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MOLDOVA
Special Topic: Pension Reform

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- ***Moldova`s pension system pays inadequate benefits at a growing cost; it struggles with compliance, and provides weak incentives to contribute.***
- ***The current pension formula requires urgent measures to prevent continuous pension benefits` decline. In the medium to long run, the need for pension reform is reinforced by population aging which further intensifies pension system imbalances.***
- ***Reforms should focus on restoring social sustainably of the PAYG scheme before considering launching a mandatory fully-funded second pillar.***

Recent Trends and Challenges

A change in the Pay-As-You-Go (PAYG) pension formula in Moldova has reduced pensions relative to wages to one of the lowest levels in the region. The general level of pensions compared to wages is low: in 2013, the average old-age pension was about 28 percent of the gross wage, which is among the lowest gross replacement rate in the Europe and Central Asia (ECA) region. While in 1995 the pension formula yielded a gross replacement rate of 44.9 percent, the changes introduced in the formula in 1998 pushed the replacement rate down. After 1999, the salaries used to calculate the salary base in the pension benefit formula were not revalued (valorized) to account for the cumulative growth of average wage between when the salary was earned and the date of retirement. That reduced initial replacement rates and created differences between new and old pensions. Moreover, minimum pension policy strongly redistributes towards persons who work in agricultural sector at the expense of the insured individuals who pay average and above-average contributions. These policies compress the benefits structure, weaken the linkage between contributions and pension benefits and discourage contribution.

Low pensions create an incentive for contribution evasion, which in turn results in the pension system deficit. In 1999, pension outlays amounted to 4.4 percent of GDP and in 2014 they reached 7.5 percent of GDP. Over the same period, the number of contributors to the system shrunk by more than 40 percent. The contribution revenues fell short to cover growing pension costs, which opened a gap of 10 percent of social insurance expenditures covered by the state budget. Currently, just about 30 percent of the working-age population contribute to the system while almost all elderly receive pensions. The shrinking contributors' base, in combination with the high number of pensioners, drives the system-dependency ratio up. The ratio is projected to rise from the current 0.76 pensioners per 1 contributor to 1 pensioner per 1 contributor by 2020 because of ageing demographic pattern. The shrinking coverage has implications for poverty among the elderly and for future fiscal cost of social protection system.

Box: Selected Terminology

Average **replacement rate** shows a relation of average pension to average wage, expressed in percentage

System **dependency ratio** is defined as a ratio of pensioners and contributors

Accrual rate is part of pension benefit formula that accounts for certain percentage of a person`s past salary per year of contribution.

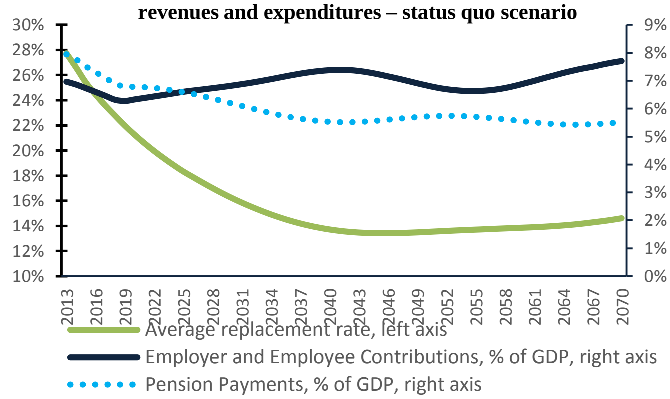
Valorization means that the salaries used to calculate the salary base in pension benefit formula are revalued to account for cumulative growth of average wage between when the salary was earned and the date of retirement.

The retirement age of 57 years for women and 62 for men is low by international standards. The relatively low life expectancy in Moldova was an argument to suspend increase in the retirement age in 2003. The life expectancy at birth in Moldova is indeed among the lowest in ECA. However, since 2006 the life expectancy at the retirement age has improved. In 2013, it stood at 15.7 years for men and 19.6 years for women similar to other transition economies in the region. Aiming to have life expectancy at retirement at about 15 years, the women's retirement age is currently too low and even men's needs to start gradually rising.

The preferential treatment of some groups through special pensions makes the system inequitable. The special pension beneficiaries such as civil servants, judges, prosecutors, members of the Government and Parliament and others account for 11 percent of the total number of old-age pensioners. The cost of such pensions is about 13 percent of the overall pension outlays. Despite recent amendments to converge special toward regular pensions, the number of such pension entitlements should be reduced further to lower their cost and improve equity.

