

**Albania**

**Pension Policy Note:**

**Key Challenges and Directions for Reform**

June 2013



**Human Development Sector Unit**

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## **I. Background and Motivation**

**The Albanian pension system, established in 1947, provides old age, disability, and survivor coverage to contributors.** Almost all elderly are covered under the pension program mainly due to almost full participation of workers in the pension system during the socialist era. The number of workers making contributions to the pension system is currently low meaning that the coverage of the elderly under the pension program will decline in the future.

**Overall spending on pensions in Albania is relatively lower than the Europe and Central Asian (ECA) average but increasing.** In 2010, Albania spent 6.2% of GDP on pensions, much lower than the European Union (EU) countries or than the average for ECA. One of the main reasons for this relatively low spending is that Albania is still younger than most of the other ECA countries and thus has fewer individuals to support through pensions. Pension spending remains low despite the fact that the pension program has to finance several generations of elderly, most of whom have full pension rights. The Albanian pension system avoided a fiscal crisis (despite the low share of workers participating in the pension system) until recently by compressing benefits; consequently, the average pension in the urban sector amounts to 1.1 times the minimum pension, indicating a weak link between contributions and benefits, and creating disincentives to fully participate or to declare full earnings. In the rural sector, the disincentives to contribute are even more perverse with those earning minimum pensions receiving additional allowances which raise their total incomes higher than that for higher earning pensioners. In the past years, the government introduced sizable increases in pension benefits, particularly for the lower pensions, leading to an increase in overall pension spending. Relative to average wage, minimum pensions are higher in Albania than in most other countries which makes it difficult to differentiate benefits by earning or contribution level without sending costs even higher. Spending on pension programs increased by 0.7% of GDP during 2005-2010, from 5.5% of GDP in 2005 to 6.2 % of GDP in 2010.

**The absence of a comprehensive approach to pension reform and sizable ad-hoc increases in pension benefits led to a significant increase in the fiscal deficit.** The pension system which was in balance in 2005 ran a fiscal deficit in the order of 1% of GDP in 2010. The total fiscal burden of the pension system on the Government budget is double that amount when government contributions paid for rural contributors are included. During 2005-2010, total Government transfers to the pension system (including Government contributions for rural pensions) increased from 1.1% of GDP to almost 2% of GDP. Along with the possible impact of the slowdown in economic growth, the following major factors contributed to the increased deficit: (i) the fast reduction in pension contribution rates from 29.9 % to 21.6% in 2009; and (ii) sizable increases in pensions well above the inflation rate particularly for the rural sector. The fiscal pressure is expected to grow further due to the expected aging of the Albanian population.

**The Government recognizes the increasing challenges in the current pension system and requested technical assistance from the World Bank in providing recommendations in addressing these challenges.** A Social Insurance Review was conducted in 2006 jointly by the

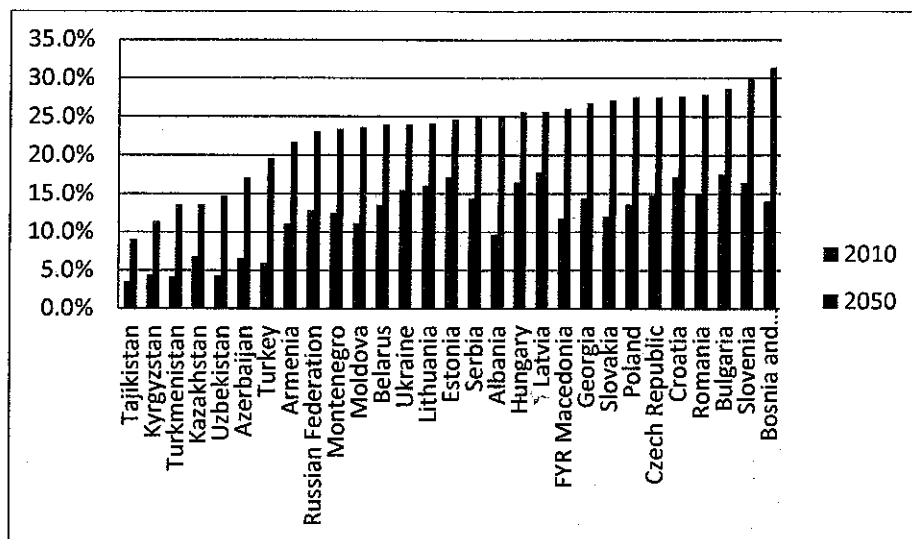
World Bank and the Government with the objective to look at the main issues in the pension system and provide broad options for reform. Following the review, the Government chose to focus mainly on improving pension administration and postponed a comprehensive reform to the pension system. The current and increasing cost of the pension system to the Government's fiscal balance prompted the Government to put pension system reform back on the agenda. While the 2006 review is useful as a starting point, some of the available options for pension reform have changed since the time of that earlier review, given the changes in the overall economic indicators as well as pension parameters (e.g. reduction in contribution rates, sizable increases in pensions particularly in rural pensions) in Albania since 2006.

**Against this backdrop, this note evaluates the existing pension system in Albania and presents options for reform.** The note is structured as follows: In Section 2, we discuss the demographic characteristics of the pension system. In Section 3, we give an overview of the structure of the pension system and its current parameters. In Section 4, we provide the projections of the current pension system and describe policy reform options. In Section 5, we present our conclusions with recommendations.

## **II. Demographics and Coverage**

**Currently, Albania has a moderately young population, but one with a rapidly growing share of elderly.** In 2010, the share of those 65 and older in the total population of Albania was 9.7 percent, well below the average for the ECA region of 12.1 percent (Figure 1).<sup>1</sup> However, by 2050, Albania is expected to have 25% of its population aged 65 and older, which puts it well over the 2050 ECA average of 23.1%. While some of the currently older countries in ECA now have smaller cohorts entering the labor force today and therefore will have smaller cohorts entering retirement in 2050, Albania which has relatively large cohorts entering the labor force today will see these larger cohorts retiring by 2050, causing a significant increase in the number of elderly.

**Figure 1: Share of Elderly (65+) in the Population in ECA Countries**



Source: UN Population Projections

**The Albanian pension system is supporting a large number of pensioners.** Table 1 shows that Albania currently has more pensioners than contributors. It also has 12 percent more pensioners over the age of 65 than population over the age of 65.<sup>1</sup> The pension system dependency ratio, which compares the total number of beneficiaries in the pension system, which affects the expenditures, to the total number of contributors, which affects the revenues, is at 103 beneficiaries per 100 contributors. This is quite high despite the relatively young population of Albania, which would suggest there should be far fewer beneficiaries, as few as 15 per 100 contributors compared to the actual 103. Looking at the system dependency ratios for urban and rural pensions separately reveals that there are 150 beneficiaries per 100 contributors in the rural scheme, significantly higher than the system dependency ratio in the urban scheme where there are 91 beneficiaries per 100 contributors. The high system dependency ratio is a reflection of lower coverage of contributors as well as the loose eligibility conditions in the rural sector which until recently required fewer years of service for a full pension than in urban areas<sup>2</sup>. In addition, participants are eligible for a partial pension with even fewer years of service.

<sup>1</sup> Some discrepancy between number of pensioners over the age of 65 and the population over 65 can be expected as some people who have legitimately earned pension rights in Albania may currently be residing elsewhere. However, in the past, there were as many as 40 percent more pensioners than elderly population which was partially attributed to lack of timely self-reporting of deaths, which allowed some families to keep collecting benefits long after the elderly person had died. The monthly reporting of deaths from the death registry to the social insurance institute has successfully lowered this ratio since the last report, although the total remains well above 100%.

<sup>2</sup> The required years of service for the rural sector were gradually increased to be equalized with that of the urban sector at 35 years by 2012.

**Table 1: Albania Pension System Data (2010)**

	Urban	Rural	Total
<b>Total Contributors</b>	<b>420,330*</b>	<b>106,054*</b>	<b>526,384</b>
<b>Total Beneficiaries</b>	<b>384,187</b>	<b>158,866</b>	<b>543,053</b>
<i>Old-age</i>	285,875	142,015	427,890
<i>Disability</i>	48,402	6,375	54,777
<i>Survivors</i>	49,910	10,476	60,386
Coverage of Contributors (Contributors/Population Aged 15-64))	18%	4%	22%
Coverage of Pensioners (Old-Age Pensioners/Total Population at Retirement Age and Above)	77%	35%	112%
System Dependency Ratio (Beneficiaries/Contributors)	91%	150%	103%

Source :Albania SII, World Bank pensions database and author's calculations

\*Including those insured by the state budget

\*\*Refers to physical number of contributors (See Box 1)

