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REFORMING THE SOCIAL SECURITY SYSTEM, APPROACHING THE EU STANDARDS

Abstract:

In this work we address the issue of social security insurance, particularly pension scheme, in post-transition Albania. After a brief recourse into the history we describe the current situation and provide evidence of unsustainability of the system and the underlying problems. We argue for setting the objective of creating a multi-pillar self-supporting system as a replacement for the unbalanced pay-as-you-go scheme. Finally, we propose roles the government and the public sector should play in developing a new sustainable system.

Keywords:

Albania, social security, transition, reform, sustainable pension

1. Overview.

... post-transition participation in formal labor markets has fallen dramatically in Albania, raising questions of whether the social insurance framework is in fact the appropriate structure for providing social protection benefits in the future for the entire population. A number of bodies have completed extensive reviews of the social insurance system. These reviews conclude that the existing system is not financially sustainable in the longer term. Within the Government, the Ministry of Finance, the Ministry of Labor and at the other side the World Bank, there is general agreement over the need to redesign the existing pay-as-you-go system, but nothing was done yet...

2. Background – History – Legislation.

2.1 Albania general data:

- Total area 28.748 km²; Population 3.6 million; Over 1 million Albanians lives abroad;
- General Background: Fertility rate 2.27; Life expectancy at birth 77.9 years; unemployment rate 13.5 % ;
- Social insurance system: Actually, in operation there are 1st and 3rd pillar (1st pillar is operated by **SII** in **PAYG** system); Pensioners paid out approximately 530.000; Contributors in the scheme approximately 650.000.

2.2. The Social insurance system in Albania is in part inherited from the past

and was designed to provide comprehensive insurance against the risks of old age, disability, death, short term illnesses, poor health, and unemployment based on contributions made by both employers and employees.

Background of Social Insurance:

- First legal act related to social insurance area - **Act "On Civil Pensions" no. 129, date 28. 10. 1927.**
- Establishment of the pure social insurance system dates back to August 1947, and comprised two schemes:
 - – for employees of the state sector (**act no. 4171, date 13. 09. 1966**).
 - for agricultural cooperative members (**act no. 4976, date 29. 06. 1972**).
- The social insurance system (according to the **Act no. 7703 "On Social Insurance in the Albanian Republic"**, approved on May 1993), while covering the risks of short term illness, maternity benefits, unemployment, and health costs as well as pensions, is largely focused on pensions based in the principle of **Pay As You Go**.

During the previous regime, the economic characteristics of the pension system can be sum up as follows:

- the system has been completely mandatory and state – based redistribution;
- social security were held in two parallel schemes: one for the employees of the state sector, while the other for the agricultural cooperative's members ;
- The social insurance system, modeled according to the Soviet experience, was too generous, predicted lower age of retirement for different categories of employees, amount of contribution schemes rather low that does not guarantee stability in time ;
- The number of contributors is growing too fast. In 1990 in public institutions and enterprises amounted 846.000 persons, while the number of beneficiaries was only 208.000 persons. In rural areas, the number of contributors was 600.000 persons, while the beneficiaries was 121.000 persons. Total isolation of the country, preventing migratory movements, return of the work as an obligation and the favorable age structure are the main factors of this tableau ;
- Deep changes that occurred in the political, economic and social life of the country after 1991, spread their influence on the social security system too. Thus, during the period 1991 – 1993, as a result of economic collapse the number of contributors in the city suffered drastic cuts really going down to about 353.000 people. Meanwhile in the village after 1992, known as the year's of agricultural cooperatives, the number of contributors was quite insignificant, representing about 5 % of the general number of persons who develop agricultural activities ;
- Parallel to the reducing of the number of contributors, this period faces

another negative phenomenon, the growth with very high rates of the number of beneficiaries from the social security schemes. To cope with this difficult situation created by the collapse and fall of communism, coupled with the bankruptcy of public enterprises, the Parliament approved and implemented special provisions to early pensions. Consequently the number of beneficiaries was added to about 150.000 people. This report aggravated enough the contributor / beneficiary reports going to 0.75/1;

