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PENSION REFORM

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Introduction by the Special Editor: The Rise of Pension Privatisation in the South Caucasus

The privatisation of pension systems has spread worldwide, especially in the 1990s and 2000s, first mostly in Latin America, followed by numerous countries in Central and Eastern Europe. In recent years, South Caucasus countries have also reformed their pension systems. Armenia and Georgia have introduced a mandatory system of private, individual pension savings, while Azerbaijan has so far maintained its pay-as-you-go system with supplementary voluntary private pension savings.

The late rise of pension privatisation in the South Caucasus is surprising given that in the wake of the 2008 global financial crisis, many countries in Central and Eastern Europe scaled down mandatory private retirement accounts and restored the role of public provision. Hungary de facto nationalised private accounts in 2010/11, Poland turned the mandatory funded pension pillar into a voluntary one in 2014, and Russia froze the funded part of its pension system in the same year to use the contributions for current pension payments.

Assisted by international financial institutions, Armenia (in 2014/18) and Georgia (in 2019) converted their pension system to compulsory individual accounts for all employees under 40 years of age. In Armenia, employees pay 2.5% and the state pays 7.5% of salaries into an individual pension account, while in Georgia, employers, employees and the state each pay 2%. The authors of this special issue have different views on this fundamental reform of the pension system.

In the first article, Gayane Shakhmuradyan is quite optimistic that the reformed system can ensure better retirement income for future retirees. She argues that despite the continued public disapproval of the mandatory funded scheme, the Armenian pension system is now more sustainable and robust, and economic inefficiencies are being overcome.

In contrast, Alexandra Aroshvili and Tornike Chivadze are sceptical about the reform of the Georgian pension system. In the second article, they point out that the privatisation of the pension scheme cannot adequately meet the needs of current and future pensioners. Their main criticism is that there is neither a basic pension nor any redistribution mechanism, which leads to injustice between the generations.

In the third contribution, Gubad Ibadoghlu provides an overview of the current state of the pension system in Azerbaijan. He believes that the current pension system in Azerbaijan is not sustainable in the long run and should be reformed. In particular, the social security principle should be strengthened, and non-insurance benefits by the state should be reduced. However, thus far, there seems to be no major debate about a mandatory funded pension in Azerbaijan.

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Economic and Political Aspects of the Pension Reform in Armenia

By Gayane Shakhmuradyan (American University of Armenia)

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Abstract

This article examines the past and the present aspects of retirement income provision in Armenia, with an outlook for the future. It particularly looks at the main drivers behind the systemic reform and the structure and operation of the old and new systems. The public attitude towards and the discourse about reform are also analysed. An assessment is made whether the reformed system can better ensure retirement income provision.

Introduction

The reform of the pension system in Armenia has arguably been one of the most contested policies adopted since its independence. Legislatively enacted in 2010, the reform entails a transition from an exclusively publicly financed and managed system (Bismarckian or pay-as-you-go (PAYG)) to one that combines tax-financed tiers with privately managed funded tiers (a multipillar system). The introduction of a mandatory funded scheme for those born after January 1, 1974, met significant opposition from the society, resulting in the formation of a movement called *Dem Em* ('I am against'). On April 2, 2014, the Constitutional Court of Armenia declared several provisions of the Law on Funded Pensions as unconstitutional, and the law went into effect covering only public sector employees. Since July 2018, both public and private sector employees have been involved in the scheme, with a contribution rate of 2.5% of their gross wages.

This paper looks at the operation of both the old and the new systems, with the purpose of discussing the causes that made the former system ineffective in providing retirement income and the features that are meant to enable the latter to fulfil its purpose. The first two sections look at the structure of the pension system and its operation. The problems faced by the old system and the extent to which the reformed system copes with those are also discussed. The third section contains a discussion of the public discourse about reform and the attitude towards its implementation.

Structure of the System

Prior to reform, the pension system in Armenia consisted of a single tier that employed a pay-as-you-go (PAYG) defined benefit (DB) scheme to provide pensions, i.e., benefits to the retired population were financed through the contributions of the working-age population. The system followed the Bismarckian logic of social insurance, implying that apart from being used by the government to finance the pensions of the retired population, the social security contributions made by employees and their employers earned for these individuals *a right to pension*. Social assistance was provided to the members of the retired popula-

tion who did not have the required length of service (five years in 2010) to qualify for an earnings-related pension (National Assembly of the Republic of Armenia, 2002).

By the reform, a transition has been made to a multi-tier system, which is modelled on the World Bank's proposed framework (Holzmann and Hinz, 2005; World Bank, 1994) and includes the following components:

1. *A zero pillar*, which provides old-age, disability, and survivor pensions to individuals with no insurance coverage. Benefits are financed from the state budget and are equal to the minimum food basket allowance.
2. *A first pillar*, which provides old-age, disability, and survivor pensions to those with insurance coverage who were aged above 40 in 2014, thus replacing their lost income. Benefits are financed from the state budget and depend on personal earnings.
3. *A second pillar*, which will provide pensions to those who were aged below 40 in 2014 and who make contributions to their mandatory individual accounts. Benefits are self- and state-financed with contribution rates of 2.5% by the individual and 7.5% by the government. Pension benefits will depend on the amount of accumulated funds at retirement and the investment return, net of management fees.
4. *A third pillar*, which will provide pensions to those who make contributions to the voluntarily funded scheme.

The third and fourth tiers of the system employ *defined contribution (DC)* schemes and operate as a complement to the second tier, which retains the DB scheme of the old system. Benefits from all tiers may be received upon reaching the statutory pensionable age (currently 63 years old for both men and women), except for cases specified by law. The required period for qualifying for an earnings-related pension has been increased from five to ten years (National Assembly of the Republic of Armenia, 2010a, 2010b).

Operation of the System

Pension systems carry out two main functions: insurance against the incapacity to work because of advanced age or disability and alleviation of old-age poverty through redistribution from the lifetime rich to the lifetime poor

(Barr and Diamond, 2010; Holzmann and Hinz, 2005; Schwarz, 2006). These functions, which are also objectives of social policy, can be fulfilled only if certain conditions are met. For one, the population has to be covered by the operating scheme, which involves workers as contributors and the retired as beneficiaries. For another, the size of the pension must be enough to ensure an adequate standard of living for the elderly population. Other conditions include the affordability and sustainability of the retirement income provision given the population and economic growth rates, equity, economic and administrative efficiency, as well as the robustness of the system or its ability to withstand adverse social, political, and economic developments (Holzmann and Hinz, 2005; Holzmann, Hinz, and Dorfman, 2008; Whitehouse, 2012). In the following paragraphs, the situation in Armenia pre- and post-reform is discussed, followed by an assessment of whether the reformed system can better ensure the provision of retirement income.

