FISCAL YEAR
January 1 to December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of November 30, 2006)

Currency Unit
Lek

Equivalent units
US$1 = 94.73 Lek

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

ECA  Europe and Central Asia
GDP  Gross Domestic Product
ILO  International Labor Organization
OECD Organization for Economic Co-operation and Development
SII  Social Insurance Institute

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Executive Summary

The social insurance system in Albania faces many problems, not the least of which is an extremely high contribution rate, among the highest in Western Europe. The original design of the system was all-encompassing, covering the risks of old age, disability, death of the family earner, short term illness, maternity, unemployment, and health costs. These benefits were to be financed through payroll contributions, assessed on both employer and employee, but in differing degrees for different benefits.

However, Albania, as many of the other transition countries, has seen an increased informalization of the labor force, which has led to limited revenue from the payroll contributions while it faces the burden of supporting several generations of elderly, most of whom have full pension rights. Albania has managed to avoid fiscal crisis in its social insurance system by severely compressing benefits and by transferring funds across the branches of social insurance. The compression of benefits has led to its own set of problems as individuals realizing that their benefits will be low regardless of how much they contribute, choose to declare lower earnings and spend more of their careers in the informal sector. At the same time, the Government has tried to raise the benefit level for the recipients of the lowest pensions, the rural pensioners, to equalize their pension levels with those of their urban counterparts. As a result, a number of inequities have arisen in the pension system with urban workers expected to pay large contributions in return for limited pensions, while rural workers pay little and receive smaller pensions, but still huge relative to what they paid.

The current policy mix may not be tenable for the future. The Government has just reduced contribution rates in order to provide incentives to participate in the formal labor market. This policy reduces revenue to the pension system without addressing the benefit structure. Rather than maintaining the benefit structure, the Government has in fact enhanced benefits, raising urban sector pensions both directly and through the recalculation exercise currently taking place and raising rural sector pensions substantially. The Government is considering further cuts to the contribution rates and further benefit increases. Clearly, reducing revenues while increasing benefits will lead to fiscal problems sooner or later.

The Albanian Government currently finds itself at a crossroads. The current policy is leading to future fiscal deficits, poor benefits, and large percentages of the population exposed to social risks. The Government either needs to fix the social insurance system, removing the various disincentives which have crept into the system as a result of attempts to patch problems as they occurred, or it needs to abolish the system and focus fiscal resources on poverty alleviation measures. If the Government chooses to fix the social insurance system, the resulting system must be self-sustainable without the enormous Government subsidies provided today. The Government can then focus its fiscal resources on providing poverty relief for those not covered in the system.

The pension system is the largest element of the social insurance system, both in terms of revenues and in terms of expenditures. As such, this paper focuses on the pension system. If the Government makes the decision to move toward social pensions and away from a contributory
pension system, it would be hard to justify maintaining the other branches of social insurance as social insurance. On the other hand, if the Government retains the contributory pension system, separate decisions may need to be taken on whether the other branches should continue as well and at what level of contribution and benefit.

The primary problems of the pension system can be summarized as follows:

- Inadequate coverage of the elderly in the long run with 40 percent of the elderly in the future left without access to the pension system arising from the low number of working age individuals making active contributions today;
- Sharp decline in benefits stemming from the linking of the maximum pension to inflation;
- High contribution rates which provide disincentives to formalization of the labor force;
- Disincentives in the benefit formula for people to declare their full wages or to work throughout their working age; and
- Over-generosity with respect to rural workers and pensioners.

These problems can be addressed by reforming the pension system such that benefits will not decline sharply in the future, contribution rates will be lowered somewhat, disincentives to contribution will be removed, and rural workers will be treated identically to urban workers should they choose to continue contributing to the pension system. Option 1 in the paper provides an example of a pension system design which fulfills all of these objectives. However, correcting these problems will not be sufficient to bring the majority of the labor force which is currently working in the informal sector into the formal sector. By making the contributory pension system self-sustainable without additional Government support, the Government can free fiscal resources to provide minimal poverty alleviation benefits to all those who do not contribute, whether they are in the rural or urban areas.

The alternative shown in Option 2 is to eliminate the contributory system entirely which automatically eliminates problems 3 and 4 above, and provide social pensions for all those above a certain age, such as 65. Under this system, rural and urban workers would be treated the same, everyone would be covered, and some level of poverty alleviation would be achieved for those unable to work due to age or infirmity. However, benefits would decline sharply, leaving the public pension system unable to provide people with a vehicle to smooth their consumption between working and non-working periods of their life. Such a vehicle could be provided separately by a voluntary pension system, ideally managed by the private sector, but regulated and supervised by the Government with tax advantages potentially provided for this form of long term savings by the Government. Should a financial market and regulatory analysis find that the Albanian financial market lacks sufficient depth to support a well regulated private pension fund industry, individuals would either have to rely on whatever financial market instruments did exist or the Government could consider setting up an interim public agency with a limited mandate,
limited either by time or by achievement of policy triggers, after which the agency would be privatized.

These are distinctly different visions of the future of the Albanian pension system. Neither is right or wrong; both have advantages and disadvantages and countries around the world have made different choices among these options. The paper lays out the implications of these choices, leaving it to Albanian policymakers to decide which of these paths best fits the future Albania.
1. The social insurance program in Albania was in part inherited from the past and was designed to provide comprehensive insurance against the risks of old age, disability, death, short term illnesses, poor health, and unemployment based on contributions made by both employers and employees. This type of system works reasonably well in the context of high formal sector labor force participation. However, post-transition, participation in formal labor markets has fallen dramatically in Albania, raising questions of whether the social insurance framework is in fact the appropriate structure for providing social protection benefits in the future for the entire population. In addition, the program involves relatively high contribution rates, initially set at 41.9 percent of payroll, of which 0.8 percent was designated for sickness, 2.3 percent for maternity, 29.9 percent for pensions, 3.4 percent for health insurance, 0.5 percent for occupational injury, and 5 percent for unemployment insurance. New legislation just implemented reduces the total contribution by 9 points, reducing unemployment insurance to 2 percent and reducing 6 percentage points of the tax designated for pensions.

2. This social insurance review will focus largely on pensions, given that they are the largest component of the payroll tax and the largest expenditure item by far. Both the sickness and maternity funds often generate small surpluses which are then used to subsidize pensions. Unemployment insurance also ran surpluses in the past with the revenue transferred to the Social Insurance Institute (SII). With the reduction of unemployment contributions, bigger holes may begin to appear in the Social Insurance Institute accounts. However, much of the discussion regarding the role of social insurance as compared to other forms of social protection provision will be relevant to all branches of social insurance. The review will also draw heavily on the recently completed health sector review (February 2006) for a specific discussion of health insurance issues.

3. The structure of the review is as follows: sections 2 and 3 discuss the demographic characteristics of the Albanian pension system and its parameters; section 4 lays out the projections of the current policy, while section 5 describes policy reform options; sections 6-8 briefly look at the implications of pension policy reform on the other branches of social insurance, and section 9 concludes.
II. Demographics and Labor Market Conditions

4. As elsewhere in Central Europe, the historical 100 percent labor force participation rates of both men and women result in large percentages of the elderly receiving pensions, while the post-transition rise in informality results in few contributors among the working age population. This imbalance between contributors and beneficiaries typically leads to fiscal problems in financing the benefits under a pay as you go system where contribution revenues from the current contributors are used to finance benefits for the current elderly.

5. Based purely on demographics, Albania is one of the younger countries in the Europe and Central Asia (ECA) region of the World Bank as shown in Figure 2.1, which compares the percentage of the population over the age of 65 for a number of transition economies. Albania has only 8.3 percent of its population over the age of 65, almost one-third smaller than the ECA wide average of 12.1 percent. Bulgaria, Latvia, and Croatia all have about 17 percent of their population over the age of 65.

Figure 2.1: Percentage of Population over the Age of 65 among ECA Countries

6. Table 2.1 provides many of the typical summary statistics for the Albanian pension system. The Albanian social insurance system runs slightly separate schemes for the urban and rural sectors, with the statistics provided by sector. Table 2.1 shows an almost even division in contributors between the rural and urban sector. On the beneficiary side, however, there is a marked disparity between the two sectors, with urban beneficiaries outnumbering rural beneficiaries almost 2 to 1. The rural sector in Albania was not covered under any form of social insurance until 1972. With 35 years of contributions required to collect a full pension, few rural workers qualify yet for a full pension, and those retiring often receive only a partial pension. The difference between the sectors is reflected in the system dependency rates, which are much higher for the urban sector with more pensioners than contributors than in the rural sector, but in both cases significantly higher than the population dependency rate.
Table 2.1: Demographic and Financial Indicators of the Albanian Pension System

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Urban</th>
<th>Rural</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of Contributors (total)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Men</td>
<td>183,500</td>
<td>236,600</td>
<td>420,100</td>
</tr>
<tr>
<td>Women</td>
<td>136,500</td>
<td>103,400</td>
<td>239,900</td>
</tr>
<tr>
<td><strong>Number of Beneficiaries</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Old Age</td>
<td>367,900</td>
<td>187,300</td>
<td>555,300</td>
</tr>
<tr>
<td>Men</td>
<td>150,700</td>
<td>77,100</td>
<td>227,800</td>
</tr>
<tr>
<td>Women</td>
<td>135,700</td>
<td>82,900</td>
<td>218,600</td>
</tr>
<tr>
<td>Disabled</td>
<td>27,600(^1)</td>
<td>3,600</td>
<td>31,200</td>
</tr>
<tr>
<td>Men</td>
<td>17,200</td>
<td>2,300</td>
<td>19,500</td>
</tr>
<tr>
<td>Women</td>
<td>10,500</td>
<td>1,300</td>
<td>11,800</td>
</tr>
<tr>
<td>Survivors</td>
<td>42,400</td>
<td>17,500</td>
<td>59,900</td>
</tr>
<tr>
<td>Men</td>
<td>700</td>
<td>3,700</td>
<td>4,400</td>
</tr>
<tr>
<td>Women</td>
<td>41,400</td>
<td>13,800</td>
<td>55,200</td>
</tr>
<tr>
<td>Orphans</td>
<td>11,800</td>
<td>6,300</td>
<td>18,100</td>
</tr>
<tr>
<td><strong>System Dependency Ratio</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Old Age Population Dependency Ratio</strong></td>
<td>115.0%</td>
<td>55.0%</td>
<td>84.1%</td>
</tr>
<tr>
<td><strong>Expenditures in million lek</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Old Age</td>
<td>30,900</td>
<td>5,800</td>
<td>36,800</td>
</tr>
<tr>
<td>Disabled</td>
<td>26,100</td>
<td>5,300</td>
<td>31,400</td>
</tr>
<tr>
<td>Survivors</td>
<td>2,300</td>
<td>100</td>
<td>2,400</td>
</tr>
<tr>
<td>Orphans</td>
<td>1,900</td>
<td>200</td>
<td>2,100</td>
</tr>
<tr>
<td>Coverage (Contributors/Total Pop 15-Ret Age)</td>
<td>16.6%</td>
<td>17.6%</td>
<td>34.1%</td>
</tr>
<tr>
<td>Pensioner Coverage (Pensioners/Total Ret Age)</td>
<td>76.9%</td>
<td>41.5%</td>
<td>118.3%</td>
</tr>
<tr>
<td>Revenue as share of GDP in 2005</td>
<td></td>
<td></td>
<td>4.93%</td>
</tr>
<tr>
<td>Expenditure as share of GDP in 2005</td>
<td></td>
<td></td>
<td>5.04%</td>
</tr>
</tbody>
</table>

