

## ALBANIAN PENSION SYSTEM: FUTURE CHALLENGES

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ehysa@epoka.edu.al**Abstract**

This study analyses the reforms and development of Albanian pension system during the last two decades. The structure of Albanian pension system is composed by three pillars: 1- Compulsory scheme (PAYG), 2- Second pillar, compulsory and private and 3- Third pillar, on voluntary base but actually the PAYG is the most dominant. In the literature review regarding Albania, but not only, there are recommendations regarding the functioning of other pillars in order to overcome the problems faced in the actual system. On the other side, there are some new views regarding the problem of interest rates used in the calculation of pension's benefits. These new ideas come as solutions to the questions raised after the financial crises. Based on these discussion, this study will suggest some possible solution for the establishment of new pension system including the Albanian one.

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***"Pensions are doomed whatever the government does. Whether interest rates go up or whether they go further down, the pensions are at risk. In the case of rising interest rates their value will be decimated. In the case of falling interest rates pension contributions will not be able to earn a return necessary to accumulate the capital needed in order to pay defined-benefit pensions in the future."***

Antal E. Fekete

**1. Introduction**

The collapse of communism regime brought with itself a series of changes in the economic, politic and social aspects. The effects of political regime changes reflected also in the employment level, which is tightly joined to the pension system. Briefly, unemployment rate increased very quickly and an early retirement took place. The number of contributors decreased significantly whereas the contraire happened to the beneficiaries' number. As result, the dependency rate (beneficiary/contributor) increased and the replacement rate (pension/wage) decreased.

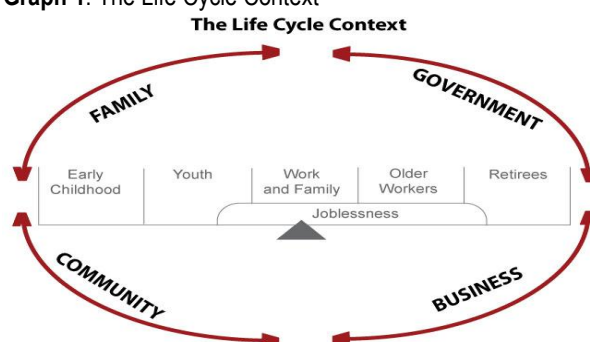
Face to this drastically changes the establishment of new legislation acts was indispensable. After years 1990s, the first act to be implemented was the Act no. 7703, date 11.05.1993, "On Social Insurance in Albania Republic". According to this law, the Pay-As-You-Go scheme was the system to be applied. This scheme would be financed through the contributions collected from those who are currently employed, while the benefits paid to the generations that have been previously employed. Pay-as-you go pension system is based on Bismarck model with wage-related contributions and benefits, but with redistribution element. The Albanian pension system is defined-benefit by the law.

**2. The Actual Pension System and its' Problems**

The pension system was and it will remain a hot topic to be discussed for. This great interest toward it comes from the fact that each person is going to be dependent from the amount of his/her pension. But in order to be part of the "scheme", the people have to contribute for it. Briefly, the contribution rate and the benefit rate are the crucial issues while setting up the pension formula.

The diagram below describes the Lifecycle Context. The main actors having effects on this life cycle are the Family, Government, Community and Business. In the center of the diagram are founded the phases of which the individuals can pass through during their lives. These are defined as Early Childhood, Youth, Work and Family, Older Workers and Retirees. The part of the people entitled 'joblessness'

can be found in all the categories except the Early Childhood period.

**Graph 1: The Life Cycle Context**

By looking at this diagram, two main issues can be identified. The first one is the individuals' part listed as joblessness. The percentage of jobless individuals is a considerable one for the Albanian case. This part of the population is going to face difficulties not only in the middle-age but also in their retired years. The second issue to be discuss is the four 'actors' affecting the life cycle of an individual. Even if these four actors are external influencers, they are the main components which 'define' the life path of individuals. If we consider the community and the business as the basement of a country's climate regarding the facilities in socio-economic aspects, the family and the government remain the composers and the distributors of our incomes. The government has to increase work incentives by supporting the community and business.

