

REFORMATION OF THE PENSION SCHEME IN ALBANIA

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Abstract

One of the main issues addressed while designing the social insurance system and the old age pension programs is how to make the system and programs produce incentives relating the savings and income redistribution as well as to function on the insurance principle (1). The saving consists in smoothing consumption over life time, postponement of consumption from early life time, period of active work and higher earnings to the old age period, when incomes are lower and due to old age it is impossible to generate earnings. Redistribution consists in transferring life time incomes from a person to another in retirement age in order to avoid poverty. A person with low incomes during the life time could save sufficiently for the old age period but this probably could lead to poverty during the working period. The redistribution avoids this phenomenon and create a beter financial situation for all in old age period. Functioning upon the insurance principle entails payment of social insurance contributions during the economic activity period in order to be entitled to a future pension in respect of old age when no earnings can be generated.

Keywords: Reformation, Pension Scheme, Financing

The schemes proposed for reformation of the Albanian pension system The Pay As You Go (PAYG) schemes

The pension schemes funded upon the PAYG principle are generally public and related to incomes (income related schemes) and financed by transferring current contributions to current pension programs, i.e. no capitalized contributions are created (Barr, 2000). The above principles apply and are enshrined in such schemes. These schemes are also referred to

as defined benefit schemes, as every contributor is projected to get back a certain monthly amount after reaching the retirement age, calculated upon a formula that takes into account all the wages or incomes from work, the insurance period and age and is not directly related to the individual contribution investment return.

The public social insurance systems operating upon the PAYG financing principle involve the three abovementioned principles. By paying social insurance contributions upon the individual wage or work related earnings throughout the entire work career everyone saves. Such savings account established from the social insurance contributions paid during the life time will be a source of incomes (a pension) during the whole retirement period. It also secures postponement of consumption from the active and working age to the old age that is accompanied by reduced or lost working capacity and consequently lack of earnings.

Income redistribution among the individuals of a generation and also between generations is one of the fundamental features of the PAYG systems. This redistribution is conducted through the pension calculating method by applying an acceptable replacement rate for all the participants of the scheme, either with lower or with higher wages.

If you take into account the individual life expectancy to the average life expectancy (by gender and unisex), then is better understood the income redistribution among participants of the scheme. The lifespan of each individual depends on many factors and it is different for everyone. The savings in the form of contributions for the persons with shorter retirement lifespan are transferred or redistributed to those whose lifespan is longer than the average lifespan, which is taken into account while designing the scheme and determining the pension calculating method.

The PAYG schemes provide benefits only for those participants who have paid social insurance contributions. The scheme provides solely benefits in cash, not in kind. These schemes do not provide any benefit for other vulnerable categories that have not paid social insurance contributions. In addition, pension amount is calculated upon the contributions paid, which eventually represent the years of insurance as well as the contribution amounts paid.

The solidarity scheme with individual notional accounts (Notional Defined Contributions NDC)

The NDC schemes are financed upon the PAYG principle, but the benefit calculation method is different from the typical public schemes dealt with on the above lines. The NDC schemes are designed to imitate the defined contribution schemes or plans, under which the pension amount depends on paid contributions and their investment return. These are called

notional defined contributions schemes, because unlike the typical schemes defined contribution, accounts are not real, but imaginary (notional). In the typical schemes defined contributions, the individual contribution accounts are real, and at the retirement age, such accounts contain the real premiums paid plus the investment return by the financial market over years.

Under the NDC schemes, accounts are imaginary; there are regular records of paid contributions and at the time of retirement, current accounts contain the total of the paid contributions adding the return over years, but not any real investment return as a product of the investment to the financial markets, but according to a notional investment rate set by the government. Such schemes are public and the pension calculation formula differs from that of the traditional schemes. While under the traditional earnings related schemes, pension amount depends on the insurance period, contributive wages and age, under the NDC scheme, the pension amount depends on the age, accumulations made to the individual notional accounts and the life expectancy predicted under the mortality tables on the national level.

When a person reaches the retirement age, the amount of contributions accumulated and the notional investment calculated are translated into a monthly amount, taking into account the national life expectancy.

As well, these schemes reflect the three principles mentioned at the beginning of the article, but at different amounts compared to the typical schemes.

Given that these schemes are financed from the contributions paid upon employees' monthly payroll, it is obvious that in this way the principle of saving and smoothing or postponing consumption from the young to the old age is applied.