7. In fact, looking at system dependency rates, which compare the total number of beneficiaries in the pension system to the total number of contributors, Albania has the highest ratio in the region and one of the highest in the world, as shown in Figure 2.2. Typically, system dependency rates shadow population dependency rates, which are the ratio of the elderly population in the country divided by the working age population. As already discussed, Albania has a relatively small elderly population, with a population dependency rate of only 19.3 individuals over the retirement age of 61 for men and 56 for women prevalent in 2004 per 100 working age individuals, measured as those from age 15 to the relevant retirement age. However, as Figure 2.2 shows, the system dependency rate is huge, at more than 84 beneficiaries per 100 contributors. In many ECA region countries, system dependency rates are high due to the prevalence of many individuals below retirement age receiving disability and other benefits.

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1 Age and gender breakdowns for beneficiaries other than old age are based on the output of a model run by the Social Insurance Fund. In the case of old age, the breakdown is based on actual age and gender data provided by the Social Insurance Fund.

2 While the total number of beneficiaries in the rural sector were provided by the Social Insurance Fund, no breakdown was available by gender and ages. The breakdown by gender and ages was assumed to follow that for the urban sector for which a breakdown was roughly available.
This is not the case in Albania, where the numbers of disability beneficiaries and survivors have been kept relatively low by appropriately strong policy measures and by strong enforcement of these measures. A separate noncontributory disability benefit, which provides higher payments to the qualified and is administered by a separate agency as well as the Ndema Ekonomika, which provides means-tested benefits to qualified individuals, have relieved the Social Insurance Institute of some of the social pressures they have faced in other countries to loosen criteria to provide benefits to a larger population.

**Figure 2.2: System Dependency Rates in Albania Compared to Rest of ECA Region**

8. On the other hand, the number of old age beneficiaries seems very high. Of 372,000 people above retirement age, more than 440,000 receive pensions of some type. Discussions with the Social Insurance Institute authorities suggest an explanation. Families of the deceased have the responsibility of informing the Social Insurance Institute that the pensioner has died and that the pension should be terminated. Until such a notice is provided, the Social Insurance Institute continues to pay benefits. The discrepancy between the number of elderly in the population statistics and the numbers receiving old age pensions suggests that in many cases, families are not informing the Social Insurance Institute and are continuing to receive the payments. This explanation seems particularly plausible given that the discrepancies between the number of people in the population and the numbers of pensioners at that age become more marked at the upper ages. Furthermore, the early results from the poverty assessment find that old age pensions have a greater impact on poverty reduction than the means-tested Ndema Ekonomika. This peculiar result is generally not replicated elsewhere in the region and particularly not in a young country like Albania, where one would expect fewer families to have access to pension income. The plausible explanation again is that poor families with an elderly relative who dies continue to collect the pension, giving the old age pension a much broader poverty alleviation role than it would have had had it been restricted to only the elderly.

9. On the contributory side, the story in Albania is much the same as elsewhere in the transition economies. Post transition, formal sector public enterprises downsized and privatized. The new private economy chose to rely heavily on the informal labor market rather than the more expensive and regulated formal labor market. As a result, the denominator in the dependency ratio formula, the number of contributors to the pension system fell drastically. The
ratio of contributors to the employed currently stands at 46 percent, which is average for the ECA region and for a country of Albania's income level worldwide. However, it should be noted that half of those contributors are from the rural sector, for which the Government makes 85 percent of the contributions. As such, they are contributors largely in name more than in substance. Taking out these contributors, the contributor coverage rate is a much smaller share of the employed, putting Albania below the ECA average on coverage.

10. From a financial standpoint, the Government is spending a total of 5.04 percent of GDP on social insurance expenditure of which 85 percent is actually pension benefits. However, even the 85 percent understates the heavy amount of pension expenditure, since of the remaining expenditures another 13 percent covers administrative costs and additional allowances given to some or all pensioners. On the revenue side, the Social Insurance Institute claims revenue of 4.93 percent of GDP, of which 78 percent is contribution revenue. However, more than two-thirds of that revenue comes from the Government itself in the form of employer and employee contributions. Another 22 percent of the revenue comes from legislated government transfers to the Social Insurance Institute. In total, the Government provides 78 percent of the revenue going to the Social Insurance Institute.
III. DESCRIPTION OF ALBANIAN PENSION SYSTEM
PARAMETERS

11. While the demographic and labor market characteristics of the pension system in Albania do not point toward long run financial sustainability, some elements of the policy design tend to exacerbate these tendencies. A crucial design element is the separate systems applicable to the urban and rural sectors. Table 3.1 highlights the critical parameters of the urban sector system.

<table>
<thead>
<tr>
<th>Parameters of Albanian Pension Scheme Applicable to the Urban Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contribution Rate</strong></td>
</tr>
<tr>
<td><strong>Retirement Age</strong></td>
</tr>
<tr>
<td><strong>Benefit Rate</strong></td>
</tr>
<tr>
<td><strong>Indexation of Pensions Post-retirement</strong></td>
</tr>
<tr>
<td><strong>Disability pension</strong></td>
</tr>
<tr>
<td><strong>Survivor pension</strong></td>
</tr>
</tbody>
</table>

12. Contributions in Albania used to be collected by the Social Insurance Institute. In 2006, collection responsibility for all urban workers was transferred to the tax authorities, who then transfer the revenue to the Social Insurance Institute. The Social Insurance Institute continues to collect contribution revenue from rural workers.

13. Contribution rates in Albania are high compared to OECD averages. Figure 3.1 shows the Albanian contribution rates for pensions alone, relative to rates in OECD countries. With the exception of Italy and Portugal, which have slightly higher rates, Albania has the highest contribution rates in this group of countries. The high level in Albania is particularly significant given that contribution rates usually rise as the country’s population ages. Albania has these extremely high rates with a still young population. The Albanian Government has recently
passed legislation to lower these rates gradually, but even then, they will be high for such a young country. Figure 3.2 shows Albanian contribution rates relative to Central European countries. Albanian rates are still high, but not completely out of line with other Central European rates as each of these countries faced the same drop in contributors as Albania did.

Figure 3.1: Albanian Contribution Rates for Pensions Relative to OECD Countries

Figure 3.2: Albanian Pension Contribution Rates Relative to Those in Other Transition Countries

14. Retirement ages in Albania are still relatively low. Initially, retirement ages for the majority of the population were 60 for men and 55 for women, with earlier ages for special categories, as early as 50 for men and 45 for women. The special categories are gradually being abolished with retirement age set to increase to 65 for men and 60 for women, but these ages will be reached by the majority of workers only in 2011 and even later for the special category workers. The ages are rising 6 months per year with the age in 2004 as shown in Figure 3.3 at 61 for men and 56 for women. As noted in Table 3.1, women with 6 or more children are still allowed to retire at age 50 with 30 years of service. In all cases, a full pension was granted with 34 years of service in early 2004, but with 35 years of service now. Prorated pensions are available with only 15 years of service.
15. The benefit formula in the pension system starts reasonably well. The formula is the basic pension, which is the same as the minimum pension plus 1 percent for each year of service. The basic pension is determined by the Council of Ministers and in 2005 was approximately 38 percent of gross covered wage for new pensioners. Theoretically, this could provide quite generous replacement rates with 35 years of service, at 73 percent of wage for an average wage person, compared to the ILO recommended 40 percent for 30 years of service. However, the average full pension in the urban sector amounts to only 40 percent of gross covered wage, not substantially higher than the basic amount. Several factors explain this discrepancy. First, there are fairly stringent limits on the maximum pension. The pension is limited to twice the basic pension, suggesting that high income individuals who might earn above the average wage will reach the limit very quickly. In fact, even if the maximum pension were wage-indexed, which legally it is not, individuals who earn twice the average wage would reach the maximum after only 25 years of work and individuals earning three times the average wage with only 18 years of work. These limits would be reached much faster under the legislated price-indexed maximum. Secondly, the pension is also limited if an individual reaches 75 percent of the net average of the best 3 successive years’ salary in the last 10 years. Although the law suggests that the past wages should be revalued based on growth in contributions each year, in practice the limits have been applied to the average of nominal wages, limiting the pensions awarded even more. Furthermore, the minimum pension, which is required to be indexed to inflation by law, has risen historically much faster than inflation in an effort to equate the minimum pension with the minimum living standard and has risen faster than the increases to above-minimum pensions. As a result, many people find themselves receiving the minimum pension, regardless of their contribution amounts.

16. Figure 3.4 shows the internal rates of return provided by the current benefit structure to individuals of high, medium, and low incomes. As can be clearly seen, high income individuals are earning relatively low rates of return relative to low income individuals who benefit both from the redistributive basic pension and from access to the minimum pension. Women earn

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1 The exact characteristics of the individuals simulated are described in the Annex
higher rates of return than men because they live longer and receive pension payments for a longer duration than men for the same wage level and the same contribution level.

