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PERSPECTIVE

Pension System Reform in Georgia

Comments and Alternatives

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- On 31 October 2017, the Government of Georgia publicly presented her reform plan for the country's pension system. The draft law envisions a new pension savings scheme that is based on personal accounts and does not include any element of solidarity. The principle is "everyone for him- or herself".

- As all workers over 40 years of age would have the possibility to opt-out of the new pensions scheme, hundreds of thousands of Georgian citizens will remain without a decent pension in the future. Thus, the government proposal does nothing to alleviate the threat of massive old-age poverty.

- Alternatively, the Georgian government should strengthen the basic pension, and develop a second pillar of the pension system that includes two tiers: a mandatory pay-as-you-go (PAYG) scheme that would deliver immediate benefits from 2020 onwards, and a funded defined-contribution scheme for workers up to the age of 50, that would increase security in the long run.

- The overwhelming majority of European pension systems have pay-as-you-go-schemes at their core. The counter-argument that PAYG is not possible in Georgia due to the challenging demographics of the country is not valid, as the new system would start from scratch.

Evaluation of Georgia's current pension system

Today, the Georgian pension system is limited to a public basic universal flat-rate pension for everyone living in Georgia at the moment of reaching the retirement age (65 years for men and 60 years for women). The current size of the pension is 180 GEL a month. The single objective of the basic pension is to avoid poverty in old age. This pension is much too low to be adequate.

In the explanatory note to the draft law on pension savings, the government argues that, although she spends only 4,3% of GDP on the financing of pensions, the sustainability of the current replacement rate (on average 16,8%) is very questionable in the long run. The government points to the demographic trend as the main reason for that. However, if the government took a look at the broader picture, including the design of the tax system, the basic pension could even be strengthened. Currently, Georgia has a flat-rate income tax, low taxes on interests and dividends, and a high level of informal economy. Thus, there are plenty of opportunities to increase budget revenues.

The current pension system is not fair and constitutes an incentive to informal work. This is due to the fact that the pension is paid out to everyone, independent of his/her employment record, residence in the country during the active life, paid taxes and level of means. It is neither means-tested, as the ILO recommends, nor based on the number of years of residence in the country as it is the case in the Netherlands, Denmark or Sweden. It does not offer the possibility of early retirement either.

Reform proposal by the government

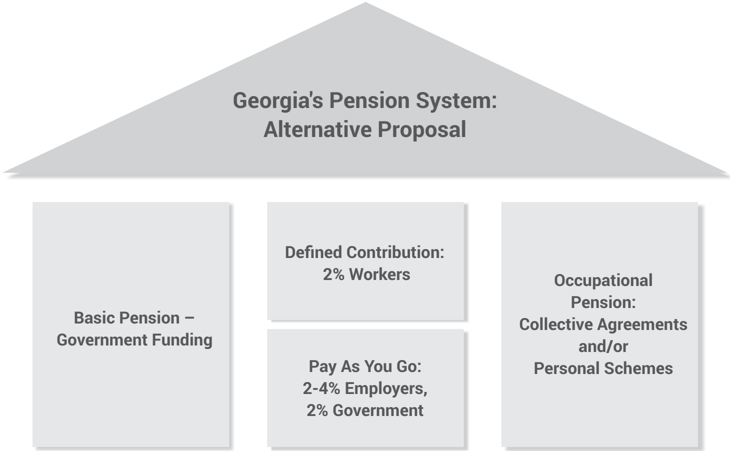
In the draft law on pension reform that was presented by the Government of Georgia on 31 October 2017, nothing is said about the strengthening and/or the reform of the basic pension.

Instead, a second pillar of the pension system is proposed based exclusively on a hybrid semi-mandatory pension savings ("defined contribution – DC") scheme (and that in a country without an equity market!). The proposed scheme would be mandatory for employees under 40 years of age from 1 July 2018 onwards. Workers over 40 years of age would be auto-enrolled but would have the option to opt-out during only 5 months after enrollment. Self-employed could join the scheme on a voluntary basis. The alternative of a "pay-as-you-go - PAYG" component ("defined benefit - DB" scheme), in which the contributions of the workers would fund the pensions of the future retirees, is not even discussed. Neither is there any mentioning of an eventual 3rd pillar pension (occupational or personal DC scheme).

In Europe, nearly all countries have developed strong PAYG (DB) schemes, complemented by public or private DC schemes. The Georgian government is, unlike most European countries, establishing a DC savings scheme instead of a PAYG scheme.

Since workers aged over 40 can opt-out, hundreds of thousands will remain without a decent pension in the future. This will cause massive poverty in old age.

The savings scheme based on personal accounts is also missing all the elements of solidarity that are guaranteed in PAYG schemes: periods of sickness, unemployment, care or parental leave will be non-contributory. There will be no possibility of pension credits or minimum rights for non-standard workers or workers on low pay. The principle of the proposed scheme is: "everyone for him- or herself". The proposed system would be managed by a politically composed supervisory board (ministers), without any representation of the social partners.