- Naturally, these developments made it necessary, taking a series of measures in order that the social insurance system adapted to short and long term development of all economic system and in particular to ensure a social protection to the citizens, more effective. In this context, was drafted and adopted the **law no. 7703 dated 11.05.1993 "Social Security in the Republic of Albania"**. Basically, the main objective of this law was, adapting the social security system with general economic developments and, on the other side to keep in mind and provide necessary funds for the preservation and fulfillment of the rights acquired. As required by law the characteristic of the system was: **PAYG** model, Mandatory based in contributions, High solidarity (lack of reserved fund, need for money to pay the existing pensioners), administered from independent public institution (**SII**);
- This time the deficit of pension system reaching 1 % of **GDP** and forecasts indicated worsening of the future situation, the contributors/beneficiaries ratio was Worsening, Albanian legislation of social insurance had to approach the to the EU countries, high contribution rate - generating informal work, high unemployment rate and high level of grey economy. These were the reasons for undertaking Parametric Reforms of 2002. Parametric Reforms of 2002 consisted on: Gradual increase of retirement age to 65 for men and 60 for women; The right for entitlement to a reduced pension; Reduction by 4% of social insurance contribution rate; Increase of maximum contributory wage from 1:3 to 1:5; Transfer of contribution collection from **SII** to General Tax Department.
- Other important legal measures have been taken in years, especially during 2005 up to 2010 where the management of the scheme was changed, and the retirement age was respectively set up, 60 and 65 for women and men.

But as we can clearly see from the figures the contributor / beneficiary report is still small and the scheme represents a number of problems such as: law pension, discount of the replacement rate, contribution measure is not linked with beneficiary measure, demographic changes leads to increase the number of pensioners as the result it needs more funds to guarantee the rights acquired.

2.3 System itself by legislation.

- The system itself is a **PAYG** system, where the first pillar **PAYG** is managed by **SII** (social security institute), there is no a second pillar and the third pillar

(private)scheme) is private, administrated and supervised by AFSA (super-
vision agency).

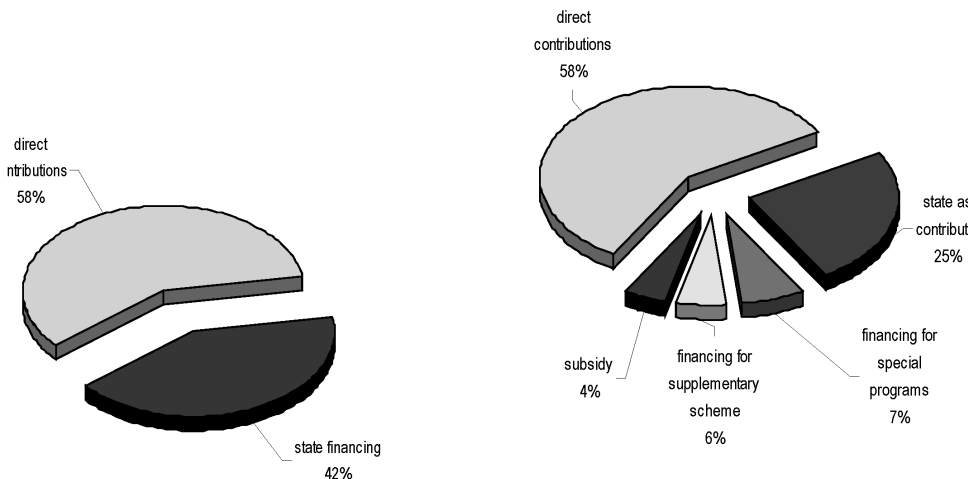
It is divided in:

- Social insurance system (SII):
 - Sickness
 - Maternity
 - Pensions
 - Employment injury and occupational disease
 - Unemployment
- Social protection system
 - Social assistance for low income families
 - Social services (Orphans, elderly, disable people etc)
- Health insurance system (HIS).

