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Currency references in this paper are to Georgian lari (GEL). The exchange rate on August 2011 was [GEL 1.66 = US$1]. Thus a monthly pension of GEL100 was $60.32 and the average monthly wage in 2009 of GEL556.8 was $335.9. Wages, pensions, and related sums are normally expressed as monthly rather than annual numbers in Georgia; unless the context suggests otherwise, this approach is followed here.

Unless otherwise noted, $ refers to US dollars.

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The series is a quick-disseminating, informal publication. The working papers may subsequently be revised and published elsewhere.

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Abstract

This paper considers ways in which pensions and their reforms could impact the future economic development of Georgia. It describes the existing pension structure and how this could be built upon to develop a new structure that would both improve the financial position of the current and future elderly and provide a means to achieve broader economic growth. As such, it considers what might be viewed as the normal parameters: the country's demographics, the cost of pensions and their distribution, and how the present and evolving future structure might resemble the World Bank's multi-pillar approach. It also considers how pensions fit in with society and how an occupational savings system, such as pensions, can play a role in economic development, following a program of pension reform that goes beyond the normal quandary of how a country can afford pensions. It then makes recommendations for discussion on pension reform in Georgia and how it could achieve these goals.

Keywords: Republic of Georgia, pension reform, state pension, private pension, retirement

JEL Classification: H55, H60, I30, J10, J26

1. Introduction

This paper looks at pensions and pension reform in Georgia. It suggests that the introduction of a defined-contribution mandatory occupational system deserves consideration, but one with characteristics that reflect the present and future needs of the economy, the country's current lack of established financial markets, and its changing demographics. Recognizing that there is no single solution for meeting the challenge of providing adequate and sustainable old-age income, such a system could advance reform of the existing state-provided pension.

Over the past decade, Georgia has made huge strides in economic development and is beginning to show significant potential. Yet, poverty remains an issue. It is alleviated to some degree by pensions and social security, and the government has made considerable effort to expand benefits in a difficult environment. But the traditional dependence on the state has put pressure on government finances, even as poor families must still rely on intergenerational family support.

The importance of pensions is generally well recognized, with state pensions reflecting the important societal role of supporting the population in difficult times. Their aim is to provide a reliable income for those who are generally not part of the workforce because of injury, military service or, more typically, old-age.[1] The concept of a state-provided pension and social security has continued in the post-Soviet era in a number of countries, including Georgia and Uzbekistan. Some have undertaken pension and social security reforms that recognize the value of the World Bank's multi-pillar approach,[2] notably Kazakhstan, in which old-age income should come from a number of sources.[3] But moving from reliance on a single source, such as a state-provided benefit, to multiple sources, has been a challenge in many countries. Georgia itself has yet to consider such reforms. As such, and given its needs, policymakers might, therefore, consider a more precise and pragmatic approach that could produce potentially greater economic benefits.

Pensions are often regarded as a huge cost that produces inadequate benefits, satisfying neither provider nor beneficiary. The cost of providing a meaningful pension income is generally beyond the ability of most governments, while those that do have the ability often lack the political will. There is also a belief that pensions do little to encourage economic growth, indeed, that they may actually reduce it. Clearly, Georgia and other countries face a serious challenge in providing a sustainable pension system.

Importantly, pensions should not be seen or judged in isolation as a single issue. Any pension structure and proposals for reform will have a considerable impact on the economy and its growth, and a consequential effect on almost every aspect of society. Pension systems, therefore, need to be fiscally, politically, and socially sustainable to achieve their objective of providing old-age income. The challenge of ageing, and saving for it, is a continuous policy endeavour that requires sustained effort. The design of a pension system—including for informal sector workers, the lifetime poor, and particularly vulnerable groups such as widows—is an ongoing task.

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[1] There are some 18 categories of benefits under social security and pensions, in addition to old-age pensions.

[2] See section 3 for further discussion on the multi-pillar approach.

[3] When reforming an existing pension and social security framework, care is needed to put in place mechanisms to assure a minimum level of benefit adequacy, to effect a reasonable degree of income redistribution from the comparatively well-off to the less fortunate, and that can provide long-term social insurance to the working population (ADB Evaluation report 2003).

While this paper will only address the pension environment and the potential options for reform, successful pension reform also requires parallel reforms. It needs a system designed to minimize the risk of delivering inadequate retirement income. Fiscally, this requires the long-term sustainability of public finances. From a labor market perspective, it requires that reforms encourage labor participation. From the financial market point of view, it means fostering the efficiency and soundness of a financial system that provides and manages products related to the pensions in the accumulation and de-accumulation phases. And from the social point of view, minimizing risk means adequate provision of risk sharing and distribution (see Holzman, McKellar and Repansek 2009).

Pensions can provide development capital that can help boost economic development, employment, living standards, and educational standards. They affect government finances, the tax structure, the development of the banking system, and the insurance industry. They produce emotive reactions because they affect every individual—everybody knows a pensioner. And, not least, pensions provide the difference between an old/age that is comfortable and one that is unacceptable.

Pension reform can provide an important turning point in a country's economic progress. Pivotal reforms in Singapore in 1955, for example, promoted economic growth and development, while in Chile, in 1980, they helped solve the problems of an unaffordable pension system that had threatened to bankrupt the country. The solution helped provide one of the foundations of future growth.

It is also important to understand some of the caveats that go with pension reform, not least so that they can be fully considered in any discussion or consultation process. Pension reform can have negative connotations. It often has its origins in an assessment of an existing system and almost always as a result of its perceived financial unsustainability because of rising costs. As such, pension reform is often associated with reducing overall benefits through delaying or reducing previously established future payments. Future and existing beneficiaries would be wary of any proposed pension reform. Successful pension reform has required effective communication and a need for all parts of society to understand and accept it.

In some countries, occupational savings are often seen as an unpopular reduction in take-home pay, or as a high business expense that, at the same time, fails to produce a satisfactory benefit. One problem is often unsatisfactory investment, particularly where returns are low and it does little to stimulate the domestic economy. A number of countries introduced occupational savings schemes even though there were no domestic markets or other means to invest contributions. A pension system runs the risk in this situation that it will be viewed as a failure. However successful or unsuccessful they may appear to be, occupational savings schemes will only meaningfully benefit those that are regularly employed. Pension reform, particularly when encouraged by taxation concessions, can widen the gap between the better off and the poor. And like savings systems generally, any pension system can be undermined by inflation, creating higher future liabilities in a defined benefit arrangement and reducing the value of historic savings.

Georgia is not alone in providing extensive and varied types of support for its elderly. Pensions are only one element in the economics of an elderly population. In Georgia as in other countries, the elderly face significant potential expenditures on healthcare, which are partly state subsidized, while many people also rely on intergenerational family support for the essential elements of life. In considering pension reform and understanding its consequences, it is, therefore, important to understand the economics of the family and the elderly in both rural and urban areas.

Care should also be taken in any discussion to distinguish between “pension benefit age” and “retirement age”. The discussion of pensions can fail to distinguish between the two, with frequent references to retirement age when pension benefit age is indicated. Retirement age is when a person finishes his or her normal employment, which has provided him or her an income that has allowed an acceptable standard of living. It is also when a person begins to draw on savings, turn to family for financial support, or rely on social security, if available, to maintain an accepted standard of living. This person would be considered retired even if he took on part-time work or less rewarding employment in the same or a different industry.

The pension benefit age is the age at which benefits begin. It is usually fixed, but may, as in Georgia, be conditional on factors such as not being employed, or, as in some countries, means tested. Private pensions are usually paid on the terms of an accepted definition of retirement, but, even in this case, a pension may be deferred until a certain age. It is in this context that many commentaries, assuming that a pension will start at retirement, use “retirement age” when they mean “pension benefit age”.

Section 2 of this paper considers the pension environment of the Georgian economy, looking at its finances, demographics and existing structure. Section 3 looks at the multi-pillar approach and its relevance in providing support for the country’s elderly. Section 4 considers possible pension reform, noting what is practical and acceptable, and looking at various issues and challenges. Section 5 recommends important issues for discussion in considering pension reform in Georgia that may provide greater assurance for the current and future elderly and a means of achieving greater economic growth.

2. The Pension Environment

Any discussion on pensions in Georgia naturally focuses on existing public sector pensions and changing demographics. The relatively minor private sector pensions market is at present designed as savings products with a possible pension element.

2.1 The Georgian Economy and Pensions

The twin crises of 2008 and 2009—the war with the Russian Federation and the global financial crisis—resulted in a rapid deterioration in output, employment, asset values, the fiscal balance, and access to domestic and foreign financing. It also worsened the environment for financing state pensions, the predominant source of old-age income in Georgia. In the wake of these twin crises, Georgia's growing elderly population is likely to pose added challenges to the government in years to come.

Since 2004, the Georgian government has introduced broad economic and governance reforms to maintain macroeconomic stability, create a more business friendly environment,[4] strengthen public finances, upgrade infrastructure, and importantly—the focus of this paper—ensure adequate old age incomes.

Despite the progress made in providing basic coverage for pensioners, state pensions remain low by many standards and private sector pension savings plans are virtually non-existent. The state pension system provides Georgian men over the age of 65 and women over 60 with an old age pension, as well as a bonus based on length of employment.[5] The public sector also provides a disability pension and payments to surviving family members, as well as a range of specialized but limited pension payments. Monthly universal pensions are below the official individual subsistence level, meaning the elderly must depend on other social assistance and intergenerational family support.

Population projections suggest a growing proportion of elderly in the population, exacerbated by Georgia's low fertility rate, which will raise the elderly dependency ratio (Figure 1 below). The rising number of possible old age pensioners and limited alternatives for saving will have implications for pension costs and place a growing burden on the rest of society.

2.2 The Economic Implications of the Twin Crises for Georgia

The Georgian economy was on a strong growth track until mid-2008, when the war with the Russian Federation in August that year, followed by the disruptions of the global financial crisis, slowed economic growth. The war damaged physical infrastructure, displaced well over one hundred thousand people, and was immediately followed by a weakening of investor, lender, and consumer confidence and a contraction of credit in the banking system. The global financial crisis exacerbated these problems (ADB 2010).

Gross domestic product (GDP) growth contracted sharply, from 12.4% in 2007 to 2.3% in 2008 and to –3.9% in 2009; and foreign investment declined steeply, from 17.1% of GDP in 2007 to 12.2% in 2008 and 7.1% in 2009. Revenue fell considerably and privatization proceeds declined, widening the public deficit from 4.3% of GDP in 2007 to 6.3% in 2008 and 9.2% in

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4 Georgia's rank in the World Bank's Doing Business Report improved from 112th place in 2005 to 11th place in 2009.
5 See Appendix 4 for regional comparisons.

2009. Gross domestic savings also dropped sharply, from 12% in 2007 to 3.2% in 2008 and to 0.2% in 2009[6] (see International Monetary Fund 2011a and 2011b).

The Georgian lari (GEL), which had first come under pressure in August 2008, came under renewed pressure starting in October and November that same year.[7] Unemployment increased from 13.3% in 2007, to 16.5% in 2008, and to 16.9% in 2009; growth of inward remittances slowed from an annual increase of 57% in 2007 to 16% in 2008 and reversed to –16% in 2009. The country also faced the significant social burden of resettling nearly 140,000 internally displaced persons.[8]

The government responded with a swift and effective post-war recovery program. This included measures to further optimize the budget and to prioritize expenditures, which increased for health, education, and social protection—especially for the poor and socially vulnerable—and cut backs in other areas.

Following the twin crises, output fell and the overall tax base shrank, as did financing for the state pension, with added fiscal implications for the state budget (Table 6). Substantial support has since been provided by international development partners to help the government maintain critical public expenditures through the budget and to help cushion the fall in fiscal revenue. But the fiscal shortage delayed, until September 2011, the government's goal of increasing monthly pensions to GEL100 per month ($60.3).

Backed by the steady implementation of economic reforms, real GDP grew more than 6% in 2010. Driven by rebounding credit to the private sector and strong export demand, growth was broad-based across all economic sectors. The recovery of private sector growth enabled the government to withdraw some of the fiscal stimulus of 2009 and improve its financial position, including by tightening current spending. The government deficit narrowed to 6.6% of GDP in 2010 as a result. Foreign direct investment inflows remain well below an initial forecast, yet their level (estimated at under $600 million, or 5% of GDP, in 2010) remained quite respectable by international standards.

2.3 Georgia's Demographics: Understanding Present and Future Population Structures and the Long-Run Implications for Old-Age Income

As discussed above, the pension benefit age[9] is 60 for women and 65 for men. A total of 836,000 (almost 19% of the population) by the end of 2010 had reached retirement age, 12.4% of whom were women and 6.4% men (Table 1). About 15% of the population received an old-age pension (Table 2), while the longer-term picture of pensioners shows a rise in old-age pensioners from 2005 onwards (Tables 3 and 5).

[6] See Appendix 4 for regional comparisons on savings in percentage of GDP.

[7] Georgia entered into a $750 million Stand-by Arrangement (SBA) with the International Monetary Fund in September 2008, which was later augmented by further purchases of $420 million. The SBA was extended to June 2011.

[8] See Appendix 5 for Macroeconomic Indicators.

[9] In this section, what is conventionally called a retirement age is the same as a benefit age; however, the paper takes care to distinguish between the expression "retirement age" and "pension benefits age", as noted in the introduction. It is important to note that those who work beyond the pension benefits age do not receive a pension on this income.

Table 1: Number of Males and Females Receiving Pensions (end 2010)

	Males	**Females**	**Total population**
Number (thousand)	285	551	836
Total population (%)	6.4	12.4	18.8

Source: Social Service Agency, National Statistics Office April 2011

Table 2: Population Receiving a Pension

End 2010	**Population** (thousand)	**Population** (%)
Old-age pensioners	662	14.9
Other pensioners	174	3.9
Total pensioners	836	18.8

Sources: Social Service Agency, National Statistics Office, February 2011

Table 3: Rise in Number of Old-Age Pensioners (thousand)

Number of pensioners	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Pensioners	900	895	902	985	837	842	839	836
Old-age pensioners	574	570	550	590	612	658	660	662

Sources: National Statistics Office, Social Services Agency, February 2011

The last decade has seen a 2% annual increase in the number of persons receiving an old-age pension, albeit after a decline in 2004 and 2005.

