



## LJUBLJANA NOTE:

### A Framework for Future Co-operation in Pension Restructuring

Within the framework of the Stability Pact / Initiative for Social Cohesion, a seminar focusing on the reform on the pension system was held. Experts from selected Central and Eastern European countries provided an overview of their different experiences in this field. Numerous participants representing the social partners of the South Eastern European countries attended. The reform of the pension system was carefully selected amongst the various priorities emerging in the social policy reform process also taking into account other ongoing processes such as the Millennium Developments goals launched in September 2000 and the Poverty Reduction Strategy Program already ratified by some of the South Eastern European countries.

#### Background:

In South Eastern Europe, the capacity of pension schemes to meet the needs of national populations has been crippled by the economic and political disruptions of the previous decade. Reduced output and the informalization of employment have deprived the schemes of contribution revenues and left large numbers of current workers excluded from coverage. Inflation has outstripped benefit increases, exposing pensioners to great hardship. In some countries, self-serving or corrupt management practices have caused workers and employers to lose trust in pension schemes, fueling a further cycle of noncompliance and loss of coverage. At the same time, the high contribution rates in effect across the region are a barrier to the creation of the new jobs needed to restart national economies, increase GDP, and improve living standards.

In this environment, the measures normally brought to bear to strengthen the financing of national schemes are far more difficult to put in place. With a major shortage of jobs, increasing the retirement age risks adding further to unemployment. With pensions already severely eroded by inflation, reducing benefit amounts would increase poverty. The region's elevated contribution rates preclude even small upward adjustments. And in countries without developed financial markets or expertise in their regulation, pension privatization would likely result in high administrative costs and low investment yields, worsening workers' prospects for retirement security.

Just as the severe problems that plague the region's pension schemes are both external to them and internal, so the solutions must target both domains. Among the

external measures, first and foremost is the need to revitalize national economies to raise output and create jobs. Given this priority, the schemes must be restructured to complement and support economic recovery efforts – i.e., to facilitate job creation, to contribute to improved productivity where possible, and to minimize negative effects. Such restructuring requires government action on three fronts.

### **Recommendations:**

First, governments must improve the collection of pension contributions. More effective enforcement of the contribution requirement will eliminate the competitive advantage of employers and employees who evade payment of contributions and thus eliminate the incentives for noncompliance. At the same time, it will reduce the financing deficits that schemes now experience and extend coverage to workers excluded by this fracturing of the labour market. Collecting contributions from a broader base of workers and employers will make it possible to reduce the high contribution rates in effect across the region and thus the barriers to employment. While each government must devise collection methods that match national circumstances, four broad areas call everywhere for action:

- to improve information sharing among government agencies (e.g., tax agency, social security agencies, and customs service) that will facilitate comparison of records and lead to the identification of delinquent employers;
- to make employers' access to government benefits and programs (e.g., loans or export/import licenses) contingent upon certification that they have paid social security contributions;
- to monitor compliance more intensively, with special measures devised for problematic industries and groups (e.g., the construction industry, the self-employed) and special measures to combat evasion (e.g., subjecting contract work to the same rules as wages and/or setting a minimum contribution base, such as the minimum wage or a percent of the average wage); and
- to institute a realistic penalty structure that provides incentives for compliance without driving enterprises out of business and jeopardizing jobs. Governments must lead by example in making timely pension contributions for public employees.

In some national environments, forging stronger linkages between contributions paid and benefits received may make workers more willing to contribute to pension systems. However, in those countries where economic impoverishment has caused workers to focus heavily on short-term considerations, no automatic assumptions can be made about the impact of such measures.

A second, related area for action involves redesign of pension benefits to make them more attractive to workers. Such redesign is needed in many countries because the combination of high inflation and redistributive benefit increases compressed all but the lowest pensions during the 1990s, making contributing to the pension scheme less attractive for large segments of the workforce. This situation cannot be changed rapidly because of the narrow contribution base and high rates in effect across the region, as described above, but change is needed in many countries over the longer term. Such efforts should respect three provisions. First, by taking the minimum standards set by the European Code of Social Security and ILO Convention 102 as guidelines, changes should assure that benefits meet a defined minimum level. Second, given the wage gap that prevails in South Eastern European countries between the earnings of men and women, such changes should not cast women into poverty in old age as a result of discriminatory wages or time spent caring for young children. This can be accomplished by granting caring credits financed from state budget revenues. Third, such efforts must recognize that public pension schemes can accomplish tighter links between benefits and contributions as surely as private ones. Moreover, pension privatization can be successfully launched only if certain preconditions are met. A rushed reform process and weak government capacities for administration and regulation all factors that pose serious threats to the success of privatization as a reform strategy.

Finally, governments must streamline pension scheme administration and make it more transparent. Such measures are needed to rebuild the trust of workers and employers, many of whom have come to view their national pension schemes as inefficient and wasteful of contribution resources. Increased confidence in schemes' administrative efficiency will also boost the willingness of workers

and employers to contribute. Streamlining administration means reducing operating costs so that a higher fraction of contribution revenues can be used for their intended purpose, i.e., to pay benefits. Transparency means regular public disclosure of scheme expenditures and payments consistent with international accounting practice. Both measures imply adjusting administrative expenditures to direct them toward the purposes of greatest importance to scheme constituents. Streamlining will require development of, and greater reliance on, automated data management systems, as well as improving regional cooperation among pension schemes to enhance the security of migrant and displaced workers. Lastly, as shown by the experience of the Central European countries which are most advanced in privatization, privatized schemes will require extensive, expert government regulation of administrative expenditures to safeguard the interests of members.

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In devising specific reforms to address these three priorities, it is essential that governments open their planning and deliberative processes to input, scrutiny, and criticism of the social partners, as well as all others with an interest in the future of the pension scheme. Only open social dialogue can endow reforms with the relevance, legitimation, and public support that pension reforms require to succeed and endure. It is essential to avoid practices of the past where major decisions on pension reform in some South Eastern European countries were made without such exchange. At the same time, workers and employers must commit themselves to developing expertise and close involvement in pension issues.

In addition, technical assistance is needed for pension reforms that facilitate economic development and job creation, including the design and testing of new collection techniques, sharing of best practices in scheme administration, resources and technology for automation, training for scheme managers and overseers, and development of capacity for actuarial projections required to adjust benefits.

In sum, the problems affecting pension schemes in South Eastern Europe today have roots both within the systems and in the larger economies in which they operate, and efforts to address these problems must target both domains. In conjunction with actions by international donors to promote economic development, pension schemes must be restructured to support those same recovery efforts through broad-based collection of contributions, redesign of benefits to increase their attractiveness to workers, and efficient, transparent administration. All three changes require increased capacity on the part of scheme policy makers and administrators. Rebuilding such capacity for sound pension governance is the main regional challenge of reform today.