxable income by the state.

One of the main questions for the population regarding the new system is whether their pension contributions will be protected, whether the assets will be invested in unreliable financial instruments, and whether the participants of the scheme will be insured against loss. This question is very crucial now, especially because financial markets volatility is very high as a result of the COVID-19 pandemic. Financial markets are very fragile and investment risks are high. The Georgian Pension Fund clarifies that in order to reduce risk, investments will be made in a diversified manner, only in reliable financial instruments. What this means, however, was unclear even almost a year and a half after the reform took place. Moreover, at the initial stage of the implementation of the pension reform in Georgia, the Pension Fund did not only have an accurately written investment document through which the funds would be disposed of, this issue remained open for a year. As of December 31, 2019, the Agency had no investment activities. The Georgian Pension Agency made its first investment in February 2020 and only presented investment policy document on 28th of September 2020. In February 2020, the Pension Agency transferred 560 million GEL to the certificates of deposit of commercial banks. The pension agency said in a statement that they have chosen the certificate of deposit because it has higher yields than other financial instruments - an average of 14.9%. Due to Investment Policy Document, the pension assets must not be invested in medium and high-risk portfolios until 6th of August 2023.

Besides investment risks, the accumulative pension system carries risks, which are even more important during a crisis.

Consequently, we cannot deny that the pension scheme based on the principle of accumulation cannot provide a decent pension for everyone as only a small part of the working age population is employed. This factor is very important for Georgia as well. Over the years, the main challenge of the employment structure in our country has been the high share of the self-employed in total employment. In 2018, for the first time, there was a case when, according to official data, the number of employees exceeded the number of self-employed and its share in total employment was 50.8%, while the share of the self-employed was 49.2%. However, according to the data of the 4th quarter of 2019, the ratio between the self-employed and the employed

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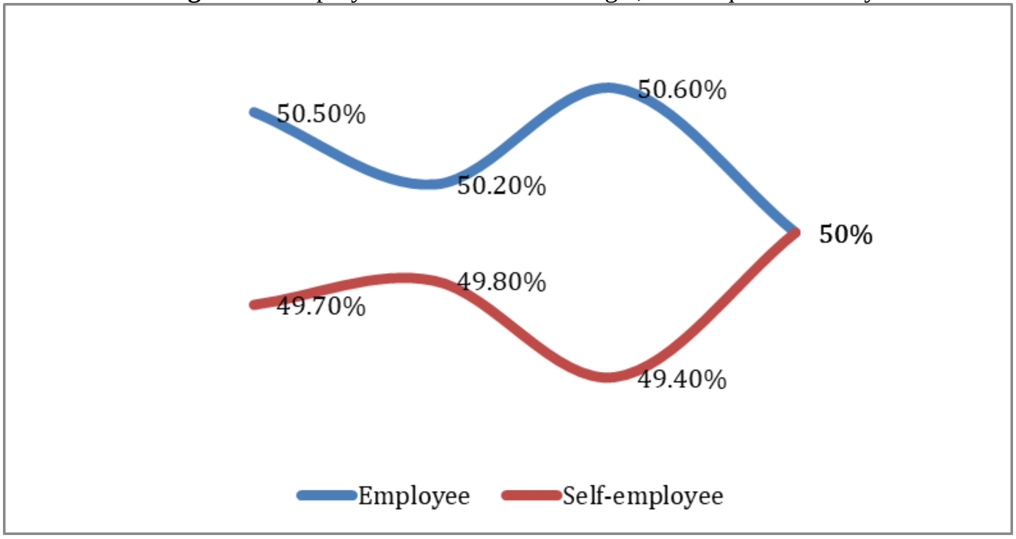
was 50% -50%. It turns out that the mandatory funded pension system will apply to only a small part of the working age population.

Figure 3. Employment structure in Georgia, I – IV quarter 2019 year



Source: Ministry of Economy and Sustainable Development of Georgian

At the same time, the accumulative pension system poses a threat to further increase social inequality among the population. In the future, the state will contribute more to the employed and high-income citizens than to the unemployed and low-income population. Consequently, under other equal conditions, social inequality will increase among the population of retirement age. This factor is exacerbated by trends caused by the coronavirus in the global employment market. According to the International Labor Organization (ILO), in the second quarter of 2020, the global economy lost 6.7% of working hours (i.e., 195 million, full-time, workforce). This is a much higher rate than jobs being lost during the 2008-09 financial crisis. 38% of the global workforce is employed in enterprises, hotels, the tourism sector, trade and transport, and services that are experiencing a sharp drop in demand and revenue today and are on the verge of bankruptcy. According to the forecast of specialists from the same organization, the most affected will be low-skilled employees, whose service mainly involves physical work. It is relatively safe for highly educated workers, who are paid higher compared people who have to work physically - this will exacerbate the problem of global inequality. Even if the recovery of the economy proceeds at a faster pace than expected, it would not be easy to get back on track and the current crisis will cause big shifts in the employment market. This will in turn affect the sustainability of the pension systems around the world.