Coverage: In 2010, the pension system covered less than ¼ of the working-age population, as only 529,100 of the 2.2 million contributed to it (State Social Security Service of the Republic of Armenia, 2020; Statistical Committee of the Republic of Armenia, 2019a). Being close to those observed in Georgia, Azerbaijan, and Albania, that rate of coverage was substantially below the near-universal coverage seen in the countries of Central and Eastern Europe (International Labour Organization, 2019; Palares-Miralles, Romero, and Whitehouse, 2012, pp. 166–169). In terms of beneficiaries, coverage was high, as the number of those who were above the statutory pensionable age was 376,000 in 2010, while old-age pensions were provided to 465,084 individuals or 14% of the population (National Statistical Service of the Republic of Armenia, 2013, p. 17). As of October 31, 2019, the number of contributors to the funded scheme was 537,627 (Central Bank of the Republic of Armenia, 2019), which is equal to 89% of the registered workers and 47% of the labour force (Statistical Committee of the Republic of Armenia, 2019a, 2019c, p. 70). Approximately one thousand individuals contribute to the voluntarily funded scheme (Capital Asset Management CJSC, 2020). The number of recipients of old-age pensions has decreased to 322,692 (Statistical Committee of the Republic of Armenia, 2019b, p. 459).

Adequacy: Poverty rates among the elderly population were high in 2010. Approximately 33% lived below the upper general poverty line of 33,500 AMD (at that time equal to approximately 90 USD), thus being qualified as ‘poor,’ and 2.5% lived below the food or extreme poverty line of 19,000 AMD (50 USD) (‘extremely poor’). Elderly individuals accounted for the largest share (11%) of the poor population (National Statistical Service of the Republic of Armenia, 2011, p. 39). In 2018, the

respective rates were lower standing at 21% for poor and 0.5% for the extremely poor, but the elderly population continued to account for the largest—and larger compared with the percentage in 2010—share of the poor population at 14% (Statistical Committee of the Republic of Armenia, 2019d, p. 52). The replacement rate of pensions (defined as the average pension relative to the average wage) was 26% in 2010 and 23% in 2018 (Statistical Committee of the Republic of Armenia, 2019a).

Affordability and Sustainability: In 2010, pensions made up the largest share of government expenditures at 18.5%. That total equalled 5% of GDP and was substantially more than the spending of other social sectors, including education and healthcare (National Statistical Service of the Republic of Armenia, 2011, p. 26). Pension spending accounted for 7% of the GDP and 19% of the government expenditure in 2018 (Statistical Committee of the Republic of Armenia, 2019e, p. 408–410). The system dependency ratio (the number of contributors divided by the number of beneficiaries) was 0.98 in 2010 (State Social Security Service of the Republic of Armenia, 2020), i.e., there was roughly one contributor per retiree, which is well below the ratio of 3:1 necessary for maintaining systemic stability (Government of the Republic of Armenia, 2008). The old-age dependency ratio (the share of population aged 65+ within the population aged 15–64) was 16% in 2010 and is projected to reach 34% by 2050 (United Nations Population Division, 2019).

Equity: Data from the World Bank’s ASPIRE database (World Bank, 2020) reveal that in pre-reform years, greater social security benefits were provided to those in the lower quantiles of income distribution. Thus, the PAYG system was intra-generationally equitable. However, in terms of intergenerational equity, the system would be inequitable if left unreformed, as benefits would be provided to current workers that were lower than their contributions (24% of wage in 2010). This is because of the high emigration and low birth rates (25% and 1.5 on average, respectively, for the period 2010–2017) (Statistical Committee of the Republic of Armenia, 2019a).

Economic Efficiency: Conceptual documents on the reform reflected the argument presented in the literature that social security contributions in a PAYG-DB system create disincentives for formal employment and private saving, thus hindering economic growth (Government of the Republic of Armenia, 2005, 2006, 2008). Statistical data are supportive of that claim in that the rate of non-agricultural informal employment decreased notably from 22% to 18% in 2014, the year when social security contributions were unified with income tax (Statistical Committee of the Republic of Armenia, 2018, p. 112).

Administrative Efficiency: The administrative costs of the Social Insurance Fund accounted for approximately

2% of its total expenditures and 7% of the non-pension expenditures (National Statistical Service of the Republic of Armenia, 2008, p. 365). To reduce the administrative costs associated with running the individual accounts, two features are incorporated into the reformed system. First, recordkeeping is centralized and carried out by the Central Depository of Armenia; second, a cap has been placed on the fees that asset managers can charge (1.5% of the net asset value (NAV)) (National Assembly of the Republic of Armenia, 2010a). As of January 8, 2020, the fees charged by the two asset managers are below the legislatively set 1.5%, while the rates of return on pension fund assets have been positive since its inception in March 2014. The average return has been 10% for balanced and fixed-income funds and 9.6% for conservative funds (Amundi ACBA Asset Management Armenia, 2020; C-QUADRAT Ampega Asset Management Armenia, 2020).

Robustness (Security of Benefits): The two determinants of the robustness of a pension system are the extent to which its financing and management are diversified (Holzmann, Hinz, and Dorfman, 2008) and (specifically for DC schemes) the share of the assets that are invested in secure financial instruments, such as government bonds and deposits (Pension System Awareness Center, 2018). As opposed to the old system, which relied exclusively on a publicly financed and managed scheme, the reformed system is diversified; pillars 0 and 1 are tax-financed and managed by the state, while pillars 2 and 3 are funded and managed privately. Data published by the Central Bank of Armenia and the Central Depository of Armenia show that approximately two-thirds of the pension fund assets are currently invested in government bonds and deposits (Central Bank of the Republic of Armenia, 2019; Central Depository of Armenia, 2019).

A general assessment of the reform that can be made at this point is that although replacement rates remain low and poverty among the elderly population persists, the reformed system can ensure a better retirement income for future retirees, as coverage, sustainability, and robustness of the system have been improved, and economic inefficiencies are being overcome. Given the challenges of ageing and the emigration of the working-age population, those are the gains from the reform.

Public Discourse and Attitude towards the Reform

The reform was advocated by the government as a means to ensure a higher standard of living for the elderly population. Increased individual responsibility in the provision of retirement income, captured by the motto “*Not only the state but also the citizen,*” was seen as the key to that objective (Government of the Republic of Armenia, n.d., p. 1). It was emphasized that the tax burden on the

employees and their employers would not increase, as social security contributions and the income tax would be integrated in a single tax on income (Ibid.). To promote public awareness, a number of initiatives were started, among which was the establishment of the Pension System Awareness Center (PSAC).

The opposition to reform, represented by the four non-governing factions in the parliament (Prosperous Armenia, the Armenian National Congress, the Armenian Revolutionary Federation, and the Heritage parties), discredited the reform as an attempt by the ruling party (the Republican Party of Armenia) to renege on its responsibility of ensuring the sustainability of the pension system. A social movement called “*Dem Em*” (“I am against”), initially comprised of IT sector employees, organized rallies and demonstrations against the reform. Leaders of the movement declared that by making the funded component mandatory, the government was impinging on the constitutionally enshrined rights and freedoms of the citizens, particularly that of property, and was violating the constitutional provision that Armenia is a social state (Dem Em Initiative, 2020).