In the absence of parametric reform and improved compliance, the pension system will converge to a quasi-flat pension system paying low benefits. The gap between people's earnings and their pensions will grow and the system will not be socially sustainable. The average replacement rate is projected to decrease steadily from 28 percent to almost 13 percent in 2047 (Figure 1). The declining replacement rates lead to falling share of PAYG expenditure in GDP. Due to the expected gradual decrease in the size of workforce, with real wages growing faster than real GDP, the share of the PAYG revenues as percentage of GDP is projected to be about the same, yielding surpluses after 2027.

Figure 1. Average gross replacement rate and PAYG revenues and expenditures – status quo scenario



Priorities for Pension Reform

A range of reforms is required to help address the above challenges. The immediate measure we recommend is to re-establish valorization of the past earnings in the pension formula along with lower accrual rate and adequate benefit indexation. Wage valorization of salary base and price indexation of pension benefits would improve the pension adequacy of new beneficiaries and maintain the real value of future pensions. This approach corresponds to international good practice because it preserves purchasing power of the elderly, furthers fiscal sustainability, and strengthens the link between contributions and benefits.

Benefit adequacy will only sustain in the longer run if the retirement age is increased. The retirement age in Moldova should gradually rise to equalize the age for women at 62 and then for both genders up to 65. Increasing the retirement age, in addition to previous measures, would improve replacement rates. As shown in the Figure 2, the replacement rate for retired women is lower than that of men. Higher retirement age would therefore improve women`s pensions. Importantly, it would strengthen fiscal sustainability of the pension system, as demonstrated in Figure 3, and would provide space for future reforms including the introduction of the fully-funded pensions (the so called second pillar).

Figure 2. Replacement rates, old age pension, male and female

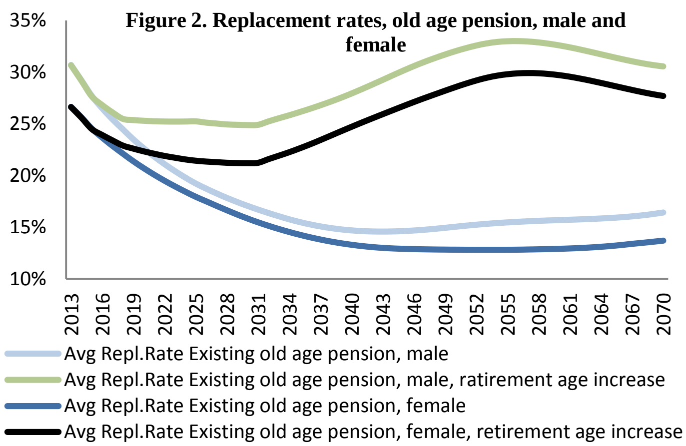
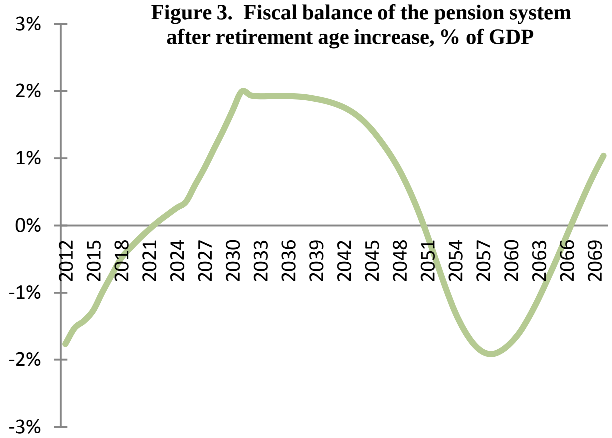


Figure 3. Fiscal balance of the pension system after retirement age increase, % of GDP



Second pillar pensions can serve as a potential strategy to maintain benefits adequacy; however, moving towards the second pillar before a country is ready contains serious risks. The risks include the potential for ballooning debt, diversion of funds due to corruption and inadequate rule of law, low rates of return because of weak financial markets. The transition costs of moving to second pillars are significant and long lasting. Therefore, a mandatory second pillar must draw on sustainable PAYG scheme. It requires functioning financial markets, including developed institutions and practices, adequate regulatory and supervision capacity, and a stable macroeconomic framework. None of these conditions has been fully met by Moldova. Given the imminent challenges and the need to develop conditions for introduction of funded pensions, the reform should begin with fixing the current system. The Government should also pursue policies aimed at higher participation in employment, reduced informality and better contribution compliance.

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