By 2010, life expectancy at birth in Georgia was 80.6 for women and 73.6 for men (CIA 2009),[10] meaning that, given the difference in pension benefit ages (65 and 60), the average period of pension payments for males is significantly shorter. Put another way, the cost of providing female pensions far exceeds that of providing male pensions.

Population projections suggest Georgia's population will decline, and the number of elderly will grow (Table 4). This trend is exacerbated by a fertility rate of 1.6 births per woman,[11] a low figure for what is a primarily an agricultural country, leading to the highest elderly dependency ratio in the region (Figure 1).[12] The US Census Bureau estimates Georgia's total population at 4.6 million and a different proportion of elderly somewhat higher than the 4.4 million estimate of the National Statistics Office (2011) (Table 4). Despite the differences, the projections still suggest the same trend.

[10] See Appendix 4, Regional Comparisons.
[11] Also see Appendix 4, Regional Comparisons
[12] Also see Appendix 4, Regional Comparisons

Table 4: Population Growth

			Over 65		
	Total population	**Over 65**	**Over 65, % of population**	**Males, % of population**	**Females, % of population**
2010	4,601	743	16.2	13.5	18.6
2015	4,525	752	16.6	13.9	19.2
2020	4,440	813	18.3	15.3	21.0
2025	4,341	902	20.8	17.5	23.8
2030	4,231	992	23.4	19.8	26.8
			Over 60		
2010	4,601	951	20.7	17.8	23.3
2015	4,525	1,022	22.6	19.5	25.4
2020	4,449	1,119	25.2	21.8	28.3
2025	4,341	1,214	27.9	24.2	31.4
2030	4,231	1,246	29.5	25.7	32.9

Source: US Census Bureau 2011.

According to the US Census Bureau, the number of women older than 60 and men than 65 is expected to increase to 26.6% of the population by 2030, compared with 18.6% in 2010. The rising number of likely pensioners will affect pension costs and represents a growing burden on the rest of society. The growth in those entitled to a pension is not so much immediate, but accelerating after 2015 (Table 5).

Table 5: Projected Number of Pensioners: Men Aged 65 and Above and Women 60

	Men (thousand)	**Women** (thousand)	**Pensionable Population** (thousand)	**Total population** (%)
2010	296.6	560.6	857.2	18.6
2015	299.7	600.1	899.8	19.9
2020	326.0	654.4	980.5	22.1
2025	364.3	710.7	1,075.0	24.8
2030	400.3	727.2	1,127.4	6.0
		Annual Growth (%)		
to 2015	0.21	1.40	0.96	
to 2020	1.69	1.75	1.73	
to 2025	2.23	1.67	0.30	
to 2030	1.90	0.46	0.95	

Source: US Census Bureau, International Data Base, February 2011, Annual growth, derived figures based on upper part of table 5.

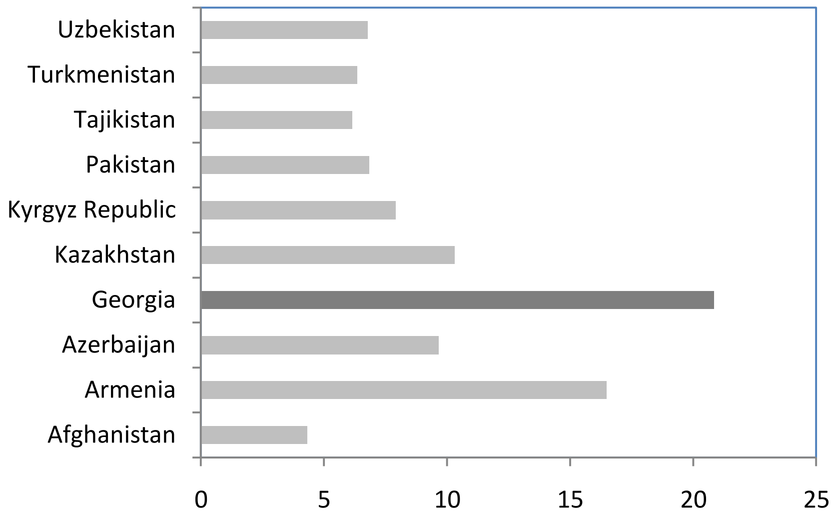
US Census Bureau *Population Pyramids* for 2010, 2020, 2030 and 2040, shown in Appendix 1, present a graphic view of how population bulges lead to future pension liabilities.

2.4 Dependency Ratio

The dependency ratio provides a common explanation of a changing pension environment. The ratio considers the number of people—elderly or elderly and young—effectively supported by the working population, with the ultimate liabilities effectively funded by the workforce through economic activity and taxation. The elderly dependency ratio has tended to increase in many countries as populations have aged. To some degree, this has been countered by a trend towards working for longer and deferring retirement.

In many countries, the change in population demographics, notably so in Georgia, has led to an increasing dependency ratio (Figure 1)—where the elderly population is increasing compared to the number of taxpayers in the workforce supporting it.

Figure 1: Age Dependency Ratio:[a] the Elderly as a Percentage of the Working-Age Population, 2009



[a] Age dependency ratio is the ratio of older dependents—older than 64—-to the working-age population (15–64). Data are shown as the proportion of dependents per 100 working-age population.
Source: World Bank, World Development Indicators Data Base.

2.5 The Pension System in Georgia and its Cost to Government

Public expenditure on social services and social protection significantly reduces the incidence of poverty in Georgia. Without pension payments, poverty in 2007, for example, would have been almost 10 percentage points higher (World Bank 2009a); without targeted social assistance, it would have been about 2 percentage points higher. To this end, total social spending rose in real terms by 10% in the post-conflict period (2008–10), despite the overall budget cuts that resulted from the crisis.

Given the importance of social services and effective public finance management to the government, social expenditures increased in nominal terms from 27.2% of the total state budget in 2007 to 33.9% in 2010. Planned expenditures for 2011 come to 32.4% of the total state budget. About 62% of social expenditure is allocated to pensions and, given low inflation, this has seen a substantial increase in pensions in real terms (ADB 2010).

Table 6: State Budget

	2004 actual	2005 actual	2006 actual	2007 actual	2008 actual	2009 actual	2010 actual	2011 planned
Health care	147,362	147,716	199,169	235,580	285,993	291,189	329,223	320,044
Education	65,292	59,172	332,611	379,252	418,666	488,430	537,844	555,010
Social protection	364,258	555,238	600,350	778,172	1,145,587	1,410,922	1,495,845	1,587,010
of which pensions	254,980	388,667	420,245	544,720	801,911	894,801	923,825	987,472
of which state financed insurance	…	…	15,366	37,260	80,453	132,773	147,258	136,160
Total expenditures	**576,912**	**762,126**	**1,132,131**	**1,393,004**	**1,850,246**	**2,190,541**	**2,362,912**	**2,462,064**
Total state budget	**1,930,210**	**2,618,557**	**3,822,513**	**5,237,131**	**6,758,832**	**6,913,107**	**7,233,001**	**7,562,003**
Health care (% of state budget)	7.6	5.6	5.2	4.5	4.2	4.2	4.6	4.2
Education (% of state budget)	3.4	2.3	8.7	7.2	6.2	7.1	7.4	7.3
Social protection (% of state budget)	18.9	21.2	15.7	14.9	16.9	20.4	20.7	21.0
of which pensions	13.2	14.8	11.0	10.4	11.9	12.9	12.8	13.1
of state financed insurance								
Total expenditures (% of State budget)	**29.9**	**29.1**	**29.6**	**26.6**	**27.4**	**31.7**	**32.7**	**32.6**
Health care (% of GDP)	1.5	1.3	1.4	1.4	1.5	1.6	1.6	1.4
Education (% of GDP)	0.7	0.5	2.4	2.2	2.2	2.7	2.6	2.4
Social protection (% of GDP)	3.7	4.8	4.4	4.6	6.0	7.8	7.2	6.7
of which pensions	2.6	3.3	3.0	3.2	4.2	5.0	4.4	4.2
of which state financed insurance	...	...	0.1	0.2	0.4	0.7	0.7	0.6
Total expenditures (% of GDP)	**5.9**	**6.6**	**8.2**	**8.2**	**9.7**	**12.2**	**11.4**	**10.4**
Total state budget (% of GDP)	**19.6**	**22.5**	**27.7**	**30.8**	**35.4**	**38.4**	**34.8**	**32.1**

GDP = gross domestic product; … = data not available
Source: Ministry of Finance of Georgia, February 2011.

Despite the progress made, challenges remain in providing not only adequate savings for old-age, but social services delivery more generally. Monthly state pensions, for example, remain below the official individual subsistence level, with the elderly in many cases depending on other social assistance and intergenerational family support, as noted.

2.6 State Pensions and their Sustainability

The largest pension payment is a state pension, a non-means tested payment that is the same for everybody. It is payable to all women aged 60 and above and all men aged 65 and above, and ceases at death. Multigenerational households may thus have two old-age pension incomes, as well as incomes from younger household members who work. It is not known how many households have such multigenerational income sources, but this is understood to reflect economic necessity and a shortage of suitable and affordable housing.

This basic monthly old-age pension was raised to GEL80 ($48) in January 2010 from GEL75 in 2009.[13] The rate has been raised substantially through the years, from GEL18 in 2004, to GEL28 (2005), GEL38 (2006),[14] GEL55 (December 2007)[15] and GEL70 (2008).[16] The increase—up until the twin crises—reflected the growth in the economy and demand for better benefits.

Importantly, substantial pension arrears were paid from 2005 onwards and pension payments have been fully up-to-date for several years. There is also a small element based on years employed for elderly pensions. About a third of the workforce is self-employed and would not be

[13] Source: A Citizen's Guide to the 2010 State Budget of Georgia. Ministry of Finance of Georgia. Tbilisi; A Citizen's Guide to the 2009 State Budget of Georgia. Ministry of Finance of Georgia. Tbilisi.
[14] Galer, Russell G. 2008 Pension Systems and Reform in Central Asia and the Southern Caucasus. Draft Report (Revised 2nd).
[15] The President of Georgia addressed the population from Bagrati cathedral yard. www.president.gov.ge. http://www.president.gov.ge/index.php?lang_id=GEO&sec_id=&lang_id=ENG (Accessed August 2011).
[16] Social Service Agency. http://ssa.gov.ge/index.php?id=69&mid=743&lang=2 (Accessed August 2011).

entitled to such additional benefits. Elderly residents of Tbilisi, the capital, are paid an additional GEL10 each month from municipal funds (Table 7).[17]

Table 7: Long Service Monthly Bonus

Long service monthly bonus for those with an employment record in GEL	
0–5 years	2
5–15 years	4
15–25 years	7
over 25 years	10

Source: Social Service Agency of Georgia February 2011.

Pensions are also payable to those who qualify either through disability or particular military records, or their survivors, for which there are no age qualifications. Groups I and II in Table 8 refer to degrees of disability.

Table 8: Pensions Paid for Disability or for Military Records

	Disability		Others
Disability pensions for war veterans	Group I	Group II	
Second World War participants	129	80	80
War on territorial integrity, freedom, independence	84	70	60
War on territory of another country	84	70	60

Source: Social Service Agency of Georgia (2011).

Table 9: Survivors Pension

On death of bread winner, to those under 18	55
Orphaned child	55

Source: Social Service Agency of Georgia (2011).

Pension and other benefits payments should be seen in the context of an average family's monthly subsistence level of GEL250.9 ($150) at the end of 2010 (Table 10).

[17] According to Municipality Offices, annual expenditure on the elderly is about GEL80 million, although this figure is likely to include other benefits, such as subsidized public transport.

Table 10: Subsistence Levels in Georgia

GEL per month	End-2008	End-2009	End-2010	Change, 2008 to 2009 (%)	Change, 2009 to 2010 (%)
Working male	130.7	126.1	149.6	-3.5	18.6
Average consumer	115.8	111.7	132.5	-3.5	18.6
Average family	219.3	211.5	250.9	-3.5	18.6
Households					
Single member	115.8	111.7	132.5	-3.5	18.6
Two members	185.2	178.7	212.0	-3.5	18.6
Three members	208.4	201.0	238.5	-3.5	18.6
Four members	231.6	223.4	265.0	-3.5	18.6
Five members	260.5	251.3	298.1	-3.5	18.6
Six and more members	308.0	297.1	352.4	-3.5	18.6

Source: National Statistics Office of Georgia (2011).

There are a considerable number of other benefits, which may be grouped under the Family Allowance Provisions and Social Allowances for Families under the poverty line, and which include basic health insurance. These may be payable to the elderly.

Pension payments and other benefits can also be seen in the context of average monthly salary levels, which in 2009 were GEL557 ($334) (Table 11).

Table 11: Average Monthly Salaries

		Of which	
Year	**Average monthly salary**	**Female**	**Male**
2006	277.9	177.6	362.0
2007	368.1	240.2	475.6
2008	534.9	367.7	678.4
2009	556.8	398.3	690.8

Source: National Statistics Office of Georgia (2011).

2.7 Government's Role in Providing Pensions and the Distribution of Benefits

The Ministry of Health, Labour and Social Affairs and the Social Service Agency (organized under the ministry) carry out the government's roles in pensions and social security.[18] The National Bank of Georgia, as banking system regulator, and Liberty Bank, the principal distributor of pensions, round out the system.

To increase the effectiveness of social services delivery and social protection, the government has in the last few years played a supportive role in implementing a model of integrated social benefits administration.[19] Continually improving the coverage rate for the poor and extremely

[18] The Social Service Agency was created through the merger of the United State Social Insurance Fund and Social Subsidies Fund in 2007.

[19] The government has a fairly comprehensive program for health, education, and social security coverage. The program is administered by the Social Service Agency. It has a set of programs and measures to simplify and improve their targeting and efficiency. They target the 21% of the population categorized as generally poor and the 8.8% categorized as extremely poor. Public expenditures on social services and social protection significantly mitigate the incidence of poverty in Georgia (ADB 2010).

poor is a key challenge. A fairly comprehensive program for health, education, and social security coverage and a targeted social safety net to protect the extreme poor are also in place.[20]

As noted, Georgia's pensions are among payments intended to reduce poverty (UNICEF and the University of York 2009). The various descriptions of old-age pensions refer to medium-term targets for bringing pensions up to subsistence levels, but make no reference to any concept of income replacement targets. Indeed, the Soviet system's legacy of generally uniform wages has yet to be replaced by any idea that income replacement is a particular goal.