In December 2013, opposition MPs filed a case with the Constitutional Court of Armenia to determine the constitutionality of a number of articles in the Law on Funded Pensions. In its decision published on April 2, 2014, the Court declared those provisions unconstitutional, urging the Government and the National Assembly to take steps towards revising the law (Constitutional Court of Armenia, 2014). Public opinion survey data from a representative sample (Caucasus Research Resource Centers, 2015) revealed that the majority of the population across all age groups and income levels disapproved of the reform (for details see Figures 1a and 1b at the end of this contribution).

The revised law went into effect in June 2014, with only public sector employees being required to contribute to the funded scheme. The mandatory operation of the funded scheme for private sector employees, conditioned by the changes in the tax code, was scheduled to take effect on July 1, 2018 (Azatutyun, 2016). The disapproval ratings of the reform remained high in 2017 (Caucasus Research Resource Centers, 2017), though a decreasing trend comparable with that in 2015 did take place (see Figures 2a and 2b at the end of this contribution).

In June 2018, confronted with the decision of either halting the taking effect of the law or not undertaking any action at all, the post-revolutionary government of Nikol Pashinyan chose a middle approach. The funded scheme, which by then already covered some 200,000 employees, was not abolished, but the contribution rates were altered, with individual rates decreasing from 5% to 2.5% of wages and the government contributions increasing from 5% to 7.5%. Referring to the negative

consequences that the abolishment of the funded scheme would have for the society and the economy, the prime minister noted that the reform “was in the national interest of the Republic of Armenia and in the long-term interest of its citizens” (CivilNet, 2018). The bill was passed in the parliament with 78 votes in favour, two against, and seven abstaining (Asbarez, 2018). The MPs who initially disapproved of the reform expressed conditional support for the new government with the expectation of further deliberations and reform (Panorama, 2018). Members of the “Dem Em” movement planned to renew their protests (Azatutyun, 2018), but as of this writing, no large-scale protests have taken place. Tax law changes introduced by the new government (adopted in June 2019, effective as of January 1, 2020) envisage that in the period 2020–2023, personal income tax rates will gradually decrease from the current 23% to 20% for all

citizens (flat taxation), while social security contribution rates will be restored to the pre-2018 rates (5% by the individual and 5% from the government) (National Assembly of the Republic of Armenia, 2019a, 2019b).

Conclusion

In an attempt to solve the fiscal sustainability problem of the PAYG system, the government of the Republic of Armenia chose to transition to a multipillar system that combines tax-financed tiers with fully funded tiers. The opposition to this reform from parliamentary factions and society at large led to the questioning of several provisions of the Law on Funded Pensions and its ultimate revision. Although the reformed system has the potential to address the problems that the old system faced, thus providing adequate retirement income, public disapproval of the mandatory funded scheme remains high.

About the Author

Gayane Shakhmuradyan is an alumna of the American University of Armenia, with an MA in Political Science and International Affairs (2019). Her research interests are in the field of comparative politics, and she wrote her master’s thesis on the pension system reform in Armenia. Currently, she is doing research at the American University of Armenia and plans to apply for PhD studies.

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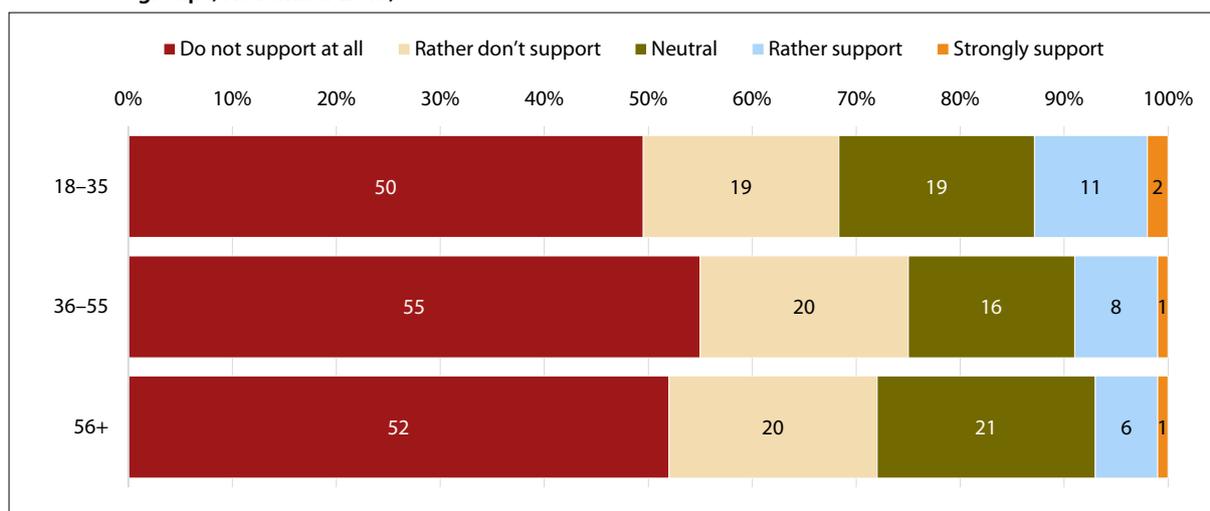
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OPINION POLL

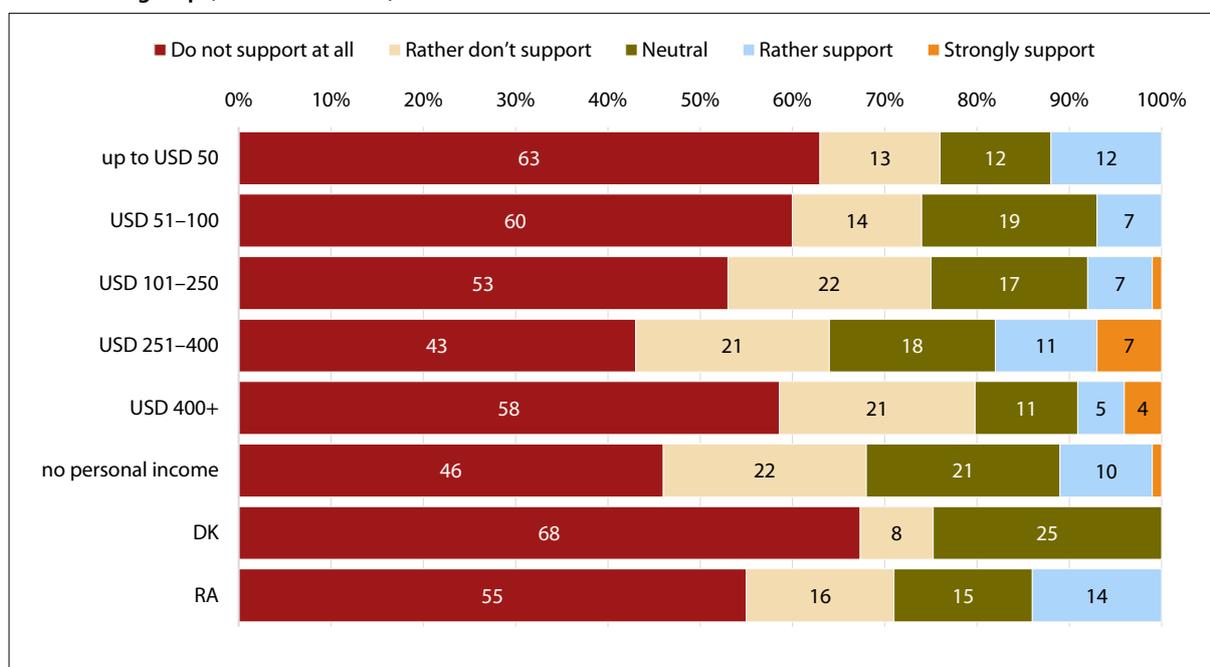
The Attitude of the Armenian Population towards Pension Reform