These schemes redistribute incomes within the same generation as well, but redistribution level is lower compared to the typical schemes, due to the fact that the pension amount is directly related to accumulation in the individual accounts. Redistribution process occurs, because the life expectancy used to calculate the monthly pension amount is the average, which is not necessarily equal to the life expectancy of each individual. As in the individual accounts there is no real but imaginary cash and in terms of these schemes, there are no lump sums, the "excessive" cash for an individual with the lifespan shorter than the average one goes to finance the pensions of the other participants of the scheme, and generally of those with a longer lifespan compared to the national average.

Similarly to the typical schemes, participation through payment of contributions is an obligation for entitlement to benefits under the NDC schemes as well.

The second compulsory pillar

The second pillar represents a compulsory public pension scheme, which differently from the PAYG pension plans, are financed from the individual contribution accounts. Contributions paid during the whole working career are accumulated in real individual accounts and invested to the financial instruments provided by the financial market. Generally, these contributions are managed by the pension plans or investment funds. Investing can be accomplished by the public funds or private investment funds and investment costs are deducted from the total assets. These schemes realize at their best the principle of saving and particularly they individualize the saving through accumulation to personal accounts. Such savings make a good tool to avoid the poverty among the elderly and smooth the consumption during the life time. The income redistribution level in such schemes is nearly zero due to the fact that all the money in the individual accounts is used to finance individual pensions; thus, that money is not used to finance the other pensions. The savings established from this scheme make up a very good instrument to finance economy and strengthen the financial market, but this advantage disappears in the countries where the financial market is a little or not at all developed, for instance Albania. Otherwise, such schemes are called Fully Funded Pension Schemes, since pensions are fully funded from individual contribution accounts. The amount of money accumulated on monthly or yearly basis to the individual accounts is invested at the market rates, and in the long run they increase the amount, thus offering a satisfactory replacement rate at retirement age. But, on the other hand, they carry the risk of financial market fluctuations and such risk is present. In the financial crisis periods, the situation of these accounts varies and could lead to its reduction as happened in the 2008 crisis, when the pension funds lost up to 30-40% of their value in a very short time. Pensions are calculated upon the account balance at the retirement time (paid principal and return from investment) and national average life expectancy at retirement age. In addition, such schemes give contributors the opportunity to be part of the decision making regarding investment policies and instruments by letting them choose the investment portfolio and the monthly pension amount. This scheme settles the deficit issue encountered in the PAYG schemes (they do not need any subsidy as the pension depends on the individual contributions). They also address the long-term financing issues directly related to the demographic pressure, such as the lower fertility rates and higher life expectancy.

Among the main disadvantages of the scheme is the lack of coverage or the low pensions for certain categories with very low incomes from work and unemployment periods during the work history. Generally, these

schemes are integrated into the PAYG schemes and thus creating the multi-pillar pension system.

The need to reform the pension scheme

Due to the demographic and economic transformations, the labor market changes during the past 20 years as well as after the long-term studies on the system, it became imperative to reform the social insurance system. This imperative is mostly related to the high deficit of the scheme (the total expenditure is significantly higher than incomes from the collected contributions), the lack of incentives to declare employment and real wages due to the limited pension amount or the ceiling set, the discrimination (positive and negative) for different categories of contributors, the difficulty encountered by the public to understand the very complicated pension calculating method, the aging population as a result of higher life expectancy, lower birth rates and higher emigration, etc.

The big question asked is: What kind of reform should be undertaken? Is it to be a parametric reform or a systemic one? Should we maintain the current system and just change the parameters or should we shift to another system, such as the NDC or the multi-pillar system?

Before giving an answer to this question, let's analyze the environment in which the Albanian social insurance system is operating and the challenges it is facing.

By the end of World War II (September 1945), the population of Albania was 1,122,044 inhabitants according to the Statistical Yearbook of the Republic of Albania, publication of 1960, divided into 238,812 people living in the cities or 21.3% and 883,232 people living in the countryside or 78.7%. All the residents of the country were not covered by any social insurance element. Most of the population lived in the countryside, in a closed economy, where everything produced was consumed there. The trade and industry were very slightly developed. As a result of the policy of that time as well as because of the trend in all the European countries, immediately after the Second World War, fertility rates sharply rose and this period is called the "baby boom" period. Even in the coming years, through certain policies, the Albanian government stimulated births, and thus from 1,122,044 inhabitants in 1945, population reached 3,255,900 inhabitants in 90's. The number of inhabitants living in the cities in 1990 was 1,176,000 or 36.1% of the population and 2,079,900 people lived in the countryside or 63.9% of the population, (Albanian Statistical Yearbook, 1991 edition). The earliest social insurance system in Albania dates in 1947 and had the next major development in 1966, when it began covering also the rural population, which mostly consisted of the agricultural cooperatives' members. Alongside with the increase of the number of population due to the