Pension distribution (and other benefits) is the responsibility of the Social Service Agency, which, as with a majority of other social transfers, subcontracts this function out to Liberty Bank. The bank is Georgia's seventh largest by assets and largest by number of branches, at 175 (Liberty Bank 2010). Bank of Georgia has 125 branches and the next largest, TBC Bank, has just under 50. According to Liberty Bank, it delivers benefits to between 700,000 and 800,000 beneficiaries. The Social Service Agency distributes other benefits directly to about 200,000 beneficiaries.

Liberty Bank has established a card system for benefit withdrawal. Every six months the cardholder must verify his or her details, notably to ensure he or she is still alive. This six-month window allows Liberty Bank to lend the next five month's pension to the beneficiary, which means that the beneficiary need only travel once every six months to the bank to obtain the benefit. According to Liberty Bank, which charges a 3% fee on each monthly benefit, 15–17% of recipients take advantage of this service.

Liberty Bank's arrangement with the Social Service Agency runs until 2014 and may thereafter be renewed subject to a bidding process. A crucial factor in maximizing the efficiency of distribution of social service benefits is a bank with a well-developed geographical branch network that is able to extend coverage to all beneficiaries.

2.8 Private Sector Pensions

The regulation and supervision of private pension funds falls under the authority of the National Bank of Georgia. Private sector pensions are voluntary occupational and individual savings schemes that allow members to withdraw their savings at any time, not after a particular age, as is the case with a state pension. As such, they are more akin to regulated savings products than to pension products and have been described as more equivalent to a mutual fund, albeit with limited investment diversification to date.

They date back to a 1998 law, which coincided with World Bank encouragement, to establish a multi-pillar system. In 2004, there was a single-year program to allow tax benefits on contributions. Despite these efforts, private pensions remain a modest market, with the product structure lacking appeal compared with direct personal savings. Until a March 2010 amendment, investments by private pensions were confined by law to bank deposits and a small amount of fixed interest.

[20] Georgia's population, as noted earlier, is about 4.4 million, of which about 2.35 million (about 53%) live in urban areas and about 2.09 million (about 47%) live in rural areas. There are also an indeterminable number of refugees and others who are not registered with the Georgian government. Registration qualifies them for schooling and a range of state benefits (National Statistics Office of Georgia 2011).

The tax position on investment and interest income in Georgia is benign and there is no tax advantage in investing in a pension product, where, similar to an individual, there is no tax on investment or interest. At the same time, the product charges a fee. The recent strengthening of the legal and regulatory framework should support the further development of private pensions. But without tax or other encouragement to ensure that returns are better than an individual making a similar investment decision, their future remains uncertain. The introduction of a mandatory system would help determine what structure is needed for private pensions to become a more meaningful contributor to retirement income.

There are six licensed pension product providers, of which three are active, all being part of insurance companies also involved in medical and property insurance, namely:

(i) Aldagi BCI, a unit of Bank of Georgia,
(ii) GPI Holding formerly partly owned by TBC Bank, and
(iii) Imedi L International.

The aggregate of pension reserves in the three product providers is about GEL8 million ($4.8 million), covering nearly 17,000 participants.[21] The largest is Aldagi BCI, with pension reserves of nearly GEL5 million and with about 5,400 participants, while GPI Holding has some GEL2.7 million in pension reserves and 11,400 participants. Imedi L International has a more marginal role with pension reserves of GEL250,000 and about 40 participants (National Bank of Georgia 2011).

Amendments to the “Law on Non-State Pension Insurance and Provision” enable the diversification of investment options for private pension funds and promote disclosure of information. Specifically, the amendments require pension documentation to indicate the investment direction of a pension scheme and how the scheme’s financial results are reflected in pension accumulation (i.e., profits gained or losses incurred through the investment of pension fund assets will be taken into account). Hence, private pension funds are not required to make good on aggregate losses in any accounting period, as was previously required when investment profit was defined as income from the investment of pension fund assets, less expenses (but not losses).The amendments support more informed decision-making by promoting better disclosure of information by private pension funds. The National Bank of Georgia’s approval of amendments in October 2010 to secondary legislation for the new law facilitates its implementation.[22] These amendments include a rule on minimum information required in private pension agreements.

[21] Discussions with the National Bank of Georgia and the two largest providers resulted in some inconsistent numbers; the figures in this paragraph suggest a market share ranking and number of members that are reasonably consistent, but actual assets may not be accurate.

[22] As amended in March 2010. See (ADB 2010) for more information.

3. The Multi-Pillar Approach and How it Applies in Georgia

This section looks at the multi-pillar approach and its relevance to support the elderly in Georgia. It also considers some of the issues in each of the pillars.

3.1 Comparisons with the World Bank's Multi-Pillar Approach

The World Bank's five-pillar approach has been described in various ways and may be seen as a summary of the various sources of income and support for the elderly. The World Bank approach to income sources for the elderly should not be used as a goal in its entirety, as if all sources should be in place, but as a guide to show what might be achievable. Some elements will work in some countries, but others will not. Each country is unique, and the ability to adopt and benefit from any of the sources will vary considerably.

The five pillars may be described as follows:

(i) A zero pillar—a non-contributory social pension, or general social assistance funded by the local, regional or national government that provides a regular payment with the principal aim of providing relief against poverty.

(ii) The first pillar—a government operated mandatory system being a regular payment made and funded by income-related taxation that relates to the level of wages with the objective of replacing some portion of life-time pre-retirement income.

(iii) The second pillar—a mandatory savings system, operated by government or by the private sector that provides a pension or an equivalent benefit, related to the amount saved or with a predetermined benefit.

(iv) The third pillar—a voluntary occupational savings system that provides a pension or an equivalent benefit related to the amount saved or with a predetermined benefit. Any sort of voluntary savings are normally included in this pillar.

(v) The fourth pillar—a savings system that recognizes informal support such as intergenerational support; formal social programs such as free or subsidized healthcare, and housing; and individual financial and non-financial assets such as home-ownership.

The Georgian pension system thus currently comprises two types: a zero pillar equivalent of a basic pension with a small employment related element, and the underdeveloped third pillar of voluntary savings.

There is no concept of a state-organized earnings-related pension, based on taxation or social security payments, nor of a mandatory savings scheme providing a pension based on the accumulated value of contributions. The additional pillar providing the wider range of support is crucial in Georgia.

Pension reform is often intended to combine the private and public sectors. The idea is that a combination of income and savings, plus family and intergenerational support, provides the elderly sufficient funds to take them through old-age. Pension policy normally focuses on encouraging a multi-pillar approach to support future old-age security.

When considering the multi-pillar approach and pension reform, it is important to note that pensions can only come from one of two sources:

1. from a government that pays them from taxation revenues;
2. from what is usually described as occupational savings at the time of employment, or self employment. This is either:
   a. a voluntary arrangement made by an employer, employee, or by a self employed person; or
   b. a mandatory system.

The following looks more closely at the types of pensions and their relevance to Georgia.

3.2 Universal Pensions

A universal pension is generally regarded as the zero pillar in the World Bank approach to income sources for the elderly. The concept is straightforward: everybody who qualifies, normally by age and residence and usually irrespective of gender, will receive the same amount each month with no reference to any form of means testing. There are two principal types of universal pension, one that provides a basic benefit that is designed to reduce the levels of poverty, but that is unlikely to provide in itself a reasonable standard of living, not dissimilar to the current system in Georgia.[23] The second provides a basic standard of living, taking into account other factors such as housing costs and healthcare, but few if any countries have the resources or political will to pay for these. This latter type of benefit is unaffordable for most countries

There is also a concern that a universal pension, by its definition, goes to everybody, including those for whom it is either financially meaningless or not particularly relevant. This may cause irritation among politicians and others who consider it an ineffective use of public money to cover the whole population, and among those beneficiaries who are less well off; it is, in a sense, indefensible.

A fundamental decision has to be made about who qualifies. While the principle is simple, the details may be more difficult to define, prompting a number of questions. The basic idea of age would seem straightforward, but residence is an issue. Should residence also be qualified, with a minimum number of years of residence or residence at a particular age? If there is a minimum or specific period of residence, this may disadvantage a Georgian national who has lived and worked outside the country for some time before retiring to his home country.

This is also affected by attitudes towards nationality. Should a non-Georgian who is resident in Georgia qualify? Would consideration be given to how long he or she had been there and, if not, would a non-Georgian dependent spouse of a Georgian national living in Georgia? And would there be a residence qualification on such a spouse?

There are also distribution and registration issues related to this type of pension, as with other types. Many recipients may, for one reason or another, be excluded from a register, while others who are infirm may find it impossible to reach a payment center, requiring a relative or acquaintance to collect the pension. Others may find it difficult to complete the necessary forms or to pass on details of changes of address. There is also the matter of people dying, and any

[23] In Georgia, those over the pension benefit age who are working do not receive a pension, so it is not quite a universal pension.

automated payment system that may continue to pay when the beneficiary has died. Within this concern, there is the possibility of fraud, in which relatives or acquaintances continue to collect a pension on someone who has died.

3.3 Government Provided Earnings Related Pensions

Pillar I under the World Bank approach is the concept of the state paying a pension with the amount largely based on what an individual earned over a working lifetime—a government obligation on a national scale. This would normally be funded by a particular tax[24] or out of general tax revenue. By definition, it only applies to those in the workforce and generally relates to a proportion of the working life, so periods of unemployment, for whatever reason, and being out of the country would not normally count as qualifying periods. As qualification is based on employment, it may be described as an occupational benefit but, since no savings are involved, it is very different to the occupational savings systems described below.

This approach is effectively a defined benefit, although the level of benefits changes over time, sometimes influenced by political rather than economic considerations. Governments have found this to be a costly exercise, as the level of benefits is also affected by inflation, where any effective funding based on taxation is also historic in nature. In addition, there have been very few attempts to use any specific, related tax revenue, such as social insurance, to fund future liabilities and such revenue goes into general government coffers.

As a result, governments tend to look at this as a pay-as-you-go proposition with a defined benefit obligation. Many government or state pensions are paid out of general revenue, often offsetting social security or related taxation and revenue, without being aware of the future cost of such payments.

Government pension problems often result from promising future earnings related benefits. It is easy to promise future payments without giving proper consideration to how such liabilities might be paid for or knowing with any certainty what the future liabilities might be without frequent actuarial valuations.

Should a Pillar I system be adopted in Georgia, it would be a number of years before any meaningful benefit would be paid out, unless there was an arrangement to recognize previous periods of employment. This would instantly raise a liability on the government without any recognized revenue to offset it.[25] As such, it is unlikely that any government would want to establish a new earnings-related system in the present day.

3.4 Occupational Savings

As noted, there are two types of occupational savings: mandatory and voluntary applying to employees; there are very few systems that apply to self-employed. These are pillars II and III, respectively, in the World Bank’s approach.

In mandatory occupational savings plans, employers are obliged by law to participate in a pension plan. Employers must set up (and make contributions to) occupational savings plans, which employees will normally be required to join. Where employers are obliged to offer an

[24] Such as National Insurance in the United Kingdom, although the concept of funding through this tax has long passed and is now seen as an additional source.

[25] This recognition of previous employment in calculating benefits based on working life was used in Mongolia and a number of other countries that generally followed the former Soviet system.

occupational savings plan and the employees' membership is voluntary, these plans are also considered mandatory (OECD 2011). Voluntary occupational pension plans are voluntary in the sense that employers, jointly with employees, are free to set up an occupational plan. An employee's membership is determined by a contract of employment. They are called by various names, such as pensions, superannuation, and provident funds, with two broad types: defined benefit and defined contribution.

Defined benefit is where the benefit is defined by some formula and effectively guaranteed by the employer or a third party, such as an insurance company. Defined contribution arrangements pay a benefit based on the value of the savings; what is defined is the level of contributions, which are then invested to produce the value at a particular age or circumstance. The benefit is based on the ultimate value of those savings and takes the form of a pension, a pension equivalent, such as an annuity or drawdown of the balance, or a lump sum in what are called provident funds. Some arrangements are called hybrid, in that they have elements of both defined benefit, such as minimum payment, and defined contribution, a payment based on final balances.

Any occupational savings arrangement depends on two main factors, the level of contributions and the investment returns on those contributions, with the level of fees and charges also affecting values. Investment returns are critical to any form of occupational savings. For a defined benefit arrangement to be solvent, there are expectations on the level of investment return. In defined contribution arrangement, the benefits are tied to its value and the employer has no further obligation after making its contributions.

In a typical long-term defined contribution arrangement, the final aggregate balances will, as a very rough rule of thumb, comprise around one-third contributions and two-thirds investment returns.

Taxation is a key feature of many occupational systems, with very different attitudes towards concessions (or not as the case may be) at the employer and employee contribution levels, concessions (or not) on investment gains and income, and on the payment of benefits.

Occupational savings clearly only benefit those who are in qualifying employment. Thus, those who are not have different prospects for old-age. [26] As a general point, any savings or pension system that benefits one group in society and not another will tend to widen the gap between the rich and the poor.

3.5 Mandatory Occupational Savings

Mandatory occupational saving plans are established and managed either by government or through statutory bodies, may include substantial or total private sector involvement, with certain basic criteria such as definitions of eligibility, types of pension benefit, and pension benefit ages established under legislation. They are generally defined contribution.

They apply to everyone in the workforce and have the three critical elements of (i) contributions (ii) investments and (iii) benefits. Employers and employees have to contribute a certain percentage of the salary. Exemptions are sometimes made, such as for foreign nationals, for certain types of workers, or for those already in existing arrangements. Mandatory employer and

[26] An example of this may be serving in the military, which may not be pensionable and where no contributions are made by employer or employee into a savings system.

employee contributions are occasionally based on minimum and maximum salary levels.[27] Benefit payment ages are defined under the legislation that created the mandatory arrangements.

Aggregated contributions are invested, domestically or internationally or both, and each employee member's record of contributions and investment returns almost always form the basis of a benefit which, as noted above, may take one of many forms. A number of systems allow for the employee member to choose how his balances may be invested.