**Figure 3.4: Internal Rate of Return for Individuals of Different Income Levels in the Urban Pension System**

17. Figure 3.5 shows the same evidence from a different perspective, comparing the pension received by the individual to his or her own last wage. Again, high income individuals are receiving pensions valued at 25-28 percent of their last salary. These pensions will be paid for about 20 years. To obtain these pensions, these individuals have paid 29.9 percent of salary for 40 years. Needless to say, the pension system is not a good deal for these workers. For low income workers, on the other hand, access to the system wide minimum pension brings their benefit rates at or even above their last salaries. From a redistributive perspective, the pension clearly redistributes toward the lower income workers.

18. From the incentive point of view, if most people are going to receive the minimum pension regardless of how much they declare in wages or going to receive low value for their pension contributions, they will obviously choose to declare the minimum wage. For the private sector, this is exactly what is happening. While the state sector employs almost 20 percent fewer workers than the private non-farming sector, state entities contribute more than twice the revenue that private companies contribute. While the private sector is supposed to pay better salaries than the public sector, more than 50 percent of private sector workers are declaring minimum wage, while only 1 percent of public sector workers are declaring minimum wage. On the pension side, since minimum pensions have risen faster than other pensions which become eroded by the maximum pension constraints, more than 68 percent of urban pensioners are collecting the minimum pension or less, while only 9 percent of rural pensioners collect benefits above the minimum level. A recalculation of pensions is scheduled for this year which will recalculate the 3 years’ average wage, revaluing the past wages for growth in contributions paid to social insurance, which is attempting to remedy some of these distortions. However, the incentives to declare as low a wage as possible and for fewer years will still exist given that the maximum wage subject to contributions is five times the minimum wage, while the maximum pension is only twice the minimum pension.
19. Further disincentives are related to postponement of retirement. The reward for postponing retirement is half the penalty imposed for those who choose to retire up to 3 years early. However, note that most people who work a full career will have already reached the maximum pension. Thus, the postponement will gain them nothing. On the other hand, many, particularly higher income individuals, will reach the maximum pension earlier than a full career would warrant or will have reached 35 years of service before having reached the retirement age. For these individuals who are already reaching the limits of the maximum pension, retiring early does not impose a penalty since the pension remains unchanged. These strict limits on pension payments might have served to keep pension expenditures in check, but they also provide individuals the incentive to retire as early as possible.

20. On the disability side, the benefit and eligibility conditions are appropriately strict. Albania has been far more successful in containing disability pensioners than its neighbors and has avoided the use of the disability pension system as a means of easing labor market transitions. On the other hand, Albania has instituted a Disability Act under the Department of Social Services, which provides a higher social assistance payment to those that qualify as disabled than offered by the Social Insurance Institute. Those that receive disability payments from SII do not qualify for the Social Services payment, so even those who might be eligible for SII disability pensions often choose not to take them. The one issue that comes up from within the pension system is that the maximum pension for disabled pensioners is 80 percent of the average salary, which is different from the 75 percent limit for old age pensioners. In every other respect, the pension formulae are identical. It is not clear why the higher limit applies to disability pensioners. Partial disability pensions are also provided for those with partial disabilities.

21. Survivors’ pensions may be slightly on the ungenerous side, with widows awarded half the deceased’s pension. Typically a couple does not need twice the income of a single person to live equally comfortably. A widow living alone could not live as well on half the couple’s income as the couple did on the full pension. If there are many widows living alone, the benefits
are typically 60-70 percent of the deceased's pension for the widow. If widows typically live with other family members, the level is adequate.

22. Most of the parameters of the rural system are identical to those of the urban system. One huge exception is the contribution rate. Rural workers are assessed flat contributions determined by the Council of Ministers, one amount for lowland workers and an even lower amount for highland workers. The Government then calculates the full contribution that would have been required based on the minimum urban salary and pays the difference between that and the flat contribution paid by the rural workers to the Social Insurance Institute. The Government contribution has amounted to around 85 percent of the total in recent years, making this system contributory largely in name rather than substance.

23. While the benefit system for the rural pensioners is structured identically to that of the urban workers, the level of the minimum and maximum benefits is set separately, and a larger percentage of rural than urban pensioners receive the minimum pension. Benefits are awarded on the basis of the minimum urban wage or higher if contributions had been paid on higher wages, while the actual contributions made by the workers are substantially lower. The pension paid in the rural system is currently lower than in the urban system, but will become equal to the urban pension around 2012. To achieve this equality, the Government has been raising rural pensions each year significantly more than urban pensions. In 2006, rural pensions were raised 20 percent while urban pensions were raised only 5 percent. Because the rural system only began in 1972, virtually no workers are retiring with full pensions, which require 35 years of service. The prorated pensions for fewer years of service are partially responsible for the low level of pensions.

24. In addition to the pensions themselves, pensioners also receive three types of additional compensation, compensation for electricity, compensation for bread, and compensation for dependents. The money to finance these additional compensations comes directly from the budget. On average they raise the monthly compensation for old age pensioners 6-7 percent. Since the payments are uniform, survivors who receive lower pensions to begin with find an increase of 12 percent from these additional compensations.
IV. PROJECTIONS OF THE CURRENT PENSION SYSTEM, 2004-2075

25. This section presents the results of pension projections for both the urban and rural systems in Albania. The projections are created using the World Bank PROST model, which has been used for pension projections in over 80 countries. The model projects the population, numbers of contributors and beneficiaries of the system, their annual contributions or benefits, respectively, and the overall financial outcome of the system. It takes the 2004 data provided by the Social Insurance Institute as given and projects forward. The projection period lasts until 2075 in order to evaluate whether the promises being made to the young labor force entrant today will be able to be met in the future.

26. Projections depend heavily on assumptions. The demographic and economic behavioral assumptions are summarized in Table 4.1.

<table>
<thead>
<tr>
<th>Table 4.1: Fertility and Behavioral Assumptions Used in Projections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumptions</td>
</tr>
<tr>
<td>Total Fertility Rate</td>
</tr>
<tr>
<td>Life Expectancy at Birth, Male</td>
</tr>
<tr>
<td>Life Expectancy at Birth, Female</td>
</tr>
<tr>
<td>Contributor Coverage</td>
</tr>
<tr>
<td>Length of Work History</td>
</tr>
</tbody>
</table>

27. Albania is in the enviable position of being a young country with population projected to grow throughout the simulation period in comparison with many of her neighbors, who are expecting sharp population declines. Population growth will, of course, slow down, but will remain positive throughout. Nevertheless, the share of the population above retirement age will rise markedly from the current 11.6 percent to 25 percent, a full quarter of the population. The old age population dependency rate, defined as the ratio of the percentage of population above the retirement age to the percentage of the population in working ages, will rise commensurately as shown in Figure 4.1. The initial drop is entirely due to the rise in retirement age from the 61 for men and 56 for women to 65 for men and 60 for women. After the change in retirement age is fully implemented, the old age dependency ratio rises steeply largely due to the growth in the number of elderly, accompanied by slower growth in the working age population.

28. The system dependency rates, the number of total beneficiaries per 100 contributors, mirrors the old age dependency rates for the most part. In both the rural and urban systems, the system dependency rates initially fall in response to the rising retirement ages. Once the retirement age is fully implemented, the rates begin to rise again. In the long run, the urban system sees rates falling slightly after 2050. Currently, all the elderly and more are collecting pensions. However, since far fewer percentages of the working population today are making contributions, the number of elderly with rights to the pension system will begin to fall as the contributors of today, those with incomplete work histories post-transition, begin to retire.
Furthermore, the model is assuming that the above-100 percent of elderly collecting pensions, which exists in today’s data, will gradually reduce to more normal levels once these cohorts have left the system. The system dependency rates for both the urban and rural systems, separately, and the two systems combined are shown in Figure 4.2. However, Figure 4.2 deserves a caveat. The modeling has assumed that contributors continue contributing for a full 35 years as they have in the past. This behavior will probably remain valid for public employees who make up a significant number of contributors. But the incentive discussion from the previous section suggests that many people have little incentive to contribute for a full career and may not be doing so in the private sector. If the latter behavior occurs, the number of contributors will fall below the numbers projected, raising the system dependency rates even further. In addition, it is important to remember that the Government’s policy objective is to equalize rural and urban pensions. If the rural contributors continue to contribute only 15 percent of the necessary contribution and receive full rights to the pension system, it is as if 85 percent of the contributors in the rural system do not make contributions. If 85 percent of the rural contributors were excluded, the system dependency rates would skyrocket to around 136 percent in the long run, implying that each true contributor needs to support 1.36 pensioners for the system to be self-financing.

Figure 4.1: Projected Old Age Dependency Ratio in Albania, 2004-2072

![Number of Individuals Over Retirement Age Per 100 Individuals Aged 15-Retirement Age](image)

29. Figure 4.3 shows explicitly the impact of the current low ratio of contributors as percentage of the working age population on the number of elderly eligible to receive pensions in the future. The future elderly receiving pensions include all men 65 and older receiving old age, disability, or survivor pensions and all women 60 and older similarly added across the pension categories. The denominator is the population of men aged 65 and older and women aged 60 and older. While the current very high rate of elderly receiving pensions clearly reflects fraud and/or poor data, the long term projection shows that just less than 60 percent of the elderly will be receiving any type of pension in the future, and for more than 10 percent of those that receive pensions, the pension will just be a survivor pension, which only pays half of a regular pension. Figure 4.3 suggests that while there may be an administrative issue currently to try to correctly identify those who should be collecting pensions and those who might no longer be eligible, in the long run, the Government will face a social issue of how to provide for all those elderly, who have no income in old age.
30. The demographic projections are then combined with some assumptions on macroeconomic variables to produce the financial projections. Table 4.2 summarizes the key macroeconomic variables used in the projections.

