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# DON'T FIX WHAT AIN'T BROKE – I

Policy Brief

Options for Kosovo

Reform of Pensions Systems in  
Transition Countries



An EU funded project managed by the  
European Union Office in Kosovo

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## EXECUTIVE SUMMARY

The Kosovar pension system shows several inconsistencies with regards to its various components. Whereas most inefficiencies are concentrated in special benefit schemes as well as family and disability pensions, the two old-age pension schemes that constitute the so-called zero pillar, i.e. the basic age and contributory pensions, are relatively less problematic.

A number of interventions are, however, desirable. This policy brief recommends a mixed strategy that simultaneously tackles the problems of eligibility, benefit design, taxation issues as well as administrative efficiency in a coherent and simultaneous way. The main recommendations are, hence, to:

### *Eligibility*

- **Introduce a pensionable age equal for the basic age and contributory systems that is linked to life expectancy** (automatically, rather than being revised periodically) in order to reduce fiscal outlays as the population ages.

### *Taxation issues*

- **Tax pension benefits as ordinary income through the Personal Income Tax** to increase equity and efficiency.
- **Do not discourage pensioners from working; hence, introduce a moderate claw-back rate based on an ex-post income test**, which eliminates most influence of the employment sector on the eligibility for pension benefits (only age, residence and the results of the income test matter).

### *Benefit structure*

- **Maintain the benefits at the current level** in order not to generate further negative effects with regards the labour supply and saving patterns.
- **Index pensions and other benefits consistently** to avoid *ad hoc* increases under governmental discretion.

*Administrative efficiency*

- **Strengthen the residence tests regarding both basic age and contributory pensions** to avoid non-residents unduly receiving a pension.
- **Create an integrated database of budget-financed cash transfers that enables the automatic exchange of data between the benefit database, the tax authority and the financial service providers** in order to reduce administrative costs and limit the possibility of retirees to receive mutually exclusive benefits.
- **Consolidate the executive capacity of existing agencies** without creating new ones in order to avoid costly duplication of administrative staff and tasks.

## INTRODUCTION

The policy brief on *Reform of Pensions Systems in Transition Countries: Options for Kosovo* has been written within the project Support to Social Dialogue in Kosovo through Capacity Building and Reorganization of Social Partners (Support to Social Partners - SPP), which is implemented by Iniciativa Kosovare për Stabilitet (IKS) in partnership with: Friedrich Ebert Stiftung (FES), Fundació Pau i Solidaritat (FPPS) Kosovo Center for Gender Studies (KCGS), Oda Ekonomike e Kosovës (OEK), Trade Union of Metal Workers, Trade Union of Energy and in association with UNIA Switzerland and Kosovo Business Alliance. This is a EU funded project, managed by the EU Office in Kosovo aimed at supporting Social Dialogue in Kosovo.

The aim of the project is, first, to provide the SSP and the Ministry of Labour and Social Welfare (MLSW) of Kosovo with a brief overview of sources, scope and coverage of material and non-material benefits related to old-age risk in various member states of the EU, including one or more Member States from Central, Eastern and South-Eastern Europe (CESE), both in terms of the applicable theoretical framework and practical management information on different old-age pension schemes.

Second, the project aims to outline the challenges as well as most common flaws and omissions in pension system reforms in the countries in transition. Bringing forward the lessons learnt from other countries' experiences might then prevent similar mistakes to be perpetuated in Kosovo.

Third, the policy brief has the objective to present a number of policy options for the MLSW and the Government of Kosovo with regards to the pension system reform, aiming therewith to improve the services and the capacity to cater to the needs of the elderly. The proposed opportunities for improvement, policy changes and relative impact of different courses of action is then complemented through the presentation of international good practices with a particular focus on the examples from those countries, policies and benefits that most suit the Kosovar situation.

To this end, the policy brief is structured as follows. Section 2 provides an overview of old-age security arrangements in the EU Member States with a

special focus on Central, Eastern and South-Eastern countries. Section 3 continues the overview but points the attention on the experience with basic pensions around the world, given their relevance for the Kosovar situation. Section 4 illustrates the challenges and omissions by policymakers in dealing with pension system reforms in transition economies, focussing on the role of poverty alleviation, implementation issues and neglect of existing problems. Section 5, first, sets the stage by giving a short description of both the Kosovar labour market and its basic age and contributory pension systems. After that, it enumerates and analyses the reform option for the MLSW and the Government for both changing the structure of the Kosovar zero pillar and for reducing the fiscal outlays on other inefficiencies related to it. Section 6 concludes with a list of policy recommendations.

## OLD-AGE SECURITY IN THE EU MEMBER STATES (AND BEYOND): AN OVERVIEW

Since the origins of modern pension systems, European countries display the widest variety of retirement arrangements worldwide. However, one can easily tell apart countries with a Bismarckian inspiration from those with a Beveridgean heritage. Even though most Central, Eastern and South-eastern European (CESE) post-socialist countries fall within the Bismarckian domain, these will be here treated separately due to their importance for this brief.

Apart from the general design, goals and inspiration of both Western and Eastern retirement arrangements, these have only relative relevance for the Kosovar situation, due to its peculiar nature. Hence, Section 3 will be dedicated to the wider, not only European experience of countries with basic, contributory and non-contributory pensions, which are more suitable for the present context.

### Western Europe

Starting with the original differentiation between Bismarckian and Beveridgean systems (see Bonoli, 2003), Table 1 summarizes the main traits of both.

Table 1 Bismarck versus Beveridge

	<b>Bismarck</b>	<b>Beveridge (original)</b>
<b>Coverage</b>	Occupational	Universal
<b>Eligibility</b>	Employment	Citizenship, residence, need
<b>Financing</b>	Social security contributions	General taxation
<b>Benefits</b>	Earnings-related	Flat-rate
<b>Social partners</b>	Involved	Uninvolved
<b>Public sector</b>	Full state provision	Limited state provision
<b>Private sector</b>	Pension funds developed late	Pension funds developed early

*Source:* Bonoli (2003)



There are stark differences in most aspects; however, the primary objective is income maintenance for those with an employment, insurance or contributory history in the Bismarckian case and universal poverty alleviation in the Beveridgean case. Originally European countries clustered as shown in Table 2.

Table 2 Country clusters

<b>Bismarckian clusters</b>	<b>Beveridgean clusters</b>
<b>Continental</b>	<b>Nordic</b>
Austria, Belgium, France, Germany, Netherlands (before '56)	Denmark, Finland, Norway, Sweden
<b>Southern</b>	<b>Anglo-Celtic</b>
Greece, Italy, Portugal, Spain	UK, Ireland
<b>Eastern</b>	<b>Mixed</b>
Bulgaria, Czechoslovakia, Hungary, Poland, Romania, Yugoslavia	Switzerland, Netherlands (after '56)

*Source:* Own classification

These original configurations paved the way to the further clustering of countries into single- and multi-pillar countries. At the most abstract level, Bismarckian countries remained committed to large, publicly administered PAYG systems. Finland, Norway and Sweden, have created a public-private mix that is mandatory for all the employed on top of the Beveridgean basic pensions. The other Beveridgean countries rely on a multi-pillar structure, where occupational and individual pensions are voluntary (in Ireland and the UK) or quasi-mandatory (in Denmark, the Netherlands and in Switzerland), leading to coverage problems in the Anglo-Celtic cluster.

Since the 1990s, most Bismarckian countries had to cope with conditions of permanent austerity and they consequently moved from welfare state expansion to retrenchment coupled with deregulation-*cum*-privatization of social policy (Pierson, 2001; Leibfried, 2010). The pattern was surprisingly similar across the board: the labour shedding through early retirement in the late 1970s and early 1980s in response to mass unemployment had to be first refinanced through higher contribution rates and deficit spending, which

became rapidly unsustainable. Then it was the turn of retrenchment through higher retirement ages, a closer link between contributions and benefits and lower indexation, also in response to the future membership of the Economic and Monetary Union (EMU) (see Hennessy, 2014). Consequently, supplementary pension pillars have started to expand in order to compensate for less generous public pensions. Hence, a convergent trend towards multi-pillarization is thus clearly visible and is likely to advance in future decades.

The global financial crisis and ensuing great recession, within the context of the fiscal consolidation through the European Semester policy cycle has prompted further retrenchment in several Member States, including linking the statutory retirement age to life expectancy, reducing disability and early retirement venues, and integrating special into general pension schemes. The 2015 Ageing Report (SPC and DG EMPL, 2015) is the first one to declare that the EU as a whole will see its pension spending decline and not raise after 2037, when the baby boomers fully retire.