increasing fertility, urbanization was expanding as well, i.e. the rural population started to move towards urban areas, in spite of the fact that up to the '90ies, movement of the population was controlled by the state and not a free movement. With the economic development of the country, employment increased regularly. The urban population was mostly working in the state-owned enterprises, while the rural population in the agricultural cooperatives, especially after the year 1965. All the employed population was covered and protected for some particular risks under the state social insurance schemes. Depending on the type of employment (government job or in the agriculture cooperatives), two social insurance schemes were set up, an urban one and another for the farming population. The main difference between these two schemes was the benefit amount. The urban insurance scheme provided higher benefits than the rural scheme. This differentiation was linked with the earnings. Wages or earnings from the agricultural cooperative work were significantly lower than wages received from the work in the state sector. Albania was a country developing a planned economy, and not a free market economy. Therefore, it did not apply payment of social insurance contributions on an individual basis, calculated upon the relevant wage of everyone, but every enterprise and agricultural cooperative transferred their own amounts to the social insurance as part of their costs. The amount paid as social insurance contribution was different every year, depending on the expenditures incurred to pay pensions. The surplus created after payments of pensions and contribution paid by the state enterprises and agricultural cooperatives were transferred to the state budget. With such a payment method, it was impossible to identify individual contributions paid on behalf of everyone, but it guaranteed that every employment period under that system was and still is considered insurance period. The benefits provided by the social insurance schemes of that time were typical "defined benefits". The pension calculation formula was so simple. Pension was calculated to be 70% of the average wage in the last three working years. The scheme was funded according to the Pay As You Go principle, and consequently no contributions and investment returns were accumulated. Since the scheme was relatively new, the number of beneficiaries was low and the number of contributors was high. This situation existed also thanks to the very young average age of the population and involvement in employment of all the active labor force. The number of pensioners in 1990 was 319,107, of which, 208,416 received urban pensions, while 112,566 received rural pensions. The number of contributors was 1,451,212, of which, 846,212 were contributors working in the state enterprises and organizations and 605,000 were contributors working in the agricultural cooperatives.

The dependency rate at that time was 4.54:1 or 4.54 contributors for 1 pensioner, which is a very good dependency rate, not existing at all today in any European country.

If the social insurance contribution was individually paid on the basis of the wage earned under and the favorable situation of the dependency rate, then the total sum collected in the fund would be much higher than the sum spent on pensions. This would create the opportunity to establish and extend a reserve fund to be used in the future, when the demographic pressure would intensify. Albania lost such golden opportunity, because in the coming years it had to encounter the lack of revenues to finance the pension scheme, which issue is still aching and having an impact even nowadays.

The political changes that occurred in the early 90s, when Albania shifted from a communist system with a planned economy to a democratic system with a free-market economy, had a huge impact on the social insurance system of the country. The economic collapse and the massive bankruptcy of the state-owned enterprises as well as the dissolution of the agricultural cooperatives brought about a drastic decline in the number of the employed people, and thus a decrease in the number of the contributors, which was automatically translated into a drastic drop of incomes and incapacity to finance pensions. Although the number of pensioners was low compared to the number of contributors, the system was found in great difficulties regarding payment of benefits. This was happening at a time when the reserve (buffer) fund supposed to cope with such situations and events was not established yet. In 1992, the number of pensioners mounted to 416,910 or 97,803 more pensioners compared to the year 1990. In 1993, the number of pensioners reached 461,235; there were 44,325 more pensioners than in 1992 or 142,128 more pensioners than in 1990. On the other hand, the number of contributors fell drastically, reaching 460,467 in 1994. So, the system was hit in the two directions. The number of pensioners increased and other side, it experienced a drastic drop in the number of contributors, which led to a higher deficit.

Under the circumstances of a burdened social insurance system, a reform was undertaken. This reform, which produced a new law that came into force on 1 October 1993, generally addressed the current issues and was intended to solve the majority of them. As a result of the changes occurring, during implementation of this law in the course of the past 20 years, the above-mentioned issues and problems have been identified.