<table>
<thead>
<tr>
<th>Macroeconomic Assumptions</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2010</th>
<th>2025</th>
<th>2050</th>
<th>2075</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>6.0%</td>
<td>5.5%</td>
<td>5.0%</td>
<td>6.0%</td>
<td>5.8%</td>
<td>5.4%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Real wage growth</td>
<td>4.0%</td>
<td>4.0%</td>
<td>5.0%</td>
<td>4.9%</td>
<td>4.8%</td>
<td>4.7%</td>
<td></td>
</tr>
<tr>
<td>Inflation Rate</td>
<td>2.5%</td>
<td>2.2%</td>
<td>2.5%</td>
<td>3.0%</td>
<td>2.8%</td>
<td>2.4%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Real Discount Rate</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

31. On the policy side, the initial results have been modeled following the law as legislated, which states that both the minimum pension and pensions in progress will be indexed by a price index, potentially with a slightly different basket of goods than the consumer price index relevant to the whole economy. From the fiscal side, the projections show not only a fiscally sustainable
system, but one which shows significant enough surpluses that the Government could easily reduce labor taxes in the future, as can be seen in Figure 4.4. The urban system is currently running a deficit, which pushes the overall system into deficit. This deficit will reverse itself as the de facto inflation indexation of the maximum pension begins to sharply curtail benefits. The rural system is currently in surplus for several reasons. First, few elderly have accumulated enough rights in the system to receive full pensions and most are receiving partial pensions. Second, even the full minimum pension in the rural system is currently about half of the full minimum pension in the urban system, although they are expected to become the same around 2012. But at the same time, the current contributions are being assessed at the urban self-employed minimum wage, with the Government paying the bulk of the contribution. If the Government remits the full contribution, the combined system will exhibit only a small deficit for 2004 and 2005 before returning to surplus. Even as the rural benefits rise to the urban minimum as is legislated, the system continues to remain in surplus throughout. This surplus is slightly reduced if the rural subsidy to contributors is netted out of the surplus, but the surplus still ends up at 4 percent of GDP in the long run.

Figure 4.4: Projected Fiscal Balances of the Pension System with the Law as Legislated

![Projected Fiscal Balance of the Pension System](image)

However, while this policy as legislated may be fiscally sustainable, it results in such a sharp reduction in benefits that it is not politically sustainable. Figure 4.5 shows the level of benefits relative to average wage. For the urban pensioners, benefits continue to fall throughout the simulation period, except for the first two years, during both of which the pensions were raised well above the inflation rate. In 2005 and 2006, pensions were raised 8 percent and 5 percent respectively in the urban system, much higher than the inflation rates of 2.5 percent and 2.2 percent. The rural benefits begin with a different pattern, but end up roughly similar. Initially, the Government is following a pattern of raising rural pensions by much more than urban pensions each year in an effort to equalize minimum pensions by 2012. Thus, in 2005 and 2006, rural pensions were raised by 15 percent per year, much higher than the increase for urban pensions, and several fold higher than the inflation rate. In Figure 4.5, this policy shows as a sharp increase in pensions relative to average wages in the first 8 years of the simulation period, with subsequent declines as the pensions become fully indexed to inflation. Pensions in many countries are linked to inflation without such sharp declines in benefits. The Albanian legislation links not only pensions in payment and the minimum pension to inflation, but by linking the maximum pension to the minimum pension, ends up linking the maximum pension to inflation as
well. As wages grow economy wide, pensions, even for new retirees, are limited to the same pension in real terms as those who retired 20 years ago, resulting in these very low average benefit rates. Note that while urban benefits are roughly twice the level of rural benefits, the benefits in Figure 4.5 are shown relative to the average wage on which contributions are paid in each subsystem.

Figure 4.5: Projected Change in Benefits if Annual Increases are Determined by the Legislation

![Projected Benefits to Old Age Pensioners Compared to Average Wage](image)

33. This policy as legislated is not sustainable for a number of reasons. Pensions serve two objectives: (i) they alleviate poverty in old age, and (ii) they provide a mechanism to allow individuals to smooth their consumption over their lifetime so that when they are unable to earn income, their consumption levels do not fall drastically. Assuming that the level of the pension is sufficient to purchase a poverty level basket of goods, maintaining this level constant even when wages rise will eliminate absolute poverty among the elderly, although pensioners will still be poor relative to wage earners. But the second objective of the pension system, which is to allow consumption smoothing, cannot be achieved in a framework such as this. Individuals earning wages will suffer a steep drop in their consumption ability when they retire. This sharp drop in living standard for middle and upper income individuals will not be politically sustainable unless some other mechanism is available for them to smooth their consumption levels. Second, these enormously high payroll taxes, which cause considerable distortion in the labor markets, are being used to provide poverty alleviation for some of the elderly, only for those who have contributed, and many of these individuals might not be in poverty at all, while others who are in poverty have no access to benefits. Third, no individual would willingly contribute 29.9 percent of salary for 35 or more years only to receive a benefit equal to less than 5 percent of average wage for 15 to 20 years. As a result, the few incentives, which currently exist to contribute to this system, will be sharply reduced as will revenues, making the system fiscally unsustainable as well as politically unsustainable.

34. In reality, the Albanian authorities have not been following the legislation and have been granting pensions more in line with the revenues they receive. If the pensions were to be fully wage indexed, which effectively is increasing pensions with the revenues received since the working age population is not falling over the simulation period, the reverse occurs, where the pensions are socially acceptable, although still including the disincentives for high income earners discussed earlier, but they become fiscally less sustainable as shown in Figure 4.6. The
overall deficit ends up at 0.4 percent of GDP, but peaks at 1.1 percent in the middle of the period. But it must be remembered that the Government is also paying 85 percent of the contribution for the rural workers, which amounts to another 1 percent of GDP. At its peak, the Government will need to provide 2.8 percent of GDP in fiscal resources to provide pensions for only 75 percent of the elderly, as shown in Figure 4.6. A deeper look at the urban system finances shows that the deficit initially improves, then gets worse again, but towards the end of the period begins to improve again. The initial improvement comes from the rise in the retirement age. Once the retirement age change is fully implemented and absorbed, the deficit becomes worse again. Around the middle of the period, the cohorts of post-transition workers begin to retire. Since fewer of these workers will have acquired rights to the pension system, the number of pensioners begins to fall and consequently the pension expenditures. On the rural side, the initial sharp worsening arises from the rapid increase in the level of benefits in an attempt to equalize urban and rural benefits. Since urban benefits are now rising faster with the wage-indexation, the rural benefits have to rise even faster to catch up. Once the benefits are equalized, the pace of deficit growth slows. The rural system does not show the improvement that the urban system does because the initial imbalance between percentage of cohort receiving benefits and percentage making contributions, which is being corrected in the urban system, did not exist in the rural system.

Figure 4.6: Projected Fiscal Balance if Pension Benefits are Fully Wage-Indexed

35. On the benefit side, benefits are of course much better under the wage-indexed system as shown in Figure 4.7. Urban benefits remain at their roughly 40 percent of average wage level. Rural benefits jump up to a much higher level, again based on the equalization between the rural benefits and the minimum urban pension level. The high replacement rate relative to the minimum wage applied to the urban self-employed, which may even be a high wage relative to what the rural workers actually earn, brings into focus the question of whether it makes complete sense to equalize the level of pensions between rural and urban workers. Rural and urban pensioners may have different needs and providing them much higher level of pensions relative to their own wages on which they paid contributions, and of which they paid only 15 percent of the contributions may be overcompensating the rural pensioners at the expense of everyone else in the economy.
36. In reality, the Government may choose a middle course between the fully price-indexed model and the fully wage-indexed model, something in between, which will be fiscally sounder. However, the contrast between the two sets of figures suggests that there will always be a trade-off under the current set of parameters. Any indexation scheme which is fiscally sound will not provide benefits even up to the International Labor Organization (ILO) core benefit level of 40 percent of average wage for 30 years of service. Any indexation, which provides the core level of benefits, will be costly and still leaves a large percentage of the elderly with no benefits. It is worth emphasizing again that all of these projections are based on conservative, optimistic assumptions that individuals will continue to work full careers as they have in the past. As already noted, the incentives in the system do not work in this direction. If individuals respond to these incentives, the fiscal situation will deteriorate regardless of indexation mechanism, and the benefits may be worse as well because increasing numbers of individuals may receive partial benefits in lieu of full benefits.

37. The problems of the current system can thus be summarized as follows:

- Inadequate coverage of the elderly in the LR with 40 percent of the elderly in the future left without access to the pension system;

- Sharp declines in benefits stemming from the linking of the maximum pension to inflation;

- High contribution rates which provide disincentives to formalization of the labor force;

- Disincentives in the benefit formula for people to declare their full wages or to work throughout their working age; and

- Over-generosity with respect to rural workers and pensioners.
To date the Albanian authorities have recognized problems in the pension system and have tried to remedy them by making small changes to the existing pension system. For example, the original law set the limit for salary subject to contributions at twice average wage. To generate more revenue, the authorities changed this ceiling to five times average wage. To avoid over-generous indexation of pensions, the authorities instituted the rule that the minimum pension and pensions in payment should be indexed to changes in prices of a specifically designated basket of goods. Most recently, in response to concerns about the high cost of labor and evasion, the authorities have moved to lower the contribution rate for social insurance in general, including the contribution rate for pensions.

The Government should be commended for recognizing problems as they emerge and for attempting to address them as they arise. The disadvantage of this approach, however, is that after many patches have been applied to the laws, the law begins to lack consistency. Each enacted change helps the problem at hand, but makes something else worse. For example, the attempt to increase revenue by raising the contribution ceiling to five times average wage may have improved revenues in the short run, but because it was not accompanied by changes in the benefit formula, the incentives for high earners to correctly report earnings and pay contributions on them have been severely eroded. Eventually, it is worth re-evaluating the pension system and thinking about whether the current system can achieve the objectives the Government would like to achieve or whether an alternative structure would be better. This section will attempt to lay out the options that the Government faces as it begins to look at alternative structures.

Currently, the pension system is being asked to do substantial redistribution to the rural sector, to do substantial redistribution to the urban poor, to be fiscally sustainable, to provide labor market incentives for formalization, and to provide reasonable pensions for people, all with only one instrument. These are too many objectives for one instrument. An appropriate approach may be to divide these objectives into at least two groups and use one instrument to achieve one of the objectives and another to achieve the other. One option would be to remove the redistribution from the contributory system and redesign the parameters to achieve fiscal sustainability, a close link between contributions and benefits, which removes the many current disincentives for participation, and reasonable pensions for those who contribute. The redistribution that is currently embedded within the pension system would need to be provided by another instrument, a means-tested social assistance pension available to all elderly below a given income level, for example. An alternative option would be to shift the focus of the public pension system toward redistribution, with the primary objective being poverty alleviation of the elderly, to be funded out of general revenue or a small contribution at a low enough rate that it does not burden the labor markets. Providing consumption smoothing through reasonable pensions to middle and high income earners would become the responsibility of a private pension system to which all workers who choose to do so would have access. This private system would be almost fiscally neutral, involving some limited tax advantages to the private pension savings only. In both options, the fiscal resources required would be targeted toward poverty alleviation of the elderly and disabled, either by providing a basic pension for all elderly and disabled or by providing a social pension for those who do not have contributory pensions.
41. The rest of this section looks at the implications of following each of these strategies from a fiscal standpoint, from a benefit level standpoint, from a coverage standpoint, and from an incentive point of view. However, it should be emphasized that within each of these discrete options lie many sub-options. Only one example of each of the discrete options is being presented. The ones presented are not necessarily optimal, but are merely being used to illustrate the potential different outcomes under these discretely different options. Once the Albanian authorities have decided on the choice of discrete option best for Albania, then specific sub-options can be tested and modeled to determine the exact nature of the parameters, which will provide the best design for Albania.