## Central, Eastern and South-Eastern Europe

Socialist countries had, due to explicit policy choices, so-called pre-mature welfare states (Kornai, 1992) with generosity and coverage rates much higher than their level of development - the rates of elderly coverage in these countries currently surpass the expected values based on GDP per capita by as much as 26 percentage points (Forteza, Lucchetti and Pallares-Miralles, 2009: 33-34).

According to Inglot (2008), socialist welfare state consisted of three layers under exclusive governmental control: i) a Bismarckian core consisting of employment as legal basis of retirement and social protection and, thus of universalism through the extension of the constitutionally guaranteed right to work; ii) post-war socialist social solidarity, which relied on a PAYG system for financing, where coverage was gradually expanded to farmers and the few small entrepreneurs, but which also espoused reinforced stratification (favours to jobs fit for the advancement of socialism); iii) imported Stalinist centralization, resulting in a monolithic public administration.

With the economic crisis of late socialism, pensions were not spared. Financial strains started to mount already in the 1980s due to excessive generosity

resulting from low retirement age and long assimilated periods (e.g. maternity leave), benefits calculated according to best- and/or last-years defined-benefit (DB) formulae and the cross-subsidization of other budget expenditures (e.g. social assistance). At the same time, many pensioners experienced poverty in old age, due to insufficient indexation.

During the transformation, the crisis accelerated, helped by a mounting demographic emergency (for Kosovo, see Table 15), unemployment, informalization of the economy and early retirement as a consequence of the transformational recession, resulting in the so-called ‘great abnormal pensioner booms’ (Tables 16-18 in the Annex) (Vanhuysse, 2006), as well as the administrative difficulties of tracing multiple contributors, raising revenues during a period of output decline and fighting tax evasion.

Remarkably, the reform patterns were very similar in CESE countries to their Western Bismarckian counterparts. Looking at four countries (Croatia, Hungary, Poland and Slovenia) the growing mismatch between the number of pensioners and contributors simultaneously led to lower revenues and higher spending (Table 3).

Table 3 Insured and pensioners (1990-2000)

1990-2000	Croatia	Hungary	Poland	Slovenia
<b>Insured</b>	-30%	-25%	-15%	-10%
<b>Pensioners</b>	+55%	+21%	+38%	+26%

Source: Guardiancich (2013)

Persistent pension deficits had to be refinanced through injections of taxpayers’ money and increased contributions. These amounted to up to 6% of GDP in Croatia and Poland, 4% in Slovenia and a more manageable 0.5% in Hungary. A rapid increase in social security contributions followed (Table 4).

Table 4 Contribution rates and years

<b>Croatia</b>	1991	18.5%	1992-3	22%	1994	27%
<b>Poland</b>	1981	25%	1987-9	38%	1990	45%
<b>Slovenia</b>	1990	22.7%	1991-2	28.8%	1993-5	31%

*Source: Guardiancich (2013)*

Refinancing was soon discontinued due to international competitiveness concerns and substituted by more or less covert retrenchment, mainly through lower indexation. Constitutional Courts struck such practice down in several cases arguing that after the initial recessions no exceptional circumstances existed any longer.

Hence, proper restructuring of CESE pension systems started only during the second reform wave in the mid-to-late 1990s and after that. It consisted in tighter contribution-benefit links in the traditional publicly administered PAYG systems, which switched to either German-inspired point systems (e.g. in Croatia, Romania, Slovakia, Serbia, Ukraine) or Swedish-inspired Notional Defined Contribution (NDC) designs (Latvia, Poland, Russia).

Additionally, most countries, with the notable exception of the Czech Republic, Slovenia, Serbia etc. followed the advice of the World Bank and introduced variations on mandatory fully-funded privately managed pillars or tiers (Table 5).<sup>1</sup> Despite its peculiarities, Kosovo has basically introduced a substitutive private pillar, the Kosovo Pensions Savings Trust (KPST), where both employees and employers contribute between 5-15% of gross salaries each.

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<sup>1</sup> So-called pension privatization, i.e. the introduction of a mandatory funded pillar, could be substitutive (the PAYG system closing down, e.g. in Chile, Kazakhstan), mixed (a portion of the PAYG system was maintained, in most countries), or parallel (the old PAYG and the new mixed system work simultaneously, e.g. in Colombia, Lithuania).

Table 5 World Bank's second pillars in CESE

	<b>Year of 2<sup>nd</sup> pillar</b>	<b>Type of privatization</b>	<b>Contributions (% of gross wages)</b>	<b>Compulsory membership</b>
<b>Bulgaria</b>	2002	mixed	2-5% by 2007	born in 1960 or after
<b>Croatia</b>	2002	mixed	5%	born in 1962 or after
<b>Estonia</b>	2002	mixed	6%	born in 1983 or after
<b>Hungary</b>	1998	mixed	initially 6%, 8% by 2004	labour market entrants
<b>Latvia</b>	2001	mixed	initially 2%, 10% by 2010	born after 1 July 1971
<b>Lithuania</b>	2004	parallel	initially 2.5%, 5.5% by 2007	none (fully voluntary)
<b>Poland</b>	1999	mixed	7.3%	born in 1969 or after
<b>Romania</b>	2008	mixed	initially 2%, 6% by 2016	born in 1973 or after
<b>Russia</b>	2002	mixed	6%	born in 1967 or after
<b>Slovakia</b>	2005	mixed	8%	labour market entrants

Source: Naczyk and Domonkos (2015)

Finally, the great recession has brought not only similar retrenchment to CESE countries as it happened in Western Europe but also the temporary or permanent abandonment of the funded private elements and a full or partial return to the PAYG pillar only.

## WORLDWIDE EXPERIENCE WITH BASIC PENSIONS

Given Kosovo's status as a lower-middle income country, according to the World Bank, as well as its idiosyncratic pension-related problems (see Section 5.2), begs for a different approach to its pension system than in the rest of Europe. Hence, this section of the policy brief inspects the role and functioning of basic pensions in a wider context, thereby presenting the World Bank's views, the pros and cons of targeting versus universalism, and an overview of worldwide basic pensions.

### The World Bank's View

In its seminal contribution *Averting the Old-Age Crisis*, the World Bank (1994) advocates a basic pension, the so-called Pillar 1, which can take any of six forms under two different financing mechanisms (Table 6).

Table 6 World Bank's basic pension types

<b>Contributory</b>	<b>Non-Contributory</b>
1. flat-rate pension	3. universal non-means-tested pension
2. minimum pension guarantee	4. residence-based pension
	5. recovery-conditioned pension (ex-post means test)
	6. social assistance pension (ex-ante means test)

Source: World Bank (1994)

After reviewing its policies, in a later contribution, the World Bank's new zero or basic pillar rules out contributory basic pensions, because they: "*cannot cover everyone, especially the lifetime poor, those with incomplete employment history, and workers in the informal sector who may stay outside the formal sector*" (Holzmann and Hinz, 2005: 95), if not at an excessively high administrative cost. Universal non-means-tested pensions have many advantages over schemes that deny basic pensions to those with too high an income, too many assets, too short an employment record, or an inadequate

record of contributions. They are “probably the best way to provide poverty relief to the elderly. Considering the difficulty of identifying who among the elderly is poor, the principal merit of the program is that its universality avoids the targeting issue” (Holzmann and Hinz, 2005: 95).

## Universalism versus targeting

There are several advantages in both approaches and there is no clear-cut distinction of whether one is superior to the other as this is contingent on several factors, including the targeted population. Table 7 shows in a succinct way the pros and cons of universalism and targeting vis-à-vis the various functions performed. Even though most of these differences are well rehearsed, it is worth commenting on few of them.

Table 7 Pros and cons of universalism versus targeting

	<b>Universalism</b>	<b>Targeting</b>
<b>Eligibility</b>	Entire population	Targeted group
– Vertical leakages	Yes (depends on the at-risk-of-poverty rate of elderly people)	Few
– Horizontal leakages	Few	Yes (depends on strictness/effectiveness of targeting)
<b>Overall costs</b>	Medium to high	Low to medium
– Administrative costs	Low	Medium to high (depending on complexity of targeting)
– Fiscal costs	High (depending on share of the population covered and generosity)	Low to medium (depending on means testing and generosity)
<b>Demand-side problems</b>	Few (ignorance if active engagement is needed, fraud)	Several (ignorance, inertia, stigma, fraud)

<b>Supply-side problems</b>	Few (corruption)	Several (administrative complexity, abuse of power, corruption)
<b>Political support</b>	Medium to high (too much redistribution may be resented)	Low to medium (if leading to unemployment/poverty traps; can give rise to 'ghetto services')
<b>Effectiveness for poverty alleviation</b>	Low to high (entirely depends on the resources distributed)	Medium to high (may target higher benefits, can be offset by poverty traps)
— Moral hazard	None (in the pure form)	Low to medium (depending on the strictness of the means test)
— Poverty traps	None (in the pure form)	Low to high (depending on the rate of taper/implicit tax rate)

Sources: Barr (2012); Gugushvili and Hirsch (2014)

There is no agreement with regards to the connection between targeting and redistribution. Whereas, in a seminal article, Korpi and Palme (1998: 661) wrote that *“the more we target benefits at the poor [...], the less likely we are to reduce poverty”*, later studies challenged this view. Marx, Salanauskaitė and Verbist (2013) replicated Korpi and Palme’s work and found out that (ibid: 42): *“targeting tends to be associated with higher levels of redistributive impact, especially when overall effort in terms of spending is high.”* There are several reasons for arriving at such diametrically opposite conclusions; however, it is worth mentioning that the authors find differences between dissimilar types of transfer provisions.