Pensions in Albania represent a key element of social protection. Pensioners maintain about 17% of overall number of population. The actual scheme provides three types of pensions: old age pension, disability pension, survivors' pension. The conditions to benefit from full old age pension are to have reached retirement age (60 for women and 65 for men) and to have completed 35 years of insurance. The pension calculation formula is as follows:

$$P_p = M_{pb} + Sh$$

**P<sub>p</sub>**: Full monthly pension age

**M<sub>pb</sub>**: Measure of the basic pension provided to all insured persons must provide a minimum standard of living. This component is corrected each year by the price index of some selected goods, as provided in the rules of the ISS and determined each year by the Council of Ministers. Currently, it is 8240 ALL per month. The monthly pension does not reach the subsistence minimum so this has been a factor that recently the government has used specific policies for the minimum income allowance.

**Sh**: Additional basic pension. This is individual and is calculated on the size and length of contributory period and 1% for each year multiplied by proving measurable average basis (salary on which contributors were paid). Council of Ministers approves annual indexation coefficient database using measurable growth rate of average individual contributions of the respective year with the previous year.

Actually there exist two upper limits of pension amount: 1- 75% of the indexed average net wage of the best three successive years in the ten last years of employment and 2- double basic pension.

**Table1.** Main parameters of pension values (2000-2020)

	2000	2001	2002	2003	2004	2005	2010	2015	2020
<b>Replacement Coefficient* (%)</b>									
<i>Urban</i>	35.00	35.40	35.80	36.20	36.50	37.20	37.60	37.90	38.20
<i>Rural</i>	13.30	13.20	13.10	13.00	12.90	12.80	12.20	10.90	10.00
<b>Coverage Rate** (%)</b>	35.40	36.73	38.31	39.77	41.51	42.14	50.27	54.49	57.56
<b>Dependency Ratio*** (%)</b>	1.04	1.01	0.99	0.96	0.94	0.93	0.81	0.82	0.82
<i>Urban</i>	1.10	1.06	1.02	0.99	0.95	0.93	0.82	0.83	0.85
<i>Rural</i>	0.94	0.94	0.93	0.92	0.92	0.93	0.77	0.80	0.78
<b>Contributors/Population (%)</b>	14.30	15.00	15.70	16.40	17.00	17.80	21.50	23.10	24.60
<b>Beneficiary/Population (%)</b>	15.00	15.00	16.00	16.00	16.00	17.00	17.00	19.00	20.00

/Source: Social Insurance Institute

\*Replacement coefficient: the ratio between the size of average pension to average wage

\*\*Coverage rate: ratio of the number of contributors to the real number of the workforce able to work

\*\*\*Dependency ratio: the ratio of beneficiaries/ contributors

Based on the data of social insurance institute, the replacement coefficient shows significant differences between urban and rural areas. While it grows from 35% in 2000 to 38.2% in 2020, showing a slight improvement for the old age pensions in the urban zone, in the village it shows a deterioration tendency, this ratio decreases from 13.3% in 2000 to 10% in 2020. This indicator mention the correlation between pension and wage, which in this case it does not denote a significant improvement. Obviously there are two problems, the first one, the divergence of the urban and rural pensions and the second one, the low levels of pension.

The progress of coverage rate, from 35.4% in 2000 to 57.6% in 2020 may be explained as a result of economic growth and employment enhancement and reduction of evasion in the collection of contributions for the social insurances.

Although the dependency ratio has improved through the time, it has decreased from 1.04% in 2000 to 0.82% in 2020, it still continues to stay at critical levels. This ratio is affected by the increase of old-age population, from the emigration and evasion. The ratios of contributor / population and beneficiary / population present the same conclusions. The first one matches an increase 5% from 2000 to 2020 and the second one 10.3%.

The Ministry of Labor, Social Affairs and Equal Opportunities, in the regional seminar on pension, held in Zagreb, in 2009, mentioned the major handicaps issues on Albanian pension system such as below:

- ☛ Low pensions, decrease of replacement rate;
- ☛ System is not producing anything that would incite and encourage people to join the scheme; maximum pension is twice minimum pension, while maximum wage is five times minimum wage;
- ☛ High evasion rate of contributors; low-leveled coverage rate;
- ☛ Those who are not paying contributions today, will not receive benefits tomorrow, thus maintaining a social burden for the future ;
- ☛ Fiscal risk stemming from the increase of number of pensioners in the current period, whose majority are getting full pensions today;
- ☛ Deficit in the system, average being 0.8% e GDP ;
- ☛ Forecasts indicate that Albania will face an aging of population in the long run, which would bring about changes in indicators of social insurance scheme.