There are a number of issues in any mandatory saving system. If it is the employee's obligation to contribute, then the employee's take-home pay will be lower. If it is the employer's obligation, then wage levels may be adjusted. There are also issues on how the contributions may be invested. Generally, the higher the contribution, the greater the benefit, which conflicts with perhaps the less realistic expectation of low contributions but high benefits.

Many mandatory systems also allow for voluntary contributions to be made. The conditions that apply to such voluntary contributions may differ. There are also some systems that allow contributions to be withdrawn before the pension benefit age, for either specific or general purposes. Such specific purposes may include housing, medical care and family matters such as weddings and funerals.

3.6 Voluntary Occupational Savings

Voluntary occupational savings plans are established by employers or occasionally by worker groups such as unions, or by individuals. The regulatory and taxation environments on voluntary occupational savings systems can be considerable.[28] Contributions are based on levels agreed by employer and employee and usually appear in a contract of employment. Investment and benefit issues are broadly similar to those in mandatory systems. In some countries, it is common for employers to match contributions made by employees up to a certain level.

Greater flexibility is apparent on pension benefit ages and methods and amounts of payments than in mandatory systems. A feature of voluntary systems is that they tend to benefit the better off within a society—those who earn enough and can afford to save.

3.7 Role of Private Sector: Savings not Pensions

As noted, Georgia has a small voluntary "pensions" system, which might more properly be called a savings system because funds the participant has contributed can be readily withdrawn before the actual pension age. The development of such savings systems in Georgia and elsewhere recognizes that there is demand for savings throughout life and not just at a retirement age. Saving for large and small events in life is a specialist area where, although saving can be encouraged, any rules or conditions over withdrawals would be minimal.

The private sector understandably tends to concentrate on those who can afford to make savings. In addition, savings are often encouraged by tax concessions. The effect is that the

[27] In Hong Kong, China, for example, the employer's mandatory contribution is 5% of salary up to HK$20,000 per month (a level about twice the median wage). The employee's 5% contribution applies to salaries between HK$5,000 and HK$20,000.

[28] Pension and tax legislation, for example in North America and the United Kingdom, is considerable, in contrast to the simpler approach for voluntary schemes, for example, in Hong Kong, China under the Occupational Retirement Schemes Ordinance and tax legislation.

better off tend to benefit more. The less well off arguably need a savings system that provides them ready access to banks and savings products for relatively small amounts, with incentives to maintain a level of savings that also allows ready withdrawals when necessary. This is likely only to be achieved through a widening of the coverage of the banking system, a costly exercise that, for many banks, would most probably be uneconomic given the relatively small potential balances per customer. However, with technology reducing operational costs, it may be a valid future objective.

4. Pension Reform, What is Practical and Acceptable

This section discusses pension reform in Georgia with consideration given to what is practical and acceptable, and identifies general ground rules for any pension reform program. The focus is on developing a pension structure that, not only pays an adequate pension, but also plays an important role in economic development. The challenge is to see pensions as a positive contributor rather than a cost, and to develop a new approach that runs in parallel with the existing state system. As such, a number of factors are considered, including how pensions interact with a wide range of social and economic factors in Georgia.

4.1 Old-Age, Military, and Other Pensions

The current state-provided pensions that cover old-age, military, and other types of pensions should be considered in determining the level of current and future benefits. On the principle that such existing pensions are payable to those who cannot contribute to the workforce, but are deserving of support, it appears inequitable to raise old-age pensions to a new level while, for example, leaving military pensions at existing levels. Any change in the level of pensions should be applied as equally and as fairly as possible to all types, particularly when a pension is likely to be a major source of income support. As such, any comment on state-provided pensions that follows would, unless the context suggests otherwise, apply to all state-provided pensions.

4.2 Pension Review Group

The government in 2010 established a Pension Review Group[29] with the aim to discuss, develop, and recommend policy change. Such policy changes are likely to be long term in nature. Some possible policy changes are unlikely to be put into effect for some years based on the nature of their importance and possible impact on society.

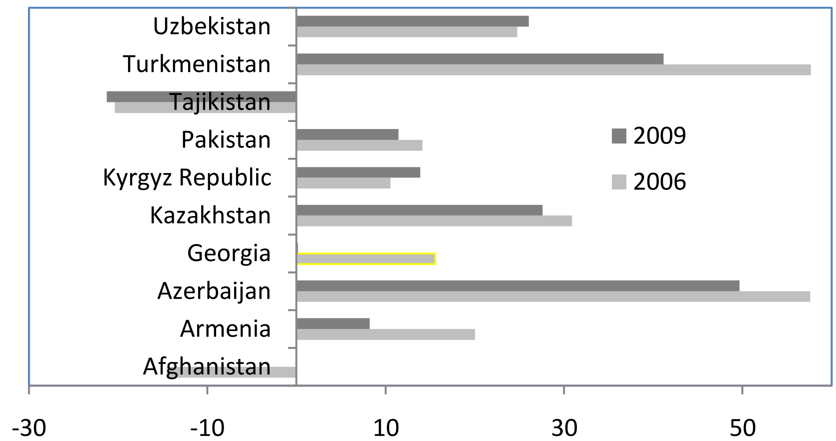
4.3 Savings, Not Just Pensions

The private sector is currently limited by low savings rates, 0.2% of GDP in Georgia (Figure 2), and low salary growth in real terms,[30] resulting in limited opportunity to create savings, with limited market penetration of existing pension products. While the recent regulatory changes on investment and disclosure may help expand market penetration, this cannot be guaranteed.

[29] The establishment of a Pension Review Group was included as a policy action in the 2010 ADB program loan to Georgia (ADB 2010).

[30] See Table 11 for wages.

Figure 2: Gross Domestic Savings (% of GDP)



Source: World Bank, World Development Indicators Data Base

In one sense, private pension funds in Georgia have elements of flexibility that savings systems in other countries may not have. That is, they allow the saver to draw on his savings when he or she needs them, such as for personal or traumatic occasions, rather than have them at a specific age, or in the case of pensions, as an income that is dispersed over many years. As such, they are not pension products as generally understood.

In terms of policy, Georgia will have to decide whether it wants to encourage private sector pension plans, or private sector savings plans. For example, if it introduced a mandatory occupational savings system, the latter might better meet the needs of many people. The challenge, therefore, is to encourage savings products rather than specific pension-related products. Discussion of this sector could thus consider savings products or even a wider appreciation of bank savings in smaller communities and rural areas, and being able to appeal to potential savers, even if only on a seasonal basis.

4.4 Government Pensions

4.4.1 An Acceptable Level

Generally, governments may be said to have a responsibility to support the less well off in the population, particularly the elderly. Any reform of the existing pension system should reflect this view and preserve this benefit. Going forward, policy decisions are needed to determine whether the basic level of support should be at current levels adjusted over time for inflation, whether a monthly target should be in line with minimum subsistence levels, or whether an increased amount that ensures a reasonable standard of living should be achieved. At the moment, it is not clear what targets might be considered or what is expected.

As to what is acceptable, it would be misleading to think that people would continue to expect and only accept a high level of benefits. Many are conscious of the need to maintain fairness in distributing benefits. Any benefit over and above a basic level can potentially come into question, in particular if a number of people are receiving benefits that, given their financial circumstances, they do not need.

4.4.2 An Affordable Pension

Pensions currently account for 13% of the state budget.[31] While this may appear affordable, it equates to what may be seen as a low level of pensions. The present pension system is only affordable arguably because of its current perceived low level. This would appear to be borne out in the following table. Any increase in benefits would add considerable pressure on government finances, increase the deficit, and further skew government expenditures. A hypothetical target could be set at GEL166 ($100) per month, for example, or some income replacement ratio. Table 12 looks at the benefit level of GEL100 a month ($60) planned for September 2011. It includes the cost of benefits, how much pensions would be as a percentage of what would be an expanded state budget, and the increase in pension costs of the various scenarios being added to the existing budget, then comparing these with the size of that “expanded” budget.

Table 12: Benefit Levels and Theoretical Costs to Government

Benefit levels	Actual GEL per month	GEL per month targets	2010 cost to government (GEL thousand)	% of expanded state budget	Current state budget (GEL thousand)
Current pension		80	923,825	13%	7,233,001
					Expanded State Budget
GEL166 ($100) target		166	1,994,348	24%	8,279,319
		Half-salary			
Average government employee salary	557	279	3,210,555	34%	9,495,526
Female	398	199	2,294,077	27%	8,579,048
Male	691	346	3,982,933	39%	10,267,904

Sources: Ministry of Finance, Georgia, Social Service Agency of Georgia, National Statistics Office of Georgia, and ADB consultant’s derived numbers.

The size of the state budget suggests that any significant increase in pensions in the existing structure would be hard to achieve. Indeed, any commitment to a future high level would have serious consequences for government finances.

4.4.3 Distribution and Registration Challenges in Government Pensions

Government pensions require a fair and efficient system of registration and distribution that recognizes all beneficiaries entitled to pensions, including dependent spouses. The system should also provide for the cessation of benefits when beneficiaries die. The efficiency of national identity card systems may need to be reviewed in order to capture the full population of elderly.

The collection of pensions is done either through a branch of Liberty Bank or by direct contact with the Social Service Agency. For most pensioners, this involves a monthly trip to a town, or within town, to a branch of the bank. As noted in section 2.7, Liberty Bank has addressed this need by advancing the next five month’s pension on request with a 3% fee on the amount. This represents a small but profitable and risk-free transaction for Liberty Bank, and arguably the

[31] See Table 6 for data on the State Budget.

beneficiary accepts the deduction of 3% as a fair price to pay that will avoid future transport costs or waiting at the bank. By requiring the beneficiary to return every six months, this allows authorities to ensure the individual is still alive. When the beneficiary is infirm or otherwise incapable of getting to the Liberty Bank branch, however, the Social Service Agency would likely take responsibility for verification and payment.

It may be noted that pension distribution and assessment of needs can be regarded as a series of regional challenges rather than just a national one. The distribution of pensions in Tbilisi is different than in rural areas where the population is spread out. Such matters are likely to be part of any review of the Liberty Bank arrangements.

4.5 On Introducing Occupational Savings

Occupational savings are a realistic means of generating savings within a society and not necessarily restricted to savings for pensions. Pensions are the best known of occupational savings systems, but any debate over a future savings structure should include the relevance of other savings needs.

A major challenge to the value of any occupational savings system that pays a pension from a particular age is that an individual will need savings at a number of other key moments in life, for example, for housing, medical care, family responsibilities such as weddings, and for periods of unemployment or difficult financial circumstances. When faced with these difficult and unforeseen emergencies, it could be argued that access to savings, which may otherwise be tied up in a pension system that may not pay out for many years, would be of substantial importance. Some systems allow access to funds for certain circumstances although it will be appreciated that any early drawdown will reduce the amount that might later produce a pension.[32]

Whether contributions are employer- or employee-related, or a combination of the two, the effect is that, on introduction, there is a reduction in take-home pay, a matter that must be seen as a true benefit if an employee is to regard change as positive or at least neutral. This means that the savings should be seen to grow and provide, in the case of pensions, a significant long-term improvement that is worth the short-term loss. This is particularly challenging when inflation is high or for those who are many years from retirement. In addition, those whose pension years are relatively close will not see the build-up of balances that younger people will and, as a result, their pensions will be lower than those who retire later.

A nationwide mandatory system requires cooperation and acceptance from both employers and employees. In addition, effort is needed to discourage mutual agreements between employer and employee to avoid contributions.

The implementation of occupational savings for the self-employed may be particularly challenging, with compliance an important issue. Many self-employed may not necessarily keep accounts and their idea of income may not be as readily defined as that for an employee. Many of the self-employed may also have seasonal or irregular income, with months of good income needed to pay off debt accrued during months of poor income.

[32] The Central Provident Fund (CPF) in Singapore was originally established to provide a retirement age benefit. However, CPF savings can be used to help finance a house purchase and medical costs, so forecasts of savings at the benefit age are likely to be lower than originally planned.

Methods to achieve a reasonable level of compliance for employer-sponsored plans usually revolve around penalties for non-compliance. Methods that allow employees to complain often result in a lack of trust between employer and employee, which can result in termination of employment. A more fruitful approach is for some overall encouragement for employer and employee to begin to contribute to the system, such as a tax concession or other conditional benefit so that at least the first year's contributions are neutral to both employer and employee.

4.5.1 Providing a Meaningful Level of Benefits, Impact of Inflation

A matter that requires careful consideration within the whole area of occupational savings is the balancing of an affordable level of deductions with a meaningful level of benefits. For example, an employee who earns GEL400 a month working for 30 years would save about GEL14,400 if employer and employee collectively contribute 10%.

For example, if the investment return is 6% and wage inflation 4%, then at the end of 30 years the balance saved would be about GEL60,000. If this were to produce a pension over 15 years, the monthly pension would be GEL333 a month and, if the funds were to continue to be invested in these returns, this amount could either go up each year or last for more than 15 years.

Although this might seem attractive, it is important to look at this in today's terms. GEL333 is just GEL107 a month in today's terms at a 4% inflation rate over 30 years. If inflation were higher than the investment returns, then the real return would be a lot lower and any savings would lose value in real terms.

Each of the parameters in any calculation of possible real return, wage inflation, retail price inflation, investment return (which is always assumed to be smooth each year but rarely is) is unpredictable. Any pension system will look good if real return is high and look poor if it is low, just as any deficit in a defined benefit arrangement can be remedied by usually unrealistically high investment returns.

Inflation is one of the more unpredictable and risky factors in any pension system. The ideal environment for any funded occupational savings arrangement is one of low inflation. Where inflation is persistently above wage growth and investment return, it quickly erodes the value of savings, as it would any form of savings. Any attempt by government to counter the inflationary impact by offering index-linked investments or comparable guarantees risks merely shifting the burden to the government.

4.5.2 Complexities of Occupational Savings

An occupational savings scheme has a number of key elements requiring different types of administration, recordkeeping, and monitoring and verification systems. These include: (i) the calculation and payment of contributions at the employer level, (ii) collection of employer and employee contributions, (iii) safekeeping of assets, (iv) investment of contributions, and (v) calculation and payment of benefits.