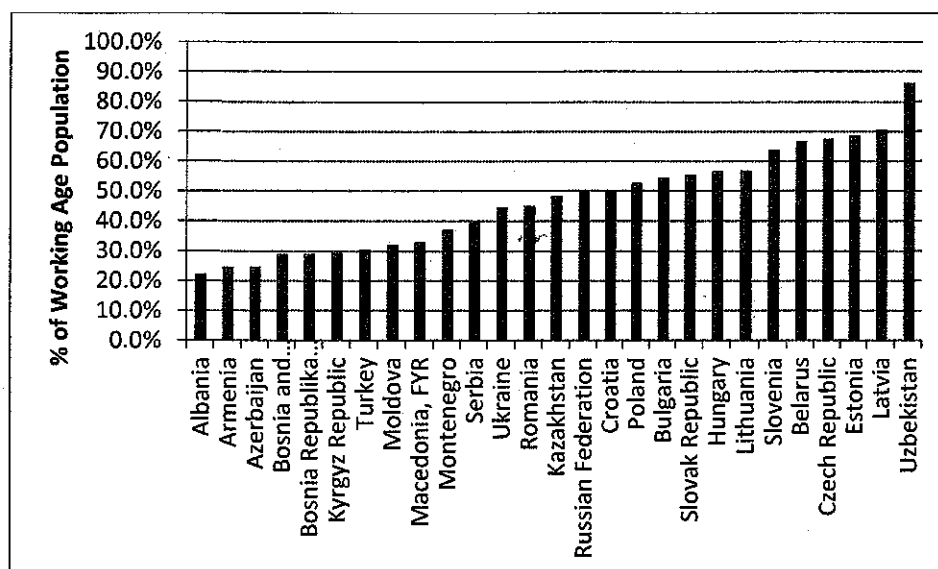
**Box 1: Methodology for Record Keeping of Rural Contributors by SII**

Similar to many other countries, the Albanian Government faces the challenge of collecting contributions from system participants. This is particularly true for rural contributors where incomes are seasonal and contributors live in remote areas. SII has made efforts to improve coverage by sending representatives to locations where farmers reside to register them as contributors. While these efforts have been successful in registering an increasing number of contributors to the rural scheme, collecting contributions from rural participants has been less successful. There are several possible explanations for this including; (i) limited knowledge by participants that they need to pay contributions regularly to be eligible for a pension; (ii) difficulty in paying contributions due to the fact that farmers live in remote areas; and (iii) unaffordability of contributions for some farmers even though they are quite low. As a result, contribution arrears in particular in the rural scheme accumulate and the government issues frequent amnesties to facilitate the payment of contributors (which in turn creates disincentives to pay contributions regularly). As such, some contributors pay contribution arrears plus the contributions due in that specific year. SII uses a methodology where it counts these contributors as more than one individual depending on the amount of arrears they pay in that specific year. As a result, in some years the number of contributors reported by the SII are inflated. The correct way of record keeping would be to count these individuals as one contributor. The reason why these individuals are paying more than they should is because they have not paid what they should have in previous years.

**Participation in formal employment is low and not improving.** The number of contributors as a share of the working age population is currently at 22%, the lowest in the ECA region and has remained in this range during 2006-2010. This is significantly lower than the ECA average of 47% (Figure 2). Since a major part of the contributions (80 percent) of the rural sector are

made by the Government, looking at the coverage rate for the urban sector would provide a more realistic picture of the overall participation in the formal sector in Albania. When the rural sector contributors are excluded, the share of contributors as a share of the total working age population falls to an even lower 18%, putting Albania even further below the ECA average.

**Figure 2: Coverage Rates in ECA (Contributors as % of Working Age Population)**



Source: World Bank Pension Database and Albania SII

### III. Main Parameters and Indicators of the Albanian Pension System

Three main characteristics of the Albanian pension system distinguish it from many of its peers in the ECA region: (i) the compression of benefits with average pensions being very close to minimum pensions; (ii) a high level of minimum pension relative to average wage; and (iii) a large and growing subsidy to the rural sector.

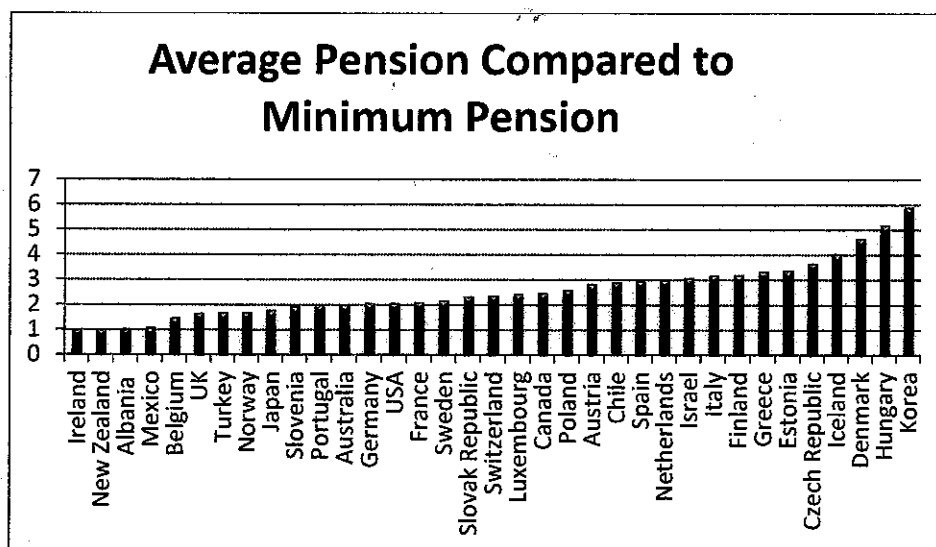
The pension system involves a significant amount of redistribution which reduce incentives to contribute for more years and declare full earnings. Albania has a traditional pay-as-you-go system where contributions from current workers are used to finance the benefits of the current pensioners. The benefit formula provides a basic pension (minimum pension) plus 1 percent of the assessment base<sup>3</sup> for each year of contributions paid (Table 2). While this benefit formula is reasonable, the cap on pensions creates a compressed benefit structure. Pensions cannot exceed twice the basic pension or 75 percent of the net average wage of any 3 successive years in the last 10 years of employment, whichever is less. This suggests that participants who earn above the average wage will reach the limit very quickly. Consequently, the average

<sup>3</sup> Assessment base is the wages on which contributions with past wages revalued by the growth in the average contributory wage.



pension in the urban sector is almost equal to the minimum pension with the income from the average pension amounting to 1.03 times the income from the minimum pension, while the average income on which contributions are paid is more than twice the minimum contributory wage.<sup>4</sup> Figure 3 shows how unusual such a compressed structure is relative to pensions provided in other countries. Only Ireland and New Zealand have similarly compressed structures, but their benefit design provides equal flat benefits to all individuals.<sup>5</sup> While the Albanian pension system does include significant aspects of redistribution towards lower income workers, it also provides a relatively low rate of return for high income individuals, creating weak incentives to participate and/or declare full earnings.

**Figure 3: Average Pension Compared to Minimum Pension in OECD Countries Compared to in Albania**



Source: *OECD Pensions At A Glance 2011 and SII.*

<sup>4</sup> A number of cash allowances are provided to pensioners, in addition to the pension amount. Some of these are only available to lower earning pensioners, raising the amount they receive, relative to higher earning pensioners.

<sup>5</sup> In the Figure 3, Mexico also appears to have low average to minimum pension ratios, but the OECD projections assume that the legislated minimum pension will actually be too low to be socially sustainable and so substitute more generous indexation of minimum pensions as a more realistic assumption for the future.

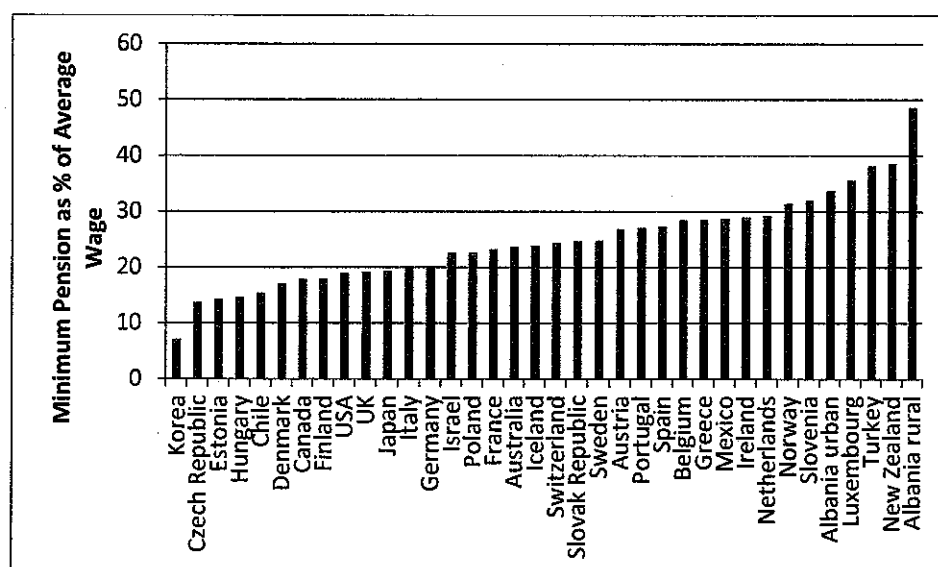
**Table 2: Main Parameters of the Albanian Pension System**