The Albanian Social Insurance Legislation, through the years, has done a lot of changes based according to the standards of the European Code and ILO Convention on Social Insurance. But of course there are other measurements to be undertaken in the future. According to the World Bank, the forecast reform for actual pension system should include:

**1.** Amendment of pension formula. - Monthly  $P = 1.3\%$  for every year of insurance multiplying the assessment base. (Instead of 1%). This formula lower very much the replacement rate for the employees with minimum wage, so is decided a minimum amount about 85 euro.

**2.** Amendment of upper limits of pension amount. So the maximum pension = 3 x minimum pension. (Instead of 2 x minimum pension).

According to the World Bank this reformation results in improvement of replacement rate but also in the worsening of financing balance system compared to 'without reformed PAYGO'.

The next recommended step, in order to have better performance and fewer disturbances in the pension scheme, is the mixture of the three pillars. There are different possibilities in the combinations of these pillars and also in the percentage they have to cover. The most recommended ones are:

**1.** Second pillar (compulsory and private) is complete. First pillar (PAYG) don't continuous to function over the last generation and all contribution paid in second pillar.

**2.** Both the second pillar and first pillar function at the same time.

The idea to mix up different pillars is not a proposed reform just for Albania. Some years before the Baltic countries had the same problem. They were trying to pass from the full public pension system (just the first pillar) to a combined system. The combined system of first and second pillar was strongly recommended.

*"Pension-reforming CEE countries missed the opportunity to adjust their old-age income security systems to the major social and economic problem of the present and future, underemployment on the labour market and the danger of mass poverty in old age expected to result from it. The drive for and debate on privatisation took minds off the deeper, more basic problem. Much remained to be done – the sooner the better."* (Augusztinovics, M., 2005)

### **3. Possible Solution for the Establishment of New Pension System**

Albania is being confronted to real problems with the system it has built, especially in regard to the different systems adopted by neighboring countries. Often it is supported the fact that the countries in transition, such as Albania, while reforming the pension system, should follow the international experience in order to develop a sustainable pension system. But we should draw attention to all the phenomena which take place through the time. The financial crises, in the end of 2008 and beginning of 2009, was very tremendous because it has impact not only in the whole economic indicators but also it brought with itself the ambiguous for a great number of 'established and proved theories'. The main problem in the financial crises was the interest rate. The pension system is one of the most discussed topics because it connects the actual consumption position of an individual with his/her future consumption. And as this system covers all the individuals, the pension system remains in the focus of all of us.

The demographic trend of a certain country is very crucial while deciding for the pension formula. In the analysis of the demographic profile the most important components to be studied are the total population, the population growth per year, birth rates, the extension of the life expectancy, etc. The U.S. Census Bureau has designed the Albanian demographic profile for 2010 and the projection one for 2025 as shown in the bellow part. One of the factors to

be focused on is the extension year of life expectancy, from 77 to 80 years in a period of 15 years. This means that the burden of financing the elders would increase through the

time. This is shown also in the graphs corresponding the Albanian population pyramid for 2010 and 2025.

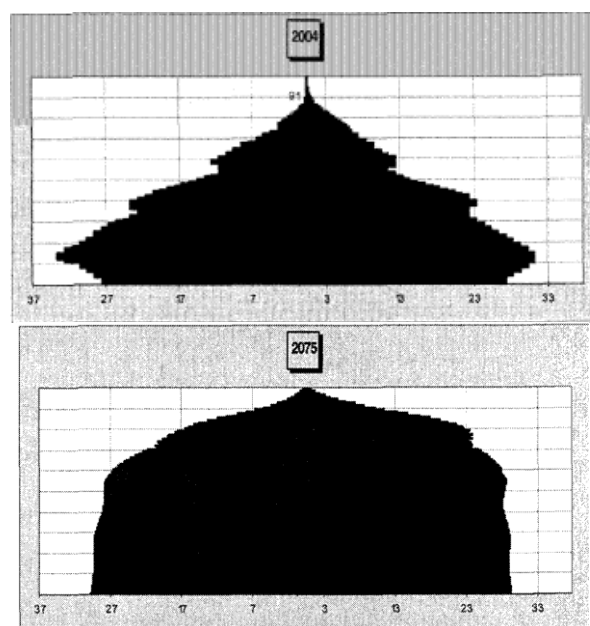
**Table2.** Albanian Demographic Profile and Population Pyramid for 2010 and 2025.