Option 1

42. This option involves restructuring the current contributory system, strengthening the incentives to contribute, and removing the majority of subsidies. At the same time, the system would be complemented by a noncontributory basic pension, which would be available to all those who are unable or unwilling to contribute. The specific parameters chosen to illustrate Option 1 are shown in Table 5.1 below. Option 1 involves reducing the contribution rate by 6 points in line with what has just been done beginning September 1 in the current system. It keeps retirement ages the same as in the current case, even though retirement ages, particularly for women, are still low by international standards. The big changes are in the benefit formula. In place of offering a basic pension and 1 percent of own salary for each year of service, Option 1 offers 1.3 percent of own salary for each year of service. This 1.3 percent accrual rate per year of service was chosen as a rate that is fiscally sustainable given the new 23.9 percent contribution rate. Different combinations of contribution rates and accrual rates will also be fiscally sustainable and can be explored as various sub-options. If the Government would like to reintroduce some element of redistribution in the benefit formula, a small basic pension could be introduced with a smaller accrual rate relative to own salary, keeping a target replacement rate of 40-50 percent in mind. However, in choosing to add a basic pension, the Government needs to be wary of reducing contribution incentives for higher income workers too much.

43. Rural workers will be given a choice. If they choose to belong to the urban pension system, they are free to do so as long as they are willing to make the full payroll contribution on the same wage basis as the urban workers with no Government subsidy. If they are unwilling or unable to raise their contributions to this level, their requirement to contribute will be eliminated, raising incomes for the working age population in this group. However, their pensions will be the current rural pension indexed for inflation. Basically they will be provided the same purchasing power that rural pensioners today have reached. At some future point, the Government may need to evaluate the poverty needs of a rural pensioner and set the level of benefit in accordance with the needs. The current rural pension was chosen simply to ease the transition from one system to another in this example. No transition period is envisaged in this example for the rural pensioners, so that regardless of whether they contributed in the past or not, they will receive the same benefit. Sub-options could include some small supplement for those who have contributed in the past based on years of contributions, but given that the bulk of contributions came from the Government, this supplement has not been included in the example modeled. Finally, as the contributory system reduces the number of elderly to which it provides
pensions, the new rural system will increase the number of elderly to whom it provides a benefit in an attempt to cover the entire population. Eventually, there will no longer be an urban system and a rural system, but a contributory and noncontributory system with individuals in both the urban and rural areas able to access either of these benefit systems based on their willingness or ability to contribute.

Table 5.1: Parameters Used to Illustrate Option 1

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Current System</th>
<th>Option 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution Rate</td>
<td>29.9 percent&lt;sup&gt;1&lt;/sup&gt;</td>
<td>23.9 percent</td>
</tr>
<tr>
<td>Retirement Age</td>
<td>Rising to 65M, 60 F by 2012</td>
<td>Same</td>
</tr>
<tr>
<td>Benefit Rate</td>
<td>Basic pension + 1 percent per year of lifetime average revalued by growth in average contributions; Subject to stringent maximum pension limits; pension cannot exceed twice the basic amount or 75 percent of net average wage of any 3 successive years in the last 10 years of employment, whichever is less;</td>
<td>1.3 percent per year of lifetime average revalued by growth in average wages; 2007 maximum pension raised to 5 times current amount; subsequently indexed to wage growth</td>
</tr>
<tr>
<td>Indexation of Pensions Post-Retirement</td>
<td>Inflation by law; often higher in practice</td>
<td>Inflation</td>
</tr>
<tr>
<td>Rural Pension System</td>
<td>Benefits expected to be identical to urban system by 2012; flat contribution with government making up the difference between that and the urban contribution rate paid on the minimum urban wage</td>
<td>Special contributory system eliminated; those who want to contribute at full urban rates may do so; others are provided benefits on a noncontributory basis at the level of today's rural pensions, kept constant in real terms</td>
</tr>
</tbody>
</table>

44. Figure 5.1 shows the projected financial balance for each of the systems. The urban, or contributory system, maintains a financial balance through the bulk of the period, with a small surplus toward the end. The initial increase in the deficit comes from the reduction in the contribution rate. The surplus at the end suggests that there is fiscal room in the future to reduce contribution rates further or to make the benefits slightly more generous. Further room to move in these directions will be opened up by raising the retirement age for women to 65 and by raising the retirement age for all from 65 to higher ages in line with increases in life expectancy in the very long term. On the rural or noncontributory side, the elimination of the contribution requirement will immediately put the rural system into deficit and it will rely throughout on fiscal resources. However, with continued growth in GDP and a social pension whose level grows only with inflation, despite the increased number of beneficiaries in the future, the amount of fiscal resources required will fall relative to GDP from an initial level of 0.7 percent of GDP. The line at the bottom shows that the overall fiscal resources required will be lower in Option 1 than in the base case, assuming that pension increases follow the path to date of growing with wages except for the first 2 years when the Government will be absorbing both the elimination of contributions in the rural system and the reduction in the contribution rate for urban workers.

<sup>1</sup> Contribution rates were just reduced to 23.9 percent as of September 1, 2006.
Figure 5.1: Projected Fiscal Balance of the Pension System Under Option 1

45. What happens to the level of benefits? Figure 5.2 illustrates the impact of these changes on the level of benefits. For the urban pensioners, the pensions will decline from their current levels, but then will hold steady into the future unlike under the current legislation where they will fall to extremely low levels. While the level of the pension looks to be less than 30 percent, the decline is largely attributed to the post-retirement inflation indexation. The newly awarded pensions are approximately 50 percent of average wage for workers who have contributed 35 years. The attrition in pension value post-retirement is typical when pensions are inflation-indexed and wages experience real growth. This type of indexation is increasingly common throughout the world. From an economic standpoint, pensioners are concerned with maintaining their purchasing power during their retirement and do not require increases in their purchasing power as they age.

Figure 5.2: Projected Benefits to Old Age Pensioners Under Option 1

46. For the rural, or noncontributory, workers, the pensions will fall relative to average wages. This fall occurs because wages continue to rise in real terms while the benefits provided remain constant. Since the benefit is noncontributory and meant to alleviate poverty, the Government needs to be concerned with providing an absolute living standard for these elderly.
not a living standard relative to wages. The rural, or noncontributory, benefits are shown relative to average urban wages, rather than relative to imputed wages in the rural sector to make an equal comparison on the level of benefits. Figure 5.2 shows the rural benefits as being below the level of the urban benefits today as indeed they are.

47. Long run coverage for the elderly, which was a problem under the current system, also improves substantially under Option 1, as shown in Figure 5.3. The above 100 percent coverage remains the same in 2005 in either case. The second pair of bars contrasts the coverage in Option 1 with the coverage under the Base Case in 2025. Already it can be seen that as the contributory system covers fewer elderly, the noncontributory system begins to cover more, maintaining close to full coverage. By 2075, the contributory system provides benefits to only one-third of the elderly with the majority of the rest covered under the noncontributory system. Full coverage was not modeled because typically there is some slippage, but that could be included as well. The Government could also choose to eliminate the noncontributory system as a separate administrative system and allow all elderly to access the Ndema Ekonomika social assistance benefit instead. The noncontributory system shown here does not require the means testing required by Ndema Ekonomika, but again, there are many sub-options to explore. Since elderly incomes are typically less variable than working age incomes, annual means testing may be an unnecessary burden for the elderly.

Figure 5.3: Percentage of Elderly Covered Under Pension System Over Time Under Option 1

48. The final comparison looks at the incentives in the new system. Figures 3.4 and 3.5 showed that the current system contains enormous disincentives to middle and high income individuals to correctly declaring their wages and the time that they work. Figure 5.4 shows the incentives under Option 1. The rates of return are not appreciably different across income groups, with women receiving higher rates of returns than men because of their longer life expectancy. The rates of return are lower for lower income individuals because these individuals typically begin work at earlier ages since they do not spend time in higher education and receive pensions for shorter periods of time because of the higher mortality rates associated with low income individuals.
49. Figure 5.5 compares the levels of benefits received to the last salaries these same individuals are projected to have earned. The graph clearly shows that most individuals will be receiving substantial pensions relative to their last earnings, particularly keeping in mind that the pensions are being compared to gross earnings from which contributions and taxes are deducted, neither of which are deducted from the pension. These numbers for middle and low income earners appear higher since these workers experience a normal decline in salary in their latter years. Their pension, on the other hand, is based on earnings which include their more productive and higher income years, boosting the pension relative to the final salary. For high income earners, who may be high level executives just before retirement and who receive substantial salary increases right until retirement, the pension based on earlier low earning years will be lower relative to their final salary.
Option 2

50. In Option 2, the Government moves in the opposite direction, recognizing that the current system is highly redistributive and provides few incentives for middle and high income individuals to contribute, but at the same time does not end up covering the whole elderly population in the long run. In this option, the Government moves farther toward redistribution by abolishing the contributory system and instituting a flat benefit, modeled in the example at the same level as the current rural benefit to be funded out of government revenue. Various benefit levels could be modeled. The rural benefit level was chosen in this case to avoid raising benefits for any group. This benefit would be available to all individuals aged 65 and older, and would be indexed to inflation since it is designed to alleviate poverty, not consumption smooth.