With regards to individual policies, at least three factors play a role: i) the design of the policy (eligibility; income or categorical selectivity; conditions for calculating the size of the transfer); ii) the distribution of social, economic and demographic characteristics that determine eligibility and size of the transfer; iii) the ranking of beneficiaries in the income distribution (depending on the measured income distribution).

For this policy brief, the design of the policy and the socioeconomic aspects of the targeted population matter the most. It is very well possible that a universal old-age pension system may be characterized as highly targeted if the elderly disproportionately cluster at lower levels of the income



distribution. Hence, it is not a given that a universal pension has much greater problems of vertical efficiency (assisting only or mainly the poor) than targeted systems, while, in principle, eliminating problems of horizontal efficiency (covering all the poor) (see Barr and Diamond, 2009; Barr, 2012).

As regards the costs, this is of course the universal benefits' Achilles heel. If the universal benefit is set at an excessively high level, especially under significant budget constraints, it raises issues of opportunity cost. Children are also likely to be poor, so what is the best allocation of resources? At the same time, if the benefit is too low and spread too thin, the poverty alleviation function is compromised. Against this backdrop, the administrative costs of universal systems are low, compared to targeting. However, technical innovations even under conditions of low administrative capacity are promising (see Sluchynsky, 2009). Notwithstanding, there are other issues both with the demand and the supply side of the equation. The administration can be complex, abusive of power, and/or corrupt. At the same time, targeting exacerbates demand side problems such as stigma placed on the claimant, her ignorance in bureaucratic matters and so on.

With regards to voters' attitudes, Korpi and Palme (1993) argued that the relative size of the electorates benefiting from and paying for redistributive measures mattered, thereby reducing the political support for targeted systems. This view has also been challenged, but should be brought into context. Some targeted systems, particularly means-tested ones, were less politically robust and prone to spending cuts, because they entailed strong work disincentives. Rather than catering to a small part of the electorate and being neglected by politicians, means-tested systems today are no longer exclusively aimed at people not in work, but also at those in work in low-paid jobs. Hence, they enjoy greater public support.

This brings us to the final point of the comparison. Targeting, and especially means testing has several behavioural disadvantages (Barr and Diamond, 2008). If the rate of taper (the implicit tax rate) is 100%, then the system leads to moral hazard problems (the beneficiary does not save for old age) and triggers inactivity and poverty traps, especially if the object of the test is family income (low incentive to work in the household). In the latter case, targeting may even create disincentives for family formation. Hence, if

targeting is unavoidable, forms other than means or income testing are preferable (see Section 5.3).

## Basic Pensions Around the World

There is a small but growing literature covering basic pensions worldwide. Holzmann and Guven (2009) and Rofman, Apella and Vezza (2015) cover respectively Central Eastern and South-Eastern European as well as Latin American countries. Barrientos (2009), Asher (2009) and Pearson and Whitehouse (2009) respectively survey basic pensions in, respectively, low-, medium- and high-income countries.

This policy brief will follow Willmore (2007), who classifies basic pensions according to their eligibility requirements. This approach suits Kosovo's peculiar system (see Section 5.2). The country has in fact adopted a mixed zero pillar, which includes a (quasi) contributory flat-rate component (the contributory pension) and a universal non-means-tested pension with a *sui generis* residence requirement (the basic age pension).

## Contributory pensions: flat-rate and minimum pension guarantees

Only few, mainly Beveridgean countries have public contributory pension schemes that contain a flat component, which consists of benefits related to the number of contributions rather than to their amount. This is the case of the UK and Ireland, where benefits are flat as they depend solely on the number of weeks of contributions, even though contributions are a percentage of covered wages (Willmore, 2007: 27-28). Redistribution here is substantial, but people outside the formal labour force or those not insured (unpaid caregivers, people on leave from work etc.) neither contribute nor are eligible to benefits, if not explicitly granted by the law. Often, flat-rate pensions of this type are financed through PAYG contributions, but this is not necessarily the case.

The Kosovar contributory pension (for details, see Section 5.2) is indeed a flat-rate contributory system as it depends on the years of contributions only and

not on the amounts contributed (some reforms are underway though). Of course, given Kosovo's idiosyncrasies it is tax financed, and due to evident gaps in coverage it is underpinned by the universal and non-means-tested basic age pension, and rightly so.

Minimum pension guarantees are often present in pension systems that are based on mandated personal accounts. It is a promise, implicit in a PAYG system that once minimum contributory requirements are fulfilled, the retirement benefit cannot fall under a certain threshold. They differ from flat-rate schemes, as they are inserted into DB systems that disburse earnings-related benefits. They can be regressive: when they are financed from government revenues they tend to benefit the relatively better off (who participate in contributory pension schemes) rather than the poor (who often do not).

Minimum pension guarantees can be combined with other types of basic pensions. In Poland, for example, on top of social assistance pensions, pensioners who contributed for at least 25 years (men) and 20 years (women) and whose total pension falls below a certain threshold, the difference is topped-up from the state budget (Holzmann and Guven, 2009: 23).

### Non-contributory pensions: social assistance, residence-based, recovery-conditioned and universal non-means-tested

The complexity, variety and little information available on non-contributory basic pensions around the world implies warrants only a cursory look at the topic, with some greater insights into the situation in CESE countries.

Social assistance pensions are the most common and come in a variety of formats. They all present to a smaller or greater extent the efficiency and equity problems delineated in Table 7, most notably administratively-intensive procedures, large errors of inclusion and exclusion, disincentives to work or save.

Willmore (2007) individuates three distinct approaches to means testing: loose targeting designed to exclude the affluent rather than restrict payments to those in poverty (South Africa); provision of non-contributory pensions only to those certified as living in poverty (Costa Rica); tight targeting of benefits to those living in extreme poverty (US, India).

In post-socialist transition countries, see Table 19 in the Annex, social assistance as a broader non-contributory program available to everyone, regardless of age, was introduced to guarantee a minimum income level. Such means-tested programs were necessary because only certain categories (such as the disabled) were eligible for social assistance under central planning, as everyone else had the constitutional right to work and hence to a pension benefit afterwards. With the transition to a market economy this 'privilege' disappeared (Holzmann and Guven, 2009: 22).

Only three countries have opted for social pensions targeted exclusively at older people, on top of social assistance, which apply a less intrusive means test and offer higher benefits: Bulgaria, Hungary and Slovenia.<sup>2</sup> In Bulgaria, social pensions are provided to persons aged 70 and above who are not collecting an old age or disability pension. Eligibility is based on average income per family member. The allowance is means tested and is adjusted in value such that the beneficiary's total income reaches the minimum threshold (roughly 18% of the average wage). In Hungary, eligibility is limited to persons age 62 and above who can demonstrate that their total income falls below 80% (95% for couples) of the minimum old age pension. In Slovenia, eligibility is limited to persons age 65 and above who have lived for at least 30 years in the country and who do not qualify for an old age pension. Benefits are equal to one-third of the minimum pension assessment base.

The countries that apply residence-based and recovery-conditioned pensions almost entirely overlap. These are the Scandinavian five (Denmark, Finland, Iceland, Norway and Sweden) plus Canada. The two exceptions are the Netherlands, which has a residence-based pension without recovery; and the UK, which applies a recovery-based pension without residence requirements. Focusing on the overlapping cases, all these countries are obviously from the

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<sup>2</sup>

The details refer to the mid-2000s.

Beveridgean cluster, which are quasi-contributory, as each year of residence in the respective country counts towards a portion of the full benefit.

Most of these countries require 40 years of residence (50 in the Netherlands) in an adult's life to qualify for a full pension, any missing year reducing the overall benefit. Usually there is a minimum 3-year residency requirement to qualify for a partial pension. The retirement age varies. Denmark linked the statutory retirement age to life expectancy in 2011, paving the way for policy diffusion in the EU. In less developed countries there are few or no examples of residence-based pensions as the administrative burden is substantial, but the advantages elusive (Willmore, 2007: 35).