Georgian employers are generally unfamiliar with any system of payroll tax or its collection. In fact, the government's current approach is to lower the cost of doing business, and they are reluctant to impose requirements on employers that may raise such costs. In addition to reconciling the need to promote savings and reduce the cost of doing business, the unfamiliarity with such requirements would require a review to determine how feasible it would be to introduce an occupational system, drawing heavily on the experience of other countries.

There are two approaches to any system of employer and member recordkeeping: (i) a single nationwide system, and (ii) a fragmented system where specialist providers provide some sort of competing service. Generally, the more widely distributed the employers are, the greater the benefit of a single national system, including national recordkeeping. Competing providers work well in highly populated areas. In rural and urban areas, product providers' coverage can be patchy. In addition, and through no fault of their own, employers may find compliance with mandatory systems to be particularly difficult. Similarly, the payment of benefits might rely on a national system. Although, as with government pensions, it may be appropriate to look at some regional distribution. Again the experience of other countries with similar geographical and distribution challenges is a worthwhile reference point.

4.6 Pensions within the Banking and Insurance Industries

Developed pension systems have a strong relationship with banks and insurance companies. Banks and insurance companies have key roles to play in private sector mandatory and voluntary occupational savings—for recordkeeping, administration, and investment management—and generally see members of such schemes as potential customers. Mandatory savings systems use banks for the collection and payment of benefits. Banks also provide custody services and brokerage for securities transactions. Insurance companies provide additional insurance services, such as life assurance and guarantees on investment performance.

However, the Georgian banking system has yet to develop these services, and their provision would be driven by demand. As such, the development of a mandatory savings system would likely provide a fair stimulus to the banking system and stimulate competition between banks for additional services. The insurance industry would also likely benefit, but at a later date.

Pensioners are unlikely as a group to bring any significant business to banks. But the attraction to banks is that the business is fee-based and relatively easy to handle; for example, the 3% charge Liberty Bank charges on advance benefit payments, discussed earlier (section 2.7).

4.7 Public Attitudes toward Pensions

In the successful introduction of occupational savings systems in other countries, organizers have used extensive public consultation and ongoing education and public relations programs to gain acceptance. Pension reform, in the short term, generates change that is usually for the worse, as far as beneficiaries are concerned. Occupational savings systems reform, for example, usually results in reductions in take-home pay and concern about what may happen to existing arrangements. A transparent and properly explained system with appropriate press and media coverage is, therefore, crucial to success.

4.8 Taxation in Georgia

Because of its strategy to lower the cost of doing business, Georgia's tax regime is now considered one of the world's friendliest.[33] Yet, as noted in the section 2.7 on the private "pension" system, the lack of tax on investment activities does not encourage the development of a tax-sheltered vehicle. Indeed, the expenses associated with investment vehicles would seem to discourage their development. The scope for giving tax breaks to encourage savings would thus appear limited at this time and would need to be balanced against other government objectives.

Pensions in Georgia are free of tax. Tax benefits for occupational systems, anywhere, usually relate to deferring taxes until a later date, with tax benefits on contributions and investment income replaced by taxation of pension income as income at a later stage, such as in the United States, the United Kingdom, and numerous other countries.

As long as Georgia's private "pension" system does not require savings to be paid as an income flow, the scope for using tax would again be limited. In addition, any tax break for one part of society would add to the burden of the rest of society to make up the difference. Given Georgia's tax position, how any future taxation system should apply to pensions should be carefully considered.

4.9 Investment Issues

With any occupational savings system, there are a number of investment-related issues, notably the volatility of investment returns and whether investment markets can absorb inflows and allow withdrawals.

4.9.1 Volatility of Investment Returns

Models of investment returns in defined contribution systems generally assume a consistent rate of return. Investment markets can be volatile and, even where long-term returns may be satisfactory, any one year may produce returns far removed from the long-term trend. This is illustrated in Appendix 3, where the timing of taking benefits would be affected by the level of the market and the value of investments.

4.9.2 Ability of Investment Markets to Absorb Inflows and Allow Outflows

In developed markets, contributions to and withdrawals from savings schemes can be readily invested in markets where liquidity and marketability are satisfactory without distorting markets. But where inflows are large compared with the value of shares, for example, their trading on any particular day on a stock market runs the danger of distorting markets. This could lead to temporarily higher prices and problems in investing the inflows, and even in investment policy being dictated by what is available rather than what is desirable as an investment. Similar problems can occur when inflows are invested in deposits or government debt.

Where domestic markets or banking systems are underdeveloped relative to the scale of contributions, the alternative of investing overseas brings its own issues, with exposure to

[33] Income tax is 20%, VAT 18%, corporate profit tax 15%, and dividend and interest income tax 5% (Invest in Georgia 2011). Also see World Bank 2011 (Business Environment Snapshot).

foreign exchange risk and an assumption that there is sufficient liquidity in foreign exchange markets to allow significant net outflows without hurting the currency and the broader economy.

It is a generally held view that the development of pension systems can make an important contribution to the development of the domestic economy by providing savings that can be reinvested and by providing a secure income for old age. Keeping such flows within the economy is, therefore, the preferred option.

4.9.3 Economic Development

Another way of looking at investment challenges is to consider how contributions may be more usefully invested in the economic development of the country while, at the same time, achieving predictable returns with little volatility. One option could be through aggregating contributions and channeling them into economically beneficial projects. Such an approach is comparable to the Singapore experience

4.10 The Singapore Experience, 1955 Onwards

The introduction of a centralized state-backed occupational savings scheme in Singapore in 1955, known as the Central Provident Fund,[34] has proved to be an important factor in not only the provision of funds for the elderly, but also in the development of the economy. Until fairly recently all contributions were aggregated and exchanged for Singapore Government debt,[35] the balances becoming a liability to the government, and the funds invested by the government in a wide variety of economically beneficial projects. Each contribution is effectively swapped for a government bond with an interest rate equal to that promised on the savings.

While critics of the Central Provident Fund suggest that much of the amount raised goes to support general government finances and offers only low investment returns to members, it is generally accepted that the fund has become an important factor in Singapore's development. When introduced, capital was in short supply, poverty was a major issue, housing standards were low, the political future was uncertain, and investment markets by modern standards were barely developed. Singapore needed capital and needed a short- and long-term solution for its elderly. Singapore maintains a social security program for those who do not participate in the Central Provident Fund.

4.11 The Challenge of Investing in Underdeveloped Markets

A number of countries have undertaken pension reform, introducing occupational savings without a full understanding of how contributions might be invested. Few countries have fully developed financial markets with both bonds and equities and with sufficient liquidity and marketability to cope with contributions and withdrawals. A savings system that invests in underdeveloped domestic markets will quickly be a major market participant, be they bonds, equities, or deposits, running the danger of distorting markets and effectively drying up liquidity.

In recent years, pension reform has generally preceded the development of suitable financial markets, with the result that investment options are few and unsatisfactory and investment returns poor, and any plans to expand such systems or raise contributions have had to be deferred.

[34] Further comments on the Singapore Central Provident Fund can be found in Appendix 6.
[35] This still applies to a vast majority of contributions.

4.12 An Opportunity to Develop a Domestic Investment Institution

Insurance companies and pension funds are often referred to as institutional investors. An occupational savings system provides a rare opportunity to develop a significant domestic investment institution that channels some or all of its contributions to economically worthwhile projects and investment opportunities. This may have particular relevance in Georgia. Potential investments could include projects that present export opportunities, for example, and that generate sustainable employment and business opportunities. The overarching aim would be to achieve satisfactory returns for participants, which could be achieved directly and, to some degree, through taxation on increasing economic activity. Much would depend on the structure of the occupational savings scheme and the willingness and ability of both the government and the private sector to participate in appropriate projects.

The use of such sources of domestic capital to help expand and develop economies has not been promoted in recent years. In other countries, developing pension systems have found investing in established financial markets, often overseas, easier and more readily rewarding. However, investing overseas means the funds are “lost” to the domestic economy, are often subject to high volatility, while some have produced disappointing returns.

Investment overseas not only starves the country of a major potential source of domestic capital, but it is only possible if foreign exchange markets are fully developed, the size of outflows for a savings system are immaterial to the volume of daily transactions, and there is no effective impact on foreign exchange reserves. For many countries, these are impossible conditions. Investing overseas also brings currency risk and the investments may have no link to the liability profile of those in a domestic occupational savings scheme. Policy should, therefore, concentrate on restricting investment as far as practical to domestic opportunities.

4.13 The Pension Benefit Age: Determining an Equitable and Socially Efficient Pension Benefit Age

4.13.1 The Problem of the Benefits Gap

The time lapse from retirement to the time of receiving benefits is referred to in this report as a benefits gap. A person may for example have “retired” or become unemployed—through ill health, family circumstances, or a wide variety other reasons—but may not receive a benefit for some years. This gap, during which income is reduced or even eliminated before benefits are paid out, can sometimes be many years, placing added pressure on social security or on intergenerational support, particularly when social security systems are not well established.

This is an increasing problem in almost every country and has been compounded by the challenges people have had in finding new employment after losing their jobs. Changes in employment patterns through globalization, increasing use of new technology, lack of retraining facilities and the costs of retraining, declining economies or industry and relocation issues have meant that many people lose their jobs in what had at one time been seen as safe and secure long-term employment.

The benefits gap is a major but often ignored factor when considering changes in pension benefit ages and overall policy.

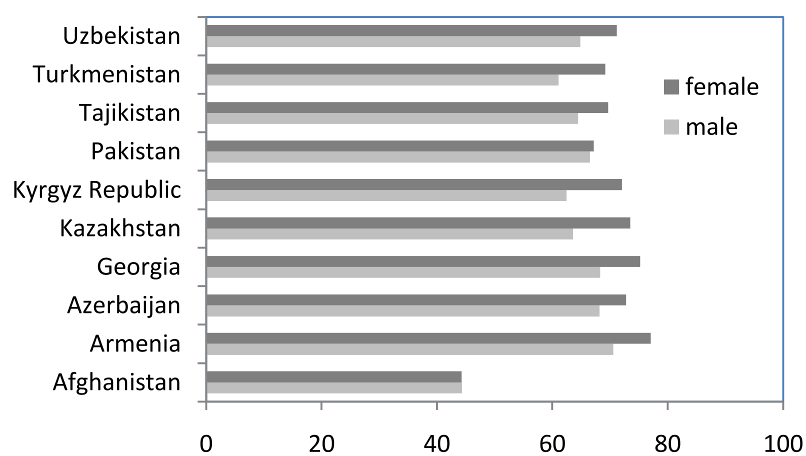
4.13.2 Changing or Leveling the Pension Benefit Age for Working Men and Women

A common feature of pension reform is to change the pension benefit age for men and women. Such changes almost always involve raising the pension benefit age rather than reducing it. And they are generally driven by the perceived future cost of providing a pension, often exacerbated by increasing longevity, rather than reflecting any immediate savings to the pension provider. There is usually substantial notice of a change in benefits age for state benefits, often 15 years or more. Actuarial valuations of pension liabilities can change significantly by delaying the pension liability for one or more years by raising the pension benefit age and the impact on pension providers of future costs can be significant.

Even though women on average live seven years longer than men in Georgia (Figure 3), their pension benefit age is 60 (while it is 65 for men) (Figure 4). The government, on average, therefore, has to provide pension benefits to women for 21 years and only 9 years for men. On this basis, about 70% of pensions are paid to women and just 30% are paid to men. It seems there would be considerable appeal to any benefit provider in raising the age that women receive pension benefits and, in this sense, level the pension benefit age.

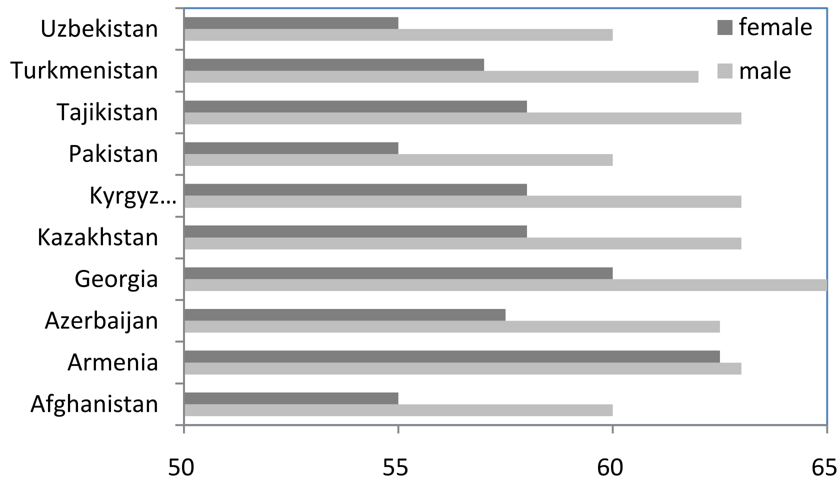
This could potentially provide an equitable and more sustainable solution for society. The idea of leveling the pension benefit age for men and women has taken root in much of Europe, where the idea of women working as long as men is accepted. A number of European countries have long-term programs to have the same state pension benefit age for men and women, with women's pension benefit ages rising over a prolonged period until equality is attained. Several Central Asian and Caucasus countries still have some way to go in this respect. Only in Armenia is the pension age nearly level—63 years for men and 62.5 years for women.

Figure 3: Life Expectancy at Birth, 2009



Source: World Bank, World Development Indicators Data Base.

Figure 4: Statutory Pension Age



Source: World Bank, World Development Indicators Data Base.

Raising the state pension benefit age—not just leveling it—has also been a recent policy factor in Europe. Again, the industrial landscape in Europe (and North America) has changed considerably in the last two decades, with much manufacturing moving to Asia and the increasing use of technology and automation reducing the need for hard manual work. Allied to better health, diet, and housing, this has contributed to the idea that both men and women can work for more years. At the same time, there is increasing economic pressure for men and women to work longer, coinciding with government policies to delay pension benefit ages based on fiscal realities.

How these broad factors apply in Georgia and how they could influence policy should be carefully considered. An understanding of the socioeconomic structure and how working patterns are changing through economic and social factors in Georgia would appear essential.