Albania Demographic Profile: 2010	Albania population Pyramid: 2010
<ul style="list-style-type: none"> <li>- Population in thousands: 2,987</li> <li>- Annual population growth rate (%): 0.2</li> <li>- Births per woman: 1.5</li> <li>- Births per 1,000 population: 12</li> <li>- Life expectancy (years): 77</li> <li>- Net migration per 1,000 population: -3</li> </ul>	
Albania Demographic Profile: 2025	Albania population Pyramid: 2025
<ul style="list-style-type: none"> <li>- Population in thousands: 3,105</li> <li>- Annual population growth rate (%): 0.1</li> <li>- Births per woman: 1.6</li> <li>- Births per 1,000 population: 12</li> <li>- Life expectancy (years): 80</li> <li>- Net migration per 1,000 population: -3</li> </ul>	

Source: U.S. Census Bureau  
International Data Base

According to this profile, Albania has begun and will continue the unwanted trend of population aging. It is expected a rapid rise of the third age population in the future, which means that the costs of social insurances will increase significantly. Even if the Albanian old age population remains low compared to the European member countries, if we look at the projection of 2075 performed by World Bank the Albanian population old age raises significantly.

**Table3.** Albanian Population Pyramid for 2004 and the Projection for 2075.



Source: World Bank, 2006

Ludwig von Mises, in his article published in 1950, entitled "Economic aspects of the pension problem" pointed out that the inflation was the greatest threat to pension rights. Sixty years after the publication of this article, in 2010, Antal E. Fekete published another article with the same title where he stated that apart the inflation to be a great threat to pension rights, the deflation is also a newly noticed threat. According to Antal E. Fekete, the problem of the deflation will have deep and negative impact in the pension schemes. He says that the pension systems are at risk. If the interest rates increase through the time, the pension value is going to decrease significantly. If the interest rates decrease, pension contributions will not be able to earn a return necessary to accumulate the capital needed in order to pay defined-benefit pensions in the future. In order to eliminate the problem of interest he proposes the usage of gold. If the present contributions are fixed at a certain gold quantity, the future pensions will not vary according to inflation or deflation rates but will be stable. He strongly supports the zero-interest policy.

"As we can see, at the heart of the problem is the destabilization of the rate of interest due, first, to sabotaging and, then, to destroying the gold standard by the government. *There is no known way to stabilize interest rates but by defining the value of the unit of currency as a fixed quantity and fineness of gold.* In this way the amount owing on deferred payments will be fixed. Any breach of promise of deferred payments will be immediately obvious as soon as it occurs. The difference is this, and a very important difference it is: a promise to make future payments in irredeemable currency is a meaningless promise, because breaching it can be — and will be — camouflaged in many different ways. This spells catastrophe. The retired segment of the population will be plunged into penury. The only way to avoid this is to stabilize the rate of interest through the rehabilitation of the gold standard with all deliberate speed." (Antal E. Fekete, 2010)

#### 4. Conclusions and Recommendations

To sum up, as all systems need revision and modification by the time, the pension system also remains in top of numerous discussions for its improvement. Pension system it is not just the problem of Albania but the effectiveness of it has been revised and still it is being revised in general

from all the countries. Even through the time before the financial crises there were just some nuances given to the pension systems, the period after the crisis highlighted some other problems not visible before. The main problem for the pension system seems to be the interest rates used in the pension formula calculation.

Other problems are things to be revised can be the following ones:

- The movement from a wage-oriented, defined-benefit model to a defined-contribution model;
- The combination of the pay-as-you-go method of financing with other methods, developing self-supporting schemes;
- The enhancement of redistributive elements, in order to create a fairer distribution in relation to contributor interests;
- The prevention of different informalities and evasion;
- The minimization of risks (as our suggestion stated the minimum usage of interest rate) and if there exist any risk the share of it between the state, employees, and employee.

As a second point to be mention, the integrated social security systems are best for all. The more integrated a system is the more benefits or less losses it has. But of course it should be drawn attention to what system we have to integrate because not always the same system is the optimal for all the countries. This integration intend to promote access to stable employment and to support adequate living standards in the national level and global one in order to guarantee pension rights to Albanian emigrants, and to all those Albanians who will work abroad in the future.

Lastly but not the least, the financial crises "tremble" in general all the theories proved and supported as the best ones. The new era brought as an immediate need the solution of different problems. One of them is pension system which is being in ambiguity because of its correlation with the interest rate. Interest rates are founded to be "frightening" for the system when they are in high rates and also in low rates. The zero-interest policy seems to be the solution to this problem. But the way how this policy is going to take place is an important issue to be discussed which covers not just the Albanian pension system but the global pension system.

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