51. The cost of providing this benefit to the entire elderly population is surprisingly low, beginning at 1.1 percent of GDP and ending at 0.1 percent of GDP at the end of the simulation period. The decline over time occurs because the real level of the benefit is held constant with real growth in GDP occurring throughout. In 2007, the cost of paying pension expenditures in both the rural and urban contributory systems is expected to be 4.2 percent of GDP. In comparison the 1.1 percent figure seems low. However, as has been discussed earlier, the pension expenditures include payments to 140 percent of the elderly population. Many of these must be fraudulent. The flat benefit calculation assumes that each elderly individual will be identified and only one flat benefit will go to each. Furthermore, the level of the benefit is at that of the rural benefit, not the urban benefit which is at least twice the rural benefit. Since two-thirds of the current beneficiaries are from the urban system, the reduction in benefit further reduces costs. Finally, men and women are not provided this flat benefit until they reach 65 beginning in 2007 compared to the current system where age 65 is not being fully phased in until 2012 for men, and for women the final age will end up at 60, not 65. Note that the contribution from the Government for rural workers will amount to 1.5 percent of GDP in 2007 under the current system and can be eliminated under Option 2, so providing a poverty alleviation supplement to all elderly is clearly affordable. At the same time, the distortionary labor tax would be completely eliminated.

52. However, there would be a transition cost in moving from the current contributory system to a general revenue financed social benefit for all elderly. Those who have already retired would need to be paid their current benefits to avoid political problems, and those who have made contributions would expect to get something higher than the flat benefit, which goes to individuals who have not made contributions. If the Government were to eliminate the contributory system, there would be no pension revenues, but the Government would still have to pay pensions already in payment and for the acquired rights of those who have contributed. These payments constitute the transition cost of moving to the flat social benefit. Figure 5.6 shows the total fiscal cost of Option 2 with transition costs if all contributions are immediately eliminated, compared to the base case with full wage indexation. The fiscal balance immediately jumps to a deficit close to 3.5 percent of GDP, the same as expenditures in the pension system since there are no revenues. The expenditures are assumed to be lower than the current expenditures because the modeling is assuming that each elderly person will receive only one benefit, contributory if they qualify for a contributory benefit or noncontributory if they do not
qualify or if their contributory benefit would be less than the noncontributory. In reality, it would probably take longer than 2007 to clean the beneficiary rolls of dead or otherwise disqualified pensioners, but this is just an example. The new legislation would not be drafted in time for implementation by January 2007 either. As the acquired rights in the contributory system diminish, the transition costs fall. By 2039, they are reduced to zero and the cost of Option 2 is only providing the flat social benefit, which is kept constant in real terms and thus falls relative to a growing GDP. However, until 2019, the cost of Option 2 will exceed the cost of the current pension system under its most expensive wage-indexed variant. The question is whether the Government has the fiscal resources to launch this option, which, in the short run, is much more expensive than the status quo, but will be much more cost effective in the long run both fiscally and from the point of view of reducing labor costs and improving the functioning of the labor market.

**Figure 5.6: Projected Fiscal Costs Under Option 2 with Complete Phase-out of Contributions in 2007**

![Graph showing projected fiscal balance if contributory system completely phased out in 2007.](image)

53. A variant of Option 2, which might be more fiscally achievable, involves eliminating contributions for those workers under the age of 40 in 2007 and for new entrants to the labor force, but maintaining them for workers above the age of 40 in 2007. Some revenue will continue to flow into the social insurance system for the next 20-25 years which will help cover some of the liabilities of the old system. In return, the workers who continue to make contributions will be receiving full pensions when they retire rather than only their acquired rights up till 2007. As Figure 5.7 shows, this variant, Option 2A, reduces the transition costs at the outset, but lengthens the transition cost period such that the transition costs do not fall to zero until 2049, 10 years after the case where everyone stops contributing in 2007. The trade-off between a longer transition period and lower initial costs may be well worth the Government’s effort. In this case, by 2010, the fiscal costs of Option 2A are below that of the base case with the wage indexation. For only three years does the government have to bear additional costs, and the cost difference goes down over the three year period, beginning with 0.2 percent of GDP in 2007, making this a more attractive option from a fiscal standpoint than Option 2.
54. From a benefits point of view, the benefits are clearly lower under Option 2 and Option 2A than under the wage-indexed base case for contributors in the urban system as shown in Figure 5.8. The contributory benefits fall in Options 2 and 2A because new retirees have fewer acquired rights than those of previous generations. At the point where the noncontributory benefit becomes higher than the contributory benefit, individuals receiving the contributory benefit are assumed to receive a top-up, raising them to the level of the noncontributory benefit. The cost of these top-ups was included in the fiscal estimates shown in Figures 5.5 and 5.6. Again, if there are issues with the starting point for the social pension, the current level of rural benefit, these can be adjusted, but variants of Option 2 will largely look like Figures 5.6-5.8. While the noncontributory benefit clearly serves a poverty alleviation role, it is unable to perform the role of consumption smoothing, as Figure 5.8 clearly shows a steep decline in its level relative to average wage. Other instruments, such as voluntary pensions, already legislated in Albania will need to fill the role of consumption smoothing. The legislation needs to be reviewed and most likely amended if it is to assume the major role of consumption smoothing, but the effect would be to assign different instruments to achieve each of the goals of a pension system.

Figure 5.8: Projected Benefits Under Options 2 and 2A Compared to Wage-Indexed Urban Pension in Base Case
55. Ideally, the voluntary system should be funded so that no companies, public or private, are taking on additional liabilities, which might eventually be passed to the Government. Private management of these funds has outperformed public management in most countries. However, the existing financial market institutional structure would need to be reviewed as well as the regulation and supervision to determine how soon Albania would be able to develop an actively functioning private pension system. Aside from the role that such a system could play in providing old age benefits, such a system would also benefit the development of financial markets in Albania. In the interim, the Government could institute a separate pension fund, operated on a funded basis, with clear rules for future privatization.

56. Despite the inability to consumption smooth under Options 2 and 2A, it should be noted that the two options do achieve poverty alleviation and eliminate the troublesome contribution rate, which imposes disincentives to formal labor market expansion. The current system neither achieves consumption smoothing nor poverty alleviation, unless pensions are fully wage-indexed, in which case, it is not fiscally sustainable.

57. With regards to coverage, by design all Albanians reaching age 65 or older would be provided a benefit regardless of their work or contribution history. Because the system would not be financed by payroll taxes, there would be no detrimental impact on the formal labor market and no incentive for under declaration of wages as exists in the current system.

Intermediate Options

58. Options 1 and 2 have provided distinctly different views of the role of the public pension system. In Option 1, the urban workers retain a modified contributory system, with the Government providing a social pension for those who are unable or unwilling to contribute, while in Option 2, the contributory system is abolished and the Government provides a social pension for all. Is there an intermediate option which retains the current contributory system for both rural and urban workers, reduces the contribution rate from its extremely high levels, and is fiscally sustainable? The answer is most likely no. While infinite permutations of each option are viable, retaining the benefit structure in the current contributory system and at the same time reducing the contribution rates is unlikely to be fiscally sustainable and unlikely to remedy the flaws inherent in the current system.

59. Reducing the contribution rates in the law as written with inflation indexation of pensions in payment, the minimum pension, and in effect the maximum pension might be fiscally sustainable, but as long as the benefit rates in the future as shown in Figure 4.5 will be lower than the contribution rates today, no one will have an incentive to increase contributions. As the benefit rates fall, people will respond by resorting to evasion. Revenues will then fall making the system fiscally unsustainable. If benefits are indexed to wage growth, then the system as it stands is already not fiscally sustainable, and reducing the contribution rate will only result in a loss of revenue.

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60. The only chance out of this dilemma is if individuals and employers would react to the cut in contribution rates by a more than proportional increase in formalization. For example, if the contribution rates are cut 10 percent, employment would need to increase by more than 10 percent to generate more revenue for the social insurance system. There are several factors that suggest that this is not likely. First, international evidence seems to suggest that each 1 percent reduction in the contribution rate results in a 0.3 percent increase in employment.\(^6\) Such a limited response to the rate reductions will not be sufficient to generate more revenue. The limited response is usually attributed to factors other than the pension system design which limit formalization, such as rigidity in labor laws. Second, in Albania there are additional disincentives within the pension system design itself which impede formalization. Finally, even if the response were sufficient to raise revenues, bringing more individuals into a system which is actuarially unbalanced will in the long run lead to additional costs. In the short run, revenues might rise, but in the long run, the additional contributors will retire and increase future expenditures even more.

**Advantages and Disadvantages of Each Option**

61. Option 1 has the advantage of maintaining a social insurance system for those who can pay. Recognizing that some people will be unable or unwilling to contribute, a separate system is provided for these individuals, preventing the social insurance system from being undermined by concerns for those who do not pay. On the other hand, moderately high payroll contribution rates will be maintained for the future. Moderately heavy investment in infrastructure in the Social Insurance Institute will be required in order to implement a social insurance system well. Furthermore, the end result will not be a unified system for all Albanians, resulting in potential labor market fragmentation, as people hesitate to move, particularly from the urban sector to the rural sector, fearing loss of benefits.

62. Option 2 or 2a has the advantage of eliminating payroll contributions entirely, greatly alleviating burdens for employers. It is a much simpler system to administer in the long run, although the more feasible Option 2a will still require a fully operational Social Insurance Institute for at least another 50 years. In the long run, the Social Insurance Institute will simply need to maintain records of who has reached a particular age and to certify disability status. But for the next 50 years when those who are over the age of 40 continue to contribute and retire, contribution records and beneficiary payment records will need to be maintained. The equality that the government has sought between urban and rural sectors will also be achieved, although not by raising rural pensions to urban levels, but by bringing urban pensions down to rural levels. On the other hand, the pension levels will be low and most individuals will want a supplement. Politically, it will be important that the government insist that all supplements be provided through contributions to the voluntary pillar rather than allow an expansion of the publicly provided benefits. However, in order for this to be a viable scenario for individuals, voluntary pensions will have to be well regulated and supervised, requiring a substantial build-up in capacity for the supervisory authority.

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\(^6\) Hamermesh provides a comprehensive survey of empirical studies of labor demand over a variety of countries and calculates this consensus estimate. The estimate and summary of studies may be found in Daniel S. Hamermesh, *Labor Demand*, Princeton University Press, 1996.
Choosing a Reform Path

63. In choosing a reform path, the Government has to take into account the following considerations. Under all scenarios, the Government needs to improve the administration of the Social Insurance Institute, improving its record-keeping with regards to both contributors and beneficiaries, particularly the beneficiaries.