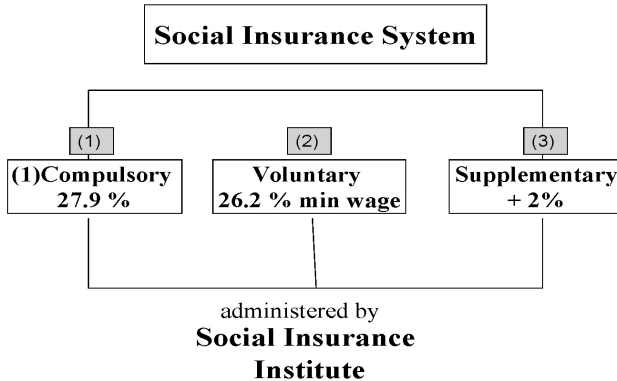
The Social Insurance Fund is financed via 4 major income resources: Contributions, Transfers from State Budget, Incomes from investment of reserve fund as well as of funds temporarily available and other incomes.

2.4 Financing of SII Budget.

For the normal functioning of the social security system and to implement payment of benefits, the State Budget financed the deficits of the scheme. Funding the state budget towards the social insurance scheme is increasing from year to year. This funding is divided into two categories: the funding of particular programs as well as government subsidies to the pension fund. Currently, the financing of the State Budget is 42 % of the mass budget of social security, divided in contributions destination with 25 %, funding of the specific programs 13 %, subsidy with the difference in the extent of 4 %.



For the importance and the role played by pension schemes in social protection and fighting the poverty, the Government during the last three years has increased the extent of subsidies in addition to increasing the rate of collection of contributions. Since 1 January 2009, there is no pension payment less than 14 thousand **leks** for urban people and not less than 7.5 thousand **leks** for rural people.



a) Compulsory Social Insurance.

This scheme protects:

- Employed persons in respect of:
 - temporary incapacity to work due to sickness
 - maternity
 - old-age, disability, loss of breadwinner
 - employment injury and occupational disease
 - unemployment
- Other economically active persons in respect of:
 - maternity
 - old-age, disability, loss of breadwinner

b) Voluntary Social Insurance.

This scheme protects:

- Individuals that are not protected from the compulsory scheme, The Albanian citizens living abroad

c) Supplementary social insurance.

This scheme protects: Parliament members, Governments members, Civil servants, Army members, Police forces.

3. Participation.

The old – age population dependency rate (the number of people aged over 65 relative to the number of working age people) should, in theory, closely relate to the social insurance system dependency rate (the number of social insurance contributors relative to the number of pensioners and beneficiaries).

The old – age dependency ratio for Albania is 19.4 %. That is, 194 people aged 65 or over for every 1.000 people of working age (aged between 15 and 65 years). However, in Albania, high levels of unemployment combined with a large number of people employed in the informal labor sector have dramatically affected the system dependency rate.

The social Insurance system dependency rate for Albania is 84.1 %. That is 841 pensioners and beneficiaries for every 1.000 people contributing to the system. The difference between the population dependency rate and the system dependency rate has created a situation where contribution rates are high, pensions are low (and strictly capped, Government subsidies are increasing) and the incentive for people to contribute to the scheme is diminishing.

The forecast demographics of Albania suggest the existing social insurance system should be sustainable in the medium to long - term.

The system dependency rate however shows the medium to long-term sustainability of the system is reduced because:

- The working population is unwilling to participate in, and/or contribute to, the system; and
- The administration's enforcement practices are insufficient to prevent people leaving (or failing to enter) the system.