To come up with a response to the question which model was the best for the new reform, all the related factors were analyzed.

Generally speaking, all the pension systems in the civilized world have been built on the PAYG principle, which basically implies payment of

contributions during the work career, entitlement to a pension at the retirement age, solidarity between generations and income redistribution.

All the European countries, except Kosovo (for reasons already known) have established their public pension systems upon this principle. Why exactly did Bismarck decide to apply such a principle? Due to the fact that the pension represents some income entitled when you get unable to work as a result of aging. It should be financed from the revenues generated during the life time in the form of savings. Apart from that, this is a scheme of solidarity and redistribution, because the life risks and the life expectancy are different for different individuals and it is necessary to avoid the risk of leaving without any income the people with longer life time or those who have faced some fatality and been invalidated at a young age.

The core of this principle is that contributions paid in a given period of time go to cover payment of benefits during the same period, in order to avoid the burden on the state budget in the very first years of the scheme. Certainly, in the very first years of the scheme, the dependency rate (ratio between the number of contributors and the number of beneficiaries) is quite high, since the number of beneficiaries is quite low.

Incomes from contributions are high and finance the pensions, thus creating a substantial financial reserve. Such an good financial situation continues in the mid-term run until contributors meet all the eligibility conditions for a pension. This is the situation created after World War II, when most of the countries either resumed their previous pension systems or established new pension schemes. As a result of the lost lives from the war hardships, the number of beneficiaries was low and the number of contributors was high, reaching its peak around the 70ies and 80ies when the labor market involved the post-war baby boomers. This was the golden period, when the contributor beneficiary ratio exceeded the limits of 4 people contributing to 1 beneficiary. The same situation was in Albania, when this indicator reached the level 4.5:1. But the situation changed when the post-war baby boomers got older and retired. The number of contributors also decreased as a result of the declining fertility, labor market problems (lack of jobs), delayed entrance into the labor market due to longer education and training period, technological development, etc. The above-mentioned factors impact the balance of the social insurance finances. The social insurance expenditure increase, whereas incomes from contributions decrease (more pensioners means more expenditure; less contributors means less incomes).

Nowadays, even in the countries with a sustainable social insurance system, the contributor beneficiary ratio is 2:1. The same phenomenon occurred in Albania, but at faster rates, bringing the dependency rate to the critical level 1.4:1. Besides the above-mentioned factors, such a weak

dependency rate has been a consequence of the very high emigration levels among the active labor force.

The questions are: Under these circumstances, what is the solution? With the mentioned negative impact of different factors, how is it possible that the Western countries still have and maintain sustainable systems providing decent benefits?

Here are the reasons and arguments explaining this situation:

1. The European countries have a developed labor market. Their economy continuously generates new workplaces.

2. Public finances are quite strong and the cash injected into the social insurance system is not a very high burden.

3. Hosting emigration from other countries is positive, because it increases the number of contributors.

4. Their vision in respect of diversification of the risks and protection schemes at the time the schemes have been financially consolidated, which surely is fruitful and effective today. By undertaking proper reforming measures for their systems, they have increased the individual savings for the elderly people.

5. Establishment of the reserve funds (buffer funds) in the years when incomes have been higher than expenditures; they have not allowed the use of the social insurance funds for other destinations other than social insurance.

6. Benefits have not been entitled upon the incomes from contributions collected, but upon the social insurance period and by living standards.

Sweden, for example, has created a reserve fund from the surplus of the previous years, which can cover payment of pensions for 5 years (supposedly, no contributions are collected), which is invested according to the rules set and now used to maintain the financial balance and pension levels. Greece could not do it. It distributed very generous benefits in their good financial times and practically led the scheme towards bankruptcy. The same mistake was made by Albania in the years when the number of contributors was very high and the number of pensioners was low. It did not create a social insurance reserve fund, but used incomes for other investment projects, often unproductive, leaving the pension system in difficulties, with liabilities unaffordable by the current contributions. At present, although Albania is ranked on the top of the European countries list as regards the average age of the population (it has the youngest population after Kosovo), the pension system is suffering from the lack of participants in the scheme and a higher number of pensioners. This is because of the lack of jobs, low urbanization, high informality rates in the labor market, high emigration rate