The level of uncertainty due to pension systems, in general, is further increased by the risks posed by the pandemic in the global economy. Due to

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IMF report, the current crisis caused by COVID-19 influences pension schemes through a number of channels. The main ones are: (1) increased likelihood of individuals exiting the labor market and claiming pension benefits; (2) labor market effects, as contracting employment and stagnating or declining real wages, may result in a declining wage tax base; (3) asset price shocks negatively impacting funded pension schemes' balance sheets; and (4) capacity of governments and private enterprises, as underwriters of pension obligations, to maintain solvency of defined benefit pension scheme under adverse conditions.

Georgia is no exception. The unemployment rate in the country increased from 11.6% in 2019 to 11.9% in the first quarter of 2020 and to 12.3% in the second quarter of 2020. At the same time, as in many countries around the world, there is a threat in Georgia due to the demand for early retirement deposits. Unlike other countries, which have long had accumulative pension schemes, this could be tantamount to a catastrophe for Georgia's pension system at an early stage of reform.

Past experience has shown that the impact of economic crises on forms of retirement is determined by declining retirement income. This can force a potential retiree to stay in the job for a while, balances the deteriorating employment market, and the latter often pushes people to retire. This is especially when they can afford it (incentive to exit the labor market as an alternative to unemployment). The whole process depends on the structure of the pension system - how easy it is to retire before retirement age, what are the employment prospects, and how many different transfers are available that can help retirees cope with the crisis. What influences a person's decision to retire depends on the effectiveness of government policies in various areas - both within the pension scheme and in the employment market.

In many countries, policy responses to the current crisis have reduced current contribution revenues through permitting deferred payment or temporary reductions of social security contributions. Contributions have also been reduced through temporary lowering of contribution rates or the pension base (China, Finland, Malaysia, Norway, Russia, Sweden). This trend causes additional risks. In the case of Georgia, there is no direct risk in these areas, as pension schemes and savings are not directly affected by the government's anti-crisis plan. However, as mentioned above, the unemployment rate is rising, which is also an important factor for the sustainability of the pension system.

Conclusion and Recommendations

The research is mainly built on the situation caused by the current pandemic crisis in the world economy and pension reform in Georgia. Countries' economies deftly maneuvered through the first stage of the

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coronavirus pandemic, thanks in part to an aid packages that sought to prevent insolvencies, mass layoffs, and a rise in poverty. Just as many other countries, Georgia, thought its economy was out of the woods. However, a second wave of infections is now on its way (in the case of Georgia, it is much greater than the first one). That is why it is impossible to predict the economic future and do a full analysis in any sphere now, and pension systems are no exception. The future is still unclear. We do not know how difficult the second wave will be, how long it can last, and how more bail-out sources governments may need. Therefore, the study may need to be revised in the coming months, presumably due to altered statistics.

The success and effectiveness of a pension reform is determined by a combination of many factors. However, certain criteria play a particularly large role in its evaluation. As we can see, the risks are many, but it is also a fact that the pension system based on the principle of generational solidarity puts a heavy burden on the economy and does not provide a decent old age for retirees. Considering the demographic trends, the situation is deteriorating from year to year. The need for pension reform is unquestionable, but at the same time, risks must be properly assessed and appropriate steps should be taken by the state. This primarily involves the development and implementation of relevant investment policy for pension savings, promoting the development of the financial market, and encouraging the employment market in order to increase the number of hired employees so that more people can join the accumulative pension scheme. It can be said that the pension reform launched in 2019 is a significant step forward in reducing social imbalances and fiscal pressures in the medium / long term. However, for further development, it is important to systematically assess the effectiveness of pension policies, taking into account factors such as changes in demographic structure, expected fiscal spending, and the inequality gap.

No matter how we define the pension system, its goals or functions, there is no doubt that the main purpose of the system is to provide a retiree with an adequate income at retirement age. One of the key macro-functional aspects of the pension system is the distribution of GDP between the working-age generation and the rest of the population, including pensioners. This must be taken into account when assessing the adequacy of the pension system and efficiency of the reform. Assessing the adequacy of the pension system also requires indicators for measuring income, poverty and income inequality, and measurement in the gender context of poverty. Responses to temporary shocks, therefore, need to be limited in time to avoid inadvertently setting the pension system on a course—in terms of sustainability, adequacy and efficiency— which does not reflect policymakers' objectives, expectations of society, or the constraints faced by the country. It is equally important to directly address specific economic problems where they arise, instead of

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relying on the pension system. Due to International Monetary Fund, it is equally important that reforms introduced in the past or currently under implementation (as in Georgia) are fully implemented since the COVID-19 pandemic-induced recession will most likely further worsen the sustainability of public pension systems, making reforms even more important than the crisis.

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