4. Contribution Rates.

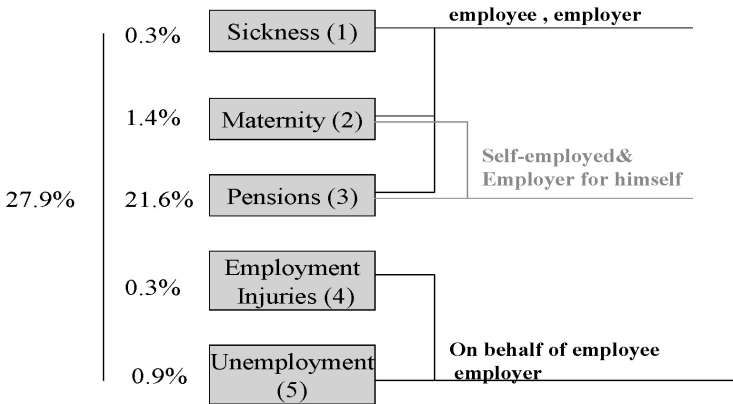
Recently (1.05.2009), the Government passed legislation to reduce contribution rates, but even so, they can still be considered high for a country with a young population.

The capacity to reduce the contribution rates in the future will be driven by three key factors. These are:

- The extent to which employees see a distinct advantage in having the full level of contribution paid by their employer;
- The ability of the administration to enforce compliance amongst employers and create an even playing field for all businesses; and
- The capacity of the economy to absorb the higher cost of full compliance in purchase price¹).

¹) Typically, high contribution rates reduce purchasing power by depressing real wages and limiting personal savings.

Contributions rate

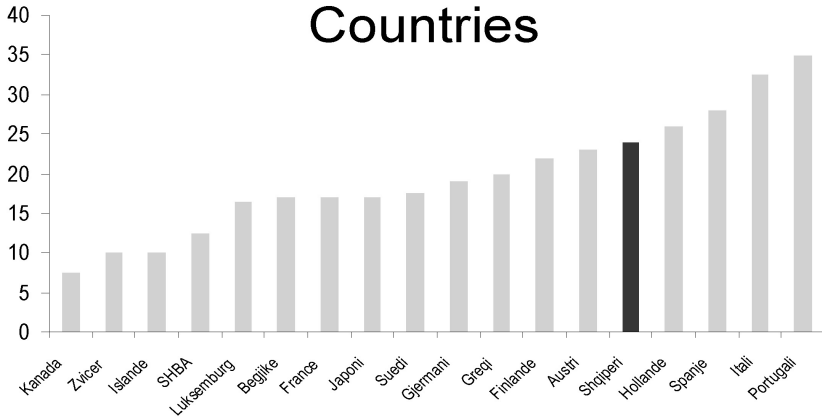


Contribution Rate 1993 - 2009

	01.10.1993	01.03.1995	01.07.2002	01.09.2006	01.05.2009
Sickness	1.5	1.5	0.8	0.8	0.3
Maternity	2.8	2.8	2.3	2.3	1.4
Pension	31.7	31.7	29.9	23.9	21.6
Empl. Injuries	0.5	0.5	0.5	0.5	0.3
Unemployment	6.0	6.0	5.0	2.0	0.9
Social	42.5	42.5	38.5	29.5	24.5
Health		3.4	3.4	3.4	3.4
TOTAL	42.5	45.9	41.9	32.9	27.9

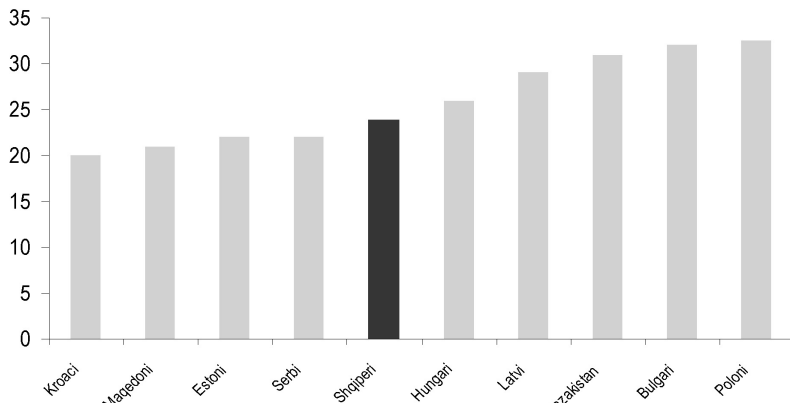
Here there are some figures regarding the contribution rates in
Albania