Figure 1a: How much do you support or not support the introduction of the cumulative pension system? (by age groups, November 2015)



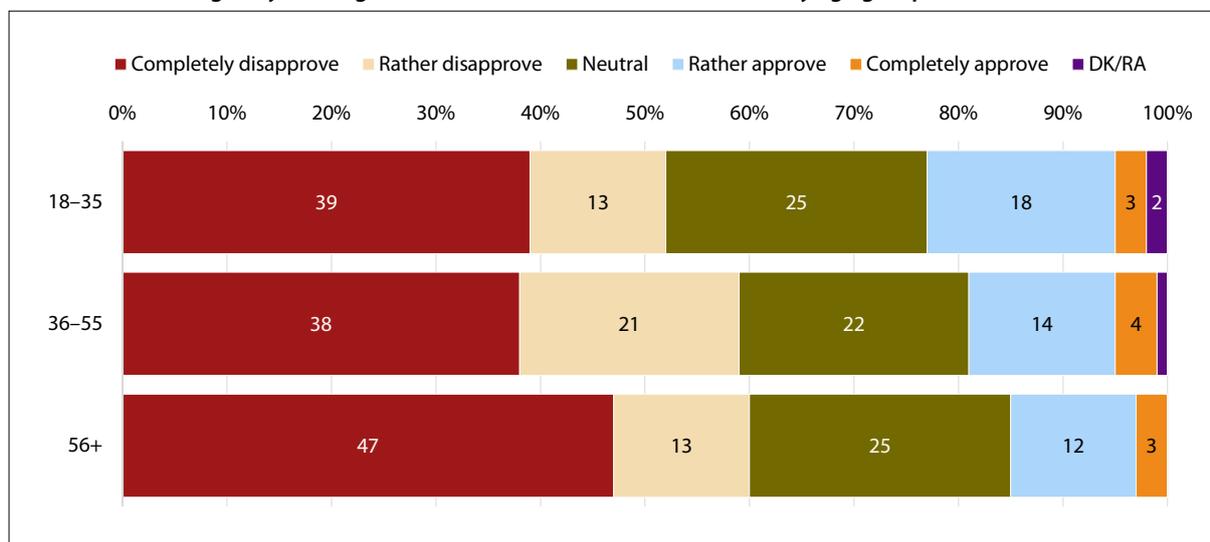
Source: Caucasus Research Resource Centers. (2015). *Caucasus Barometer 2015 Armenia*. <https://caucasusbarometer.org/en/datasets/>

Figure 1b: How much do you support or not support the introduction of the cumulative pension system? (by income groups, November 2015)



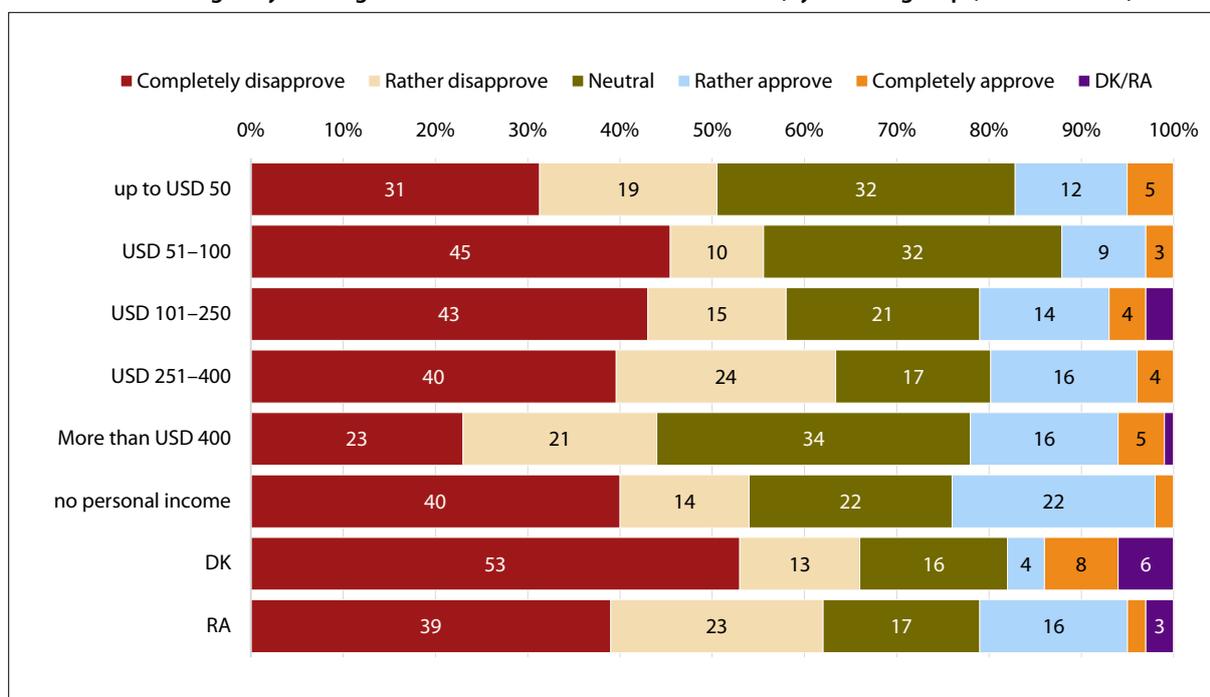
Source: Caucasus Research Resource Centers. (2015). *Caucasus Barometer 2015 Armenia*. <https://caucasusbarometer.org/en/datasets/>

Figure 2a: How much do you support or not support the introduction of the cumulative pension system, which will be obligatory starting from 2018 for citizens born after 1974? (by age groups, October 2017)



Source: Caucasus Research Resource Centers. (2017). *Caucasus Barometer 2017 Armenia*. <https://caucasusbarometer.org/en/datasets/>