4.13.3 Change in Pension Benefit Age and its Impact on the Benefits Gap

Any proposals for changing the pension benefit age should take into account the benefits gap, as discussed above in section 4.13. The benefits gap is different in each country and varies considerably within Georgia, with some areas having a larger gap than others—such as where local industry is in relative decline or employment opportunities are scarce. There may be differences as well between rural and urban areas. As with pensions, the social and economic impact of the benefits gap will vary with levels of intergenerational support.

The benefits gap is an example of personal circumstances that has a knock on effect on the family. It may be possible to analyze the aggregate of all the benefits gaps in Georgia and draw conclusions about the impact of changing pension benefit ages, but the impact will always be on individuals.

Any increase in the benefits age is likely to have a significant impact on the level of poverty in Georgia, requiring state support until benefits begin at a later stage than originally anticipated.

4.14 The Gender Impact

In designing a pension system and pension reforms, it is also essential to take gender impact into account. Employment based old-age systems pose a problem in this regard, in that women are many times less likely to work in formal sectors and generally earn lower wages. As already discussed, women are also more likely to outlive their husbands, who often provide the family income. The longer life expectancy of women means that they are more likely to become widows than men are to become widowers, making survivors pensions of significant importance to them.[36]

Views diverge on the impact of contributory employment-based systems on women. While contributory systems tighten the link between payroll contributions and benefits, some argue that they hurt women, especially those not formally employed. Others argue that women are helped by the removal of distortions that have favored men and by the generally better-targeted public pillar. But even with equal retirement ages for men and women, pensions are likely to be far lower for women than for men due to their lower participation in the formal sector, generally lower wages, and longer life expectancy.

Multi-pillar systems contain public-defined benefit elements, usually financed by general revenues and which deviate from a “pure defined” contribution. These generate transfer payments that favor women, but detailed arrangements vary—such as in the degree of targeting to low income earners, eligibility criteria, retirement age—and they dictate which women benefit and how much.

[36] See James et al. 2003 for further discussion of the gender impact of pension reform.

5. A Possible Pension Structure in Georgia

This section recommends issues for the discussion of pension reform in Georgia that may provide greater assurance for the current and future elderly and a means of achieving greater economic growth.

5.1 Recommendations for Discussion

A combination of private and public sector savings and benefits might be considered for Georgia. The comments above, however, suggest that there are parts of the World Bank multi-pillar approach that might work, while other areas are unlikely to be acceptable, affordable, or even practical. Of particular importance is the absence of financial markets to invest contributions from occupational savings, suggesting the need for some creative thought about a more constructive investment policy that benefits the whole the country.

The government may view pension development from two basic perspectives. The first is to maintain the existing universal pension system with some additional features—a zero pillar in the World Bank approach. The second is to consider introducing a mandatory occupational savings scheme that pays a pension—pillar two in the World Bank approach. Voluntary savings may also have some appeal, encouraging the government to create a positive environment for their development.

The present pension system, which keeps many out of poverty, would likely remain the most affordable and desirable policy, although there may be scope for raising benefits, with consideration given to other benefits being raised at the same time.

A regionally administered system of benefits recognizing individual needs, such as differences in living standards and conditions across the country, could be further explored. Higher benefits are effectively paid in Tbilisi and their experience might serve as the basis for further pilot programs.

The introduction of a mandatory occupational savings scheme—covering all employees, with contributions from employer and employee—could be managed by the government or by a designated state pension fund that maintains centralized recordkeeping and has responsibility for allocating a pension based on the accumulated value of an individual's aggregate savings.

As discussed above (Introduction), a pension system needs to be both fiscally and politically sustainable to achieve the objective of providing adequate old-age income. The attraction of a significant source of domestic capital that can be used for medium- and long-term economic benefits is an important development objective in Georgia.

The broad principles of any change to the existing system would need to be further studied, discussed, and understood by key stakeholders, including the government, employers, private sector pension funds, as well as the pension recipients, with clarity on what policy could and should achieve. Given its unique circumstances, one option that should be further explored is, therefore, the development of a two-pillar system in Georgia, plus a private sector alternative.

5.2 A Two Pillar System

The introduction of the two pillar system would comprise:

(i) a continuation of the existing system of a poverty reducing state-provided pension; and
(ii) the introduction of a mandatory occupational savings system to provide a pension.

The key feature of the defined-contribution, mandatory occupational savings system would include contributions invested in a special class of government guaranteed debt mandated to finance economically rewarding projects, with an interest rate structure that would pass through to members' accounts as an investment return.

The interest rate structure would be influenced by a number of factors, notably the cost of existing government domestic debt, bank interest rates, inflation, and what is acceptable and achievable in Georgia. There would be no need or reason to tax these investment returns.

5.3 The Existing Universal Pension System

The existing pension system reasonably achieves its objectives of reducing poverty and could well remain in place. While an increase in benefits might be welcomed, and the possibility of indexation of annual increases considered, care should be taken as to whether a higher level is fiscally sustainable. While poverty remains an issue, consideration should be given to assessing the existing level and range of benefits and providing a support system that is effectively means tested.

5.4 A Mandatory Occupational Savings System

In the longer term, consideration could be given to introducing a defined-contribution, mandatory occupational savings system that provides a pension at retirement age, based on the aggregate value of the savings. The aggregate value of a defined-contribution system is the value of all contributions plus credited investment returns. Such contributions would be swapped for government guaranteed debt, or development bonds—the purpose of which would be to provide capital for the development of the economy (see section 5.5 below). The liabilities of the system would then be matched by government debt, thus giving government the liability to pay the pension based on the value of savings.

Generally, the combination of employer and employee contributions to a defined contribution system should require extensive consultation to identify the policy that best fits the unique circumstances of any individual economy. Whatever the combination, wage levels and take-home pay will need to be adjusted. Should only employees make contributions, a reasonable approach may be to start at a low level and rise gradually to an intended long-term level, as was the case in Australia. Should employers make contributions, it may be easier to start at a higher level before moving to a long-term target level. Multiple employment would lead to multiple contributions based on all wages, however defined and at whatever frequency.

5.5 Individual Accounts

Contribution records would be maintained for each individual member, with investment returns credited each year. A single centralized recordkeeping system would be maintained, rather than a number of systems, capturing data on employer and employee contributions, member balances with credited investment returns, and pension payment calculations. Contributions would be aggregated and exchanged for government debt.

5.6 Investment of Contributions: Development Bonds

Contributions would be invested solely in a new class of government bonds, as they are received. These would be issued and redeemed at the same par level, with a fixed interest rate. The interest would then be added to the value of the contribution each year and be reinvested in a further government bond. The bonds would be designated “Development Bonds” and be a liability of the government.

Government would invest proceeds in economically beneficial projects or in joint venture partnerships with the private sector and international agencies that generate employment and encourage export industries and in infrastructure development that produced direct income and indirect income through widening the tax base. There would be a high degree of transparency in their investment, which would possibly require the establishment of a Georgian Infrastructure Development Body with high standards of governance.

This approach would also avoid the volatility normally experienced in financial markets and the unpredictable returns. For those close to retirement age, it would avoid the uncertainty of investing contributions in a volatile market, and provide predictable savings and thus a predictable pension.

5.7 Pensions

A pension would be payable at a determined pension benefit age, or on permanent disability, for as long as the funds credited to an individuals’ account were in surplus. In the event of death, any balance on an account would be payable as a pension to a surviving spouse or, if none, a named dependent.

In the defined contribution system, the value of the contributions, together with their investment returns, would form the basis of calculating a pension. Where there are no annuities, the normal approach is a drawdown, where part of the balance is paid out each month according to a formula or, in some countries, within a particular range, either driven by tax considerations or basic rules.

Once this balance had been used to pay pensions, no further pension would be payable. Whether the state would then pay anything would need to be determined, but any liability at this point would become a liability of the state, not of the funds in the scheme, which, being defined contribution, would be credited to existing members’ accounts. Because each individual had a different pattern of contributions over many years, each individual would have a different balance, resulting in a different pension.

In a drawdown approach, there are various ways to calculate the pension and, in each, there is considerable benefit of having the balance invested in the benefit paying stages. See Appendix 2, Table 1 for an example.

The first approach is to pay a changing fraction of the balance year by year. In the example in Appendix 2, assuming an investment return of 5% on the balance and given a life expectancy of 15 years, it is possible to pay a pension based on 1/15 of the balance in the first year, 1/14 in the second year, 1/13th in the third year, and so on, producing a rising benefit for 15 years. A second approach is to pay the same benefit, 1/15 of the opening balance, year by year. This extends the payment period, by up to 26 years, but makes the benefit vulnerable to inflation. A third approach is to increase the same initial benefit by, say, 3% a year, a rate lower than the investment return, which takes the pension payment period in the example up to just over 18 years.

Early withdrawals for specific or general purposes may be considered under such an approach, but each withdrawal would reduce the amount available to pay a pension.

5.8 Staggered Introduction

For the introduction of this scheme, it may be appropriate to include public-sector employees in the first year and the private sector following a year later. This would enable the administration of the various parts to become familiar with issues without having to deal with the whole population at once.

5.9 Employer or Employee Contributions: Finding the Optimal Combination

Table 13 above assumes that employers and employees both contribute to the pension. There are clearly many combinations, including: (i) the employer contributes the entire amount, making it look like an employer payroll tax; (ii) the employee contributes the whole amount, making it look like an income tax, with a later benefit as the pension comes through; or (iii) some combination of (i) and (ii).

It may be argued that it does not matter what combination is used, that the economic effect is the same, and that wages will adjust. If the employer pays the whole contribution, one would expect wages to either fall or not rise as much as they would have done had they not paid the contribution. The net effect on employees' take-home pay would adjust. If employees paid in the whole contribution, take-home pay would fall, but the employer would have no reason to reduce wages or reduce the amount by which they would have risen.

In some countries, there have been suggestions that the government also contribute. This assumes healthy government finances, in that it comes out of tax revenues. It is also, in effect, a transfer from general finances to the employed population at the expense of those who are not employed.

5.10 Economic Implications

There are a number of economic implications of developing an occupational savings system. Generally, the economic implications of pension and social structures and policy propositions are not always fully understood. This provides a valid argument for detailed economic pension studies, recognizing how changes in pensions and demographics and how any contemplated reform might affect the economy. Such a study would be appropriate should Georgia consider changes as suggested in this paper, follow another strategy, or merely maintain the present structure.

While the complexities of this are beyond the scope of this paper and need to be considered in any economic modeling, it is worth also considering both the deflationary impact and wage adjustments.

5.11 The Deflationary Impact

At its introduction, an occupational savings scheme is deflationary, taking money out of the economy, an effect that may last until the economy adjusts, possibly for a period of up to five years. Much will depend on what happens to the aggregated contributions and the velocity of such funds as they re-enter the economy.

If they are invested in bank deposits, the impact will depend on how quickly and to what parts of the economy any subsequent loan growth will go. If they are invested in government bonds or the equivalent, the effect will be through additional spending programs and their particular impact. If they are invested in established financial markets, their impact will be minimal as they will, in most, cases merely buy existing securities. Although this gives cash to the previous owners of securities, it is unlikely to come into the economy.

5.12 Wage Adjustments

The initial impact of reductions in take-home pay will reduce discretionary consumer spending and put pressure on household budgets. As noted above, this can be poorly received given that the benefit of a pension is many years away for most people. One way to accommodate a change in wages and take-home pay is to have a low level of contributions at the outset and for this level to steadily rise to a long-term target level.[37] This will mean that pension savings will build more slowly. The additional costs to employers will add pressure to reduce wages at a time when employees want them to rise and, at the very least, delay any wage increases until the labor market adjusts to the increased costs.

5.13 On Timing and Notice of Introducing Changes

Introducing an occupational savings system presents formidable challenges that will influence the timing and phasing in of certain parts of the pension system. An additional point to consider is the possible public reaction to any change. Occupational savings systems are complex and their introduction would need to be carefully planned and sequenced. Georgia, for example, has had no experience of an occupational savings system, and a mandatory savings system would be likely to have an impact on the cost of doing business and the way businesses are run.

Drawing from experience and lessons in other countries may be useful in developing a new pension system and for implementing reforms. In many cases, planning is centered around a certain introductory date, with all the elements of employer and employee education, contribution systems, employer and employee recordkeeping, administration, investment, and benefit payment systems due to be in place at that date.

Employer and employee recordkeeping systems are usually thoroughly tested prior to their introduction. It may, however, be difficult in theory to replicate the volume of paperwork in practice when considering contributions,[38] with the result, for example, that errors are common and need individual checking and reconciliation.

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[37] The example of Australia is useful in that, when compulsory superannuation was introduced, the equivalent to pensions, the initial 3% employee contribution rate was gradually raised to the target of 9%.

[38] An example of a chaotic start is Hong Kong, China's Mandatory Provident Fund system in 2000, where employer mistakes in correctly filling in what had seemed simple forms resulted in errors that took up to 12 months to resolve in cases.

Everything necessary should be in place comfortably before target dates. Yet, often individual country characteristics are not adequately considered. And, while new occupational savings systems are rarely delayed, they are often characterized by administrative issues such as errors and omissions, which may result in the pensions not being paid, and contributions not being invested. It may also be appropriate to introduce a new occupation savings system in a staggered fashion.[39]

[39] A staggered approach was recently used in the Government of the Maldives, where the smaller public sector was brought into a mandatory system a year before the private sector, enabling a smoother introduction.

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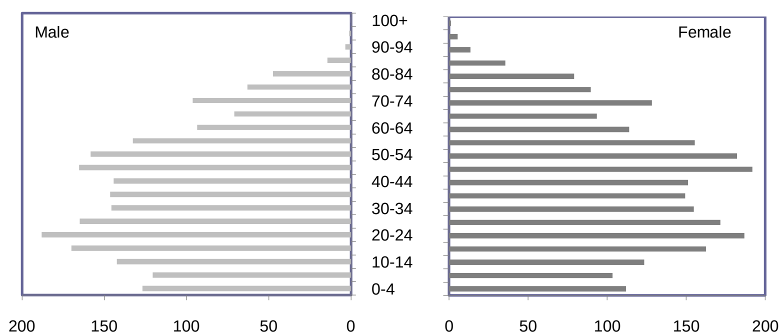
Appendix 1: US Census Bureau Population Pyramids

Section 2.3 discusses demographics in Georgia. The following shows present and projected population pyramids for Georgia, taken from the US Census Bureau International Data Base. Their figures are based on maintaining broadly existing trends in birth and mortality rates, immigration and emigration. While the figures are different than other sources quoted here, they are useful in showing a changing population figure.