As mentioned above, these countries recover benefits from affluent retirees (claw-back) and tax pensions as normal personal income, which is fair on equity grounds. Recovery is an ex-post means test: each beneficiary of a universal pension is also required to return part of it out of other income earned during the year. The implicit tax rate can be anywhere between 0% and 100%, increasing disincentives to work and save as it rises. In general, recovery-based pensions mimic a normal income tax system, which is more effective, less costly, and less demanding on the public administration than ex-ante means testing of social assistance schemes.

Finally, as for universal non-means-tested pensions, apart from Kosovo, seven countries (Botswana, Brunei, Mauritius, Namibia, Nepal, New Zealand, Samoa) and Mexico City provided retirement benefits without any additional test above and beyond age, residence and citizenship. Australia offered a similar benefit between 1973 and 1978. Bolivia expanded its 'Dignity Income' in 2008 and Trinidad and Tobago introduced its 'Senior Citizens' Grant' in 2010 (Rofman, Apella and Veza, 2015). No other transition post-socialist country has a universal non-means-tested pension and New Zealand is the only high-income country in the sample.

As for eligibility requirements, the qualifying age varies significantly, ranging from 60 in Brunei, Mauritius and Namibia to 75 in Nepal (which severely limits beneficiaries and fiscal costs). Kosovo is the only country where current residency is the only additional requirement. In the other countries, the prospective beneficiary has to demonstrate to either have resided for a number of years, to be a citizen or both.

Regarding the population covered, the Kosovar basic age pension has slightly expanded (with fluctuation) in the past few years, covering circa 7.4% of the population in 2015 (see Table 11). This is relatively high in international comparison. In the mid-2000s, only New Zealand (12.0%) and Mauritius (9.2%) registered more beneficiaries. Nepal recorded the lowest number: 1.1%.

In terms of generosity, the Kosovar basic age pension has been often depicted as the most generous universal non-means-tested system in the world in terms of per capita GDP. According to Palacios and Sluchynsky (2006) benefits total 45% of per capita GDP, towering over all other middle- and low-income countries, which is much higher than the recommended and non-distortionary 15-20% and the real-world average of 18%. However, the data refer to the early days of the program. Being the benefit adjusted *ad hoc* and not indexed systematically (either to prices, wages or GDP), its value has fluctuated substantially, between 20% and 29% of per capita GDP, thereby not distancing itself excessively from the recommended values (see Table 11).

With regards to administrative costs, Sluchynsky (2009) notes that Kosovo’s plan, despite being the least expensive program per member in absolute terms, is relatively inefficient when costs are adjusted for income, as shown in Table 8.

Table 8 Administrative costs of selected social pension programs

	Year	Cost as % of transfers	Cost per beneficiary (USD)	Cost per beneficiary as % of GDP
<b>Botswana</b>	1999	4.5	15	0.4
<b>Kosovo</b>	2006	1.5	9	0.6
<b>Mauritius</b>	1999	2.5	17	0.5
<b>Namibia</b>	1999	15.0	51	2.5
<b>New Zealand</b>	2006	0.5	48	0.2

Source: Sluchynsky (2009: 210)

That is surprising, given that operationally it is the simplest program program:  
i) it pays a flat benefit to a group with the least eligibility requirements; ii) identification mechanisms are simple (in 2002, policymakers decided to use the civil register identification as the sole and sufficient proof of identity, age, and residence); iii) disbursement of all payments happens in an automated centralized process (the combination of easy-to-read bank coverage maps, joint account options, and complementary mobile bank services proved to be a success).

## PENSION SYSTEM REFORMS IN TRANSITION ECONOMIES: CHALLENGES AND OMISSIONS

In their seminal book, Barr and Diamond (2008) enumerated some of the most common blunders by policymakers in transition economies when reforming their pension systems. In general it is possible to individuate three broad areas, where problems have arisen despite being foreseeable and no timely or satisfactory intervention happened: i) inadequate attention to poverty relief, leading to persisting gaps in coverage and insufficient future benefits for vast portions of the population; ii) insufficient emphasis on implementation, generating low internal coherence of the system and suboptimal administrative capacity; iii) failure to address acknowledged problems, where a delay in tackling the unsustainable trajectory of a pension system increases the size of the change required later.

Many of these problematics have been highlighted by the World Bank's Independent Evaluation Group (World Bank, 2006) while assessing the implementation of the institution's multi-pillarization policy, launched in the mid-1990s. In a rather similar vein, the 2016 IMF's assessment of the challenges befalling the Kosovar broader social security system (Feher, Jirasavetakul and Jousten, 2016) shows clearly that some common mistakes have not been avoided and that they require immediate correction.

### Inadequate Attention to Poverty Relief

Regarding the neglect of the core objective of poverty alleviation and other distributional consequences, international organizations, such as the World Bank and, more recently, the European Commission, have focussed excessively on fiscal sustainability (World Bank, 2006; Barr and Diamond, 2008; Guardiancich and Guidi, 2016).

This creates two major sets of problems. First, in middle and lower-middle income countries there arises the need to focus more on the pension prevention pillar due to large gaps in coverage. In Latin America, many of the promises carried by multi-pillarization did not come true. In particular,



coverage levels did not improve (as was supposed to happen as contributions became more tightly bound up with benefits). On the contrary, they fell as a result of increasing labour informality (Cetrángolo, Bertranou and Casanova, 2015). Consequently, many of these systems have undergone a re-reform (Mesa-Lago, 2014).

The situation in post-socialist CESE countries is different, as coverage levels were higher than warranted by their stage of development. However, during the transition to a market economy, as mentioned in Section 2.2, coverage of the working population has fallen and this is likely to affect the elderly in the future, especially as CESE countries have opted for contributory schemes, where poverty alleviation is mainly delegated to social assistance systems that are prone to leakages.

As regards pension benefit adequacy in broader terms, this is an ancillary problem with respect to poverty alleviation. In post-socialist countries, a number of reforms tightly linking contributions to benefits might generate problems of poverty among prospective retirees. As Barr (2012) indicates, if the only endogenous variable by which the system is adjusted to changing circumstances (e.g. life expectancy, employment growth or productivity growth) is the pension benefit, then at its limit it reduces the entitlement of all beneficiaries to the minimum pension. Currently this seems to be the case of Latvia. There, overall old-age pension spending is bound to decline for an already low 7.7 per cent of GDP to 4.6 per cent by 2060 with severe repercussions on the poverty rates of pensioners (SPC and DG EMPL, 2015).

Given the peculiar characteristics of the Kosovar labour market and pension system (see Sections 5.1 and 5.2), the coverage problem here did not arise as a consequence of the introduction of the universal non-means-tested pension, which is – at least on paper – still relatively generous (see Table 11). Rather, the problems concerning poverty alleviation in Kosovo are of a different nature. Feher, Jirasavetakul and Jousten (2016: 6-7) point out the inconsistencies in the system's design, which lead to the overprotection of certain risks and categories at the expense of others: i) the coverage of the social assistance scheme and the level of benefits are inadequate; ii) the lack of an overarching social policy vision leads to similar risks being treated differently by various schemes; iii) certain risks remain uncovered while other risks (notably, longevity) are addressed by multiple schemes with benefits

accessible in parallel; iv) regulations are often inconsistent, presenting contradictory provisions.

## Insufficient Emphasis on Implementation

Several implementation problems gravitate around the introduction of mandatory funded pillars (administrative capacity, shallow financial markets etc.), thereby applying to Kosovo as well. This policy brief is less concerned about the private than the public pension system in Kosovo. Hence, both the administrative capacity of the public sector as well as the political aspects of implementation are more important.

The former proved egregiously insufficient in several developing countries; e.g. in Bolivia both civil records were so poor as to spur widespread abuse, and the public administration unprepared to pay out benefits in remote areas of the country (Barr and Diamond, 2008: 209). The politics of implementation have been exploited in the post-socialist region through, for example, the continuous tinkering with details of the system before each election in Hungary and the excessive expansion in coverage and generosity of pension benefits for war veterans in Croatia (Guardiancich, 2013).

Kosovo has not been at all immune from severe problems during implementation. With regards to administrative capacity, Feher, Jirasvetakul and Jousten (2016: 6-7) decry that there are no efficient controls over benefit claims by Kosovar citizens residing abroad, leading to widespread abuse. With regards to political exploitation (and future sustainability problems), expenditures on war-related and other special benefits payable to working age people take up an incommensurate portion of social transfers.