Benefit Type	Minimum Contribution Period Required	Retirement Age	Contribution Rate	Benefit Rate	Indexation
Full Old-age Pension	35 years	65/60 for Men-Women	21.6% for pensions 13.8 % paid by employer and 7.8 % by employee <sup>6</sup>	-Basic pension + 1% per year of lifetime average revalued by growth in average contributions; Subject to stringent maximum pension limits; pension cannot exceed twice the basic amount or 75% of net average wage of any 3 successive years in the last 10 years of employment, whichever is less;  -0.34% per month additional for postponing retirement beyond ~ retirement age;	Inflation Indexation by law but typically ad-hoc in practice
Reduced Old-age Pension	35 years	62/57 for Men/Women	21.6% for pensions 13.8 % paid by employer and 7.8 % by employee	-0.6% reduction per month for early retirement	Inflation Indexation by law but generally ad-hoc in practice
Partial Old-age Pension	Minimum 15 years	65/60 for Men/Women	21.6% for pensions 13.8 % paid by employer and 7.8 % by employee	Prorated based on years of insurance	Inflation Indexation by law but generally ad-hoc in practice
Full Disability Pension	At least 50% of the difference between claimants' age and age 20.	N/A	No specific contribution rate. Total contribution rate for old-age, disability and survivor's pension is 21.6% of wage	-Basic pension + 1% per year of lifetime average revalued by growth in average contributions - Maximum pensions either twice basic amount or 80 percent of last wage	Same as old-age pension
Survivor Pension	N/A	Widow at age 50 or if caring for a child or disabled; widower at age 60 or if caring for a child or disabled; orphan up to age 25 if studying or 18 otherwise or if disabled; parents who lived in deceased's household for at least 1 year and are age 65 or disabled;	No specific contribution rate. Total contribution rate for old-age, disability and survivor's pension is 21.6% of wage	Pension equal to 50% of deceased's pension for widow or widower and 25% for orphans or other eligible dependents, subject to maximum of 100%	Same as old-age pension

<sup>6</sup> Total social insurance contribution rate is 24.5%. In addition to the 21.6% contribution rate, employees pay 0.3 % for sickness, 1.4 % for maternity, and employers pay 0.3 % for work accidents/occupational diseases, and 0.9 % for unemployment insurance.

The level of minimum pension relative to average wage is also quite high relative to other countries. Figure 4 shows that the Albanian minimum urban pension, at 34% of average wage, is among the highest in Europe. Among the OECD countries shown in the graph, only Turkey, Luxembourg, and New Zealand provide higher minimum pensions. Since New Zealand only provides a flat benefit, it is reasonable that this might be relatively higher, but in Albania's case, the high minimum pension is supposed to underpin a higher contributory average pension, which then results in higher pension spending than warranted. And for the rural farmers, the minimum pension is even higher, at 49% of the average contributory wage of these rural farmers, making it among the highest minimum pensions in the world. The high level of minimum pension makes it more difficult to allow differentiation of benefit levels without first lowering the ratio of minimum pension to wage.

**Figure 4:** Minimum Pension Compared to Average Wage In European and High Income Countries Compared to Albania



Source: OECD Pensions at A Glance 2011 and Albania Social Insurance Institution.

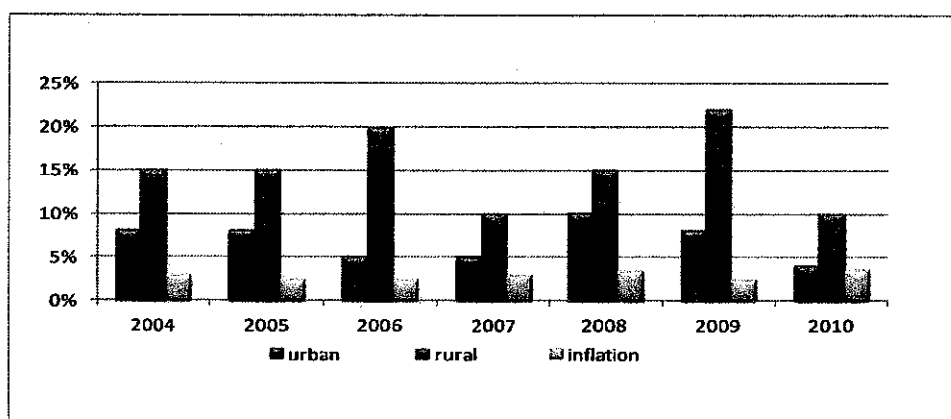
The amount of redistribution is even higher for the rural sector<sup>7</sup>. Most of the parameters of the rural system are identical to those of the urban system except for contributions. For the urban sector contributions are paid on the basis of declared wages. Individuals who are self-employed in agriculture (rural sector) pay a pre-determined flat amount as contribution to the pension system. The Council of Ministers determines two flat amounts, one for individuals engaged in agricultural activity in areas classified as lowland and another for those working in highland. The Social Insurance Institute calculates the full contribution that would have been required based on the minimum urban salary and the Government pays the difference between that and the flat contribution paid by the rural workers to the Social Insurance Institute. The Government

<sup>7</sup>The rural sector as used in this note refers to self-employed in agriculture. Rural sector employees are treated as any other employee and are subject to the rules of the urban sector.

contribution has amounted to around 85 percent of the total in recent years. Since contributions are largely paid by the Government, rural pensions have essentially become a social assistance benefit.<sup>8</sup> The rate of return on contributions by rural pensioners is actually much higher than that of urban pensioners, as their benefits are higher relative to what they pay into the pension system. Benefits received do not necessarily reflect the income level or contributions of individuals since most receive the minimum pension, and this weak link between contributions and benefits makes the average rural pension closer to a social assistance benefit. The Government has plans to increase the contribution rates to equalize with urban contributions by eliminating the Government contribution rate for rural contributors, but the progress on increasing the contribution rate has been slow so far.

**Ad-hoc indexation of pensions leads to uncertainty for pension system participants and for the fiscal outlook of the pension scheme.** Despite the legislated inflation indexation, pensions are currently increased on an ad-hoc basis. Over the past years, the increase in pensions was significantly higher than the inflation rate in particular for rural pensions (Figure 5). Increases in rural pensions were more substantial than for the urban sector with the intention to equalize urban and rural minimum pensions, even though the rural sector pays contributions on a much lower base. This further exacerbates the unequal treatment of urban workers in the pension system. Between 2004 and 2011, the income received by a minimum urban pensioner increased by 68% while the income received by a minimum rural pensioner increased by 163%. The absence of implementation of a transparent pension indexation rule makes the pension system vulnerable to political pressure and leads to uncertainty for the system participants, and for the fiscal outlook of the pension scheme.

**Figure 5:** Increase in Pensions in Albania



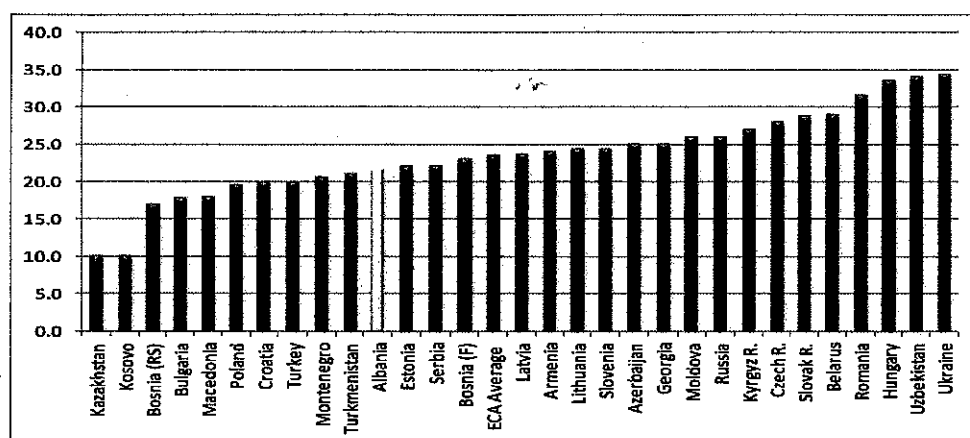
Source: Albania SII

**With regard to other pension system parameters, contribution rates were reduced beginning in 2006, at a faster rate than ideal, but brought the current contribution rates in**

<sup>8</sup> Due to the frequent amnesties for contribution arrears, rural contributors do not even pay the low contributions in a timely fashion because they expect that they can pay even a lower amount when the next amnesty is announced.

**line with the regional average.** The Government reduced contribution rates starting in 2006 in order to provide incentives to participate in the formal market. Pension contribution rates were reduced from 29.9% in 2005 to 21.6 % in 2009 (in two steps, a 6% reduction in 2006 and a further 2.3% reduction in 2009)<sup>9</sup>. This was done without addressing the disincentives to participate inherent in the benefit structure. While the reduction in the contributions rates was faster than ideal, the current pension contribution rate in Albania is currently around the regional average (Figure 6).