Figure 2b: How much do you support or not support the introduction of the cumulative pension system, which will be obligatory starting from 2018 for citizens born after 1974? (by income groups, October 2017)



Source: Caucasus Research Resource Centers. (2017). *Caucasus Barometer 2017 Armenia*. <https://caucasusbarometer.org/en/datasets/>

Pension Privatization in Georgia: Accumulation Against Solidarity

By Alexandra Aroshvili and Tornike Chivadze

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Abstract

On 01 January 2019, a new pension plan was launched in Georgia. Oriented towards long-term accumulation and based on individual contributions, the plan represented a Georgian version of an otherwise typical private pension system where, together with the employee, the employer and the state (each contributing 2% of the employed person's taxed salary to the pension account) participate in pension accumulation. With this reform, apart from improving the social conditions of the pensioners in Georgia, the government should have responded to ongoing demographic and fiscal challenges, according to which the number of pensioners will be constituting a quarter of the population by 2030, while the number of hired workers (payers of income tax) is already lower than the number of existing pensioners (Geostat 2018). Thus, considering the current budgetary parameters, a substantial increase in basic non-contributory pensions seems to be out of reach. This article discusses why Georgia's pension reform cannot adequately meet the needs of current and future pensioners, the short- and long-term impacts that we should expect from ongoing reform, and what might be the real motivation behind this process. Additionally, we will contemplate the existing alternative and the problems with the political discussions around it.

Elderly Individuals in Georgia

Georgian pensioners have been Soviet citizens for decades, and their retirement insurance was centrally covered by the Soviet state-run pension system "Gosstrakh". Based on intergenerational contributions, this system generated generous retirement benefits throughout the Soviet Union (Koplatadze, 2000; Buckley, 1998). However, due to the collapse of the Soviet Union and years of hyperinflation, these deposits vanished into thin air.

After the fall of the Soviet Union, Georgia attempted to recover its share of Gosstrakh (the organization itself was under Russian ownership by that time) in vain: Under severe international pressure in the late 1990s, Georgia was forced to sign a so-called "Zero Option Agreement" with the Russian Federation that aimed to restructure interstate debt (Gugushvili, 2009). Apart from the fact that the country could no longer receive its share in the Soviet pension fund, this agreement implied that Georgia was free from the responsibility of returning these funds to the beneficiaries of the Soviet insurance system or compensating them as an independent state. Since that time, no significant pension reform has been implemented in Georgia that would offer a pension higher than the equivalent of minimum subsistence.

The basic flat-rate universal pension in Georgia today is 200 GEL (equal to approximately 70 USD), and this is the highest rate over the course of almost 30 years of independence. However, the current pension cannot meet even the most basic needs of elderly individuals as the official minimum subsistence level is 193 GEL. The current pension replacement rate in relation to the average salary is 19%. These indicators are alarming when

they are compared to EU and OECD averages (ranging from 60 to 75%) and a regional average of 40% (Ministry of Economy 2014).

Despite its miserably low amount, the existing pension has a significant impact on general inequality and poverty, which illustrates that the socio-economic conditions in the country are alarming. As of 2017, if we subtract old age pensions from household incomes, the poverty level in the country would increase by 20%. In addition, the impact of existing pensions on general inequality is stronger than the impact of social assistance, and this impact has an upward tendency (Kakulia et al. 2017). According to the World Bank, an increase in pensions of 100 GEL (equal to 35 USD) would have reduced the poverty level by 15%, and an increase of just 20 GEL (equal to 7 USD) would have decreased the poverty level by 2.8% (Ministry of Economy 2014). The introduction of basic pensions in 2006 had a positive impact on poverty reduction among children, also indicating that basic pensions remain an important mechanism for combating general poverty. (UNICEF 2014) Due to the involvement of international financial institutions, the Ministries of Economy and Finance of Georgia have developed a private saving pension plan, which does not provide the reinforcement of basic pensions or integrate any redistributive mechanisms into the pension system. This particular action was also the government's offer of rethinking the historical meaning of pension: withdrawing its social function and considering pensions as an individual responsibility or as a powerful macroeconomic tool for economic growth and capital market development. As the website of the Pension

Agency maintains: “In long and short-term perspective, the pension assets will create a significant investment capital base (several billion GEL), which will be crucial in Georgia’s capital market development and its 80% at least will serve the economic growth of Georgia its acceleration”.

Who Will Benefit and Who Will Pay the Price?

The reform is based on a 6% contribution of monthly salary to the personal account of the employee. According to the approved law, the accumulated assets will be controlled by the LEPL “Pension Agency” and then transferred to private companies for management. Assets will be invested in financial markets using a variety of financial instruments, and the proceeds will be placed in the personal accounts of the employees. After retirement, the beneficiaries can receive a single lump sum pension or a monthly programme payment based on the sum of proceeds divided by the number of month between retirement age and average life expectancy (set by the National Statistics Department of Georgia at the time of retirement).

One of the most important criteria for evaluating pension plans is coverage of the workforce. Participation in the retirement plan is mandatory for employees under 40 years of age. Inclusion in the plan for those who are self-employed is voluntary with a 4% contribution. Individuals over 40 can leave the plan.

In developing countries, an additional feature of pension plans is the facilitation of the labour formalization process. It should be noted that in the process of estimating the coverage of reform, the structure and characteristics of the domestic labour market, which is affected by a large shadow economy, have not been taken into account. The reform also relies on inappropriate methodological assumptions, such as employee registration and average wages.

Employment in Georgia is calculated according to the ILO standardized methodology, which aggregates hired and self-employed workers. However, the vast majority of self-employed people are actually unemployed. By 2017, 51% of the employment rate represented self-employed individuals, 82% of whom were involved in agriculture. (Ministry of Economy 2018) Their share in total employment is 43%, while their share in GDP is only 8% (Geostat 2017) indicating low agricultural productivity and limited incomes. As of 2015, only 2% of self-employed individuals were entrepreneurs or employers and would register as taxpayers. It is obvious that most of the self-employed individuals would not formalize their labour and would therefore refuse to join the pension plan because if they joined,

they would have to pay an additional 20% in income tax as well as the 4% pension contribution. Consequently, the 2% subsidy of the state does not act as an incentive for the formalization of labour.

Notably, the average salary of employees aged 50 to 60 was approximately 650 GEL as of 2015 (Geostat 2015, equal to 270 USD at the time). Typically, in the last decade of working age, incomes tend to decrease rather than increase, which suggests that hundreds of thousands of future retirees, whose incomes are low, will depend on the basic pension because they will not have enough time to save enough for a higher pension.

The figure used for the average salary, which amounted to 1125 GEL (425 USD) at the time the reform was launched, is also irrelevant for the planning of the reform. This figure does not take into account the median distribution, income inequality, or the difference between very high and very low salaries, and by using average values, fails to determine the fluctuations in the wages of the majority of the population. Data obtained from the Georgian Revenue Service indicate that in 2017, 64% of total revenue recipients received less than 1,000 GEL, which is 21% of total revenue. In total, 90% of the revenue recipients received only 50% of the total revenue, while the remaining 10% received 50% of the total revenue.