## Failure to Address Acknowledged Problems

A golden rule of all pension reforms is not to postpone addressing problems that are being apparent, because the bill may become unsustainable in the near future, as, for example, happened in Slovenia after a mild parametric reform of the PAYG system failed due to a referendum in 2011.

Moreover, the problems in design do not affect the pension system by itself, but affect the economy as a whole. In Kosovo, a few problems in this regard have been identified. First, a series of inefficient retirement incentives generate inactivity and poverty traps: i) social protection leans heavily towards permanent, instead of temporary benefits, thereby discouraging employment; ii) eligibility rules discourage labor supply and increase benefit-dependence.

Second, the previously mentioned imbalances in the system have long-term fiscal repercussions. In fact, Feher, Jirasavetakul and Jousten (2016) note that the gradual expansion of noncontributory earnings-related pensions (both the abuse of the basic and contributory systems as well as veterans' benefits) generate unfunded pension liabilities, implies perverse redistribution and may pave the way for the overhaul of the current pension system.

# POLICY OPTIONS FOR THE MINISTRY OF LABOUR AND SOCIAL WELFARE AND THE GOVERNMENT OF KOSOVO

Focusing on the zero pillar, the Government of Kosovo has basically three options, that is: i) change the way the zero pillar is organized, leading to various modifications in the eligibility of the beneficiaries; ii) maintain the zero pillar's current structure and eligibility, but increasing its future fiscal sustainability in light of demographic ageing; iii) a combination of both.

In order to understand the challenges ahead, a brief description of the current Kosovar labour market and pension system follow.

## The Kosovar Labour Market

There are several sound reasons why Kosovo adopted a multi-pillar pension reform, which is underscored by a universal non-means-tested pension. Starting with the labour market, Table 9 provides some basic indicators.

Table 9 Labour market indicators for Kosovo (2012-14)

	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>Activity rate total (20-64)</b>	42.5	46.4	47.7
<b>Activity rate men (20-64)</b>	64.3	69.5	71.4
<b>Activity rate women (20-64)</b>	20.3	23.7	24.2
<b>Employment rate total (20-64)</b>	29.7	33.0	31.3
<b>Employment rate men (20-64)</b>	46.6	51.5	48.4
<b>Employment rate women (20-64)</b>	12.4	14.9	14.5
<b>Unemployment rate total</b>	30.9	30.0	35.3
<b>Unemployment rate men</b>	28.1	26.9	41.6
<b>Unemployment rate women</b>	40.0	38.8	33.1
<b>Unemployment rate total (&lt;25)</b>	55.3	55.9	61.0
<b>Unemployment rate men (&lt;25)</b>	52.0	50.4	56.2
<b>Unemployment rate women (&lt;25)</b>	63.8	68.4	71.7

Source: Eurostat

The figures neatly show that despite some improvements, labour market conditions in Kosovo were in 2014 very far from the European averages.<sup>3</sup> This means that *de facto* there are few regular contributors to the social security system and that the probability of generating contributory gaps is high.

The magnitude of the phenomenon increases when own-account, domestic, unpaid family workers are included in the picture. According to Eurostat, the self-employed (including both own-account workers and employers) plus family workers totalled 31.8% of all employed persons in Kosovo (ages 15-64) in 2014 – signalling an increasing trend. The three groups usually display worse employment quality indicators than wage earners (lower wages, lack of social security coverage and non-registration in labour and fiscal records).

These labour market characteristics testify to a large informal economy, which provides the means for self-subsistence to the population involved, but limits the access to formal types of social insurance and reduces government revenues. Krasniqi and Topxhiu (2012) indicate several reasons for the large levels of informality.

First, the demographic composition of the population is anomalous in the European context. According to the 2011 census (KAS, 2013), over 47% of the population was younger than 25, leading to an estimated 35 thousand new job seekers each year, which the labour market cannot absorb. Hence, in the late 2000s, social security did not cover up to 67% of adult and 73% of young workers.

Second, the characteristics of transition economies that apply to Eastern Europe (the rapid transformation into a market economy and low salaries in the formal economy) are in Kosovo compounded with the effects of the ethnic conflict of the late 1990s. The country's informal economy, estimated at 27-35% of GDP in 2004-2006, is in line with the rest of South-East Europe,

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<sup>3</sup> According to Eurostat, for 2014, the active population for the cohorts aged 20-64 was 76.9% in the EU-28, ranging from 86.0% in Sweden to 68.4% in Italy; and the employment rate for the same age group was 69.2%, ranging from 80.0% in Sweden to 53.3% in Greece. As for unemployment, variation was greater: the EU-28 average was 10.2% in 2014, ranging from 6.6% in Denmark to 26.5% in Greece; and youth unemployment was 22.2%, ranging from 15.0% in Estonia to 53.2% in Spain.

larger than in the Visegrád countries and Slovenia, but smaller in comparison to the former Soviet Republics (Schneider, Buehn and Montenegro, 2010: 24).

Finally, and a further complication, Kosovo witnessed large-scale outflows of working-age people due to the conflict in the late 1990s and economic difficulties. So remittances and visits by members of the diaspora support families, seasonally boost consumption, but at the same time make it difficult to identify households in need and distort the structure of fiscal revenues (Feher, Jirasavetakul and Jousten, 2016).

## The Kosovar Pension System

As indicated by Gubbels, Snelbecker and Zezulin (2007: 11-13), there were three specific problems relative to the Yugoslav pension system and the conflict that complicated matters.

First, during the conflict, the Serbian authorities stopped paying benefits to ethnic Albanians and, before that, in 1989, many were excluded from the system and removed from formal-sector labour positions. Second, the coverage of the Yugoslav PAYG system was low as roughly 50% of the population over 65 did not receive any benefits. Third, during the NATO intervention, a cruise missile and the ensuing fire partly destroyed most contributory records of working age Kosovars.

The current pension system consists of seven schemes, implying that their fragmentation has been rising in recent years – a trend that is contrary to the European Semester’s recommendations and developments in EU Member States (Guardiancich and Guidi, 2016), which tend to unify most pension levels and rules. Table 10 gives a succinct description.

Table 10 Basic features of Kosovar old-age and disability pension schemes

Scheme	Target group	Age	Earnings tested	Pension tested	Benefit type and amount
<b>Basic age pension</b>	All	65+	No	Yes	Flat (€75/month)
<b>Contributory pension</b>	Beneficiaries based on law from before 1999	65+	No	Yes	Education-linked (€158-240/month)
<b>Disability pension</b>	100% disability	<65	Yes (categorical)	Yes	Flat (€75/month)
<b>Work disability pension</b>	Work accident or professional disease	<65	Yes (categorical)	Yes	Flat (€75/month)
<b>Family pension</b>	Beneficiaries based on law from before 1999 or family of work disabled	Spouse <65	Yes (categorical)	Yes	Flat (€50/month + 20% per eligible child)
<b>Trepca early pension</b>	Involuntarily unemployed; >50% disability	50-64	Yes (categorical)	Yes	Flat (€105/month)
<b>KPST</b>	All	65+	No	No	Phased withdrawal (min €150/month) or annuity

Source: Feher, Jirasavetakul and Jousten (2016: 32)

Of interest here are the two old-age pension schemes that constitute, together, the Kosovar zero pillar. The basic age pension is a tax-financed universal flat benefit, covering all citizens aged 65 and over, who do not qualify for other budget-financed schemes and who are residents of Kosovo. This equates to the World Bank's universal non-means-tested pension as shown in Table 6.

Table 11 Basic and contributory pension indicators

Year	Basic age pensions				Contributory pensions			
	No. retirees	Monthly rate	% of per capita GDP	Annual budget (mio €)	No. retirees	Monthly rate	% of per capita GDP	Annual budget (mio €)
2008	138,847	€40	21.3%	65.641	27,774	€75	39.9%	11.287
2009	130,347	€45	23.2%	73.604	22,883	€80	41.2%	12.104
2010	109,585	€45	21.8%	63.641	30,641	€80	38.7%	30.900
2011	107,145	€45	20.2%	61.192	32,415	€80	35.9%	31.670
2012	113,043	€50	21.4%	69.204	34,722	€101	43.3%	42.038
2013	117,042	€60	24.5%	87.340	36,015	€112	45.8%	49.413
2014	125,883	€75	29.2%	na	38,651	€140	54.5%	na
2015	132,000	€75	27.6%	na	40,365	€140	51.6%	na

Source: KAS (2016)

Individuals have to report at an office designated by the Ministry at least every six months (with exceptions) to qualify for continuous benefit receipt. The Ministry of Labour and Social Welfare administer the plan. Between its inception in 2002 and the end of 2015, the scheme has expanded both in terms of the flat sum disbursed, which increased from 28 to 75 EUR/month, and in terms of beneficiaries, which climbed (with fluctuations) from 93 to 132 thousand (see Loxha, 2012; Feher, Jirasavetakul and Jousten, 2016; KAS, 2016).