among the younger population, as well as massive early retirement. Today, in Albania the solidarity, which gives impulse to the pension schemes, is weakened. On one side, in most of the cases it is the young population that has emigrated or emigrates and they normally contribute to the schemes of the hosting countries. On the other side, their retired parents continue to live in Albania and receive their pensions, which are financed from contributions of employed and self-employed people living in Albania. Practically, the employed people are contributing to the pensions of both their parents and emigrants' parents, which means a higher burden for them (such burden includes both higher contributions and higher general taxes). The public pension scheme is also subsidized from the state budget. Referring to the demographic prognosis, situation remains bleak, since population is expected to shrink, number of births is declining and the cohort of population over 65 years of age compared to the overall number of population will increase. This prognosis shows that our children will have to maintain a heavy burden on their shoulders, i.e. financing our pensions in two directions, either by paying higher compulsory contributions or by paying back the debts received to finance the deficit.

Which could be the solutions

1. Financing current pensions from general taxation and saving contributions to pension funds to finance the pensions of the future pensioners.

The 2015 social insurance budget was projected to be over 106 billion ALL. Incomes from contributions are planned to reach about 62.5 billion ALL. Expenditures for the pension scheme are planned 87 billion ALL, whereas incomes from contributions to cover only pensions are assessed to reach 55 billion ALL, which means that the deficit produced is 22 billion ALL. This budget is equal to 22.3% of the state budget for 2015, projected to be 475 billion ALL. The state budget is projected to transfer and subsidize social insurance by 43 billion ALL. If it was decided to finance pensions from general taxation, the government would have to allocate 63 billion ALL, or 13% of the state budget, for payment of current pension or to increase revenues through increased taxes or increased public debt. Would the Albanians accept further taxes increase? I do not think so. Would it be reasonable for the Albanian economy to nearly double the current budget deficit from 60.5 to 103.5 billion ALL? This is not only unacceptable, but it is modest to say it is dangerous. This is not the only financial difficulty, but it is also the pension funding duration. If it were only for one year or five similar years, it could be a sacrifice worth doing in order to solve such a sharp problem. But financing would at least be extended for a 50 to 55 year period until the death of the today's last contributor, because every

contribution paid today is a liability in the form of the future pension. This period is so long that an individual who is paying contributions for the first time this year would roughly complete 35-40 years until retirement and enjoy the pension for about 17 years on average. If this alternative was posed to the Albanians, they would not accept such a great and intolerable sacrifice.

2. Continuation of the existing scheme and its financing from contributions and state budget, but in parallel with establishment of the second compulsory pillars with capitalized contributions.

By this approach, the existing scheme and the same financing method would be maintained. But of course, a second pillar or a compulsory saving account will be established. Contributors will be part of two mandatory schemes by paying contributions and the pension will be composed by two parts, one to be received from the existing PAYG scheme and another one from the second pillar. The pension amount from the first PAYG pillar will be calculated according to the same principles as in the existing scheme, with changed formula parameters and the pension amount from the second pillar would depend on the amount of money accumulated as paid contributions and the return obtained from contributions investment. Contributions investment instruments will be determined by taking into account also the risk level and investment return rate. This two pillar scheme would guarantee an adequate protection for the population, would better maintain the living standard at the third age by not drastically reducing consumption, especially for people with higher incomes, would increase savings level and apply a moderate and accepted income redistribution.

Financing method of the second pillars is realized

a. The existing contributions are divided between the two pillars, the current public PAYG scheme and the second compulsory pillar with capitalized contributions.

The percentage of contributions to be capitalized may vary, but for a positive effect or to secure a replacement rate of about 20%, it should be at least 5% of the gross social insurance contributory wage. The 5% reduction of the contribution rate of the existing public scheme would reduce incomes by 11 billion ALL (55 billion for 24.5% and 5% = 55/5) and increase the state budget subsidy the same amount. If so, the state subsidy will be higher than direct incomes from contributions, which again is unaffordable by the Albanians, because either the taxes or the public debt would increase or there would be no investments in the economy. If we take into account that in the coming years, the number of pensioners will increase, the expenditures and subsidy will become intolerable as well.

b. A 5% increase of the current contributions rate financing the public scheme and financing the second pillar by the same rate. This is a solution,

but it would bring about reduction of the net wage, which even with such rate is still low and insufficient. Mentioning the fact that 50% of employed persons declare that are paid with minimum wages (22,000 ALL per month), to understand the effect produced. The increased labor tax would diminish competitiveness of the country versus the other countries of the region in terms of foreign investment, in the event that this increase would be shared by both employers and employed persons.