It is interesting to note that hardly any two countries have a similar present and future population structure. That they are called population pyramids reflects the early studies of population, where there were more younger people than older people, thus creating an image that approximated the shape of a pyramid. In an era of generally ageing populations, a number of countries have top-heavy population “pyramids”.

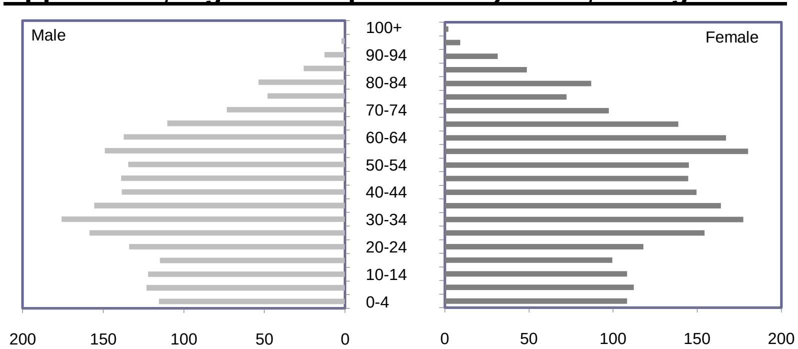
Population imbalances in Georgia, between males and the generally higher number of females, should be noted, particularly given the earlier female pension benefit age and longer life expectancy.

Appendix 1, Figure 1: Population Pyramid, Georgia 2010



Source: US Census Bureau, International Data Base. Accessed February 2011.

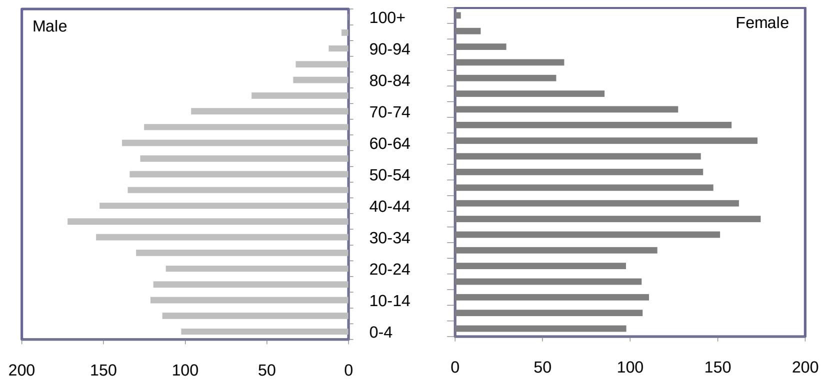
Appendix 1, Figure 2: Population Pyramid, Georgia 2020



Source: US Census Bureau, International Data Base. Accessed February 2011.

During 2010–2020, a significant population bulge will approach retirement age, notably females now in the 45–54 age range. The US Census Bureau expects the birth rate to remain steady at lower levels. The next population bulge, males and females 20–24 years old, may represent a challenge in creating worthwhile employment.

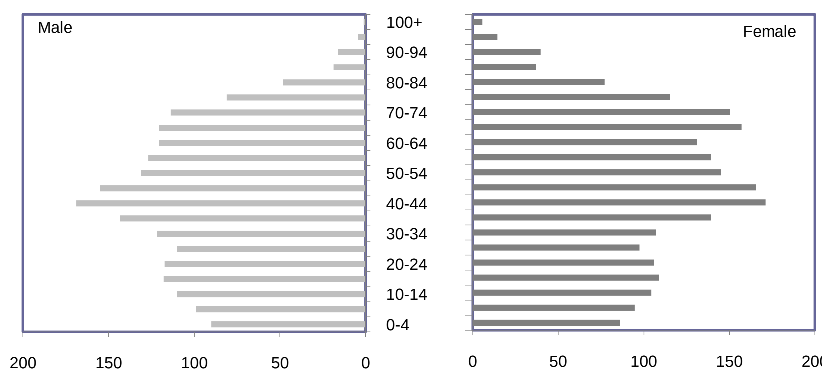
Appendix 1, Figure 3: Population Pyramid, Georgia 2025



Source: US Census Bureau, International Data Base. Accessed February 2011.

The next decade will see the first significant increase in the elderly, in particular those more than 70, putting their own pressures on pensions, healthcare, and housing, to some degree.

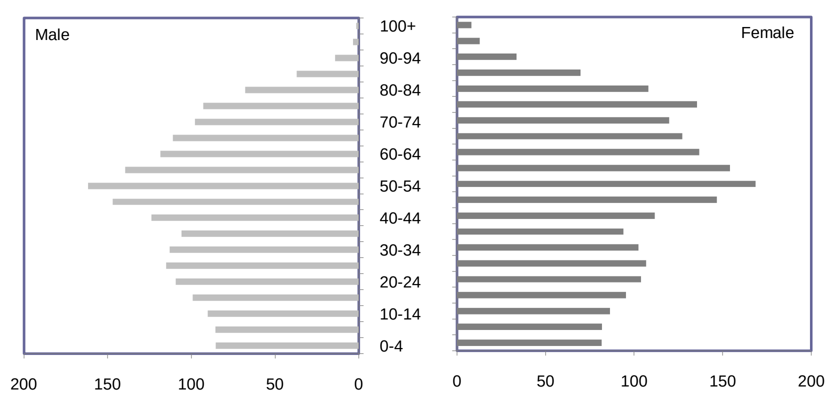
Appendix 1, Figure 3: Population Pyramid, Georgia 2030



Source: US Census Bureau, International Data Base. Accessed February 2011.

Towards 2040, the ageing population and the ageing workforce are likely to have significant impact on Georgian society.

Appendix 1, Figure 4: Population Pyramid, Georgia 2040



Source: US Census Bureau, International Data Base. Accessed February 2011.

Appendix 2: Paying Pensions from Balances

The following illustrates three different patterns of paying pensions from a balance, assuming constant investment returns, showing how long the pension payments may continue. Each starts off with a balance and the idea that one-fifteenth of the balance will be paid in the first year. The remaining balance, meanwhile, achieves an investment return.

The first table assumes a reducing fraction of the balance payable each year, one-fourteenth in the second year, one-thirteenth in the third year, and so on, until the balance is depleted at the end of year 15. The pension will rise at the investment rate of return.

The second table looks at maintaining the same initial payment, meaning that the pension will go beyond 15 years as the unpaid balance gets an investment return and, in this case, will pay the same pension up to year 26.

The third table looks at increasing the pension, but by a lower rate than the investment return, which stretches the payment out to year 18.

Appendix 2, Table 1: Illustrative Examples of Paying Pensions from Balances

	Fifteen years expectation					Consistent first year's payment				Annual increase of 3%			
	First year 1/15, second year 1/14…					Each year 1/15 of original balance							
Year	Balance	Benefit	Annual increase	Investment Return	Year end balance	Balance	Benefit	Investment Return	Year end balance	Balance	Benefit	Investment Return	Year end balance
				5%				5%				5%	
1	1,000	66.7		46.7	980.0	1,000	66.7	46.7	980.0	1,000	66.7	46.7	980.0
2	980.0	70.0	5%	45.5	955.5	980.0	66.7	45.7	959.0	980.0	68.7	45.6	956.9
3	955.5	73.5	5%	44.1	926.1	959.0	66.7	44.6	937.0	956.9	70.7	44.3	930.5
4	926.1	77.2	5%	42.4	891.4	937.0	66.7	43.5	913.8	930.5	72.8	42.9	900.5
5	891.4	81.0	5%	40.5	850.9	913.8	66.7	42.4	889.5	900.5	75.0	41.3	866.8
6	850.9	85.1	5%	38.3	804.1	889.5	66.7	41.1	864.0	866.8	77.3	39.5	828.9
7	804.1	89.3	5%	35.7	750.5	864.0	66.7	39.9	837.2	828.9	79.6	37.5	786.8
8	750.5	93.8	5%	32.8	689.5	837.2	66.7	38.5	809.0	786.8	82.0	35.2	740.1
9	689.5	98.5	5%	29.5	620.5	809.0	66.7	37.1	779.5	740.1	84.5	32.8	688.4
10	620.5	103.4	5%	25.9	543.0	779.5	66.7	35.6	748.4	688.4	87.0	30.1	631.5
11	543.0	108.6	5%	21.7	456.1	748.4	66.7	34.1	715.9	631.5	89.6	27.1	569.0
12	456.1	114.0	5%	17.1	359.2	715.9	66.7	32.5	681.7	569.0	92.3	23.8	500.5
13	359.2	119.7	5%	12.0	251.4	681.7	66.7	30.7	645.7	500.5	95.1	20.3	425.7
14	251.4	125.7	5%	6.3	132.0	645.7	66.7	29.0	608.0	425.7	97.9	16.4	344.2
15	132.0	132.0	5%	0.0		608.0	66.7	27.1	568.4	344.2	100.8	12.2	255.6
16						568.4	66.7	25.1	526.9	255.6	103.9	7.6	159.3
17						526.9	66.7	23.0	483.2	159.3	107.0	2.6	54.9
18						483.2	66.7	20.8	437.4	54.9	110.2	-2.8	- 58.0
19						437.4	66.7	18.5	389.2				
20						389.2	66.7	16.1	338.7				
21						338.7	66.7	13.6	285.6				
22						285.6	66.7	10.9	229.9				
23						229.9	66.7	8.2	171.4				
24						171.4	66.7	5.2	110.0				
25						110.0	67.7	2.1	44.4				
26						44.4	68.7	-1.2	- 25.5				

Source: Gadbury Group Limited

Appendix 3: Volatility

The following looks at the impact of volatility in a defined contribution system.

As noted above, models of pension systems assume consistent annual rates of return over long periods. However, investment returns, even if predictable and matching expectations, are not consistent year-on-year, let alone month-on-month, and this volatility can have a significant effect.

Figure 13,[40] for example, illustrates the position of a member of Hong Kong's Mandatory Provident Fund system investing in what has become the most popular category for inflows, a Hong Kong equity fund.

The Mandatory Provident Fund system requires a monthly mandatory contribution by employer (5% of the monthly wage up to HK$20,000 [about US$2,580]) and employee (5% of the monthly wage between HK$5,000 and HK$20,000). The choice of product is made by the employer and the employee is free to choose from a range of investment choices within that product. (For interest, HK$20,000 compares with a median wage of some HK$11,000.)

The 10-year return to December 2010 from the example fund, the Fidelity Retirement Hong Kong Equity Fund, was 146.4%, equivalent to a compound annual return of 9.5%. The actual annual returns were as follows:

2001	-18.1%
2002	-16.3%
2003	36.3%
2004	17.8%
2005	8.5%
2006	36.4%
2007	54.5%
2008	-45.8%
2009	63.6%
2010	10.4%

The Mandatory Provident Fund member invests each month and the level of the particular investment fund that is chosen each time the contribution is received will determine the number of units acquired each month, the aggregate number of units then showing how much the savings are worth at any one time.

Although the long-term returns would appear to be reasonable, the yearly volatility would cause concern. The issue is further compounded by the fact that investors would have made monthly contributions at different levels, often referred to as dollar cost averaging. At an early stage, the impact of investing at different levels is high. At a later stage, an additional investment, no matter at what level, makes little difference to the average cost of units; the unit value becomes a more important factor.

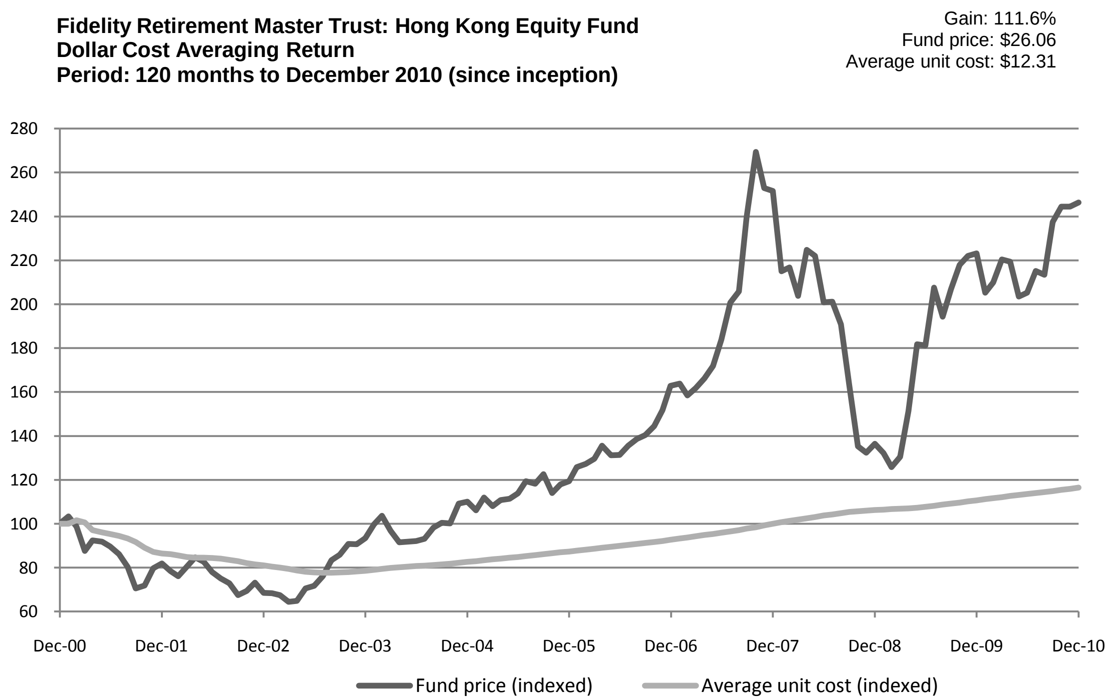
At this later stage, it will be seen that the volatility in the value of the fund would have affected the value of those savings considerably, even month by month. This would have had a

[40] All investment returns in this section source Gadbury Group Limited, Hong Kong.

significant effect on the value of savings of any retiree who was obliged, for example, to take his savings because he had attained a particular age no matter what the level of the market.