64. If Option 2 is the preferred option, the Government needs to consider:

- The political acceptability of abandoning the concept of social insurance and moving to general revenue funded social assistance for the elderly;
- The source of funding for the social pension which will replace the contributory pension and the source of funding for the pensions of those grandfathered under the old system;
- The level of the social pension to be provided and how this will change over time (to avoid a ballooning social promise in the future);
- The population to be grandfathered under the old system and those who will fall under the new system;
- The recognition of the acquired rights of those who have years of contribution under the old system, but move to the new system;
- The existence of sufficient financial market instruments for investments of voluntary pension savings by those who want more than the basic social pension; and
- The existence of sufficient regulation and supervision of voluntary pension markets in order to provide individuals with enough confidence to use them to increase the level of the pensions they will receive in old age.

65. If Option 1 is the preferred option, the Government needs to consider:

- Whether it is politically feasible to separate the pensions of those who actually make contributions from those who do not even though it increase inequality
- The creation of a new balance between contributions and benefits for the long run, which will perhaps reduce the basic component of the pension instead of imposing a ceiling on the overall pension while reducing the contribution rate if possible; and
- The population to be grandfathered under the old system and those who will fall under the new system, and the benefits to be provided to each group.
The World Bank recommends a four tier pension system, with the first, often referred to as zero pillar, being some provision for the elderly regardless of contribution status, either only for those who are poor or for all elderly. It then recommends a first pillar which is a mandatory, publicly managed pension, typically of a defined benefit type, a second pillar which is a mandatory, privately managed defined contribution pension, and finally, a third pillar which is voluntary. Most countries in the world do not have all of these various pillars. While the predominant form of pension provision internationally includes a mandatory publicly managed defined benefit system for at least a subset of the population, a number of high-income countries do not include this component, making them more similar to a variant of Option 2 suggested above. These countries include Australia, Iceland, Ireland, Mexico, the Netherlands, and New Zealand.

**Australia.** Australia began with a general revenue financed pension for all elderly complemented by private occupational pensions on a voluntary basis. As providing a pension for all elderly became expensive over time, a means and asset test was introduced which allows some two-thirds of the elderly in Australia to collect some public pension, but depending on the means and asset holding of the individual, not necessarily the full public pension. Currently, the full pension pays approximately 25 percent of average wage. The government also began to mandate private occupational pensions in 2001.

**Iceland.** The government provides a basic pension of 9 percent of average wage and additional pension supplements of 16 percent of average wage and 7 percent of average wage, which are withdrawn as income rises. In addition, the government mandates private occupational pensions.

**Ireland.** Ireland provides options for three basic pensions, eligibility for two of which is based on years of contributions, while the third is noncontributory, but means-tested. All three are similar in value, the two contributory ones replacing approximately 30 percent of average wage, while the noncontributory one replaces 28 percent of average wage. Only one benefit may be received, with different retirement ages applying to the different contributory periods. While Ireland does generally require contributions, the benefit is not based on own income or contributions, but the same for all people with the same number of years of contributions. In addition, private voluntary pension schemes cover approximately 50 percent of employees.

**Mexico.** Mexico has only a private mandated pension system, with a government guarantee for those who fulfill 25 years of contributions. The guaranteed benefit is 100 percent of the January 1997 minimum wage, kept constant in real terms, approximately 23 percent of today's average wage.

**The Netherlands.** The Netherlands provides a basic pension worth approximately 34 percent of average earnings with the requirement that those who work must contribute. The value of the pension is not based on salary or the amount of contributions, but on the years contributed. However, the same pension is available to those who have not contributed on a means-tested basis. In addition, a voluntary private occupational system covers 91 percent of workers.

**New Zealand.** The government provides a universal benefit of 38 percent of average earnings for all residents who have reached a specific age, out of general revenue, with no contributory requirement. In addition, participation in voluntary private pensions is strongly encouraged.

In addition, countries like Canada and Denmark which have modest earnings related public pensions, also provide small universal pensions, regardless of contributory status in addition to targeted pensions to the elderly in need. While Sweden, Switzerland, and France have both targeted social pensions for the elderly in need and earnings related public pensions, they also mandate private occupational pensions.
66. In addition to pensions, which are long term insurance, the social insurance systems in Albania also provide short term insurance against the risks of sickness and maternity through the Social Insurance Institute. Contributions worth 0.8 percent of payroll are collected for sickness insurance and 2.3 percent of payroll is collected for maternity insurance. In addition, employers pay 0.5 percent of payroll for employment accidents and occupational diseases.

67. For sickness insurance, the first 14 days of a sickness are covered by the employer, with the sickness insurance only beginning with the fifteenth day of a specific illness and progressing for up to 6 months. The amount of the payment is 70 percent of the last year’s salary if the individual has been insured less than 10 years and 80 percent if the individual has been insured more than 10 years. If an individual needs to change jobs to a job with lower salary due to illness, the Social Insurance Institute will pay the difference in salaries, up to 50 percent of the original salary for a period of up to 3 months. Expenditure on this insurance is minimal, with only 2,523 individuals having received benefits in 2005. The average duration of benefits is unknown, but cannot be significant as the total expenditure was only 182 million leke, compared to 40.2 billion leke in pensions.

68. Similarly, maternity benefits cover a full year with a minimum of 15 days prior to childbirth and 42 days after childbirth. Women receive 80 percent of the average wage of the last year for the first 165 days of maternity leave and 50 percent for the remainder of the period. While 10,193 women received this benefit in 2005, the benefits also seem small with the total expenditure on this benefit at only 796 million leke.

69. Both of these branches of social insurance regularly run surpluses, which are transferred to the pension’s branch in order to cover deficits there. If the Government is looking to cut contribution requirements, the true cost of these insurances might need to be evaluated. Temporary sickness insurance could also be covered as it is in other countries by individual accumulation of unused sick days, which provides incentives to individuals to minimize their use of these employer-paid days. On maternity, the issue is a little trickier. Maternity benefits are often provided by employers. However, the possibility of having to cover maternity benefits may discourage employers from hiring women in their childbearing years. Therefore, there are arguments for keeping maternity leave in an external organization. However, if the Government chooses Option 2 for pensions, which eliminates pension contributions immediately or in the long run, there may not be strong enough arguments to maintain a social insurance system for these risk branches. The disability benefit provided by the Ministry of Labor may be able to accommodate these additional risks.
VII. UNEMPLOYMENT INSURANCE

70. Contributions for unemployment insurance are collected by the Social Insurance Institute and theoretically transferred to the National Employment Fund, which administers the benefits. In practice, the Government allows the Social Insurance Institute to keep the revenue in lieu of part of the contribution it owes on behalf of the rural workers and transfers the amount needed to pay benefits directly from the budget to the National Employment Fund. A contribution rate of 5 percent of payroll, recently reduced to 2 percent, is paid by employers for this benefit.

71. To be eligible for a benefit, an individual has to have made 12 months of contributions, to be actively involved in job search, and to be ineligible for other long term or short term social insurance benefits other than partial disability. The benefit is a flat amount, irrespective of previous wages and contributions, and is currently set at 37.5 percent of minimum wage by the Council of Ministers. An additional 5 percent of the benefit is provided for each child aged 15 years or younger residing in the household of the unemployed, as well as supplements for the purchase of bread and electricity. The total payment averages about 50 percent of minimum wage and is twice the level of the social assistance benefit, Ndema Ekonomika.

72. Benefits are usually received for a 12 month period. However, to discourage revolving door hiring and firing, if an applicant becomes unemployed a second time within 2 years of receiving a benefit, the benefit is provided for only 10 months. If the applicant becomes unemployed a third time within 2 years of receiving the second benefit, the benefit period is cut to only 8 months. During the period when benefits are being received, the National Employment Fund makes contributions to the Social Insurance Institute on the worker's behalf so that the employee does not lose service credit for this period of time.

73. Approximately 11,000 individuals of the 153,000 registered as unemployed in Albania receive the benefit. The majority of the rest receive Ndema Ekonomika. The program has been used to support workers downsized during the privatization of public enterprises. These workers often receive payments for up to 2 years.

74. Sixty to 70 percent of the revenue from the contribution of 5 percent of payroll was needed to support this benefit. The recent reduction to 2 percent of payroll may be insufficient to cover the benefit. If fiscal resources are required to supplement the payroll contributions, a question arises of why some individuals receive benefits and others who pay taxes, but not contributions, do not.

75. As with much of the pension contribution, the focus of this benefit is on poverty alleviation and not consumption smoothing. With contributing workers eligible for only a flat benefit, the system provides no incentive to correctly declare wages above the minimum wage level, again encouraging underreporting of wages.

76. If the Government chooses to fix the contributory pension system to give individuals incentives to participate, the Government may want to do the same with the unemployment
insurance system. Within the same fiscal envelope, the duration of benefits could be reduced while the amount increases.

77. If the Government chooses to abolish the contributory pension system, it may want to consider abolishing this program as well, given that individuals in need do have access to Ndema Ekonomika. The level of benefits in this program is so low that it is not an attractive option for a middle or high income worker who becomes unemployed, and the Ndema Ekonomika already exists for low income workers.
VIII. HEALTH INSURANCE

78. Health insurance, which rounds out the social insurance branches in Albania, is already facing the issues that the pension system will face in the future. Unlike the case of pensions, where current beneficiaries receive benefits on past contribution histories, which in most cases are complete, health insurance beneficiaries largely receive benefits based on current contributions. Since only a limited portion of the work force is making social insurance contributions, only a limited portion of the population has access to health insurance. As a result, the share of private sector health care spending in Albania is 61 percent, well above the ECA average of 33 percent and above the average of both lower middle income countries internationally of 54 percent and upper middle income countries internationally of 42 percent. Thus, a large percentage of the population faces the risk of poverty when confronted with an illness requiring treatment.

79. Furthermore, since the Ministry of Health provides hospital care, the uninsured end up using resource-intensive hospital care in lieu of cheaper primary care, which is either financed through health insurance or through point of service payments by the beneficiary. As a result, the lack of coverage in the health insurance system is leading to serious resource misallocation in health provision. The Albania Health Sector Note produced in February 2006 provides ample details on this and other health sector issues.

80. Finally, of the public sector health spending, which does take place, 93 percent comes from the budget. Two-thirds of this is Ministry of Health spending, which in theory is available to all residents of Albania, although in practice, there are geographical and other constraints to access. However, one-quarter of this public spending is spending by the Health Insurance Institute. This spending is restricted to benefit only those covered by health insurance, which is about 40 percent of the population. But the revenue to finance most of this spending comes from the budget. The budget is obligated to make contributions on behalf of the public sector workers, all children under one year, pregnant women, war veterans, the disabled, the unemployed and recipients of social assistance, cancer patients, people under compulsory military service, and pensioners. Budgetary resources, collected from a broad population base, are thus being spent to support spending for a limited segment of the population.