**Figure 6: Pension Contribution Rates in ECA as % of Wage**



Source: World Bank Pension Database and Albania SII

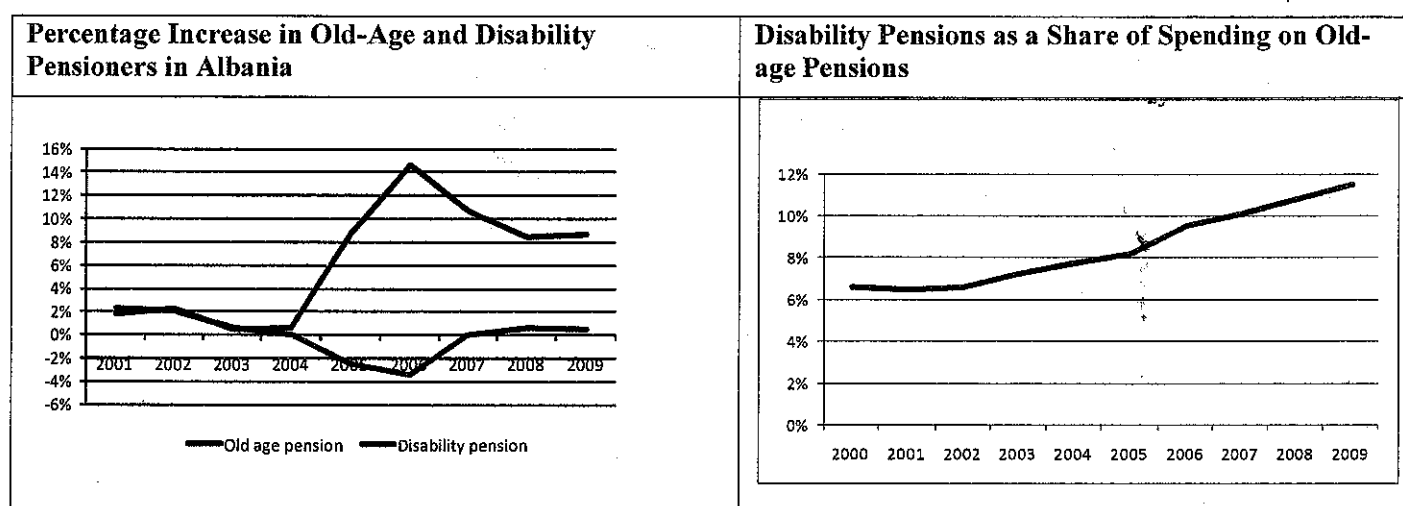
**Relatively low retirement ages also contribute to the fiscal pressure.** Retirement ages in Albania are gradually increasing. Retirement ages gradually increased from 55/60 to 60/65 for women/men during 2002-2012.<sup>10</sup> But retirement ages are still low in particular for women. For men, life expectancy at retirement is 15 years, making it difficult to increase the retirement age beyond the current standard retirement age right away. For women, however, life expectancy in retirement is 24 years. Most OECD countries have equalized retirement ages for men and women, and many have increased retirement ages beyond 65 (Annex 1). For both women and men, life expectancy at retirement is projected to increase as people live longer. In 2025, life expectancy for women and men will increase to 16/25 years at retirement age providing room to further increase retirement ages.

<sup>9</sup> Along with reducing contributions, the Albanian Government introduced several other measures to support this policy including requiring employers to pay contributions based on pre-determined reference wages based on work places. To further enhance this policy, the Government required employers to pay contributions on the basis of a reference number of employees. Following the implementation of these complementary policies for a few years, these policies were eliminated as the experience demonstrated that they did not produce the expected results.

<sup>10</sup> As the Albanian pension system reformed, many early retirement privileges were eliminated, with retirement ages for these occupational groups rising at the same speed as for the rest of the population, with the result that these workers will not face the uniform national retirement ages until somewhat later.

For disability pensions, while spending relative to old-age pensions is not high, this share has recently been increasing. The number of disability beneficiaries which was at 9 % of old-age pensioners in 2006 increased to 13% of old-age beneficiaries in 2010 (Figure 7). There has not been a significant change in the eligibility rules for disability pensions so the explanation for the increase in the recent years could potentially be due to implementation of the criteria. Also, those who are eligible for disability pension are also eligible for a disability assistance benefit which has increased significantly in the recent years. This overlap between disability pensions and the non-contributory disability benefit could provide an incentive to qualify for a disability pension rather than old age, which allows the individual to continue receiving the non-contributory benefit during retirement<sup>11</sup>.

**Figure 7: Disability Pensions Relative to Old-age Pensions**



Source: SII and World Bank Staff Calculations

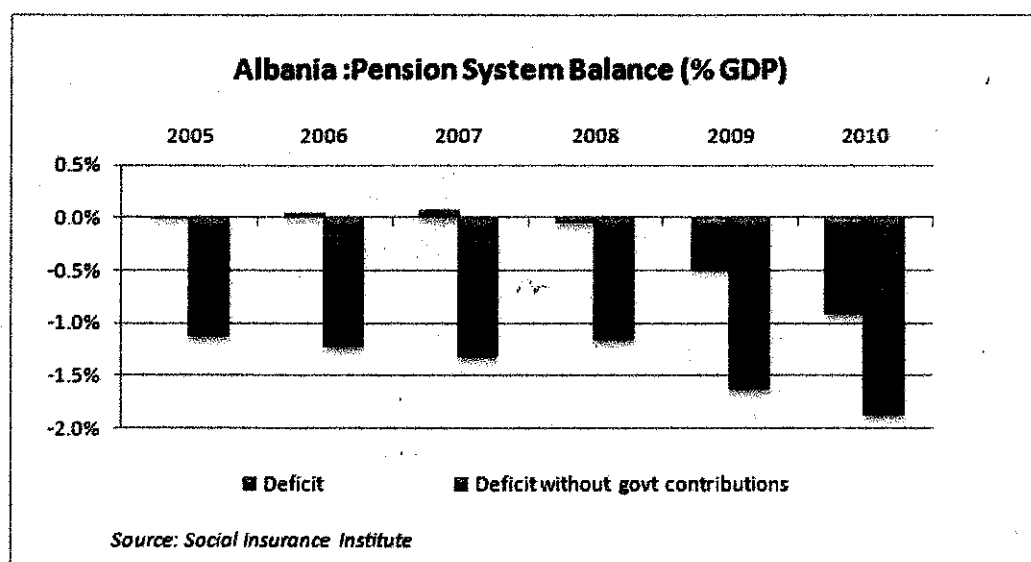
**Policy changes that reduced revenues and increased expenditures led to a fiscal deficit.** The pension system was almost in balance in 2005. The deficit increased significantly during 2005 and 2010 reaching almost 1% of GDP. During the same period, total Government transfers to the pension system (including Government contributions for rural pensions), increased from 1.1% of GDP to almost 2% of GDP (Figure 8). Reducing the revenues (contributions rates) while increasing the pension expenditures (significant ad-hoc increases in pension benefits) led to this fiscal deficit. Although the Albanian Government attempted to compensate for this decline through complementary measures, such measures did not make up for the revenue loss from the reduction in contribution rates<sup>12</sup>. The reduction in contributions did not result in a significant increase in the number of pension system participants as had been expected. At the same time,

<sup>11</sup> There are other benefits of receiving a disability pension such as tax exemption for cars, free transportation and so on.

<sup>12</sup> See footnote 9.

the sizable ad-hoc increases in benefit levels contributed to the rapid increase in fiscal deficit. These ad-hoc increases had a significant impact on the pension system deficit given the high current coverage of the elderly.

**Figure 8: Albania Pension System Fiscal Balance**



Source: Albania SII

#### IV. Projections of the Current Pension System and Reform Options

##### IV.1. Projections of the Current System

The current system, if allowed to continue as it is, will in all cases generate fiscal deficits in the short, medium, and long run. Benefits, if provided as legislated, will be quite low. Providing more generous benefits will require even larger fiscal deficits. And a significant portion of the elderly will not be receiving pensions in the future because their current informal sector work does not give them eligibility to social insurance pensions in the future. The next section describes the evolution of the current system starting with the demographics.

The population of Albania is projected to shrink over the long term but the share of people above retirement age will increase. The current population of Albania is 3.2 million and is expected to slightly increase until 2026 to reach 3.3 million, after which it will start shrinking (Table 3). The population is projected to decline by 29 percent to 2.2 million by 2080 due to low fertility rates and emigration<sup>13</sup>. While the share of working age population will continue to grow until 2025 and then start declining, the share of Albanians above retirement age is expected to

<sup>13</sup> The current fertility rate in Albania is 1.53 births per women. This is lower than the replacement fertility rate (the rate which will maintain the existing population) which is in the range of 2.1-2.3 births per women.

decline until 2013. This initial decline is due to gradually increasing retirement ages. Once this gradual increase is complete and standard retirement ages reach 65/60 for men/women, the share of population above retirement age will start increasing and will reach almost 40 percent of the population if the current retirement ages are kept.

**Table 3: Albania Population Projections**

	2010	2011	2012	2015	2020	2025	2030	2040	2050	2060	2070	2080
Total Population	3,204	3,216	3,228	3,260	3,301	3,318	3,309	3,206	3,023	2,804	2,552	2,286
Share in Population												
Age 0-14	22.7%	22.1%	21.5%	19.8%	18.0%	17.2%	16.3%	14.1%	13.0%	13.0%	12.8%	13.3%
Age 15-Retirement Age	55.1%	66.3%	66.6%	67.4%	66.9%	65.0%	63.5%	62.0%	57.2%	50.9%	48.2%	48.5%
Retirement Age and Above	22.2%	11.7%	11.9%	12.8%	15.1%	17.8%	20.2%	24.0%	29.8%	36.1%	39.0%	38.2%

*Source: PROST Projections based on UN population data*

**In line with the aging of the population, system dependency rates are projected to increase.** For both urban and rural schemes, the system dependency rate (number of beneficiaries per 100 contributors) will slightly decline initially as retirement ages increase. Once the gradual retirement age increase is fully implemented, the system dependency rates will start increasing. In the urban system, there will be 150 beneficiaries per 100 contributors by 2040. For rural, the number of beneficiaries per contributors will be almost the same by 2040 with 101 beneficiaries per 100 contributors. Overall, there will be 136 beneficiaries per 100 contributors in the Albanian pension system making sustainability of the pension system difficult. Typically pension systems expect the reverse, more contributors than beneficiaries, allowing a large number of contributors to contribute a small percentage of average wage which can then generate more generous pensions for a smaller number of pensioners. The main reasons for this increase in system dependency ratio are the aging of the population and the continued low rate of formality. The system dependency rate is projected to rise despite the fact that a large share of the elderly will not have access to pensions as discussed further below.