Pension Contribution Rate compared to the OECD Countries



With the contribution rate of 29.9%, Albania stood after Spain; with the new contribution rate of 23.9%, it moved 2 countries ahead, between Austria and the Netherlands

Pension Contribution Rate compared to other Countries under transition



Compared to other countries in transition, with the contribution rate of 23.9%, Albania is positioned in the middle as shown graphically

5. Pension Rates.

Until recently, the retirement age in Albania was 60 years for men and 55 years for women, with a number of special exceptions where retirement might be as young as 50 for men and 45 for women. The Government elected to increase the retirement age and, by 2011, retirement ages will be 65 for men and 60 for women. The special exception types are also being gradually eliminated.

The rate of pension is defined as the minimum pension being approximately 38 % of gross covered wage for new pensioners) plus 1 % for each year of service. This results in a replacement rate of 73 % of wage after 35 years of service. The **ILO** recommended a replacement rate of 40 % after 30 years.

This replacement rate may appear generous. However, the difference between the average wage (as declared) and the income required to maintain a minimum living standard is very narrow in Albania and may justify a higher than usual replacement rate

Despite the apparently generous design of the system, the maximum pension is limited to twice the basic pension. High earning individuals (earning twice the average wage) are able to reach the maximum level after 25 years of work and so have little incentive to continue contributing to the scheme for their full working life.

The value of the basic pension is indexed to inflation by law. However, a desire to equate basic pension with minimum living standards has caused the value of the pension to rise more quickly than inflation. As a result, many people have no incentive to pay contributions on their full income because they receive the minimum pension irrespective of their contribution amounts.

The net result of these policies is to drive high earning individuals out from the system entirely and to encourage the remainder to declare only the minimum wage.

6. Short-Term Benefit Rates.

Short-term benefits are recently reduced and are available for sickness (0.3 % of payroll) maternity insurance (1.4 % of payroll), employment accidents and occupational diseases (0.3 % of payroll) and unemployment insurance (0.9 % of payroll). Access to these programs is tightly controlled and contribution rates, at least before **01. 05. 2009**, have been sufficient to cover payments.

Unemployment Insurance is also provided through the Social Insurance Institute. Historically, surplus unemployment insurance contributions were used to pay pensions, but there is no data available about the extent to which the new contribution rate is sufficient to cover liabilities.

Unemployment Insurance is set at 37.5 % of wage for a specific period (8 – 12 months) plus an additional 5 % of wage for each dependent child. Albania has 153.000 registered unemployed. Approximately 11.000 of these receive

unemployment insurance. The remainder is long-term unemployed with no claim on social insurance because the period covered by their insurance has been exhausted. The long-term unemployed receive financial assistance through “**Social Aid**”.

7. Financial and Social Sustainability.

It is concluded that the current pension system is not sustainable. In summary, the longer term problems of the system manifest in two ways:

1. The proportion of the population who will not be covered by the system in the future.
2. The general decline in the value of the pension in comparison to average wages.

At this time Albania has a comparatively low old age dependency rate, however, the World Bank demographic forecast shows this rate will increase over time.

This increase in the underlying old age dependency rate will have a significant effect on the system dependency rate. As discussed earlier the current system dependency rate is already high and further increases will place a greater burden on contributors. In this situation it will not be possible to maintain both adequate rates of pension and affordable contribution rates.

In these circumstances we can expect the participation rate to drop below current levels. This, in turn will impact upon the number of retirement aged people who are eligible to claim a pension. The World Bank review includes the following forecast regarding the proportion of the population aged over 65 who will be eligible for a pension in the future.