Alternative proposal

Alternatively, we would like to propose a new pension system which takes care of all citizens and leaves nobody behind. It consists of three pillars – the enhanced public basic pension, a second public pillar composed of two tiers, and a voluntary third pillar DC scheme that might be added at a later stage. The third pillar could take the form of an occupational pension scheme based on collective agreements and/or personal schemes.

The strengthened public basic pension (first pillar) would be means-tested and/or based on number of years of residence in the country (or potentially on general low social contributions of 1-2%, complementing the government budget).

The second public pillar would be composed of two tiers (layers):

- A mandatory DB (PAYG) tier for all employees and self-employed from 16 to 64 years (vesting period of one year).
- A funded DC tier on the basis of personal accounts which should be mandatory for all employed people up to 50 years on 1 January 2018 and voluntary for all employees aged over 50 and for the self-employed on the same date (vesting period also one year).

This two-tier second pillar system would introduce visible results from 1 January 2020 onwards through the PAYG-tier and security in the long run through the DC-tier.

The PAYG-tier would start up on 1 January 2019 with a contribution by the employers of 2% up to the ceiling of 60.000 GEL as foreseen in the draft law and a contribution of the government of 2% up to 24.000 GEL/year and 1% up to 60.000 GEL/year (law). In the four following years the contribution of the employers should increase by 0,5% a year and reach 4% in 2023. The PAYG-pension formula could be:

Average revaluated salary over the whole career up to a ceiling of 50% of the contribution ceiling = 30.000 GEL	X	Accrual rate of 0,5%	X	Number of insurance years

After 45 years of insurance this would result for a worker on average pay (1.071 GEL/month) in a gross replacement rate of: average wage x 0,5% x 45 years = 22.5% of average wage (in nominal terms: 241 GEL/month).

Together with the basic pension, the replacement rate for a worker on average wage would be 16,8% + 22,5%= 39,3%.

This PAYG scheme would have a buffer-fund to cover the non-contribution periods (6 months unemployment, 6 months sickness, parental leave etc.) and the pension credits for the low-wage earners. The fund would be financed basically through the contributions on the difference in salary between the contribution-ceilings and the benefit-ceiling (in our proposal 50%). In case the benefit-ceiling would be too high given the salary structure in Georgia, it can be lowered to generate the required solidarity means for the fund.

The system would be managed on a tripartite basis and allow also early retirement for hard and risky professions based on higher social contributions.

The funded DC scheme based on individual accounts would be financed by the contribution of the employees (1% of the full salary on 1 January 2019; increased by 0,5% in 2020 and 2021 up to 2%). The DC scheme should be under the supervision of the social partners and the government. Workers should have the choice between investment in group insurances (with fixed guaranteed return) or pension funds (with market return). Vesting period would also be one year.

The contribution should be collected centrally by the pension agency, together with the contributions for the DB scheme.

Elements to be considered:

- economies of scale;
- low administrative and investment costs;
- portability;
- favorable tax regime;
- choice between annuities and lump-sum pay out;
- spread of risks internationally and nationally.

Altogether, the basic pension, the PAYG (DB) pension and the funded (DC) pension would guarantee after a full career of 45 years of insurance a pension with a gross replacement rate of 16.8 % + 22.5% + (estimated) 11 % = around 50 % of the average salary over the whole career.

Pay-as-you-go: Not suitable for Georgia?

According to many critics in- and outside the Georgian government, a PAYG (DB) system would not be possible in Georgia because of the unfavorable demographic situation. In our own opinion, the PAYG scheme would be perfectly possible in Georgia, given the fact that the system would start from scratch. During the first 25-30 years the scheme would accumulate billions of GEL for the simple reason that in the beginning, when approximately 750.000 formally employed workers all contribute to the scheme, only a few (15.000) new pensioners per year would start to benefit from the scheme. In 2020 for instance, there would be 385 million GEL income from contributions and only one million GEL expenditure. In the following years the scheme would grow fast with the product of the contributions (385 million GEL/year), the return on investments (2%/year interest = 7.7 million GEL on 385 million GEL), plus the effect of the indexation of the contribution base (the salaries).

On the expenditure side, the total sum that has to be paid to the new pensioners (15.000/year) will also increase, but it will for long time remain below the receipts of the scheme. When the expenditure reaches the level of earnings, the scheme can start to use part of its accumulated reserves to close the balance. If after the eventual consumption of the reserves more money is needed, the government can still always modify the mechanisms or the parameters (e.g. the indexation formula or the accrual rate). In my opinion, this will not even be necessary.

Based on our proposed PAYG scheme, workers on average pay would have a PAYG pension (in current prices and on top of their basic pension) of 321 GEL/year in 2024, 642 GEL/year in 2029, 1.285 GEL/year in 2039 and 2.570 GEL/year for those who retire in 2059 after having contributed 40 years to the new scheme.

About the author

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