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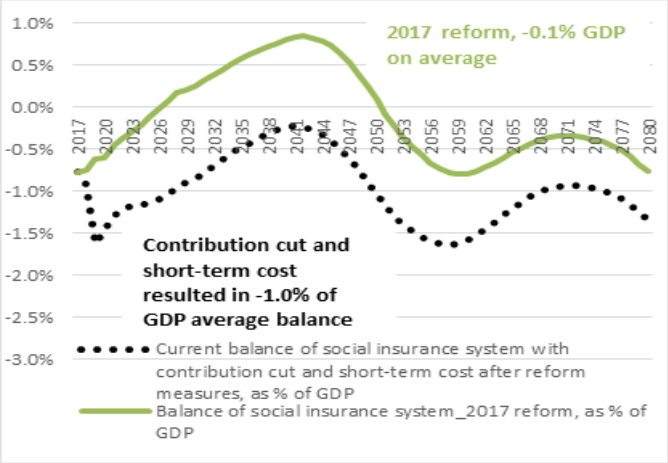
Fall 2019 MEU Special Focus Note: Unfinished Pension Reform

The 2017 pension reform strengthened fiscal and social sustainability of the pension system in Moldova; yet, the gains of this reform were not sustained for long. The reform was designed to: (i) ensure a fiscally sustainable pension system; (ii) improve adequacy of pension benefits; (iii) tighten the link between contributions and pensions and thus heighten incentives to contribute; and (iv) reduce inequities in the pension system. The reform was likely to bring the system to a fiscal balance (the average deficit of 0.05 percent GDP) for the period of 2017-80, and the average replacement rate, instead of slipping to 13 percent, was projected to rise to 30 percent. However, the subsequent policy reversals in 2018 undermined fiscal sustainability, while existence of privileged pensions still undermines the system equity.

The Fiscally Balanced System Eroded After 2018

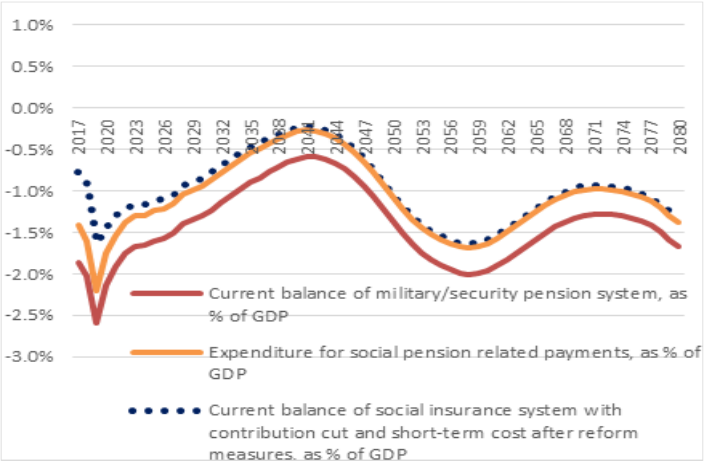
Several policies were reversed after the 2017 reform, among them acceleration of the valorization and recalculation of pensions for working pensioners' schedules, a 10 percent increase in social insurance pensions that were below the subsistence minimum, and a contribution cut. The last measure alone created a sizable, and permanent, pension system deficit of about 0.7 percent of GDP a year on average through 2080. Ad hoc measures led to an average deficit of 0.9 percent of GDP for the projection period (Figure 1). The system has also been burdened by additional spending financed from the state budget; these are "special" pensions—for military and security forces, socially privileged pensions, and Chernobyl and compulsory military pensions. There were also supplements to pensions and one-off top-ups to pensions paid in 2018–19. Taking all these measures into account, Moldova's pension system **deficit is on average 1.4 percent of GDP higher** through the simulated period, with a substantial dip in the short term (Figure 2). If the double indexation now being proposed by the authorities is adopted in its current form, its effect would amount to a real increase in pensions without any commensurate revenue increase, and the deficit would rise even further.

Figure 1. Pension System Deficit: 2017 and Beyond



Source: World Bank PROST Model for Moldova.

Figure 2. Pension System Deficit with Special Pensions



Source: World Bank PROST Model for Moldova.