In this eventuality the state will be faced with a large increase in the number of people seeking poverty relief from state funds (“**Social Aid**”).

In addition, the current legislation does not guarantee current contributors will receive an adequate pension. The World Bank forecasts a sharp decline in the value of the pension if it is indexed to inflation as the law currently requires.

Within pay as you go social insurance systems there is a linear relationship between system dependency rates, contribution rates and the value of pensions. A decline in participation necessarily requires either an increase in contribution rates or a reduction in the value of the pension. This, in turn, reduces the incentive to participate, which reduces participation still further etc, etc. The above figures demonstrate a trend towards lower participation rates, lower rates of pension and a greater burden being carried by those people who forced to remain in the system – being public sector workers.

8. Assessment of Current Performance.

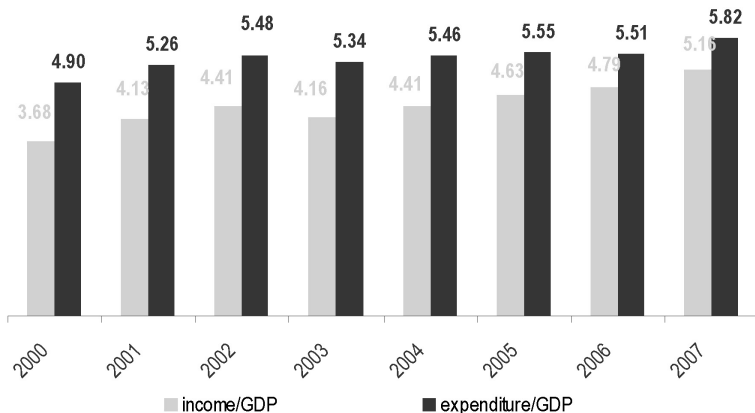
The primary problems associated with the pensions system can be identified as follows:

- Inadequate coverage of the elderly in the long run with 40 percent of the elderly in the future left without access to the pension system arising from the low number of working age individuals making active contributions today;
- Sharp decline in benefits stemming from the linking of the maximum pension to inflation;
- High contribution rates which provide disincentives to formalization of the labor force;
- Disincentives in the benefit formula for people to declare their full wages or to work throughout their working age; and
- Over-generosity with respect to rural workers and pensioners.

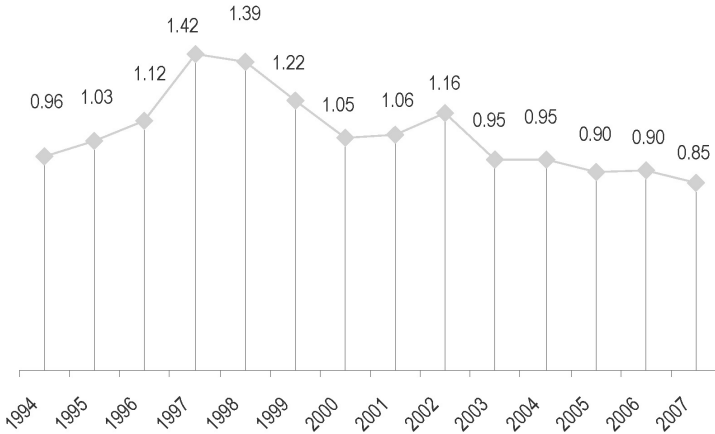
To sum up, long term demographic and economic trends suggest that the existing pay as you go system will eventually lead to:

- Significantly lower rates of pension compared to wages in the longer term; and/or
- Contribution rates remaining at existing levels or higher in the longer term; and/or
- Increasing government subsidization for:
 - The social insurance fund in general;
 - Rural workers; and
 - Low income families eligible for assistance through "Social Aid".

