Pension System in South Caucasus: Challenges and Reform Options

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There are three different types of pension systems in the world:

- **Pension System based on a Solidarity Principle** – the payments were made by employees, employers to the State budget. Consequently, the pensions are directly financed from the state budget. Also called **Pay-As-You-Go (PAYG)** system.

- **Pension System based on an Accumulation Principle** – the amount of pension is in correlation with contributions to pension funds. This model comprises individual character of pension, also called **fully funded** system.

- **Mixed Model of the Pension System** – this model means collaboration with the both models (**Solidarity and Accumulation**).
## Advantages and Disadvantages of PAYG and Fully-funded Pension Systems

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<th>Pension Systems</th>
<th>Advantages</th>
<th>Disadvantages</th>
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</table>
| Pay-as-you-go (PAYG) pensions | Simplicity and transparency  
Solidarity Principle        | Budgetary burden  
No “choice” |
|                          | Low administration costs  
Progressive redistribution  
Wide coverage  
Do not inhibit the mobility of labor  
Low risk | Over-commitment to a specific level of pensions  
Resistance to tax funding |
| Fully-funded (FF) pensions | Higher returns from professional equity investment  
Saver has independence and choice  
Increases savings and growth  
Promotes the development of financial markets  
Effective, Corporate governance  
Automatically adjusts the level of pension to available returns | Regressive impact on the distribution of income, High administrative costs  
Limited coverage  
Uncertain return (high risk)  
Need for a social security safety net  
In some cases limits mobility of labor (occupational pensions) |
Pension system reforms in South Caucasus region

• Armenia is changing its existing pay-as-you-go (PAYG) pension system, which was financed on the principle of the solidarity of generations, to the multi-pillar system.

• The pension system in Azerbaijan can be considered as a mixed model (PAYG and fully funded pension schemes).

• Georgia's current pension system is operating on a pay-as-you-go (PAYG) basis. Starting in January of 2018, the government proposes to shift to a mixed model.
Multi-Pillar System in Armenia

From 2008, the only source for the pension system is the annual state budget.
Multi-Pillar System in Armenia

Multi-Pillar System of Armenia incorporates the following components:

Pillar 0 – Social Pension: providing social pension to those individuals who have reached 65 and whose length of service is up to 10 years.

Pillar 1 – Contributory State (Employment) Pension: continue providing pensions both to the current pensioners and those people who will not be obligatory participants of the mandatory funded component. The mandatory participants of the funded component will be only entitled to receive a base pension from this pillar. Under this component, pensions will be paid to individuals with more than 10 years’ length of service.

Pillar 2 – Mandatory Funded Pension: providing mandatory funded pensions to individuals born on and after January 1, 1974, as well as individuals above 40 who will voluntarily join the mandatory funded component and make mandatory funded contributions.

Pillar 3 – Voluntary Funded Component: providing voluntary funded pensions without any age restrictions to those who will join this component and make voluntary funded pension contributions.
### Components of Armenian Multi-pillar Pension System

<table>
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<th>Social Pension</th>
<th>Basic Pension</th>
<th>Funded (voluntary) pension</th>
<th>Funded (mandatory) pension</th>
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<td>0 Pillar</td>
<td>I Pillar</td>
<td>II Pillar (mandatory)</td>
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<td>III Pillar</td>
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- **0 Pillar**: Social Pension
- **I Pillar**: Basic Pension
- **II Pillar**: Funded (voluntary) pension
- **II Pillar (mandatory)**: Funded (mandatory) pension
- **III Pillar**: Social Pension
The pension system in Azerbaijan

• The pension system in Azerbaijan can be considered as a mixed model, which consists of two elements:
  
  • A notional defined contribution (NDC) social insurance program: implemented in 2006, is financed by an employee contribution of 3% of gross earnings and an employer contribution of 22% of payroll.
  
  • A non-contributory social assistance program: funded by general revenues, provides benefits to non-working men aged 67 or older and women aged 62 or older who are not eligible for the earnings-related pension.
Conclusion

• PAYG pension system is facing challenges due to changing demographics, while the alternative Fully Funded pension system offers many benefits.

• However, the PAYG system plays an important role in poverty reduction and serves a valuable welfare distribution function, so its disappearance would have many undesired social consequences.

• Nevertheless, the changing demographics calls for the introduction of more sustainable system. One possible solution is a reform that is a mix of PAYG and the Fully Funded pension system.

• Any decision about a possible mix of systems should be based on comprehensive quantitative analysis and a study of international experience.