The cut in contributions permanently undermined the sustainability of the system. The significant loss of revenues will not be compensated for by either wage growth or an increased number of contributors. The projections above incorporate the observable increase in wages and number of contributors to date, but further simulations looked at hypothetical scenarios of additional wage growth and a large enough increase in the number of contributors to fully offset revenue loss. Since higher wages would over time also accelerate the growth of pension spending, the offsetting impact would be reduced. The deficit in such a scenario would remain at 0.9 percent of GDP. The number of contributors would need to rise nearly six times to reduce the deficit to 0.6 percent of GDP.

There are several ways to make the system financially sustainable. Among them are reversing the contribution rate cut, a commensurate increase in the rate for individual social contributions, further increase in the retirement age, or a combination of these.[1] However, the first step would be to reduce exemptions from social contribution payments.

Exemptions from Social Contributions Erode Revenues and Social Sustainability

Currently, about eight categories of contributors, ranging from agricultural employees to attorneys-at-law, are paying subsidized or minimal contributions for social insurance. Yet family doctors, another self-employed category, are paying

[1] Restoring the rate of 23 percent for employers in 2020 would nearly eliminate the deficit (to 0.1 percent of GDP on average for the simulation period, with current assumptions about wage growth). Raising the rate for individual contributions from 6.0 to 9.3 percent would reduce the deficit nearly as much. To compensate for the deficit created, the retirement age would continue to rise after 2028 until the pension age for both men and women reaches 66. The scenario that is a combination of measures would raise the retirement age to 64 for both genders, increase the employers contribution by 1.5 pp to 19.5 percent and introduce a employee contribution ceiling up to 5 times the average wage.

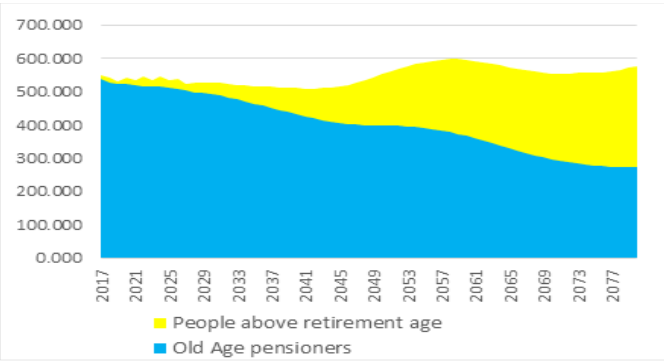
contributions on reported income. Assuming that exempt professions earn a wage at the level of the average wage, their effective social contribution rate would be 11 percent, compared to 24 percent for a person employed in the private sector (18 percent from the employer and 6 percent from the employee). As some exempt categories, such as lawyers, usually earn more than the average wage, their effective social contribution rate would be even lower. For categories contributing a fixed amount, this would mean restricted participation (no temporary disability, unemployment, or maternity benefits), and a limited old-age pension. Since 2009, moreover, the participation of groups like farmers has been voluntary. Although this category was difficult to administer and the contribution collection rate was very low (44 percent in 2008 compared to 93 percent for others), their massive exodus from the system in 2009 created even bigger problems (Table 1). These citizens do not qualify for an old-age pension because they cannot meet the minimum contributory period. Pension system simulations show that eventually almost half the people above retirement age would be ineligible for pensions (Figure 3). Thus, they would need to rely on the social assistance program Ajutor Social, which currently has only about 50,000 beneficiaries.

Table 1. Farmer Contributors to Social Insurance,2003–09

Year	Number of farmers registered
2003	332 408
2004	351 196
2005	304 265
2006	227 530
2007	191 773
2008	197 778
2009	3 024

Source: National Social Insurance.

Figure 3. People Past Retirement Age and Eligible for Old-age Pensions



Source: World Bank PROST Model for Moldova.

Eliminating exemptions would improve both pension system revenues and the social rights of currently exempt categories. If exempt categories were to contribute on par with the private sector (24 percent of the average wage in Moldova), that would add about 0.15 percent of GDP to the social insurance budget. Farmers, if brought back into the pension system, even with historical collection challenges and assuming incomes of 60 percent of the average wage, could bring in about 0.7 percent of GDP to the pension budget while becoming eligible for old-age pension in the future.

Privileged Pensions in Moldova Are Overly Generous and Expensive

Privileged pensions, such as those of the judiciary and military, create significant inequity. For judiciary pensions, although the number of such pensioners is very low (283), their benefits are 5.4 times higher than the general Pay-As-You-Go (PAYG) old-age pension (9,834 leu against 1,834 leu). Military pensions, the bulk of the privileged pensions (over 21,000), are on average 2.3 times higher than general PAYG pensions (the average military pension is 4,633 leu), and the military retire about 20 years earlier. In terms of the replacement rate, new pensioners are granted 60 percent of the average military wage, or 85 percent of the average wage, and for the simulation period the replacement rate for existing military pensions averages 39 percent of the average military wage, or 56 percent of the national average wage. This compares to the general PAYG retiree replacement rate of 30 percent for new and 26 percent for current pensioners of the national average wage.