The reform also disregards important characteristics of the Georgian labour market such as the sectoral structure of the economy and the overall quality of jobs: service and construction development are the two leading sectors. (Ministry of Labour 2015) These sectors are characterized by low wages and unstable and informal employment. (Solidarity Center 2018) Consequently, contributions are irregular and insufficient for accumulation. Overall, the data indicate that low incomes and uneven redistribution would render the individual accumulation system pointless, since the majority has nothing to accumulate, and labour market inequality will transfer into old age poverty. The government’s pension reform does not integrate any type of specialized concession for target groups, nor does it consider redistribution mechanisms often found in traditional pension systems, for example: providing continuous contributions for the temporarily unemployed or early retirement for employees working under severe or harmful conditions. Other redistribution mechanisms are solidarity funds for low-income contributors or the augmentation of healthcare services for elderly individuals or the strengthening of the basic pension. It should be noted that these types of balancing mechanisms are vitally important in the context of uneven coverage of reform and generally, in an unequal society (Barr and Diamond, 2006) since without them, only a narrow segment of the population benefits from the pension.

The reform does not cover current retirees or those retiring in the next 10–15 years because they do not have sufficient time to accumulate funds. It also does not cover self-employed individuals or the majority of the 20% of employees who are under 40 years old and working at unstable and low-wage jobs. As a result, only a very narrow segment of the population benefits—those who already enjoy a private pension plan.

It is important to note that in addition to the above-mentioned problems and the contradictions between the proposed pension plan and local needs, the reform excludes solidarity as a fundamental notion. It does not allow for intergenerational redistribution or redistribution within generations and has a kind of “extractive” character: the pension scheme primarily extracts funds from those with low incomes and the state. (The contribution from the employer is unprecedentedly low. Under this new reform, the contributions of employers and employees are not taxed—the actual contribution of the government is 2.8% out of a monthly contribution of 6%. According to Eurostat, the average contribution of an employer in pension systems is at least twice as much as the contribution of an employee.) Finally, these funds are transferred towards financial markets.

Historically, the real profit from these types of schemes goes to financial players, namely, stock markets, insurance companies and capital markets, not only locally but globally. (Naczyk and Palier, 2014). However, the existing joint-stock market in Georgia is not developed enough. Additionally, the 2008 experience has shown that financial crises weigh heavily on pension assets and pension funds. (Orenstein, 2011) Considering the probable effects of the reform, additional resources will become necessary to limit social harm.

There Is an Alternative

During the pension reform, the social-democratic faction of the Georgian parliament proposed a bill, with a main pillar that was based on the principle of intergenerational solidarity. The scheme allotted 4% of the overall 6% contributions to the pillar of intergenerational solidarity and the remaining (minimum) 2% to individual accumulation accounts. The intergenerational solidarity pension was calculated on the basis of contributions and their duration. The proposed pension contained some mechanisms of redistribution: 1. Bonus years were provided to the beneficiaries in the first decade of the system since they did not have sufficient years for contributions. 2. The bonus years were reduced annually for new beneficiaries who had more years of real contributions than their predecessors. This should have provided for a rapid and massive rise in pensions and the covering of thousands of future retirees, who would not receive

an adequate pension raise even with the 6% individual contributions.

By calculating average lifetime earnings, those earning less than the existing average salary would benefit from “accrual rates”—the lowest earning individuals would receive the highest rate, etc. We see identical formulas in similar pension schemes in the Czech Republic, the U.S., Switzerland, Portugal and the U.K. The policy was thus oriented on reducing poverty and potentially reducing labour market inequalities among elderly individuals. Since the calculations were based on the average of lifetime earnings and not the salary of the most recent working years, the proposed method involved valorisation, which considers the inflation in the years of contribution and permits the indexation of pension on current inflation. The draft also proposed supplying temporarily unemployed individuals with contributions over a six-month period.

This plan would stimulate the formalization of employment, as citizens would benefit from a larger pension based on small contributions, especially in the first years. Since the plan was based on contributions, there is a strong balance between the current contributors (the active labour force) and the beneficiaries (retirees who contributed in the past), which allows large amounts of funds to accumulate and be distributed to retirees, whose numbers rise annually. The draft also meant for the investment of pension assets (the funds remaining after the distribution of pensions) into housing: the formation of a National Housing Fund, which would have worked with the Pension Fund on affordable housing policies.

The primary differences between the draft provided by the social democrats and the approved reform lie in the fundamental principles. The former was oriented towards institutionalizing intergenerational solidarity, while the latter was oriented towards encouraging individual saving. The alternative draft was created to benefit the workers, those with low incomes and other target groups. In contrast to the approved reform, the alternative draft proposed that beneficiaries receive pensions from the beginning of their retirement until their death.

The alternative draft was not supported by the Georgian parliament. One member of the social-democratic faction Beka Natsvlishvili left the parliamentary majority in protest.

What Does the Pension Reform Reveal?

Considering the incredibly sensitive nature of the subject, the government should have tried to obtain public legitimation. However, as research reveals, the details of the reform were unknown to the majority of society. Based on a representative poll conducted in 2017 by

Friedrich Ebert Stiftung, we can conclude that only 2% of the survey participants considered themselves to be fully informed (FES 2017). After implementing the reform, a poll conducted by NDI has shown that 51% of the survey participants had never heard of the pension reform at all (NDI 2018).

Because the vast majority of society had no awareness and consequently no legitimation or involvement in the process, the government was able to pass the prepared scheme as “the main pillar.” The main pillar originally represents a traditional intergenerational solidarity plan that often exists in multipillar pension systems. It provides the main pension incomes for elderly individuals along with the universal public pensions in countries of the European Union and OECD. In reality, the above-mentioned pillar was neglected. The plan proposed by the government is a typical private plan that is voluntary almost everywhere because its foundation stands on the principle of individual accumulation.

This subject has been also excluded from the political and media debates about the reform. The arguments that parliamentary opposition used to criticize the given reform were even more libertarian in means of problematizing its obligatory character as well as government participation in the reform. A similar position was held by the majority of non-governmental organizations. To sum up, the political discussions about the pension reform had revealed considerable incompetence of the media, experts and politicians about this issue.

Implementing the reform has also revealed a global tendency: developing countries are manipulated into employing such radical solutions. The historical analysis shows how the representatives of local governments

were used as secondary actors by international financial institutions and other financial players to carry out similar reforms mainly in post-socialist and Latin American countries (Naczyk and Palier, 2014). According to pension system experts, this process involves the privatization of pensions and implies that pensions have transformed from having a historically social function to having a macroeconomic function that employs market principles (Ebbinghaus, 2015) and is subordinated to growth imperatives.

