Annex III. Albania's Pension System and Fiscal Challenges[1]

The deficit in the state pension system has widened. Over the last decade spending on old age pensions increased from 3.6 percent of GDP in 2000 to 4.3 percent in 2009. That increase reflected higher spending on rural pensions, which more than doubled from 0.4 percent of GDP to 0.9 percent. Spending on urban old-age pensions, by contrast, remained more or less stable. Over the same period the share of pension contributions in GDP declined from 3.3 percent to 2.9 percent, with the fall since 2006 mainly due to the reduction in employer contribution rates from 29 percent to 20 percent that year. In 2009 the rate was lowered further to 15 percent, motivated by effort to increase compliance. Moreover, rural contributions remain heavily subsidized. The government finances the widening funding gap in the state pension scheme out of general taxation, taking financial resources away from other types of spending.

Table 1. Old Age Pensions, percent of GDP

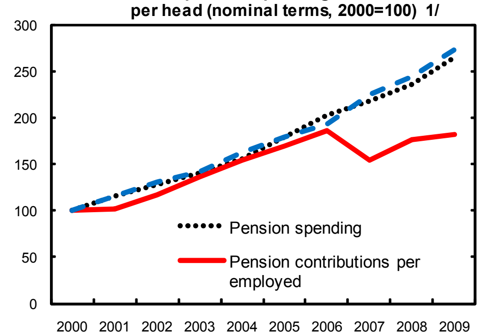
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Old-age pension	3.6	3.8	4.0	4.0	4.1	4.2	4.2	4.2	4.0	4.3	4.3
urban	3.2	3.4	3.5	3.4	3.5	3.6	3.5	3.4	3.3	3.4	3.4
rural	0.4	0.4	0.5	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9
Pension contributions	3.3	2.6	2.7	2.9	3.1	3.1	3.2	3.0	2.9	2.9	n/a

Sources:ISSH, INSTAT, and IMF staff calculations

Despite the substantial increase in spending on rural old-age pensions, they still—on average—amounted to only 16.3 percent of the average wage or 37 percent of the official minimum wage in 2009. While this compares favorably with the situation in 2000 (when these figures were 6.8 and 14.6 percent, respectively), they are only half as generous as the urban old-age pension. The latter was on average equivalent to 29.4 percent of the average wage and 66.8 percent of the official minimum wage in 2009. Despite this continuing relatively low level, the rural pension accounted for a third of pre-transfer consumption of the poorest quintile and as such was more than twice as important as the social assistance program for this group of society as a source of income.

Per capita pension spending increased in line with the average wage over the previous decade. This is despite the fact that pensions are legally indexed to inflation only.[2] Up to 2006 pension contributions per person employed followed a similar trajectory. The reduction in employer contribution rates that year has resulted in diverging trends since.

Increase in pension spending and contributions per head (nominal terms, 2000=100) 1/



Source:s Instat, ISSH;I MF taff calculations.
1/ Pension contributions per employed has been calculated by dividing total old-age pension contributions by the number of people in employment.

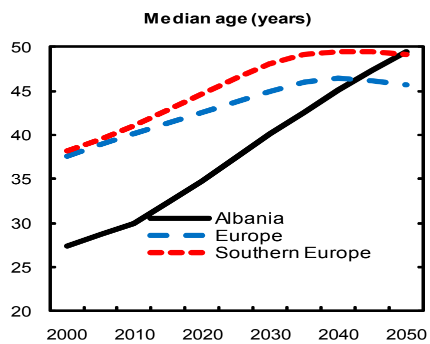
The scheme's deficit is particularly worrying as the Albanian population is young. If anything, one would expect a substantial surplus based on demographic fundamentals. According to the

[1] Prepared by Frank Eich.

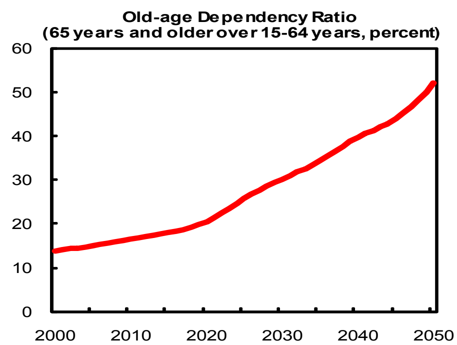
[2] *Pension Systems and Labor Costs in Southeastern Europe*, Anita M. Schwarz, World Bank, 2007, page 10.

United Nations 2010 revised population projections, the median age of the Albanian population was 30 years in 2010; more than a decade younger than the European and Southern European averages.

Demographic trends pose significant challenges to Albania's pension system. The Albanian population is projected to age dramatically over the coming decades, with the median age exceeding the European and Southern European averages by mid century. Similarly, Albania's old-age dependency ratio is projected to triple from around 18 percent now to just over 50 percent and thus close to the European average. On current policies the wedge between spending and contributions would continue to widen, requiring ever greater transfers from general taxation to fill the gap. This would prove to be unsustainable within a relatively short period of time.



Sources: United Nations 2010 Revision of World Population Prospects (medium variant).



Source: United Nations 2010 Revision of World Population Prospects (medium variant).

Thus, pension reform is a priority, especially addressing the imbalances in the existing pay-as-you-go system. The 2006 and 2009 reductions in contribution rates should be revisited in order to strengthen the finances of the social security system, not least as these have not led to an increase in compliance. Second, the continued need for subsidizing rural contribution should be assessed. Third, pension spending increases could be kept at bay, by raising pensions by less than earnings. Looking beyond these immediate measures to bolster the social security finances, more fundamental changes should be contemplated; such as eliminating the distinction between urban and rural pensions (which would allow for better targeting) and making the link between contributions and pensions more apparent. The high degree of redistribution within the pension system (the maximum pension is only twice the minimum pension) has often been pointed out as a major reason why higher income earners are reluctant to participate in the scheme. After the state system has been made sustainable and coverage expanded–and the regulatory environment strengthened-a move towards a multi-pillar system could be considered. Such a move would preferably lead to additional pension savings rather than merely diverting existing contributions away from the social security scheme. International evidence shows that the diversion of contributions away from the first pillar into private pensions could create substantial and sustained transition costs with a negative effect on the public finances.[3]

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[3] *A Fiscal Indicator for Assessing First and Second Pillar Pension Reforms*, Mauricio Soto, Benedict Clements, and Frank Eich, IMF, 2011.