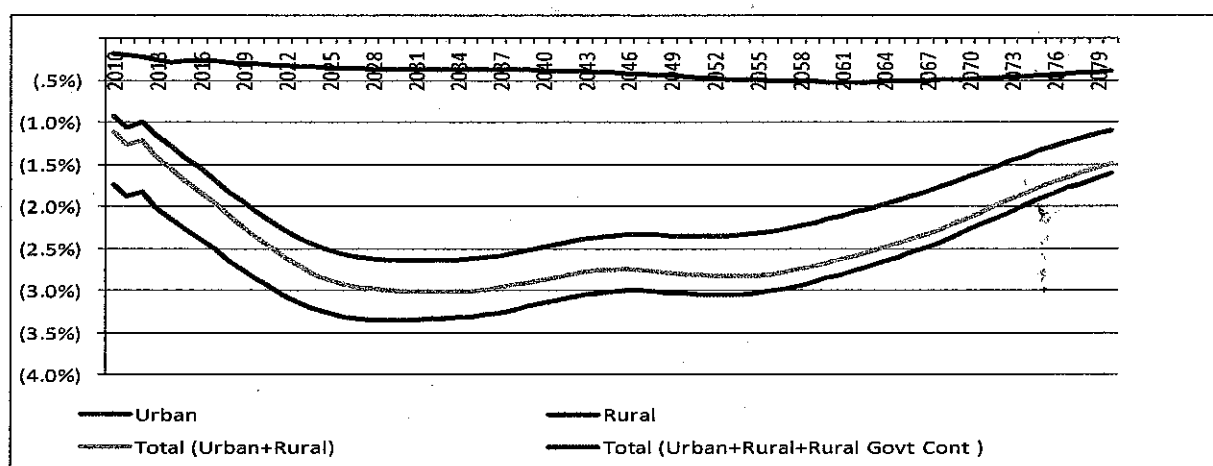
**A large share of the elderly will not have access to a pension benefit in the future.** Currently, most of the elderly have access to a pension benefit due to almost full participation rates during socialist times. But the informality in the labor markets is currently high limiting the number of individuals participating in the pension system. Since the participation rate in the current pension system is currently low, 56 percent of the elderly are projected to have no access to a pension benefit in the future. Since leaving a substantial number of elderly with no means of subsistence is neither socially or humanely acceptable, the Albanian Government will need to find mechanisms to provide at least minimal support to even those elderly without a pension benefit to prevent these individuals from falling into poverty.

**The Albanian pension system is fiscally unsustainable.** We projected the fiscal balance of the pension system according to the current parameters of the pension system including the legislated indexation rule which states that the pensions in payment are to be increased by the inflation rate. The results of the projections show that Albanian pension system will be in deficit



throughout the projection horizon. The total deficit, including both urban and rural pension schemes, will reach 2.9 % of GDP in 2025 (Figure 9). When the government contributions to the rural pension scheme are included, the deficit reaches as high as 3.3% in 2025. In the longer run, the pension system continues to be fiscally unsustainable although the deficit is projected to gradually decrease mainly due to the shrinking of the beneficiary population coming from a much smaller share of the elderly satisfying the pension eligibility conditions. Despite this gradual decrease the fiscal burden of the pension system will continue to be high with a pension system deficit of 3% of GDP in 2050 and 1.6% at the end of the projection horizon. But this is only part of the fiscal cost. Some Government support will be required for the majority of the elderly, the 56%, who will not have access to pension income in the future. The cost of supporting these additional elderly, whether through the social assistance program (Ndema Ekonomika) or through some other mechanism needs to be added to the fiscal costs to get the true liabilities of the Government.

**Figure 9: Fiscal Balance of the Pension System in % of GDP (Inflation Indexation)**



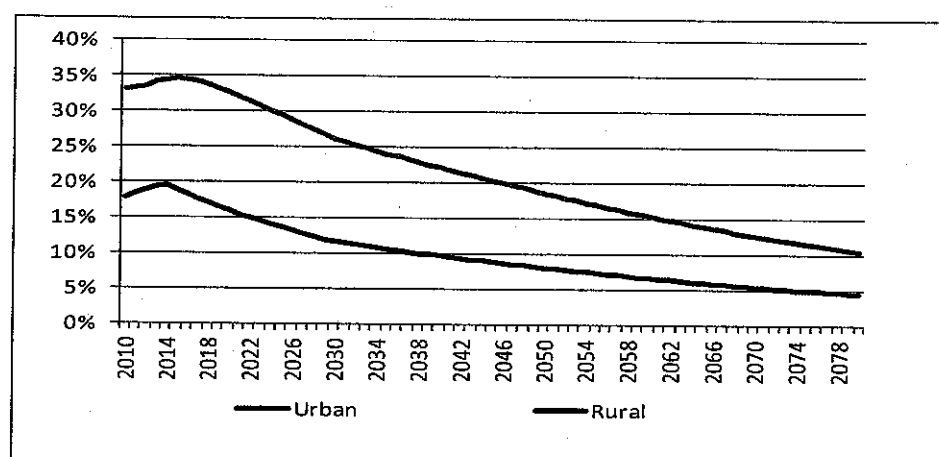
Source: World Bank PROST Projections

Moreover, the Albanian pension system, as legislated, is likely to be socially unsustainable. With the current parameters of the pension system including the legislated inflation indexation, the benefit levels will continue to decline. We projected the average pensions currently being paid using the current parameters and inflation indexation. Average benefit level (replacement rate) is defined as the average pension received by old-age pensioners relative to average wage. Currently, the average old-age pension for the urban sector stands at 33% of average while the average rural old-age pension is much lower at 19% of the economy wide average wage. The inflation indexation policy will result in much lower benefits in the future with the urban and rural sector replacement rates declining gradually to 10 % and 5 % respectively in the long-run,<sup>14</sup> as shown in Figure 10. Such low benefit levels certainly undermine the consumption smoothing

<sup>14</sup> Note that the average wage used to calculate the replacement rate for the rural are derived using urban average wages. There is no data on the wage levels of rural contributors as they pay contributions based on a flat rate. However, it is safe to assume that the rural wages are lower and the replacement rates for the rural would be higher if the rural average was used in the calculation of the replacement rates.

objective, one of the main objectives of a pension system, and are unlikely to be politically and socially sustainable. In a contributory pension system like the one in Albania, individuals typically expect to receive benefits based on their income level as they pay contributions as a proportion of their wage. In the Albanian pension system, while people are asked to pay contributions based on their earnings, a cap is applied at the time of benefit calculation, equal to twice the minimum pension. Since minimum pensions are legislated to be linked to inflation, the maximum pension also becomes linked to inflation. This link significantly restricts the benefit and weakens the connection between contributions paid and benefits granted at the time of retirement. Many countries in the OECD and EU link pension benefits to inflation, as is legislated in Albania, but none link the maximum pension to inflation. This significant redistributive aspect of the pension system creates disincentives to work longer periods and to declare full earnings in Albania since pensioners receive a similar benefit when they retire, regardless of how long they have paid contributions or how much they have paid. While the current benefit levels have a positive impact on poverty alleviation, the poverty impact of pensions will significantly go down as the replacement rates erode in the long term and as fewer households receive pensions. This will further undermine the existence of the Albanian pension system since it is not realistic to expect workers to pay 21.6 % of contributions for 35 years to receive a meager benefit in the future.