Conclusion

By instituting active pension reform:

1. The state did not restore justice for existing retirees (to balance the loss of Soviet contributions).
2. The state has not fulfilled its social obligation to the abovementioned generations by providing them with adequate living pension allowances during their lives.
3. The state did not fulfil either its moral or social obligations of developing a plan that considers redistribution mechanisms based on the principle of intergenerational solidarity, which would have the capability of significantly mitigating the condition of retirees and vulnerable groups of future generations—the latter being the majority of the population.
4. The Parliament declined to use the alternative bill—an additional pillar that did not imply the complete replacement of the government’s reform. This decision has closed down the opportunity of reducing retirement poverty in coming years, at the very least. At the most, it has eliminated the possibility of paying a financially stable and socially just pension of higher value to future generations.

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The Current State of the Pension System in Azerbaijan: Challenges and Prospects

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Abstract

This contribution gives an overview of the current state of the pension system in Azerbaijan, examining the regulation of the retirement age and disability pensions as well as the generosity of pension benefits. Major indicators are compared to those of other countries in the post-Soviet region. The contribution continues to assess reform needs and reform plans. The contribution concludes with brief recommendations for pension reform.

Introduction

According to official data, at the beginning of 2019, 13.2% of the total population of Azerbaijan (equal to 1.3 mn out of nearly 10 mn people) were pensioners. (State Statistical Committee 2019) In comparison to the post-Soviet region, this is a very low number. While in Azerbaijan, as indicated above, there are 130 pensioners

per 1,000 people, the figure is 154 in Armenia, 157 in Kazakhstan, 200 in Moldova, 264 in Ukraine, 273 in Belarus, and 296 in Russia. (Interstate Statistical Committee 2019) Furthermore, Azerbaijan's state finances have benefited from an oil boom. Accordingly, pressure for pension reform has been relatively weak. However, the current system is not sustainable in the long run.

The law “On Labour Pensions”¹ adopted on February 7, 2006, regulates the pension system in the country. The state pension policy of the Republic of Azerbaijan is determined by the “Concept of Pension Reform in the Republic of Azerbaijan for 2014–2020”². There are three categories of labour pensions: old age pension, pension for disabled persons and pension due to loss of the family head. The following sections give an overview of the related regulations as of 2019.

Retirement Age

Amendments to the law “On Labour Pensions” of March 10, 2017, provide the right to retirement with a pension if the pension capital accumulated in the insurance section of the individual account of a person who has reached the pension age allows for a pension payment that is not less than the minimum amount of the labour pension; alternatively, if that is not the case, an insurance period of 25 years also entitles a person to receive an old age pension.

To reduce pension payments, the retirement age has been gradually increasing since July 1, 2017. According to Article 7 of the law “On Labour Pensions”, each year 6 months are added to the minimum retirement age. According to the adopted schedule, from July 1, 2019, to June 30, 2020, the age limit is 64 years and 6 months for men and 61 years and 6 months for women. After July 1, 2026, when the transition period ends, the retirement age will be equal for men and women, standing at 65 years.

Compared with the region, the retirement age of 65 years is high. Among the post-Soviet countries, only Georgia, Latvia, and Lithuania currently apply this age. Kazakhstan, Kyrgyzstan, Tajikistan, Armenia and Estonia follow with 63 years. In Russia, Ukraine and Belarus, the retirement age is currently 60 years. It is also important to note that the Soviet tradition of gender differences in the retirement age, i.e., women retiring earlier than men, has currently been abandoned only in 6 countries (Latvia, Lithuania, Ukraine, Kazakhstan, Armenia, Estonia).

While the retirement age of 65 is not high when compared to Western countries, the lower life expectancy in the post-Soviet region has to be taken into account. Thus, Estonia and Belarus are among the post-Soviet countries with the highest average life expectancy after retirement and thus with the longest average payment period for old age pensions. The corresponding figure in both countries is 14 years. Armenia follows with 12

years, and Russia and Ukraine with 11 years. In Azerbaijan, the figure is only 7.5 years. (CESD 2017. p.16). According to the latest WHO data published in 2018 the life expectancy in Azerbaijan stands at 73.1 years (70.3 years for men and 75.7 years for women). With this figure Azerbaijan ranks 96th in a global comparison. The ongoing increase in the retirement age in Azerbaijan will further reduce the average period of pension payments per person, which will become a factor contributing to a decline in social welfare. Furthermore, the fact that the period of receiving an old age pension is so short creates difficulties in pursuing effective collection policies, because incentives to care for one’s pension are low when the pension payments cover only a few years.

Disability and Loss of Family Head Pensions

A labour pensioner has the right to move from one type of labour pension to another, except for the transition from the old age pension to disability pension, according to Article 34 of the law “On Labour Pensions”. At the same time, only one pension is granted to adult persons who have different pension rights. This means that a disability pension is only paid as long as a person receives no old age pension.

In Azerbaijan, the disability pension is established in connection with the limitation on an insured person’s ability to work for reasons of mental or physical disability resulting from illness or injury. Disability groups, causes of disability or limited health under the age of 18, as well as the period of disability occurrence are determined by medical and social expert commissions in accordance with the legislation. Disability pension is provided to Group I disabled persons if they have 4 months of insurance period for each full year of the working age, provided that the total insurance period is not less than 5 years. Disability pension is provided to Group II and III disabled persons if they have a determined insurance period, provided that the pension capital recorded in the insurance section of the personal account allows a pension guarantee that is not less than the minimum amount of labour pension.³

According to the current legislation, family members (children under the age of 18 with parents who are deceased or killed, as well as children of disabled persons over the age of 18 whose limitations on health were identified up to the age of 18, and students studying full-time at an education department of educational institutions up to the age of 23) who assume the respon-

1 <http://www.e-qanun.az/framework/11566>

2 <https://president.az/articles/13330>

3 <http://sosial.gov.az/elilliyegoreemekpensiyasi>

sibility of the deceased or killed head of the family have the right to a labour pension due to the loss of a family head.⁴ Labour pensions due to the loss of a family head consist of only the insurance section.

Pension Benefits

Old age pensions and pensions for disabled persons consist of two parts, one part based on insurance and one part based on individual savings. Both parts are recorded in an individual pension account, and the respective part of the old age pension is calculated as the ratio of the pension capital in the respective part to the number of months of the expected pension payment term.

Since 2017, each year the old age pensions have been indexed according to the annual growth rate of the average monthly nominal salary for the previous year, as defined by the State Statistical Committee. Until 2017, the labour pensions were based on the consumer price index for the previous year. For orientation purposes, the average nominal monthly wage growth rate in 2017 was 5.7 percent and in 2018 it was 3 percent, while inflation amounted to 12.9 percent and 2.3 percent, respectively.

According to the data from early 2019, the average monthly pension in the country was 222.6 manat⁵ (at that time equal to approximately 130 USD), amounting to just 40% of the average monthly nominal salary in the country. In detail, the old age pension stood at 249.3 manat (145 USD), the disability pension at 185 manat (110 USD) and the loss of family head pension at 175.4 manat (110 USD).