Beneficiaries of military pensions on average retire at 43; the general male retirement age is 63. While it is usual for military service to have a lower retirement age, in NATO, CIS, and other comparable countries the difference is usually no more than 10 years. Also, for some type of professions (such as the border patrol, those working in penitentiaries) Moldova counts 1 year of service as 2 or 3, creating opportunities for very early retirement. Military and other security personnel are encouraged to serve longer by a 3 percent accrual per year of service beyond the minimum of 25 years, which further increases inequity. Finally, the military pension benefit is calculated based on the income of the last year of service, but in the PAYG system the average income of the whole contributory period is considered.

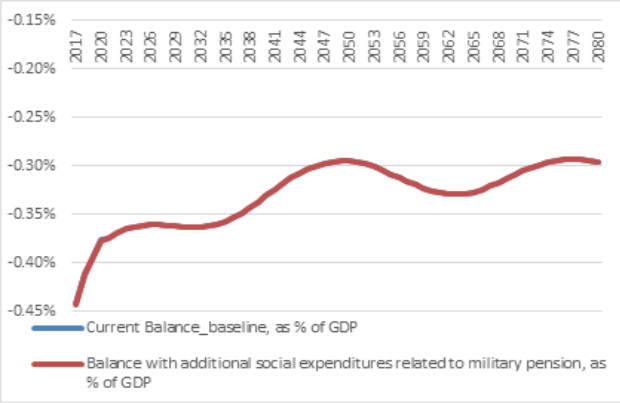
Because military pensioners comprise about 3 percent of regular pensioners but consume about 10 percent of pension spending, the cost per beneficiary is three times higher. Starting in 2017, military and security forces started to contribute to the mandatory social insurance system, but military pensions are fully financed from the state budget. Comparing what is collected from military contributions to what is paid for military pensions would produce a deficit of 0.33 percent of GDP on average through 2080 (Figure 4).

To reduce inequity and ensure fiscal sustainability, privileged pensions could be harmonized with the general PAYG system. For example, an increase of the minimum retirement age for privileged pensions to 46.5[2] years in 2020, and a 0.5 percent increase a year until the retirement age reaches 53—still 10 years lower than the general retirement age; removing the 3 percent incentive for service longer than the minimum; and gradually increasing the period of pensionable income for the

[2] Estimated based on 2017 average retirement age of 43 with 24.6 years of service, including 3 years on average not actually served but counted as 2 or 3 for every year served in special services. Thus, 25 calendar years of required service if introduced in 2020 plus 21.4 service entry age gives 46.4, rounded to 46.5.

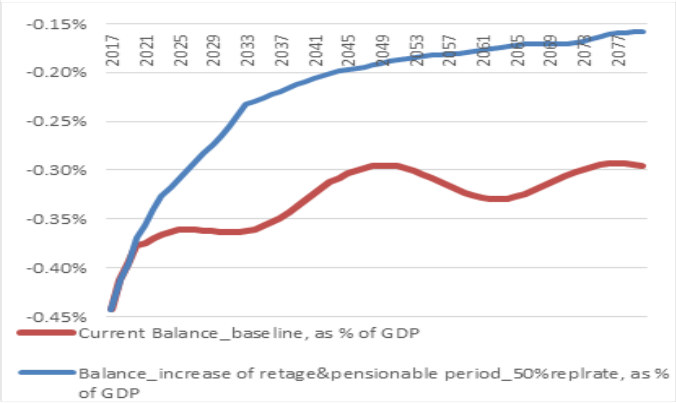
calculation of the benefit—while retaining the 50 percent replacement rate guarantee—would bring both accrual and replacement rates closer to those in the general system, and also help to reduce the system deficit (Figure 5). Further, the length of service could be gradually increased to a minimum of 30 calendar years, even for professions where 1 year counts as 2 or 3.

Figure 4. Balance of the Military Pension Scheme



Source: World Bank PROST Model for Moldova.

Figure 5. Retirement age increase - balance of the military pension scheme



Source: World Bank PROST Model for Moldova.

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