81. The recommendations coming from the Health Sector Note parallel the recommendations for the pension system closely. One option recommended is to consider shifting to a public health financing system, which relies exclusively on general taxation rather than on payroll taxes. This option would parallel the Option 2 for the pension system, where the recommendation is to abolish the contributory system and move to a general revenue financed age pension. There is a difference between the two types of social insurance, nevertheless. Pension benefits, like unemployment benefits, have the objective of consumption smoothing in addition to poverty alleviation. A flat pension will not achieve that objective and will need to be complemented by a voluntary pension system, which enables consumption smoothing. The equivalent in health care is for the Government to provide a comprehensive basic health package, not just hospital care, and to allow individuals to purchase extras through fee for service or through the purchase of supplemental health insurance.
82. The second option presented in the Health Sector Note is to create a two-tiered benefits package with a general revenue-financed basic package for all and retaining an expanded benefits package for those who make their own health insurance contributions. This recommendation is parallel to Option 1 for pensions, where those who contribute can accomplish both poverty alleviation and consumption smoothing through the public pension system, while those who do not contribute get a basic pension, provided through general revenues.

83. However, because these two branches of social insurance are substantially different, it is not necessary to adopt parallel policy for both types of insurance, particularly since the tax authorities are doing the majority of the contribution collection. Thus Option 1 in pensions could still exist with a public health financing system alone and Option 2 in pensions could co-exist with a two-tiered health financing system. If the tax authorities were not doing collection, economies of scale in administration might encourage use of parallel systems across the branches of social insurance, but in this case, the economies of scale are already being realized by the tax authorities.
84. The social insurance system in Albania while covering the risks of short term illness, maternity benefits, unemployment, and health costs as well as pensions, is largely focused on pensions. The bulk of the revenues are earmarked for the pension system and the bulk of the expenditures are also targeted toward pensions. However, there are significant flaws in the current design of the pension system, which evolved as a patchwork of attempts to fix previous problems.

85. The Government now finds itself at a crossroads in terms of pension design. The Government could either do a fundamental restructuring of the current system, eliminating many or most of its flaws, but this would still leave a system which imposes relatively high payroll costs and leaves large segments of the population unprotected against various risks. On the other hand, the Government could choose to abolish the contributory system, eliminating the high payroll costs, and focus on providing poverty alleviating benefits against the many risks that an individual might face, but this would not provide vehicles for substantial consumption smoothing.

86. Whatever the Government decides with respect to the pension system will have implications for the other branches of social insurance. Most of these other risks could either be covered by the Government at a poverty alleviating level or could be covered directly by employers if there were no contributory pension system. On the other hand, if the contributory pension system is to continue, each of these insurances needs to be evaluated to determine the appropriate level of contribution required and some, if not all, could continue. In this case, a further evaluation needs to determine whether those not covered by formal social insurance also require coverage against a particular risk and to determine whether this should be provided perhaps through the Ndema Ekonomika benefit.
All of the simulations and projections in the paper were produced using the World Bank’s PROST model. PROST (Pension Reform Options Simulation Toolkit) is a generic PC-based projection model developed by the Social Protection unit of the World Bank.

The model is designed to simulate the behavior of pension systems and can assess their financial sustainability under different sets of assumptions over a long time frame. It allows modeling of different pension reform options – from parametric reforms of pay as you go defined benefit schemes to systemic reforms, such as introduction of fully funded defined contribution schemes. The program can be adapted to a wide range of country circumstances and can handle simulation periods of 100 or more years.

As with any simulation model, the outcome from PROST depends largely on the nature and quality of data as well as on the set of assumptions used for the simulations. Since PROST has been used in some 80 countries to provide quantitative input for pension policy discussions, its methodology has proven to be sufficiently robust and its flexibility has permitted easy adaptation to specific country circumstances for sensitivity testing and comparisons under a wide range of economic and policy scenarios.

In the case of Albania, there are some serious concerns about the validity of some of the numbers, such as the large number of elderly collecting pensions, well above the population numbers. However, since it appears that the data provided are internally consistent with the size of the pension expenditures and the size of the benefits provided, they were used as given, in the simulations. Over time, as PROST applies mortality rates to the current pensioners, the number of pensioners will decline to more normal levels, with fewer and fewer pensioners at the highest ages.

PROST basically follows single age/gender cohorts over time and generates population projections which, combined with labor market assumptions, are used to forecast future numbers of contributors and beneficiaries. These in turn generate flows of revenues and expenditures. The model then projects fiscal balances.

All data and assumptions required by PROST for population projections were provided by the Bank’s Population unit: initial population by age and gender, and projections of age-specific fertility rates, mortality rates, and migration flows. However, these were compared to the data produced by the UN Population Department as well as to the data collected by INSTAT in Albania and were all found to be consistent. The population pyramids for 2004 and those projected for 2075 are shown in Figures A.1 and A.2. As can be seen from Figure A.1, the bulk of the Albanian population is young; by 2075, as seen in Figure A.2, the demographic structure will change to a much more uniform age structure.
These projections are derived from the initial population numbers, with the population changing over time as fertility and mortality changes and as cohorts progress through life. The mortality assumptions used produce the life expectancy changes shown in Table A.1. The total assumed fertility rate also changes over the simulation period and is also shown in Table A.1. Internationally, the objective is to provide a pension for a period of approximately 15 years. Life expectancy in Albania even for men reaches 15 years at age 65 in 2006 well before the retirement age reaches age 65. By the time, the retirement age reaches 65 for men; life expectancy at 65 is almost 16 years, suggesting that retirement ages for both men and women should rise in Albania in the future.
Table A.1: Projected Life Expectancy and Total Fertility for Various Years

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<th>Male</th>
<th>Female</th>
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<td>2005</td>
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<td><strong>Life Expectancy</strong></td>
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<tr>
<td>At birth</td>
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<td>71.9</td>
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<td>At age 20</td>
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<td>At age 60</td>
<td>18.2</td>
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<td>At age 65</td>
<td>14.6</td>
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<tr>
<td><strong>Total Fertility Rate</strong></td>
<td>228.9%</td>
<td>227.2%</td>
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</table>

Contributors are calculated in the model as a percentage of the age-gender specific population. These ratios are kept constant throughout the simulation period. For the urban sector, the exact contributor composition is unknown. The Social Insurance Institute provided information they had obtained from a simulation model. For the rural sector, ages and genders of contributors were provided. Figure A.3 shows the percentage of contributors in each age and gender group in the urban sector. As can be seen, the contribution percentages are quite low for young workers. Only in the 10 years prior to retirement do the contribution percentages increase, as workers try to gain qualification for a retirement pension.

Figure A.3: Contributors in the Urban System in Albania as a Percentage of the Age-Gender Population Cohort in 2004

Moving to the beneficiary side, there are no age-specific data on the rural beneficiaries. A census was just completed of the urban old age pensioners, and this distribution was used to estimate the age distribution for the rural pensioners. For disability and survivors, the Social Insurance Institute had only simulated data from a model to estimate the age distribution of disability and survivor pensioners and only for the urban sector. These distributions were also applied to the rural sector where the number of pensioners of each type are known, but not the
age distribution. However, it should be noted that PROST uses these data differently than the contributor data. While PROST will allow the user to assume that contributors as a percentage of age group remain unchanged over time, future beneficiaries are derived by tracking cohorts of contributors over time, since the contributors of today are the beneficiaries of the future. Figure A.4 below thus shows the 2004 distribution of urban old age pensioners. As noted in the text, there are large numbers of old age pensioners in the upper age brackets which are most likely attributable to fraud. The data are only shown for men since the inflation in number of pensioners largely applies to men and the women’s data would not even show up given the scale required for the men’s data. The men’s data is also truncated at age 96 in the figure since at higher ages the values are even higher and throw the scale of the graph completely off. The modeling applies mortality rates to these large numbers of pensioners so relatively quickly the above 90 year olds are removed from the system, and the system begins to behave in a normal fashion.

Figure A.4: Male Old Age Pensioners in the Urban Sector in 2004

Disability pensioners are quite small in Albania, as noted in the text. Figure A.5 shows the disability for both male and female disability pensioners in the urban sector, as provided by the model of the Social Insurance Institute.

Figure A.5: Disability Pensioners in the Urban Sector in 2004
The widow and widower pensioners are shown in Figure A.6. As is expected, they are predominantly women, but at some ages reach a fairly high percentage of the population. This is notable especially since these beneficiary numbers apply only to the urban sector while the population numbers apply to the country as a whole. The orphan numbers are not presented here as there is nothing especially interesting about them.

Figure A.6: Widow and Widower Pensioners in the Urban Sector in 2004

The data presented here certainly make apparent the difficulties of doing projections and analysis when the data are incomplete. These data have been used as starting point for the analysis since there was no alternative. However, the results are only as good as the data that go into them and in this case, the results should be viewed with some caution. The data also point to the need to develop a better statistical database in the Social Insurance Institute.

The assumptions used for the distributional analysis which compares the impact of the pension systems on pensioners of different incomes is presented in Table A.2. While there is no empirical basis for these specific values in Albania, they are meant to illustrate the differences between individuals. Since there are contributors beginning work as young as 16, the assumption is that low income individuals without higher education are the ones who begin at that age. Those that engage in post-graduate education may not begin until age 25. All are assumed to have continuous careers and to retire at the legal retirement age. Since lower income individuals experience higher mortality than lower income individuals, differential mortality rates are assumed. The same is the case for starting wage and for wage growth patterns. While the specific values are not empirically driven, these patterns of differential rates across income groups have been found to hold in a number of countries and there is no reason to believe Albania an exception. The exact specification, nevertheless, should be taken as merely an illustration.

<table>
<thead>
<tr>
<th>Table A.2: Assumptions Used in Distribution Analysis</th>
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<tbody>
<tr>
<td><strong>Age of Starting Work</strong></td>
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<tr>
<td>Age</td>
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<tr>
<td>Retirement Age</td>
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<tr>
<td>Mortality Rates as % of Age Specific National Rates</td>
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<tr>
<td>Starting Wage as % of Cohort Average</td>
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<td>Annual Wage Growth as % of Age Specific Average Wage Growth</td>
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REFERENCES