Under the current financial and economic situation of the country, establishment of the second pillar, although theoretically more acceptable, is very difficult to be implemented. Besides the above mentioned points, the absence of the domestic financial market is another disadvantage for the creation of the second pillar.

Notional Defined Contribution

Notional accounts are designed as imitation of the defined contribution schemes described above under the second pillar, where pension amount depends on the contribution and its investment. Contributions are recorded on individual accounts (files) throughout the career, but they are virtual accounts and not real accounts in terms of money. These schemes are financed upon the PAYG principle, similarly to the typical public PAYG schemes, which means that current contributions go to fund pensions of the same period. In these terms, accounts are virtual and do not contain any cash, but only figures that indicate liabilities of the scheme to be translated into future benefits. Investment of these virtual funds is done upon an investment rate determined by the government and not decided by the market. As all the traditional social insurance schemes, they are public schemes.

However, the pension calculation formula differs from that of the traditional schemes due to the fact that the pension is calculated as the product of accumulation and investment of contributions in the individual accounts at the retirement time. Even in these schemes, pension amount depends on the contributions accumulated into accounts and life expectancy at retirement age. Unlike the fully funded schemes, the impact of the governments is quite significant, because they determine the investment return rate administratively and not according to the real market.

Even in these schemes you can identify income redistribution between different generations and within the same generation. This scheme represents a mixture of the typical PAYG scheme in terms of financing and the fully funded defined contributions scheme in terms of pension calculation method. Among the main advantages of this scheme are: fairness, transparency and increased financial sustainability of the pension scheme (Edward Palmer).

Reformation of the existing scheme by changing the parameters of the scheme (parametric reform)

Under this option, is maintained the same scheme, to be funded according to the same PAYG principle, but parameters are changed, such as pension calculation method; changes of the eligibility criteria, changes of the contribution rates or social insurance contributory wages, etc. The parameters changed in pension calculation could be: calculating method, the wage upon which pensions are calculated, moving from the last wage or of the last years to the average wage of all work career, past wages actualization indexes, removal of the ceiling and floor for the pension amount or setting new ceilings, change in the pension the specific weight of the part that "is guaranteed" and the part that depends on wages etc.

The eligibility criteria that can change are: increase of retirement age, increase of insurance period for qualification, establishment of criteria for participation in recent years, tightening criteria for early retirement to discourage early retirement, incentives to postpone retirement and continue with employment after the retirement age etc. In the field of contributions, it can be changed: contribution rates increase or decrease it, the minimum contributory wage and the maximum wage harmonizing it with the pension formula, so that pension amount is fairly linked to paid contributions and people are incited to make real declarations and participation. The change of these parameters will lead to improved financial sustainability of the scheme in the long term and on the other side will provide more adequate and reasonable benefits. Thus, distortion is avoided and all participants are equally and adequately treated.

The pension scheme in Albania suffers from a high deficit, which according to the long-term forecasts will be a very heavy burden for the budget and economic growth. It has lack of incentives for participation due to the weak link between the paid contributions and the pensions provided, tending to turn the scheme from an insurance scheme into a social scheme with flat benefits, very high income redistribution level, etc. The reform to be undertaken should address all the above-mentioned issues.

Lets analyze all the options provided above in order to solve the problems the scheme has been currently facing.

Multi – pillar system

Establishment of a multi-pillar system would create a direct link of the pension and the paid and accumulated contributions, thus making the scheme more fair and transparent. It would increase the savings of the population, secure domestic financing for the economy, affect development of the financial market and alleviate the pressure of demographic factors on the pension scheme. But the transition costs described above will be too high

and unaffordable by the public finances in Albania. Besides the high burden this option would impose on the short term state budget, it would shift such burden to the other generations, as it takes time to put an end to the transition costs. It will probably be up to 50 years. Also, the increased labor tax (contribution rate) would have an impact on the living standards of the population by reduction of the net wage of employees, would be an obstacle in terms of the competitiveness of the Albanian economy to attract foreign investments. It would also increase informality in the economy and discourage them to participate in the scheme.