Until 2015, the Ministry of Finance annually determined the pension benefit, based on the minimum Consumption Food Basket. Indexation was unsystematic and conditional on the sufficiency of funds from the budget. With the 2014 Law on Pension Schemes Financed by the State, the Finance Minister is still in charge and again determines the amount depending on the budget and the inflation rate. The cost of the program in 2015 was a bit less than 2.1% of Kosovar GDP, that is, circa 11% of total Government's expenditures and circa 40% of all expenditures on social contributions and benefits (Table 12).



Table 12 Selected national and government accounts

	2008	2009	2010	2011	2012	2013	2014	2015
<b>GDP mio €</b>	3,882.8	4,069.6	4,402.0	4,814.5	5,058.7	5,326.6	5,567.5	5,771.5
<b>GDP 2008=100</b>	100.0	104.8	113.4	124.0	130.3	137.2	143.4	148.6
<b>GDP per capita</b>	2,258	2,329	2,480	2,672	2,799	2,935	3,084	3,258
<b>Govt rev. mio €</b>	959.9	1,142.4	1,139.0	1,311.3	1,383.4	1,355.7	1,349.5	1,706.1
<b>- as % of GDP</b>	24.7	28.1	25.9	27.2	27.3	25.5	24.2	29.6
<b>Govt exp. mio €</b>	957.6	1,138.0	1,220.0	1,362.7	1,445.0	1,490.2	1,512.1	1,612.3
<b>- as % of GDP</b>	24.7	28.0	27.7	28.3	28.6	28.0	27.2	27.9
<b>Social C&amp;B mio €</b>	137.9	156.1	171.8	176.3	198.5	228.7	282.1	306.9
<b>- as % of GDP</b>	3.6	3.8	3.9	3.7	3.9	4.3	5.1	5.3
<b>- as % of govt exp.</b>	14.4	13.7	14.1	12.9	13.7	15.3	18.7	19.0

Source: KAS (2016)

The contributory pension is budget-financed and targeted to citizens aged 65 and over with at least at least 15 years of contributions prior to 1999 into the social security scheme of Yugoslavia. The contributory pension basically equates to a contributory flat-rate scheme, as indicated in Table 6, although it is slowly evolving into a DB scheme of sorts.

Here as well, both the amounts disbursed as well as the number of beneficiaries increased over time. In 2008 it amounted to a top-up of 35 EUR/month over the basic pension disbursed to circa 28 thousand beneficiaries. In 2015, the over 40 thousand eligible individuals were entitled to a flat benefit of EUR 140, with the same residence and administrative procedures in place as for the basic pension. The total budgetary cost, hence, amounted to almost 1.2% of GDP.

In 2014, there have been several changes to the contributory pension. First, various non-contributory periods count towards eligibility, such as years of work in the parallel (informal) health, education and other sectors in Kosovo between 1989 and 1999. Second, all eligible beneficiaries are granted an extra 25 years of notional earnings history, rewarded with a 0.5% benefit increase per service year added, that is, in total 12.5%. This means that the total benefit increased from 140 to 158 EUR/month as of January 2016 with an estimated cost of EUR 8.7 million in 2016, i.e. slightly less than 0.2% of GDP. Third, there will be some benefit differentiation according to the individual beneficiary's education attainment (to restore some of the lost earnings-related nature via a proxy). The IMF estimated that this could cost EUR 7.4 million, i.e. almost 0.15% of GDP.

As a final note, there is a noticeable gender imbalance in the claimants. Whereas women overwhelmingly take up basic pensions (65%), they represent only 12% of the people entitled to a contributory one, possibly due to short or inexistent contributory histories. A reform of the basic pillar will hence affect women overwhelmingly.

## Changing the Zero Pillar

The most obvious way of changing the basic age pension, whereby maintaining its necessary non-contributory character would be to introduce an eligibility test above and beyond the current ones (age and residence) and keep the administration either independent from other programs or integrated into general social assistance. Table 13 shows the pros and cons of the two approaches.

Table 13 Independent targeting versus integration into general social assistance

Principal advantages	Principal disadvantages
<b>Targeted social pensions</b>	
— Reduction in fiscal cost	— Targeting system required

<ul style="list-style-type: none"> <li>– Potential for reduced horizontal inequity with other groups</li> <li>– Political support can be higher than for universalism</li> </ul>	<ul style="list-style-type: none"> <li>– Incentive, administrative, efficiency and equity problems relative to each targeting type (see Table 14)</li> </ul>
<b>Inclusion of elderly in poverty-targeted general social assistance program</b>	
<ul style="list-style-type: none"> <li>– Minimization of administrative costs, duplication of functions avoided</li> <li>– Issues of one group being more worthy of support than another avoided</li> <li>– Social security administration able to stay service oriented rather than become gatekeepers</li> </ul>	<ul style="list-style-type: none"> <li>– Stigma possibly greater if support called social assistance rather than a pension</li> <li>– Receipt of family-based social assistance not suited to empowering the elderly within the household the way receipt of an individual specific pension might</li> <li>– Political support for social assistance often less than political support for pensions</li> </ul>

*Source: Grosh and Leite (2009: 163)*

In fiscal, administrative and efficiency considerations it is advisable not to create a specific agency to run pensions but rather ‘piggyback’ on existing administrative structures. There is a clear tendency in several countries to centralize and automatize social security procedures and communication. For example, in Latin America, only Paraguay is reported to have an independent directory in charge of non-contributory pensions. All the others either manage them through the institutions responsible for the rest of the (contributory) pension system or for social assistance (Rofman, Apella and Vezza, 2015: 30-31).

Currently basic pensions are tested only against residence and age requirements, whereas for contributory pensions a proven record of insurance is required. Even though there have been significant advances in targeting in the past decades, especially in proxy targeting - Table 14 shows the pros and cons of each method – this policy brief advises against a further ex-ante income test above and beyond testing against other pension benefits.

Table 14 The pros and cons of targeting methods

Principal advantages	Principal disadvantages
<b>By age</b>	
<ul style="list-style-type: none"> <li>— Administratively simple</li> <li>— High age threshold, such as 75 or 80, can limit numbers substantially</li> </ul>	<ul style="list-style-type: none"> <li>— Inaccurate; elderly are not always poor or the only poor</li> <li>— Because the poor die younger on average, high age thresholds redistribute to the well off</li> </ul>
<b>By household structure (only elderly, or elderly and children in ‘missing generation’ households)</b>	
<ul style="list-style-type: none"> <li>— Household structure easier to observe than income</li> <li>— Limits benefits substantially because may constitute only 1–2 percent of all households</li> </ul>	<ul style="list-style-type: none"> <li>— Inaccurate; many elderly living alone are those who can afford to</li> <li>— Worrisome incentive for families to have their elderly live alone</li> </ul>
<b>Community-based methods (determination of need by local officials or committees)</b>	
<ul style="list-style-type: none"> <li>— In most such schemes, elderly often included as a priority group</li> <li>— Relatively little administration needed</li> </ul>	<ul style="list-style-type: none"> <li>— Possible costs to community cohesion not well understood</li> <li>— Accuracy not well known</li> </ul>
<b>Means testing</b>	
<ul style="list-style-type: none"> <li>— Usually the most accurate</li> <li>— Relies on an excellent measure of household welfare</li> </ul>	<ul style="list-style-type: none"> <li>— Requires developed administration</li> <li>— Welfare hard to verify by the authorities</li> <li>— May discourage work</li> </ul>
<b>Proxy means testing</b>	
<ul style="list-style-type: none"> <li>— Usually provides fairly good individual-level targeting of program</li> <li>— Based on poverty status using a relatively small amount of information</li> </ul>	<ul style="list-style-type: none"> <li>— Requires the most developed administration</li> <li>— Requires staff with computer training skills and moderate to high levels of IT</li> <li>— Formula can be insensitive to quick</li> </ul>

changes in household welfare or disposable income

— Sensitive to selection of variables

*Source: Grosh and Leite (2009: 165)*

There are at least three reasons for advising against an ex-ante income test for basic pensions. First, the experience with social assistance in Kosovo<sup>4</sup> is deemed to be relatively positive in terms of efficiency, but there are several horizontal leakages, e.g. poor children are excluded (Roelen and Gassmann, 2011). That several elderly fall off the scheme is to be expected if the basic age pension becomes general income tested, an occurrence that might have severe consequences on individual well-being. In a natural reverse experiment, Jencen and Richter (2004) found out that during the 1996 crisis, as various Russian households lost their entitlement to a public pension, the probability of men dying for all causes within the next two years increased by 5%, even though several households were able to replace 20% on average of the lost income through working longer, selling assets and borrowing.