**Figure 10:** Projected Benefit Levels as % of Average Wage with Inflation Indexation

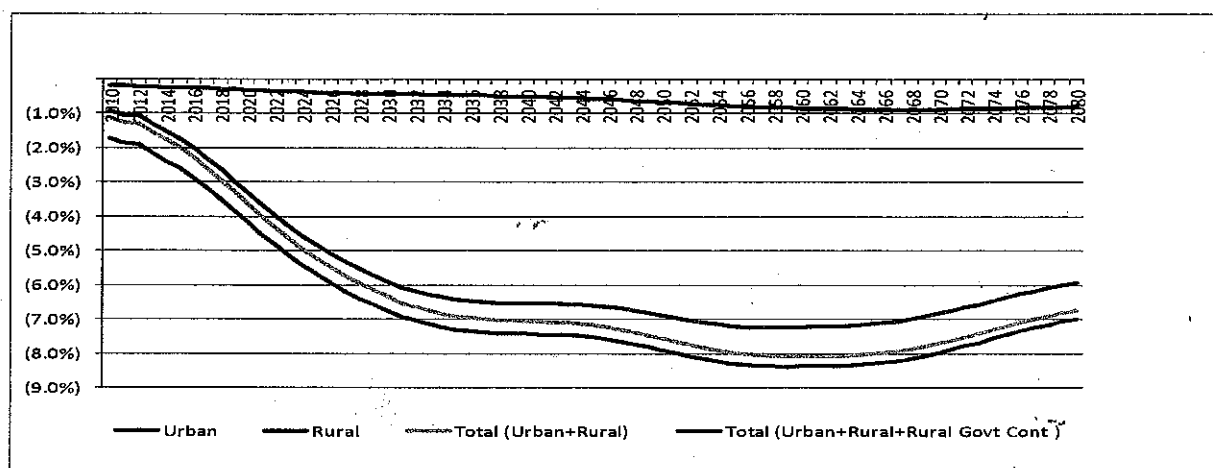


Source: World Bank PROST Projections

**In practice, pension increases have been higher than the legislated inflation rate indexation with detrimental impact on fiscal sustainability.** Pensions were increased on an ad-hoc basis and at times were higher than the increase in wages. We projected the fiscal balance of the pension system under the current parameters but assuming that the past trend of increases approximating wage indexation continues. As expected, the deficit of the pension system is much higher compared to strict inflation indexation. While the maximum total deficit for the urban and rural pension schemes is at 8.1 % of GDP in 2058, the Government will need to finance high deficits much earlier. The total deficit reaches 3.6 % of GDP as early as 2020 under

the wage indexation of benefits. When the Government contributions for the rural sector pension scheme is included, the financing need from the Government for the rural sector is higher reaching a maximum of 8.4 % of GDP in 2057, as shown in Figure 11.

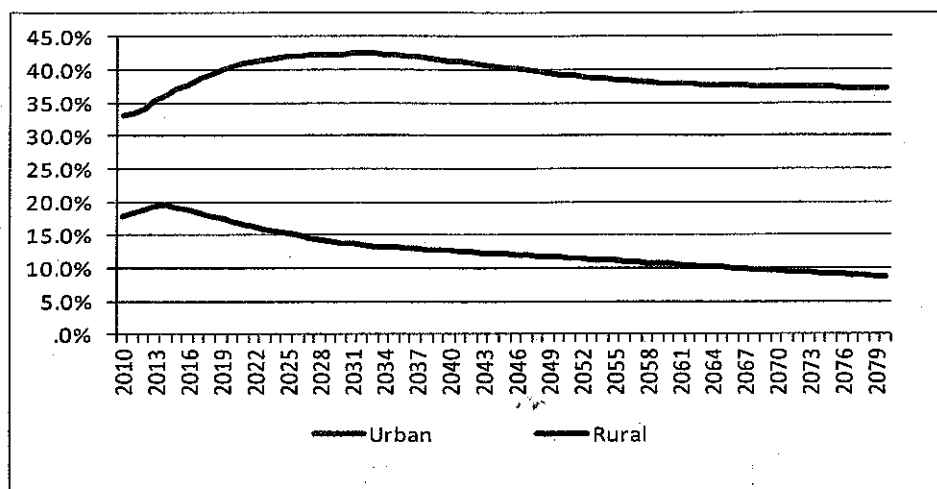
**Figure 11:** Fiscal Balance of the Pension System in % of GDP (Wage Indexation)



Source: World Bank PROST Projections

As expected, the projected benefits levels improve with wage indexation. Pension benefits for the urban sector are around 39 % of average wage as shown in Figure 12. Rural benefits continue to be at a lower level than urban and are on average 13% of average wage. For the rural sector, the Government has introduced the policy to equalize urban and rural minimum pension levels along with equalizing the contribution rates for these schemes. In practice, while the minimum pension for the rural was increased significantly, the increase in contribution rates for the rural sector was minimal. The projections assume that the rural pensions were increased by wage growth from the current levels without the equalization of contribution rates. If the assumption was that the equalization occurred first and then the rural pensions were increased before being wage indexed, then the replacement rates for the rural pensioners would experience a sharper increase in the beginning and would maintain their value relative to average wage. This would however further increase the fiscal cost of the rural sector. Providing a similar pension to urban and rural sector workers implies granting similar benefits to urban and rural despite the fact that the rural would be paying contributions on lower wages even if the contribution rates are equalized.

**Figure 12: Projected Benefit Levels as Percent of Average Wage with Wage Indexation**



Source: World Bank PROST Projections

The projections show that there is a trade-off between fiscal sustainability and adequacy of benefits. The Albanian government typically does not follow a set indexation rule and has been increasing pensions on an ad-hoc basis which is difficult to model. We projected indexation of benefits using two alternative parameters, inflation and nominal wage growth to show the impact of these two different policies. Under the current parameters, the Albanian pension system involves a significant amount of redistribution. The changes made to the pension system have brought the pension system to a state that the pensions system requires increasing resources from the Government budget to finance the deficits even when the benefit levels are low and do not provide adequate income replacement.

## IV.2. Recommendations for Reform Options

While the objective of the changes introduced in the recent years was to improve the pension system, these changes affected the overall consistency of the pension system in Albania. The Government introduced several policy changes to the pension system to provide better benefits to its pensioners and to improve old-age income security. These changes were made without a comprehensive approach to the address the existing challenges in the pension system. As a result the pension system has become overly redistributive and fiscally unsustainable. In the urban sector, there is significant redistribution from high and middle income earners to low income earners. As a result, average and minimum pensions are at similar levels. The benefit structure resembles a flat benefit although people are required to pay different contributions based on their income to be eligible for a pension when they retire. As a result, the urban scheme entails significant disincentives to contribute for longer periods and to declare full

earnings. The rural sector requires transfers from the budget both to supplement contributions and to finance the deficit. Consequently, the rural pension scheme has become a de facto social assistance scheme which is administered as a contributory scheme. The reduction in contribution rates and sizable increases in pensions affected the fiscal sustainability of the pension system. Despite the fact that the Government has to finance an increasing pension system deficit, the large degree of informality in the labor market results in a significant share of the elderly without access to a pension benefit in the future.

**There is a need for a comprehensive approach to address the challenges in the pension system.** Pension systems around the world have two objectives: (i) alleviation of poverty in old age which involves redistribution to those at risk of poverty, and (ii) replacement of working age earnings, which imply higher pensions for those who earned and contributed more. There are trade-offs between these two objectives since basing pensions strictly on contributions and earnings will not prevent poverty among the lifetime poor or among those with incomplete earning histories. At the same time, focusing on poverty alleviation alone will leave middle and higher income contributors dissatisfied and with little incentive to contribute. While some countries like Ireland have chosen to focus on poverty alleviation, others like Germany have focused more on replacing earnings, leaving social assistance to deal alleviation of old age poverty. Most countries have chosen something in between with some poverty alleviation and some income replacement. The Albanian system is currently very close to an almost exclusive focus on poverty alleviation, as shown in Figures 3 and 4. The Government has two main options in terms of the direction of pension reform. The first option is to keep the contributory system but strengthen it by tightening the link between contributions and benefits and therefore enhancing the ability of the pension to replace the income individuals earned during their working years. The second option is to recognize that the pension (or the income earned by the pensioner) is almost the same for all urban pensioners and slightly lower, but the same for all rural pensioners. It might be simpler to eliminate the contributory scheme completely and institute a social pension that will be available to people above a certain age and therefore enhance the poverty alleviation objective. This would allow those who are unable or unwilling to contribute to receive at least some basic protection in old age and would eliminate the need to spend time and energy collecting contributions and maintaining records, only to end up not differentiating much between pensioners. These basic benefits could be financed by a rise in income taxes, by a rise in value-added taxes, or could continue to be financed by a labor tax, whichever could raise sufficient revenue with limited disincentives. The basic benefit could be supplemented by voluntary private savings for those who want greater consumption smoothing in old age.

**We projected the impact of these two broad options on fiscal sustainability and pension levels and present them below.** Note that within each of these broad options, there are many sub-options and choices to be made; what has been modeled represents only one of these many sub-options. Once the Government chooses a particular direction, modification of these options can be produced and their impact projected. In all cases, the reforms are projected to begin in 2014.

### **Option 1: Enhance Contributory Scheme**

The section below shows one option that strengthens the contributory system and provides a social pension to all those who will not have sufficient contributory history to collect a pension in the future. The particular elements of the option were chosen, both with the objective of maintaining a contributory system, but also with the aim of achieving some fiscal consolidation. Should the fiscal constraints ease, some of the elements of the reform package could be altered to allow for greater fiscal spending.