The following chart illustrates this. It looks at the cumulative impact of investing a consistent amount each month. Each contribution buys units of the example fund, the Fidelity Retirement Hong Kong Fund; the average cost of the units changes each month, with each contribution and the value of the units shown in blue, both starting at 100 on the left hand scale. Thus, when the first two years saw declining markets, the average cost of units declined, after which markets improved. This illustrates the benefits of dollar cost averaging in a declining market, assuming the level of the market would eventually recover.

Appendix 3. Figure 1: Illustrative returns from regular savings

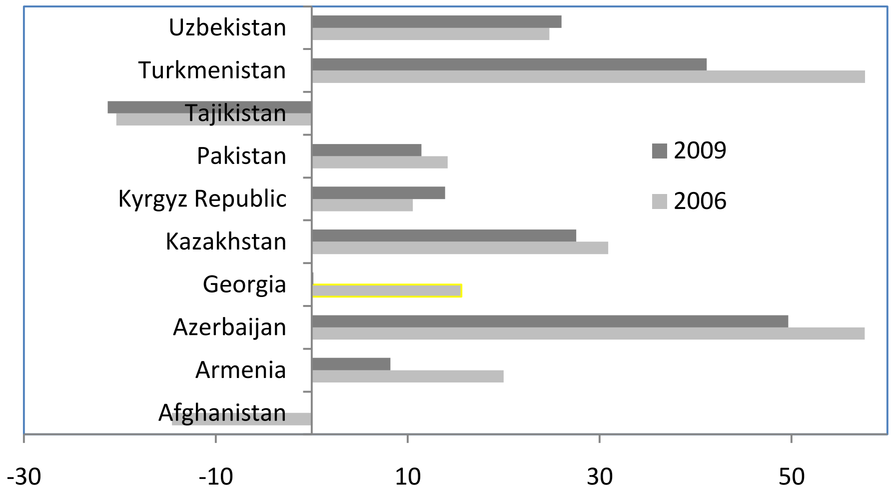


The impact, for example, of someone retiring in 2007 would contrast with someone retiring in 2009, with the latter-date retiree ending up with less than half of the former's balance. This coincidence of a retirement date and the level of markets could thus be either positive or negative and, unless anyone is prepared to guarantee a particular level of return, an unlikely occurrence, the member would be exposed to this volatility.

Appendix 4: Regional Comparisons

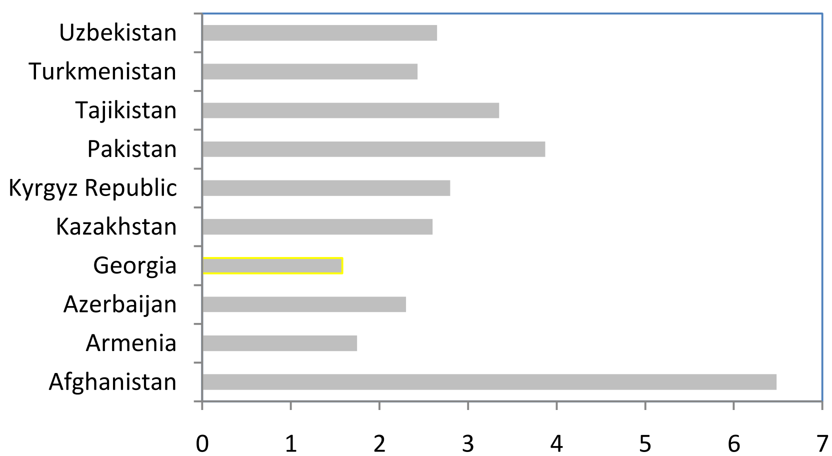
The following considers a number of regional comparisons on economic and demographic matters.

Appendix 4, Figure 1: Savings as % of GDP



Source: Development Indicators Data Base, World Bank, accessed May 2011

Appendix 4, Figure 2: Fertility Rate, Total (births per woman), 2009



Source: Development Indicators Data Base, World Bank, accessed August 2011

Appendix 4, Table 1: Life Expectancy at Birth

Country		2001	2002	2003	2004	2005	2006	2007	2008	2009
Afghanistan	male (% of total)	42.0	42.1	42.4	42.6	42.9	43.3	43.6	44.0	44.3
	female (% of total)	41.9	42.0	42.2	42.5	42.8	43.2	43.5	43.9	44.3
	total	41.9	42.1	42.3	42.6	42.9	43.2	43.6	43.9	44.3
Armenia	male (% of total)	68.2	68.6	69.0	69.3	69.6	69.9	70.1	70.4	70.6
	female (% of total)	74.9	75.3	75.7	76.0	76.3	76.5	76.7	76.9	77.1
	total	71.5	71.9	72.3	72.6	72.9	73.1	73.3	73.5	73.7
Azerbaijan	male (% of total)	64.5	65.2	65.8	66.3	66.8	67.2	67.6	67.9	68.2
	female (% of total)	70.7	71.0	71.3	71.6	71.8	72.1	72.3	72.6	72.8
	total	67.5	68.0	68.4	68.9	69.3	69.6	69.9	70.2	70.4
Georgia	male (% of total)	67.8	67.9	67.9	68.0	68.0	68.0	68.1	68.2	68.3
	female (% of total)	74.9	74.9	75.0	75.0	75.0	75.0	75.0	75.1	75.2
	total	71.3	71.3	71.4	71.4	71.4	71.4	71.5	71.5	71.7
Kazakhstan	male (% of total)	60.5	60.7	60.5	60.4	60.3	60.6	60.7	61.9	63.6
	female (% of total)	71.3	71.5	71.5	71.7	71.8	72.0	72.6	72.4	73.5
	total	65.8	66.0	65.9	65.9	65.9	66.2	66.5	67.0	68.4
Kyrgyz Republic	male (% of total)	65.0	64.4	64.5	64.3	64.2	63.5	63.2	63.0	62.5
	female (% of total)	72.6	72.0	72.2	72.2	71.9	72.1	72.0	72.0	72.1
	total	68.7	68.1	68.3	68.2	68.0	67.7	67.5	67.4	67.1
Pakistan	male (% of total)	63.9	64.2	64.6	64.9	65.2	65.6	65.9	66.2	66.5
	female (% of total)	64.7	65.0	65.3	65.6	65.9	66.2	66.5	66.9	67.2
	total	64.3	64.6	64.9	65.2	65.6	65.9	66.2	66.5	66.9
Tajikistan	male (% of total)	60.3	60.8	61.3	61.9	62.6	63.2	63.7	64.1	64.5
	female (% of total)	68.1	68.4	68.6	68.8	69.0	69.2	69.3	69.5	69.7
	total	64.1	64.5	64.9	65.3	65.7	66.1	66.4	66.7	67.0
Turkmenistan	male (% of total)	60.2	60.3	60.3	60.4	60.4	60.5	60.6	60.8	61.1
	female (% of total)	68.0	68.1	68.2	68.4	68.5	68.7	68.8	69.0	69.2
	total	64.0	64.1	64.2	64.3	64.4	64.5	64.6	64.8	65.0
Uzbekistan	male (% of total)	63.9	64.0	64.1	64.2	64.3	64.4	64.5	64.7	64.8
	female (% of total)	70.3	70.4	70.4	70.5	70.6	70.7	70.9	71.0	71.2
	total	67.0	67.1	67.2	67.3	67.4	67.5	67.6	67.8	67.9

Source: Development Indicators Data Base, World Bank, accessed May 2011

Appendix 5: Macroeconomic Data: Georgia

Appendix 5, Table 1. Georgia: Macroeconomic Indicators

Item	2007	2008	2009	2010	2011	2012	2013	2014	2015
Nominal GDP (millions of lari)	16,994	19,075	17,986	20,791	23,577	26,428	29,345	32,430	35,839
Real GDP annual change (%)	12.3	2.4	-3.8	6.4	5.5	5.3	5.0	5.0	5.0
Consumer price index (%)	11	10	1.7	7.1	11.6	7.2	6.0	5.8	5.5
General government (% of GDP)									
Annual change in revenue	…	30.7	29.3	28.2	28.5	26.5	26.3	26.1	26.1
Tax revenues	…	24.9	24.5	23.4	24.9	24.0	24.0	24.0	24.0
Current expenditures	…	28.5	30.1	26.0	24.1	23.0	22.7	22.2	22.2
Capital expenditures	…	8.6	8.4	8.8	8.0	6.7	6.5	5.9	5.6
Overall balance	…	(6.3)	(9.2)	(6.6)	(3.6)	(3.3)	(2.9)	(2.0)	(1.7)
Total public debt	22.3	27.6	37.3	39.1	36.8	37.6	37.0	35.5	34.8
Investment and saving (% of GDP)									
Investment and saving	25.7	21.5	15.3	15.0	16.5	17.0	17.5	18.0	18.0
Public	3.4	4.3	6.9	7.1	6.5	5.7	5.8	5.4	5.6
Private	22.3	17.2	8.5	7.9	10.0	11.3	11.7	12.6	12.4
Gross national saving	6.1	(1.1)	4.1	5.4	5.7	7.3	9.4	11.2	12.2
Public	4.2	2.2	(0.8)	2.2	4.4	3.4	3.6	3.9	3.9
Private	1.8	(3.4)	4.9	3.2	1.4	3.9	5.8	7.3	8.3
Saving and investment balance	(19.7)	(22.7)	(11.9)	(12.6)	(13.2)	(12.6)	(11.6)	(10.7)	(9.6)
External sector									
Exports of goods and services (% of GDP)	31.1	28.7	29.8	34.8	36.7	37.4	38.6	38.8	38.9
Imports of goods and services (% of GDP)	57.9	48.9	52.2	53.8	52.5	51.8	51.0	50.2	50.5
Gross international reserves (millions of $)	1361	1480	2110	2263	2795	2669	2669	2715	3005
FDI (% of GDP)	17.1	12.2	6.1	4.3	5.2	5.4	5.7	5.5	5.5

Source: International Monetary Fund. 2010, 2011a, 2011b.

Appendix 6: The Singapore Central Provident Fund

This paper contains a number of references to Singapore's Central Provident Fund, particularly in the matter of investing contributions. It suggests that part of the Singapore experience might be useful to Georgia. A full description of the Central Provident Fund can be found on its web pages.[41] The following offers a brief overview.

The Central Provident Fund was established in 1955 to provide financial security for workers in their retirement or when they were no longer able to work. Over the years, it has evolved into a comprehensive social security savings scheme that not only provides for members' retirement needs, but also housing, healthcare, and family protection needs. It is a mandatory defined contribution system, and applies to all Singapore citizens and permanent residents, including all in part-time, temporary, and full-time employment, and their employers. The self-employed are obliged to contribute to the healthcare element.

The Central Provident Fund is characterized by high contribution levels when compared with other mandatory systems. Contribution levels vary depending on the age of the member, for example, those aged below 35 will have employer contributions of 15% and employee contributions of 20% of the monthly wage, up to a maximum wage of S$4,500. Of the 35% contribution, 23% goes into the member's Ordinary Account, 5% into the Special Account, and 7% into the Medisave Account for this age group.

Aggregate contribution levels are the same for those up to 50, but the proportion going in to the Special and Medisave Accounts are slightly higher; those above 50 have lower contribution rates.

Balances in the Ordinary Account can be used to buy a house, investment, and other approved purposes, and later on for retirement purposes. Special Account balances are used for retirement, while Medisave Account balances are used for members' and their families' medical expenses. Housing purchases are allowed, subject to certain withdrawal limits and all related sales proceeds must be re-credited to the Ordinary Account. House purchase began in 1968 (Public Housing) and later through the Residential Property Scheme (1981). Some 90% of Singaporeans own their own properties, according to Central Provident Fund documents.

Central Provident Fund Savings currently earn a minimum government guaranteed return of 2.5% per annum. Ordinary Account savings earn market-related bank deposit interest rates, with a current government guaranteed minimum of 2.5%. At the time of writing, bank deposit rates were below 2.5%.

Special and Medisave Accounts earn a return pegged to a long-term bond rate, 4% at the time of writing, with an extra 1% return on the first HK$60,000 of aggregate accounts.

Members with balances above particular levels can choose to invest that excess into approved investment products, such as unit trusts, insurance products, and government-related bonds.

Members can draw balances at age 55 through a retirement account, subject to leaving minimum sums in this account and in the Medisave Account. At age 62, balances are paid as tax free sums, on a drawdown basis, until the balance has gone, lasting a maximum of some 20

[41] www.cpf.gov.sg

years, depending on the amount withdrawn. A new, optional lifetime annuity plan was introduced in September 2009 that will become mandatory in 2013.

Investment of Funds

Aside from the contributions going into special investments, contributions are used to purchase Special Singapore Government Securities, where the coupon is pegged to Central Provident Fund rates, either 2.5% or 4%.

Thus, the payment of benefits or withdrawals of any type are guaranteed by the Singapore Government. Up to a withdrawal, the government can use the funds for whatever purpose it chooses, mindful of the need for it to make an economic return on the contributions, although it is clear that, like any government, it has the option of raising taxes to pay its liabilities. Certified Provident Fund balances, the government's liability, amounted to SG$166.8 billion at the end of 2009, an increase of 10.2% over 2008.

Although Central Provident Fund contributions were not designated for particular purposes, they have helped Singapore to manage its government accounts, noting the predictability of inflows and outflows. It is widely accepted that the Central Provident Fund has been a key feature in the government's policy of developing Singapore's industrial base and establishing its major financial institutions.

About the Paper

This paper considers ways in which pensions and their reforms could impact the future economic development of Georgia. It describes the existing pension structure and how this could be built upon to develop a new structure that would both improve the financial position of the current and future elderly and provide a means to achieve broader economic growth. As such, it considers what might be viewed as the normal parameters: the country's demographics, the cost of pensions and their distribution, and how the present and evolving future structure might resemble the World Bank's multi-pillar approach. It also considers how pensions fit in with society and how an occupational savings system, such as pensions, can play a role in economic development, following a program of pension reform that goes beyond the normal quandary of how a country can afford pensions. It then makes recommendations for discussion on pension reform in Georgia and how it could achieve these goals.

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