Second, there are relatively few fiscal gains to be achieved through this intervention. In fact, strengthening both the residence test and the overall coherence of the pension system is likely to improve financial sustainability more. Moreover, the required administrative capacity to manage such new targeted system is substantial, because means testing is in Kosovo problematic due to economic informality and large inflows of remittances, and the operating costs are likely to partly offset the prospective savings.

Third, if testing against other pension income is sensible, general income and other means testing creates inactivity and poverty traps. The likely consequences are to severely limit the possibility for people aged 65 and over to engage in gainful employment and self-employment as well as create tangible disincentives for younger, lower income workers to save or formalize their employment status.

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4 Social assistance benefits in Kosovo are targeted towards poor families on the basis of a hybrid form of targeting, including categorical targeting, a proxy-means (asset) and means (income) test.

## Reducing Fiscal Outlays for The Zero Pillar

Willmore (2007: 35) enumerates four major ways of reducing the costs while preserving the universality of a pension system: i) set up an investment fund as tax-smoothing device; ii) tax the universal basic pension as ordinary income; iii) reduce the population eligible for the benefit (higher age of eligibility); iv) reduce the ratio of the pension benefit to per capita GDP (lower generosity). Of course, the underlying fifth way is to: v) increase the administrative efficiency and cost-effectiveness of the scheme. Understandably options (i) and (ii) are more suitable for high-income countries, while options (iii), (iv) and especially (v) have high potential of success in low- and middle-income ones. This policy brief will explore options (ii) to (v).

### Taxing universal basic (and other types of) pensions

As universal basic pensions are financed from general revenue, a way of ensuring both vertical equity and fiscal sustainability is to have a progressive Personal Income Tax (PIT) that applies to pensions as well. In this case pensioners contribute themselves to lowering the costs of the universal pension, with wealthier pensioners paying a proportionally higher share of the burden. This method is successfully implemented in all Nordic countries and in New Zealand, but is not always applicable to lower- and middle-income countries, where the objective is poverty alleviation and administrative capacity is low.

In Kosovo, all social transfers are exempted from PIT. However, as Feher, Jirasavetakul and Jousten (2016: 30) suggest, these should be both subject to income tax and health benefits – to be compensated by the state to the neediest recipients. This has the advantage to treat all sources of income in the same way (no distortionary effects on the labour market, thereby reducing the inactivity and poverty traps mentioned above), share the burden of social security between all generations, improve vertical and horizontal equity. Of course, such taxation would primarily apply to recipients of contributory pensions.

Moreover, people engaged in dependent employment or self-employment who are also recipients of social security benefits should be allowed to continue working but at the same time be subject to a moderate rate of taper (the partial claw back of pension benefits as their income rises). This would mean that the whole benefit structure be turned into a recovery-conditioned pension system, where an ex-post means test is performed through the tax administration.

### Increase the pensionable age

One of the ways, indicated by most experts (see Barr, 2012; Barr and Diamond, 2008) as the most effective in containing costs and at the same time increasing the adequacy of benefits is raising the statutory retirement age.

Focussing on universal basic pensions, there are obvious trade-offs to be considered in relation to age targeting, as shown in Table 14. The advantages are maintaining the system’s administrative simplicity and the possibility to adequately target the number of recipients. The disadvantages are vertical leakages (benefits flow to people who are not poor), the crowding out of funds that may otherwise flow to other groups at risk of poverty (e.g. children) and that too high thresholds are regressive, as the poor die younger than the rich.

Given that Kosovo’s population is the youngest in Europe, the current age of 65 is currently sustainable, but is not suitable for the future. In fact, rapid ageing (also a result of sustained working-age population migration), which can be clearly evinced from Table 15, might pose a challenge in the medium- and longer-term.

Table 15 Aged as % of total population (1980, 2015, 2050)

Year	Age group	World	More developed	Less developed	Least developed	Kosovo
1980	+65	5.8	11.7	4.0	3.1	-
2015	+65	8.3	17.6	6.4	3.6	8.0
2050	+65	16.0	26.5	14.4	6.6	22.8

<b>1980</b>	+70	3.5	7.6	2.2	1.6	-
<b>2015</b>	+70	5.3	12.3	3.9	2.1	5.2
<b>2050</b>	+70	11.4	20.5	10.0	4.1	16.8
<b>1980</b>	+75	1.9	4.2	1.1	0.7	-
<b>2015</b>	+75	3.3	8.2	2.2	1.1	3.0
<b>2050</b>	+75	7.6	15.0	6.5	2.3	11.1

*Sources:* United Nations (2015); KAS (2013).

*Notes:* The projections for Kosovo refer to the years 2016 and 2051. All projections are based to either the UN or KAS medium variants. The UN divisions into more, less and least developed countries apply.

Hence, a sensible solution, which may also help the labour market to gradually adapt, is to link the statutory retirement age to life expectancy. If this is done automatically, it also reduces the politicians' incentive to tinker with the system, as it may happen's when periodical reviews are necessary (see Schoyen and Stamati, 2013).

Moreover, such adaptation is in line with the European Semester's recommendations with regards to pension policy. The first Annual Growth Survey (European Commission, 2011) recommended several fiscal consolidation measures to be adopted in order to increase the sustainability, but at the same time also adequacy of national pension systems. Among these, the explicit recommendation thought up by the European Commission to link the statutory retirement age to life expectancy was based upon the pioneering reforms in Denmark. These have been followed by a host of EU Member States (SPC and DG EMPL, 2015).

As there is no silver bullet, beneficiaries have either accept to save more, receive lower benefits or work longer, thereby postponing retirement. Of the three, the latter option is the most palatable, provided that the labour markets are ready to brood into uncharted territory. In New Zealand, for example, the age of entitlement increased from 60 to 65 during a period of 10 years until 2001. This adjustment, together with lower indexation, led to a fall in the share of public pension spending from 8% to less than 5% of GDP.



## Reduce the pension benefit

As mentioned in Section 3.2.2, the Kosovar basic age pension was rather incorrectly categorized as the most generous in the world. To be fair, it still errs on the profligate side, but it is only slightly higher than the recommended 15-20% of per capita GDP. The recipients' general perception is that the benefit is modest compared to the cost of living in the young country.

As Feher, Jirasavetakul and Jousten (2016: 30) mention time and time again, it is not the basic age or contributory retirement systems that are problematic with regards to generosity. It is rather the host of other special pension schemes (e.g. the inequitable and costly war-related benefits), inefficient disability assessment procedures and unsystematic indexation of all benefits that should be addressed first.

Hence, an important part of the overall pension strategy is to subject all budget-financed benefits to systematic indexation and avoid *ad hoc* increases by decree.

## Increase the pension system's administrative efficiency

There are at least two interventions that may improve the efficiency of the Kosovar pension system.

First, even though the basic and contributory pension cannot be paid to the same person, the numbers do not add up. In fact, at the end of 2015, there were reportedly 172,365 recipients of basic (132,000) and contributory pensions (40,365) in Kosovo, against an estimated population aged 65 and above of circa 142 thousand. So there may be as many as 30 thousand people (more than 20 per cent of the cohort) who are unlawfully receiving principally the basic pension. The IMF adduces four possible causes: i) individuals claiming both basic and contributory benefits; ii) unreliable population estimates based on the 2011 census; iii) non-declaration of deaths; iv) flaws in the concept of residency, both for benefit eligibility and for the census.

In order to improve the situation, which may generate savings worth €8-10 million per year, residency requirements should be made stricter and more rigidly enforced, as it happens for social assistance. This would mean that the recipients of all types of old-age (and disability) pensions should present themselves more often to the designated government agencies, lest they trigger a suspension of benefit disbursement, and that retroactive collection of benefits should be limited.

Second, the administrative costs of the pension system should be reduced through a gradual integration of all social security payments, checks and tests with the tax administration as is the trend in many developing countries and established practice in all Scandinavia. In fact, the Kosovar pension system, despite its simplicity is not the most cost-efficient, as mentioned in Section 3.2.2.

Hence, a consolidated database of budget-financed cash transfers for individual and households as well as of recipients, through the introduction of, for example, a Danish-inspired Personal Identification Number (CPR-nummer) should be complemented by automated data exchange between the benefit database, the tax authority and financial service providers licensed to execute money transfers benefitting natural persons (Feher, Jirasavetakul and Jousten, 2016: 29). This will serve the double purpose of: i) reducing overall administrative costs; ii) severely limiting the possibility to individuals to receive several mutually incompatible benefits at the same time.