### **Option 1: Improving Incentives to Contribute**

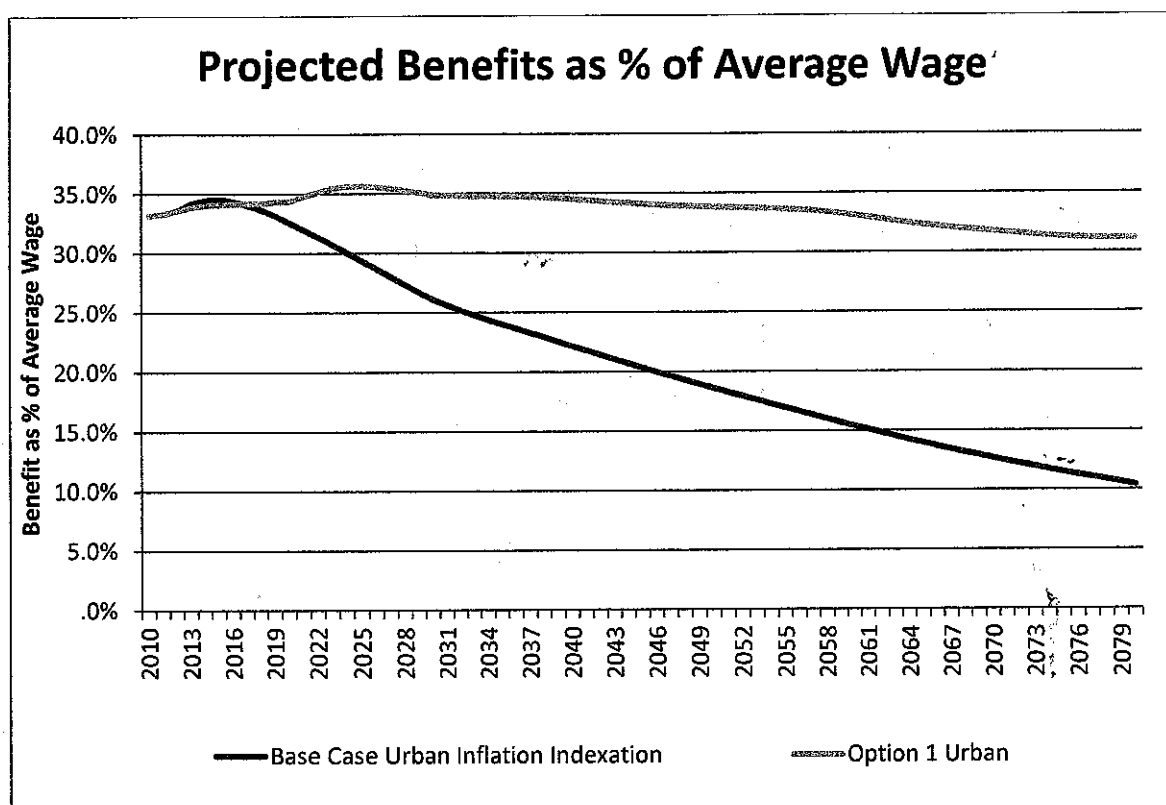
**In this option the redistributive aspects of the pension system are gradually eliminated.** The particular reform package shown below is for illustrative purposes only, to show what a reform which reinstates a contributory system might look like, given the constraints of fiscal consolidation. The actual elements of a reform package put forward by Government could require different eligibility conditions, could provide different benefits, and could introduce the change faster or slower than shown. The package includes the following elements:

- *A gradual increase in the maximum pension, with the maximum pension indexed to 150% of nominal wage growth from 2014 onwards;*
- *A gradual elimination of the basic benefit, with the basic benefit held constant in nominal level from 2014 onward. The accrual rate of 1% per year of service remains intact;*
- *Restoration of a gap between average and minimum pension, by holding the minimum pension constant in nominal terms until 2020 and then indexing it by inflation onwards;*
- *Indexation of the average pension to inflation from 2014 onwards. The combination of this element and the previous element will result in an average pension equal to twice the minimum by 2021 and then forward as well;*
- *A rise in retirement age for women to age 65 between 2014 and 2020, followed by an increase in the retirement age for both men and women to age 70 by 2080, in line with increases in life expectancy; and,*
- *Institution of a social pension equal to the 2014 minimum pension for rural workers, for all who do not qualify for the urban pension, but only available at age 70. The rural pension system with its subsidized contribution rates will be eliminated, with farmers no longer being required to pay contributions, but in turn receiving only the social pension. Current contributors in the rural system who are willing to make the full urban contribution without subsidy are welcome to continue contributing and will then receive the same pension as an urban worker upon retirement. Current pensioners in the rural system will continue to receive their pension indexed to inflation going forward.*

**This option clearly raises the urban benefit levels as shown in Figure 13.** While the current policy results in a drop in the future benefit level to 10% of average wage from the current 33%,

the reform option limits the future drop to only 31% of average wage. The initial slightly higher benefit rates comes from the gradual lifting of the cap on benefits beginning in 2014, with the higher benefit rates in later years also dependent on linking benefits to contributions paid, without the repressive impact of the current cap.

**Figure 13: Projected Benefits Under Current Policy and Option 1**



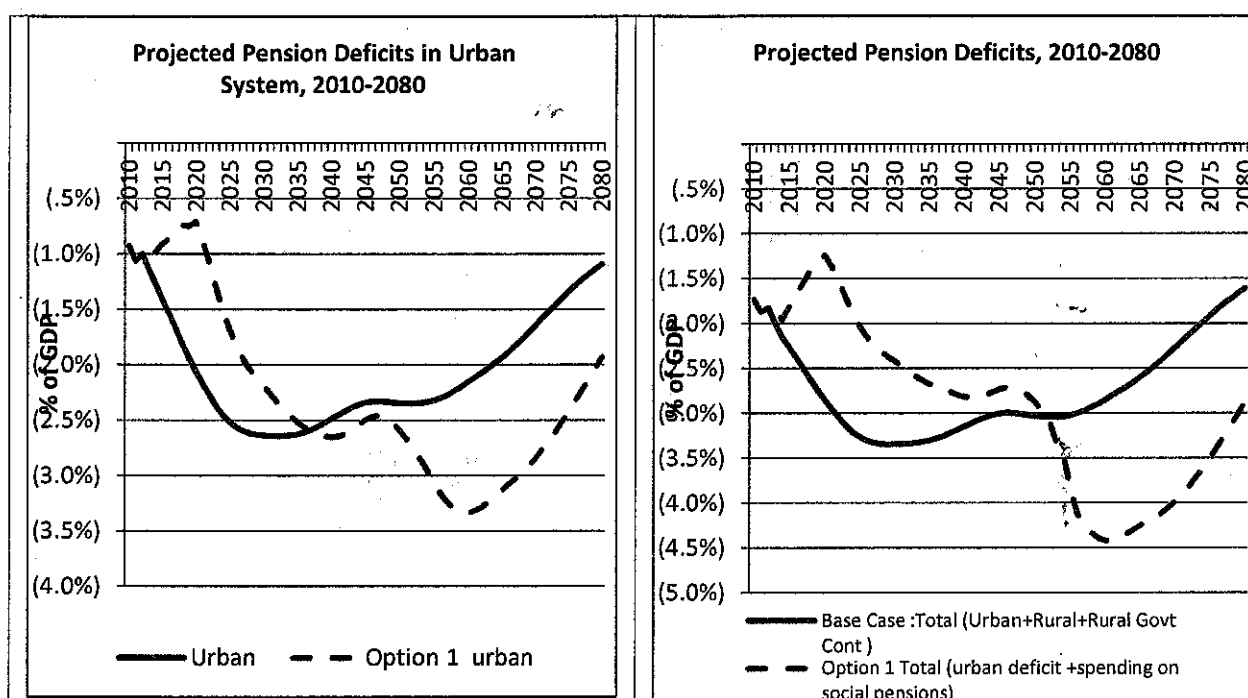
Source: World Bank PROST projections

Higher benefit levels coupled with the greater future coverage among the elderly will result in higher fiscal deficits in the pension system in the long run, but the fiscal consolidation measures within the reform package will result in smaller deficits in the short and medium run, with savings of as much as 1.4% of GDP by 2020. The left-hand panel of Figure 14 shows that the fiscal consolidation measures described for Option 1 are effective in reducing deficits immediately. It is only after 2037 that the deficits in the urban system start to exceed the deficits in the base case. But by that point, the benefits in the urban system under the reform will be more than 50% higher than in the base case. Furthermore, the better rates of return for higher and middle income individuals are likely to result in higher income declarations and more revenue being collected by the Social Insurance Institute and the tax authorities as well, reducing the deficit further.

The reform option provides better retirement outcomes for the contributors and for those working in the informal sector, but in the long run these benefits will result in higher costs than the current system, but only if the current system maintains its inflation-indexing. The right-hand panel of Figure 14 shows the Government's outlays for the whole pension system, including deficits of the urban and rural systems and the subsidies for rural contributions in the baseline, compared to the deficits of the

urban (contributory) system and the cost of the social (noncontributory) pension in the reform option. Savings are substantial, again about 1.4% of GDP by 2020. The current system only becomes cheaper than the reform option in 2052, but the reform option provides pension income to the 56% of the elderly who will have not access to pensions in the long run in the current system. It is unlikely to be socially sustainable to leave 56% of the population with no support during old age, suggesting that many people will require social assistance in the future under the current system. Once the cost of that social assistance has been added to the current system costs, there may be little difference, even in the long run, between the current system and the reform option.