As shown in table 1 on p. 18, 2.56 insured people in 2016, 2.7 insured people in 2017 and 2.86 insured people in 2018 corresponded to one pensioner. Although the dynamics of the past three years have been positive, Azerbaijan has not yet reached the minimum level of sustainability for this system—3 insured people per pensioner.

Reform Objectives

At present, the main objectives of the pension system of the Republic of Azerbaijan are to reduce the dependence of the pension system on budget funds (to minimize non-insurance costs), to increase the functional dependence between the size of the social insurance collection and the size of the amount of the designated pension, to concretize government obligations to finance the pension system, to stimulate the transition to “minimum pension capital”, to create opportunities for the application of a voluntary savings component to the insurance and

to create opportunities for the establishment of non-governmental pension funds (institutions). To achieve these goals, the base part of labour pensions has been abolished so far, the minimum age for the right to receive an old age pension has been increased, the “minimum pension capital” criterion has been introduced, and the requirement of minimum work experience to obtain the right to labour pension has been abolished. The required level of work experience for those who are entitled to a labour pension on preferential terms has been increased by 5 or 10 years in different fields and, as a result, since 2017, Azerbaijan has transitioned from a three-tier system to a two-tier system of labour pensions. However, in the Concept, important issues such as the increase in the insurance premium rates for 2014–2015, as well as the increase in the insurance rates of those people who pay the mandatory state social insurance based on the minimum wage (persons who use agricultural lands on their property, persons engaged in private businesses and labour activity) have not yet been resolved.

Moreover, the pension system in Azerbaijan has not yet been adapted to the needs of the market economy and has not been integrated into international standards. In addition, the pension system has not been financially viable, and this system has not been able to achieve the reliable social protection of retirees in the long term due to the continued serious dependence on state financial resources. Thus, a number of the non-social insurance obligations of the existing pension system in our country have led to an increase in social security spending and transfers from the state budget, significantly increasing the financial burden of this system.

As a result, expenditures in the approved budget of the State Social Protection Fund in 2018 amounted to 3578.7 million manat⁶, which is six times more than in 2006, with 589.5 million manat. During the same period, the amount of transfers from the state budget increased 7.8 times, from 167 million to 1300 million manat, and the share of total expenditures increased from 28.3 percent to 36.3 percent. In the budget of 2019, incomes for mandatory state social insurance are predicted to be 67.1%, and the funds allocated from the state budget are predicted to be 32.8%.⁷

Although recent actions taken at the state level in the direction of formalizing work places, registering labour contracts, and eliminating informal employment expanded the possibilities of using the savings potential of the mandatory state social insurance, in Azerbaijan, the indication of the specific weight of expenses on the

4 <http://sosial.gov.az/ailebashchisiiitirmeyegorepensiya>

5 <http://marja.az/news/37393>

6 http://sai.gov.az/upload/files/DSMF_layihe2018_27OKTYABR_F%C4%B0NAL.pdf

7 http://sai.gov.az/upload/files/DSMF_deyishiklik_Final.pdf

payment of labour pensions by age has had a tendency to decline compared to international indicators, while in contrast, the indication of the specific weight of the expenses on the payment of labour pensions by disability, has had a tendency to increase in comparison with the specific weights of world practices.

The “Concept of economic and social development of the Republic of Azerbaijan for 2018 and the next three years” is aimed at the self-regulation of the insurance-pension system and the achievement of an independent future development. As a priority of the policies on social protection and social security, the Concept also aims at improving the structure of the mandatory state social insurance premium rates, increasing the insurance rates of the people who pay the mandatory state social insurance based on the minimum wage (persons who use agricultural lands on their property and persons engaged in private businesses and labour activity), and optimizing the ratio of the number of people paying the insurance premium to the number of pensioners in 2018–2021.

The Impact of Lower Oil Prices

In 2015 Azerbaijan’s economy started to be effected by lower world oil prices. Since then, various measures have been put in place to reduce the share of transfers from the state budget to the State Social Protection Fund. Thus, as outlined above, the retirement age is currently increased step by step to 65 years. The retirement age of 65 will be introduced in 2021 for men and in 2027 for women.

Another measure has been to change the method of calculating compulsory social insurance contribu-

tions. According to the new methodology, employers pay 15 percent (previously 22 percent), and employees pay 10 percent (previously 3 percent) compulsory social insurance contributions if the monthly wage more than 200 AZN (117.65 USD). Finally, the authorities have tightened controls in order to detect and legalize hidden employment.

Recommendations

In connection with the above, appropriate measures should be taken to further strengthen financial sustainability, regulate the impact of the financial burden of expenditures on government obligations not based on social insurance principles on the system, and strengthen the link between social security contributions and social insurance payments for the long-term development of the pension system. For this purpose, the non-diversification of pension insurance principles for both property and payment sources shows that the use of the reform potential in the country is low.

In conclusion, I would like to emphasize that to strengthen the pension system in Azerbaijan and reduce its financial dependence (ensuring a balance between income and expenditure), the government should first try to legalize the labour market. In this way, it would be possible to increase the ratio of the number of insured persons to the number of pensioners, as well as increase the income of the Social Security Fund. At the same time, it is necessary to regulate the amount of expenditure by automation and transparency of the mechanisms of pension assignment.

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Table 1: Key Indicators of the Pension System for 2016–2019

Indicator	Unit	2016	2017	2018	2019
Number of insured people registered in the individual accounting system	thousand people	3372	3545*	3737	-
Number of labour pensioners (at the end of each year)	thousand people	1315	1311	1304	1300
By age	thousand people	782	769	760	756
For disabled persons	thousand people	384	384	380	390
By loss of family head	thousand people	150	158	164	149
Average monthly amount of pension	manat	192	209	217	223
	USD	120	122	128	131
Minimum amount of pension	manat	110	110	110	200**
	USD	69	65	65	118
Cost of living for labour pensioners	manat	123	130	144	149
	USD	77	76	85	88

Notes: *to November 1, 2017, **from October 1, 2019

Source: State Statistics Committee of the Republic of Azerbaijan

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The Caucasus Analytical Digest (CAD) is a bimonthly internet publication jointly produced by the CRRC-Georgia (<http://crrc.ge/en/>), the Research Centre for East European Studies at the University of Bremen (www.forschungsstelle.uni-bremen.de), the Center for Security Studies (CSS) at ETH Zurich (www.css.ethz.ch), the Center for Eastern European Studies (CEES) at the University of Zurich (www.cees.uzh.ch), and the German Association for East European Studies (DGO). The Caucasus Analytical Digest analyzes the political, economic, and social situation in the three South Caucasus states of Armenia, Azerbaijan and Georgia within the context of international and security dimensions of this region's development. All contributions to the Caucasus Analytical Digest undergo a fast-track peer review.

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