## CONCLUSIONS: A MIXED STRATEGY

The Kosovar pension system shows several inconsistencies with regards to its various components. Most complications, inefficiencies and budgetary overruns are concentrated in special benefit schemes, family and disability pensions. In comparative terms, the two old-age pension schemes – the basic age and contributory pensions – are relatively less problematic.

As shown throughout the policy brief, the best recommendation to achieve greater efficiency in the basic pension design, also in line with some of the latest findings of the World Bank (see Robalino and Holzmann, 2009: 18-19), is to adopt a mixed strategy that tackles the problem on several fronts.

### Eligibility:

- Introduce a pensionable age equal to the statutory age of the contributory system that is linked to life expectancy (automatically, rather than being revised periodically) in order to reduce fiscal outlays as the population ages.

### Taxation issues:

- Tax pension benefits as ordinary income through the PIT to increase equity and efficiency.
- Allow the recipients of pension benefits to continue working, but at the same time introduce a moderate claw-back rate based on an ex-post income test, thereby mostly eliminating any influence of the employment sector on the eligibility for pension benefits (only age, residence and the results of the income test).

### Benefit structure:

- Maintain the benefits at the current level in order not to generate further negative effects with regards the labour supply and saving patterns.
- Index pensions and other benefits consistently to avoid *ad hoc* increases under governmental discretion.

### Administrative efficiency:

- Strengthen the residence tests regarding both basic age and contributory pensions to avoid non-residents unduly receiving a pension.

- Reduce administrative costs and limit the possibility of retirees to receive mutually exclusive benefits by creating an integrated database of budget-financed cash transfers that enables the automatic exchange of data between the benefit database, the tax authority and the financial service providers.
- Consolidate the administrative capacity of existing agencies without unnecessarily duplicating staff and tasks.

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Table 16 Unemployment rates in CESE (1990-2000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
<b>CZ</b>	0,7	4,1	2,6	4,3	4,3	4,0	3,9	4,8	6,5	8,7	8,8
<b>HU</b>	1,4	8,2	9,3	11,9	10,7	10,2	9,9	8,7	7,8	7,0	6,4
<b>PL</b>	6,5	12,2	14,3	16,4	16,0	14,9	13,2	10,9	10,2	13,4	16,1
<b>SK</b>	1,2	9,5	10,4	14,4	13,6	13,1	11,3	11,8	12,5	16,2	18,6
<b>SI</b>	na	7,3	8,3	9,1	9,1	7,2	6,9	7,1	7,4	7,4	6,4
<b>BG</b>	1,6	10,5	15,0	16,3	18,6	13,7	13,0	14,5	16,0	17,0	16,4
<b>RO</b>	na	na	na	na	na	na	na	na	na	7,1	7,3
<b>EE</b>	0,6	1,5	3,7	6,6	7,6	9,7	10,0	9,6	9,8	12,2	13,6
<b>LV</b>	0,5	0,6	3,9	8,7	16,7	18,1	20,5	15,4	14,3	14,5	14,6
<b>LT</b>	na	0,3	1,3	4,4	3,8	17,5	16,4	14,1	13,2	14,6	16,4
<b>RU</b>	na	na	5,3	6,0	7,7	9,2	9,3	10,8	11,9	12,9	10,7
<b>UKR</b>	0,0	0,0	0,2	0,3	0,3	0,3	1,3	2,3	3,7	4,3	11,6

Source: European Bank for Reconstruction and Development

Table 17 Informal economy in CESE as % of GDP (1990-2000)

	1989	1990	1991	1992	1993	1994	1995
<b>CZ</b>	21.7	24.3	31.7	31.8	27.1	24.5	21.8
<b>HU</b>	24.6	25.6	31.1	33.2	33.6	31.4	29.6
<b>PL</b>	22.9	31.6	32.5	31.7	31.1	27.9	23.9
<b>SK</b>	21.7	24.3	32.0	32.0	34.1	32.0	28.4
<b>SI</b>	26.7	26.8	27.4	31.2	28.4	25.0	22.7

<b>BG</b>	23.3	28.9	33.7	34.1	34.0	35.9	34.0
<b>RO</b>	17.3	24.4	36.9	39.0	37.5	34.2	28.3
<b>EE</b>	16.9	22.0	32.0	37.4	38.4	38.1	35.8
<b>LV</b>	17.3	19.4	22.6	41.7	45.5	43.1	43.7
<b>LT</b>	17.0	21.0	31.7	47.4	52.2	47.6	46.0
<b>RU</b>	na	na	na	37.8	36.0	39.1	39.2
<b>UKR</b>	na	na	28.1	37.4	47.0	54.6	52.8

Source: European Bank for Reconstruction and Development

Table 18 Pensioner booms in CESE, thousands (1990-1999)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	%
<b>CZ</b>	na	na	na	2,521	2,519	2,523	2,498	2,507	2,545	2,537	0.6
<b>HU</b>	2,587	2,668	2,795	2,868	2,948	3,010	3,059	3,104	3,139	3,184	23.1
<b>PL</b>	5,598	6,154	6,505	6,703	6,873	7,036	7,172	7,313	7,466	7,524	34.4
<b>SK</b>	na	na	na	na	1,386	1,387	1,393	1,402	1,415	1,435	3.5
<b>SI</b>	na	419	449	458	458	460	463	468	472	476	13.6
<b>BG</b>	2,273	2,347	2,443	2,440	2,424	2,409	2,381	2,392	2,387	2,381	4.8
<b>RO</b>	2,570	3,018	3,201	3,253	3,439	3,600	3,740	3,875	4,020	4,181	62.7
<b>EE</b>	361	374	383	387	376	375	375	374	375	378	4.7
<b>LV</b>	610	648	661	665	663	666	662	664	660	653	7.0
<b>LT</b>	879	909	891	897	907	898	930	990	1,076	na	22.4
<b>RU</b>	32,848	34,044	35,273	36,100	36,623	37,083	37,827	38,184	38,410	38,381	16.8
<b>UKR</b>	na	13,100	13,600	14,200	14,500	14,500	14,488	14,487	14,535	14,520	10.8

Source: National statistical agencies

Table 19 Basic pensions in nine CESE countries (circa 2006)

Country	Benefit	Coverage	Eligibility	Benefit level	Indexation	Beneficiaries	Spending
<b>Bulgaria</b>	Social pensions	Persons over 70	Persons over 70 and not collecting a pension; average income per family member must be lower than the GMI for a full 12 month period	BGN 63 (17.75% of average wage)	50% inflation, 50% wage growth of the previous year	4,592 or 0.20% of total pensioners	NA
<b>Croatia</b>	GMI	Entire population	Persons with income below a guaranteed minimum income	Set as a percentage of the state-defined subsistence allowance	Ad hoc	2.7% of the population	0.22% of GDP
<b>Czech Republic</b>	GMI	Entire population	Persons with income below a guaranteed minimum income	CZK 3,126	Prices	4% of households	NA
<b>Hungary</b>	Old Age Allowance	Persons over 62	Persons over 62 with income below 80% of minimum old age pension	Supplements actual income to reach 80% of old age minimum pension	Based on old age minimum pension	6,679 beneficiaries (0.4% of population at	0.01% of GDP

						age 62 or above)	
<b>Poland</b>	GMI	Entire population	Persons with income below a guaranteed minimum income	Approximately 16% of average wage	Regular increases based on social assistance legislation	NA	NA
<b>Romania</b>	GMI	Entire population	Persons with income below a guaranteed minimum income	RON 92 (9% of average wage)	Based on the Consumer Price Index	834,000 beneficiaries	0.2% of GDP
<b>Serbia</b>	GMI	Entire population	Persons with income below a guaranteed minimum income	23% of average wage	Changes in cost of living	1% of households	0.14% of GDP
<b>Slovakia</b>	GMI	Entire population	Persons with income below a guaranteed minimum income	SKK 4,980 (approximately 27% of average wage)	Minimum subsistence level (close to CPI)	182,479 beneficiaries	0.45% of GDP
<b>Slovenia</b>	State Pension	Persons over 65	Persons above age of 65 who do not qualify for a pension from the first pillar pension scheme	33.3% of minimum pension assessment base	Growth of minimum pension assessment base	NA	NA

Source: Holzmann and Guven (2009)

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The Kosovar Stability Initiative (IKS) is an independent, not-for-profit think tank focusing on empirical research and analysis of socio-economic development in Kosovo. IKS was created in 2004 in recognition of the pressing need for independent, in-depth analysis of important issues involved in promoting stability and prosperity in Kosovo. Its innovative and policy-relevant research aims at initiating debates on important issues for Kosovo's future.

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