**Figure 14: Projected Pension System Deficits Under Baseline and Reform Option 1**



Source: World Bank PROST projections

## Option 2: Focus on Poverty Alleviation

Given how close the Albanian system already is to a flat uniform pension, an alternative would be to eliminate the contributory system altogether and implement a flat pension for all at retirement age. Figures 3 and 4 emphasized how close the Albanian system already is to providing flat benefits. A number of countries like Ireland, Australia, New Zealand, Kosovo, Kazakhstan, and Georgia provide similarly flat benefits to all individuals above a certain age. In the case of all but Ireland, these benefits are financed from general revenues. The only difficulty in moving in this direction immediately is that all those who have contributed to the pension system would rightfully expect to get something more than the social pension that those who have never contributed will receive. If the government pays people the value of the rights they have already accumulated in the pension system without collecting contribution revenue, the government will run even larger deficits than it is currently running. One solution to this dilemma would be to abolish the contribution requirement immediately and terminate future accrual of pension rights, but agree to pay the rights that have already been accrued. These rights could be financed



by a new labor tax which initially could be of the same magnitude as the current contribution rate to social insurance. While benefits are paid out of general revenue, the new labor tax would add to general revenue. This approach would eventually add revenue to the Treasury as the pension obligations decline over time, and the labor tax continues to generate revenue. At this point or at the point at which the Treasury determines it can pay the remaining expenditures out of other revenue, the labor tax can be gradually reduced. This is the approach taken by Georgia which initially converted its contribution into a social tax and then merged the social tax with the income tax so that individuals were paying only one higher income tax which included the previous social tax.

Under this option, many of the reform options from the previous option would also be implemented.

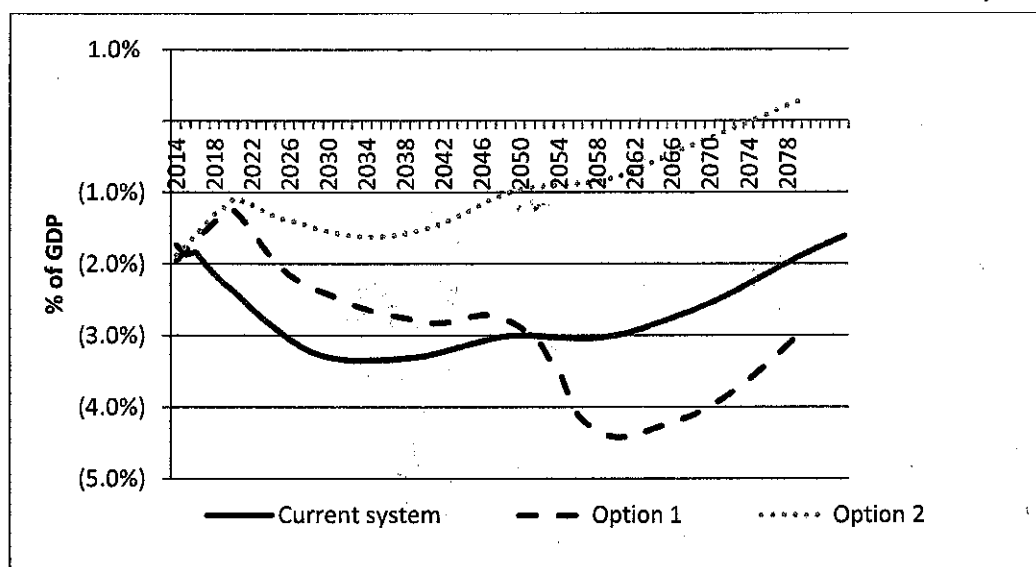
- *Holding the **minimum pension** constant in nominal terms until 2020 and then indexing it by inflation onwards;*
- *Indexation of the average pension to inflation from 2014 onwards;*
- *A rise in retirement age for women to age 65 between 2014 and 2020, followed by an increase in the retirement age for both men and women to age 70 by 2080, in line with increases in life expectancy; and,*
- *Institution of a **social pension** equal to the 2014 minimum pension for all workers but only available at age 70. The rural pension system with its subsidized contribution rates will be eliminated, with farmers no longer being required to pay contributions, but in turn receiving only the social pension;*
- *No contributions required for either rural or urban sector, with past urban contributors receiving what they have accrued in the former pension system or the social pension whichever is higher and the rural contributors receiving only the social pension since which is equal to the minimum rural pension that they would have received in any case;*
- *New labor tax in the amount of 21.6% of wage initially, to be decreased over time as fiscal space opens up;*

Figure 15 shows the net projected impact of this option on general revenue. Under this option, revenue comes to the Treasury from the labor tax, and pension expenditures are paid out of the Treasury to the Social Insurance Institution for distribution to pensioners. Figure 17 shows the net impact on the Treasury; when the balance is negative, other resources from the Treasury are needed to cover the pension expenditures; when the balance is positive, the labor tax revenue exceeds the pension payments, and additional revenue is earned by the Treasury. Given the large fiscal savings over the current system, which reach 1.8% of GDP by 2020 and continue increasing, some of these could be retained as fiscal savings, while some portion could be used to reduce the labor tax.

**While Option 1 pays much higher benefits for those who contribute than Option 2, Option 2 has the advantage of eliminating pension contribution rates and replacing them with a gradually reducing labor tax, which might help curb informality and generate growth. However, the lower level of long run benefits under Option 2 is not likely to be sufficient for middle and higher income individuals. Providing supporting infrastructure for voluntary,**

automatic enrollment, or even mandatory savings schemes will become critically important to provide middle and higher income individuals the opportunity to replace part of the income they earned during their working years. From an individual's standpoint, the capacity for saving will increase as the pension contributions are eliminated and the labor tax which replaces them is gradually reduced.

**Figure 15:** Projected Pension Deficits Under Option 2 Compared to Status Quo and Option 1



Source: World Bank PROST projections

## V. Conclusion

The pension system in Albania suffers from a number of problems: (i) it is costly; (ii) it is projected to provide very low benefits in the future; (iii) it provides incentives to higher and middle income individuals to underdeclare earnings and hours or to avoid the system entirely; and (iv) subsidizes the rural self-employed at the expense of the rest of the system. The problems that the Albanian system faces are intertwined. The system is costly because the government reduced contribution rates in an effort to reduce informality, it provided pension increases above the rate of inflation particularly for lower income pensioners, and it provides increasing subsidies for rural contributors. It is projected to provide low benefits in the future because the Government restricted the maximum pension in order to control costs, but this restricted maximum pension provides few incentives for higher or middle income earners to contribute and report on full earnings. The limited contributions further raise the fiscal costs and subsidies required to keep the system running.

With Government policy at a crossroads, one alternative would be to re-establish a strong link between contributions and benefits, separating the income replacement function of the pension from the poverty alleviation function. As a result of all the policy changes, the system is close to providing a uniform pension for most people, with the income from the average pension almost equal to the income from the minimum pension. Either the Government needs to provide a better link between

contributions and benefits and decompress the current benefits or it needs to consider eliminating the contributory benefit and to provide a poverty-alleviating flat benefit to all elderly and disabled. In the case of the first choice, the currently high minimum pension relative to current average wage means that decompressing the pension benefits will raise fiscal costs unless fiscal consolidation of benefits takes place. However, individuals will get higher pensions in the longer run and will have a greater incentive to contribute. The current rural pension which is de facto social assistance, but faces political pressure to be raised to the level of the urban minimum pension despite minimal contributions, needs to be replaced with a social pension for noncontributors which will cover those who do not work or contribute in the urban sector as well. The advantage for workers is that they no longer have to contribute. From the Government's perspective, the political pressure to equalize rural pensions with urban pensions should disappear and the Government can provide a benefit which is more affordable.

**The alternative to the above strategy is to focus exclusively on poverty alleviation in the public system, leaving income replacement to voluntary or mandatory savings instruments.** The alternative would be to move all the way to a social pension as has been done in Kazakhstan, Georgia, and Kosovo where a flat, poverty-alleviating benefit is provided to all elderly above a certain age. The advantage for workers would be that they no longer need to make contributions, but will face a gradually declining labor tax, with positive implications for labor costs and growth. The advantage for Government is that the difference between informal and formal sector workers disappears and the effort involved in collecting contributions and maintaining records only to give people the same pension when they retire disappears. In moving from a contributory system to a noncontributory one, one approach modeled here would be to provide benefits based on rights already accrued up to the date of the reform and provide a benefit equal to the rural minimum to everyone else, indexed for inflation. This approach will need to be complemented by a vigorous effort on voluntary savings to provide higher and middle income individuals the opportunity to replace a more significant level of their working age income during retirement.

## Annex 1: Legislated Retirement Ages in the OECD Countries

OECD	Legislated Normal Retirement Age
Australia	67
Austria	65
Belgium	65
Canada	65
Chile	65 Basic/T
	65/60 DC
Czech Republic*	65/62-65*
Denmark	67
Estonia	63
Finland	65
France	65 DB, 60 DB (Occ)
Germany	67
Greece	65
Hungary	65
Iceland	67
Ireland	66/65
Israel	67
Italy	67
Japan	65
Korea	65
Luxembourg	65
Mexico	65
Netherlands	65
New Zealand	65
Norway	67
Poland	67
Portugal	65
Slovak Republic	62
Slovenia	63
Spain	67
Sweden	65
Switzerland	65/64
Turkey	*58/60
United Kingdom	68
United States	67

\*Turkey: First wave of retirement age increase to 58/60. Second wave to 65

\*Czech Republic: pension age for women varies with number of children they have had.

Source: *Pensions at a Glance 2011*, [www.socialsecurity.gov/policy International Update USA SSA](http://www.socialsecurity.gov/policy%20International%20Update)