Pension System in South Caucasus: Challenges and Reform Options

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Typology of pension systems

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

Pension Systems	Advantages	Disadvantages
Pay-as-you-go (PAYG) pensions **Solidarity Principle**	Simplicity and transparency Low administration costs Progressive redistribution Wide coverage Do not inhibit the mobility of labor Low risk	Budgetary burden No "choice" Over-commitment to a specific level of pensions Resistance to tax funding
Fully-funded (FF) pensions **Accumulation Principle**	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

				Funded (voluntary) pension
		Funded (mandatory) pension	Funded (mandatory) pension	
	Pension for years of service	Pension for years of service		
Social Pension	Basic Pension			Social Pension
0 Pillar	I Pillar	II Pillar (mandatory)	II Pillar (voluntary)	III Pillar

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.