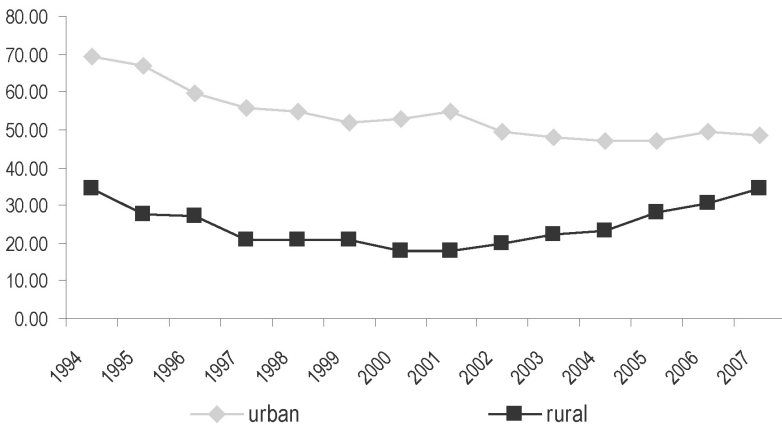
Indicators of Compulsory Scheme



Indicators of Compulsory Scheme Dependency Rate (beneficiaries/contributors)



Indicators of Compulsory Scheme Replacement Rate (pension/net wage)



9. Objectives.

Therefore the social insurance system needs to be reformed before it collapses either socially (most of the aged population are ineligible for pension) or financially (most of the working age population refuse to contribute).

Throughout the world a number of developed economies now face unfunded future liabilities because of their inability to address the inherent problems associated with a pay as you go social insurance system and an ageing population. Pension reform necessarily requires a commitment from within the government to accept high short - term costs in return for the long-term income security of the aged, disabled and disadvantaged.

Although all bodies accepted that the existing pay as you go system needs to be re -engineered, we believe that ultimately the system must be replaced by a multi - pillar system that supports self - funded retirement. The extent to which the existing system needs to change is dependent on the speed and timing of transition to a multi-pillar system.

9.1. Government Mission.

The Government should create conditions that ensure the long-term sustainability of poverty alleviation measures for the aged and allow individuals to create sufficient wealth during their working lives to support themselves in their retirement. This includes:

- Increasing the proportion of the population who are able to provide for a self-funded retirement.
- Reducing the proportion of direct government subsidies required to maintain social insurance programs
- Reducing the impact of social insurance on labor costs and reducing the proportion of individuals engaged in the informal employment sector.
- Licensing retirement investment institutions that will ensure a fair rate of return for contributors
- Regulating the activities of licensed investment institutions to ensure compulsory investments are secure and protected.

9.1.2. Public Sector Mission.

The public sector should apply and oversight social insurance policy and ensure that program objectives are achieved and individual rights are protected. This should include:

- Enforcing the collection and/or payment of compulsory contributions to social insurance programs
- Assessing eligibility and entitlement to income support programs.

- Applying stringent controls to the use of funds invested by the licensed investment authorities and ensuring the level of capital adequacy is in line with the Basel II Capital Framework.
- Regularly monitoring the financial position of the licensed investment authorities to ensure that funds are secure, returns are fair and investors' rights are protected.

9.1.3. Transition Mission.

The transition from the existing pay as you go system to the proposed multi-pillar system will protect the fiscal interests of the state, the needs of the pensioner and the entitlements of the contributor. This will include:

- Minimizing the impact of transition on the state budget.
- Preserving the financial security of the aged during the transition phase.
- Maintaining the incentive for individuals to contribute during the transition phase

10. Conclusions.

In line of these objectives the general scheme of a modern and sustainable pension will be based on three pillars:

- First pillar, through which mainly ensure the protection of the elderly from poverty. This column is going to be compulsory and completely under the management of the state.
- Second pillar, which allows individual selections of a distribution for the entire life of its consumption. This column can be public or private and is based on capitalizing or redistribution, but must be clearly separated from the first pillar.
- Third pillar, which is completely private and is based on capitalizing optional election by individuals.

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