Transformation of the current scheme from a traditional PAYG scheme into a NDC PAYG scheme

Transformation of the pension scheme to a NDC would secure a direct link of the pension amount to the contributions paid throughout the entire work career, secure fairness in pensions, create incentives to declare the real wages and consequently an increase in the number of contributors and revenues as well. To implement this scheme, first there should be created the individual virtual accounts for each contributor. Currently, in Albania there are no individual accounts. It will take a relatively long period to create them. Taking into account the fact that this year the men to retire were born in 1950 and the women in 1955 as well as the age they started working under the socialist system, it results that we should create personal accounts for all persons starting from 1964 up to date. This factor is not in favor of transition to the NDC. To the virtual accounts there will be added all the contributions paid on monthly basis and this contributions or accumulated money will be notionally invested over years until the retirement age is reached. But during the time span of 35-45 years the individuals to retire have worked, contribution rates have been changing and reduced to about 72% (from 42.5 to 24.5%) producing differences in the balance of individual virtual accounts for the persons who have done the same work and equally paid.

Also, the maximum wage has changed, from 3 to 5 times minimum wage, creating differences in the amounts accumulated in individual accounts and therefore resulting with different pension amounts.

Considering the facts that most work history for the cohort who retires this year and in the coming three or four years is under the communist regime, with low reference wages, that the majority of citizens after the nineties have paid contributions on minimum wages and that they have uncovered period, it results that pensions will be lower. The smaller pension amounts compared to those of the earlier pensioners would create social injustice and conflicts. Even the balance of NDC scheme in the long term results with deficit throughout the 70 year prognosis.

Parametric reform of the current scheme.

Under this option the parameters changed are as follows:

1. Increase retirement age to compensate the increase of life expectancy. Increase of retirement age will be gradual in order to avoid problems at the age cohorts close to retirement as well as to give time to contributors for decision making with regard to employment. Retirement age will increase for both genders in order to have the same retirement age 67 to be reached from the gradual increase by the year 2056. The increase will be 2 months a year for women since the very first year and 1 month for men starting from 2033.

2. The gradual increase of insurance period from 35 to 40 years. This increase will be gradual with 4 months each year reaching 40 years after 15 years from the start of implementation. This increase of insurance period will be an impetus for the continuation of employment and simultaneously will affect the increase of revenues and old age pension amounts.

3. Maintain the same pension calculation formula, but change its parameters. Keep the formula composed of two parts, a "guaranteed" basic amount for all, based on years of insurance and the second part, connected directly with the periods of insurance and contributive wages.

$P = A + 1\% * I_y * W$ (p = pension, A = guaranteed basic amount, I_y = insurance years, W = average wage), but changing the parameters of the two parts reducing the "guaranteed" basic amount and paying more attention to the part that depends on the contributions paid. These changes help to better link the pension amount to paid contributions and also secure the differentiation among pensions.

4. Removal of the administrative ceilings as regards the maximum and minimum pensions, leaving the pension amount to be a product of years of insurance and contributions paid.

5. The wage upon which the second part of the pension will be calculated as actualized average wage of all work career ensuring fairness in calculation and avoidance of distortion while calculating the last wages which do not indicate the real contributory history.

6. Change of actualization indexes of the past wages aiming to increase them and bring closer to reality, delivering higher pensions, to compensate reduction of the basic amount and pension differentiation based on contributions.

7. Raising the minimum wage in order to achieve a better protection of citizens at retirement age. Raising the minimum wage will increase pension amount and guarantee a better protection level.

8. Elimination of the requirement that the maximum wage should be 5 times the minimum wage. The maximum wage will be the same with the actual one and will be subject to annual indexation by wage index.

Removing the ceiling avoids its unjustified increase as a result of the minimum wage policies ensuring the standard of living.

9. Provision of penalties for earlier retirement in order to discourage earlier retirement as much as possible.

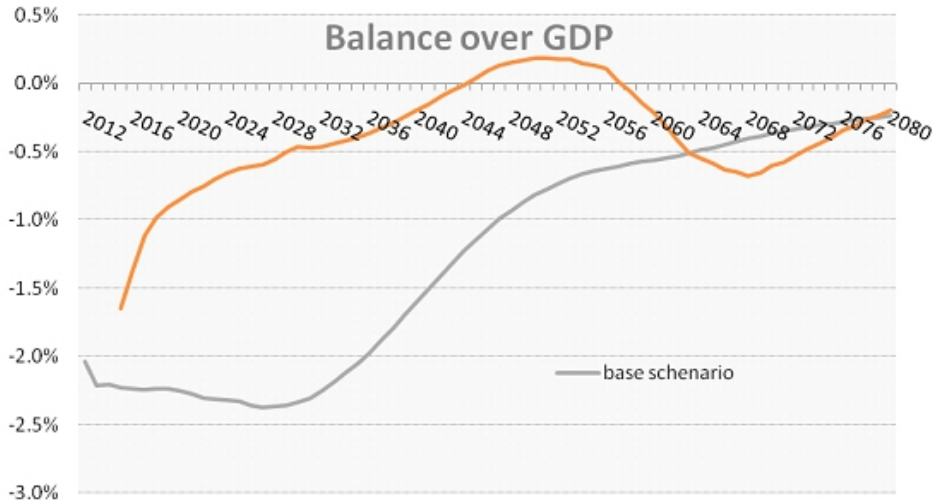
10. Increase pension amount for people who postpone retirement age and continue employment and contributing.

11. Pension indexation following only the price increase index and eliminate the political influence of the government for electoral interests.

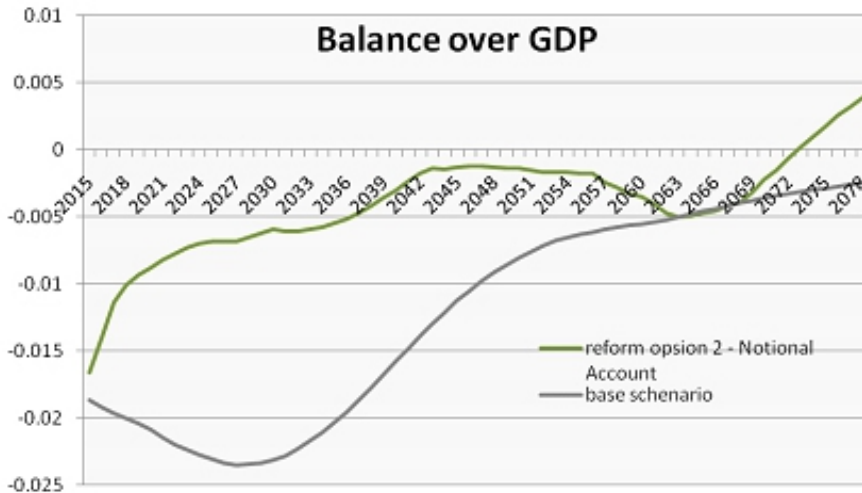
These changes of the parameters will better address the problems of the existing scheme, as they improve the financial sustainability of the scheme in the long term, provide better pensions for the people who contribute for longer periods and on real wages, secure a direct link of pension amount to contributions paid, avoid deviation relating the pension amounts for certain categories, do not create significant differences with the existing pensions by harmonizing them, create incentives for participation and disclosure of real wages, makes contributors part of the decision making process on pension amounts, makes the scheme understandable and transparent, formalize the labor market etc.

The balance of the scheme in the long term in two options

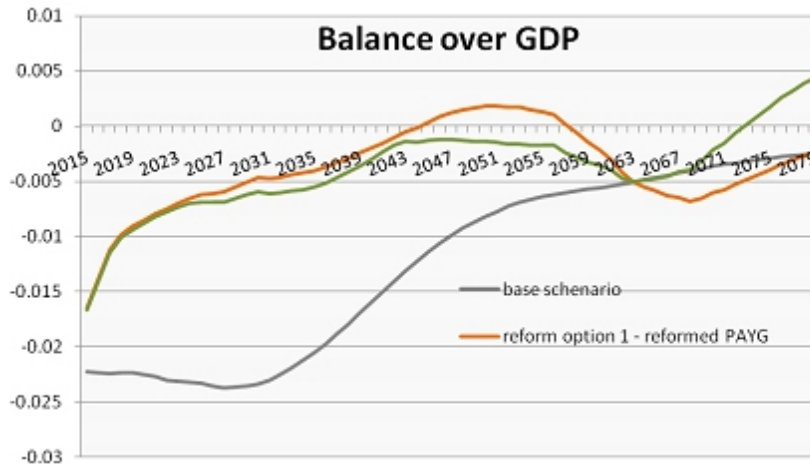
PAYG scheme with reformed parameters



NDC



The two options:



Conclusion

Based on the above arguments and graphs on the long term balance, the best option or approach on the pension reform in Albania, is the parametric reformation of the current scheme. This option address better the problems the scheme is facing, has better balance in long terms, link the pension with the contributions paid and the future contribution, increase fairness of the pensions, increase transparency, increase participation and formalization of the labour market and economy.

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