

# PENSION SYSTEM REFORM IN THE REPUBLIC OF MACEDONIA

\*Habil Mustafai, page 69-78

March, 2017; 2 (1)

## ABSTRACT

Pension system reforms process has been initiated in 1993 due to deficits of the Pension and Disability Insurance Fund (PDIF), low fertility rates, demographic aging and high unemployment rates in the country. Fully funded pension insurance differs radically from previously existing currently funded pension insurance in terms of treatment and records of contributions paid in respect of the determination and payment of the pensions. In this insurance each member has an individual account, which recorded its assets and provides a contribution, which increases the funds.

The fully funded pension system, which consists of mandatory and voluntary pension insurance, provides only one type of fund selection to the insurers, or one portfolio for investing of their assets. That way insurer receives the same relation to the risk or same opportunities for contributions regardless of their desire and appetite. The desire and appetite for risk usually differ depending on the age of the insurer. Also, the composition of one portfolio increases the risk of loss of assets of older insurers without possibility for their return through the capital markets.

With the establishment of the multifunds, the members of the system will be able to accumulate and invest their contributions according to their own choice. In this paper, the current pension system in Republic of Macedonia.

**Keywords:** pensions, multifunds, subfunds, pension system, portfolio



**\*Habil Mustafai PhD**

PR, Agency for supervision of fully funded pension insurance  
MAPAS

**e-mail:**

habilmustafai@gmail.com

**Article type:**

1.01 Original scientific articles

**UDK:** 364.35-027.1(497.7)

**Date of received:**

December 6, 2016

**Date of acceptance:**

February 10, 2017

**Declaration of interest:**

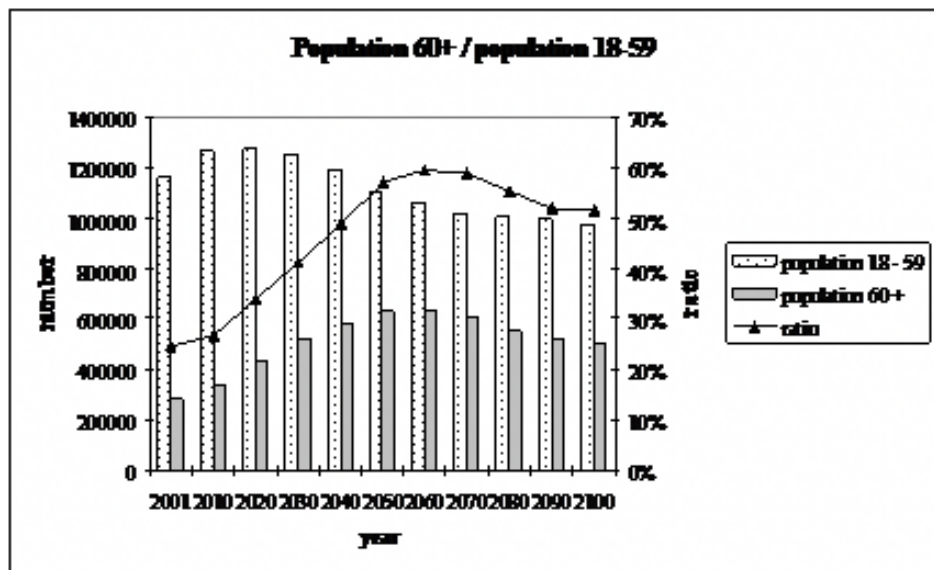
The author reported no conflict of interest related to this article.

## 1. INTRODUCTION

In Macedonia, as in other European countries, there is a trend of aging population. This leads to an increase in the number of elderly people in the total population, the changing ratio of pensioners - employees – insurers. In the future, the numbers of pensioners are expected to be equal with the numbers of insurers, which would cause difficulties in the payment of pensions. Because of the current funded system, current insurers pay for the pensions of current pensioners. It causes the insolvency of the pension system in long term.

Over the last decade, almost every country in Europe has made changes to its national pension system to ensure its stability for the future. Demographic changes are the main reason for pension reform. Across Europe, life expectancy increases and the duration of the pensions as well increases. Simultaneously, the average family size decreases because people are choosing to have fewer children's. These two trends together lead to an increase the number of elderly people in relation of the number of working-age people. In Macedonia, the proportion of people aged over 65 with people aged 18 to 64 is projected to increase from 17.68% (current level) to 53.03% by 2060 and to decline to 47.34% in 2080 (mapas.mk,2017).

This projection from PDIF demonstrates that the demographic changes increase the pressure on the Macedonian pension system, which was funded only as the *pay-as-you-go* basis. Pay-as-you-go means that current retirees are paid with contributions of current employees. The cost of funding pensions will grow the volume, which will be unbearable for every individual and every economy in the framework of the state budget. Such funding scheme is very sensitive to the ratio of pensioners to the contributors. The ratio is shown in the next graph.



Source: Pension and Disability Insurance (PDIF)

From the graph it can be observed that in the initial period of the projections by 2030, the number of insurers grows, and in 2030 the number of the insured begins to decline due to demographic trends and stabilization of economic growth. The number of pensioners continues to grow in the next 50 years and then declines. The ratio between contributors and pensioners, from the current 1.74 to 1 retiree insurer in long-term, decrease to 1.03 contributors per 1 pensioner. This trend of the ratio means that less and less insurers will pay for a growing number of pensioners.

Considering the ratio of pensioners to contributors that gradually increases with demographic changes, the unreformed pension system will lead to an increase in the contribution from the current 18% of gross salary (which equals to 33% of net income) to approximately 38 % of gross salary (equals to 66% of net income). Such increase in the contribution rate would diminish the net income of workers, the country's potential for economic growth and would likely cause a further increase in the unemployment rate. The reform includes raising the retirement age, changing the rate which pensions are indexed and the introduction of mandatory and voluntary fully funded pension insurance that significantly reduces the impact of demographic change.

## 2. OBJECTIVES OF PENSION REFORMS

- Safety in the exercise of the pension and disability insurance;
- Provide short-term and long-term solvency of the Pension and Disability Insurance;
- Maximum safety and minimum risk;
- Guarantee of fair pensions for all generations;
- Strengthening public confidence in the pension system by achieving the other objectives of the reform;
- Stimulating the development of capital markets and encourage economic growth.

The main aim of the reformed pension system is a care and protection of the interests of each member, because each member deserves retirement security.

Primary purposes of the voluntary fully funded pension insurance in the Republic of Macedonia are:

- Providing a higher income in retirement for those contributors who are already insured in the first or second pillar (mandatory pension and disability insurance) and who are willing and able to allocate additional funds for greater financial security or maintain a higher standard of living after retirement;
- Providing pension to persons who are not covered by mandatory pension insurance for themselves or others. These include long-term unemployed, employees at projects in foreign missions, spouses who are not employees, and other persons, whether employed or unemployed;
- Providing preconditions for the establishment of occupational pension schemes in the process of harmonizing the Macedonian social security system with the European Union.

### **3. THE STRUCTURE OF MACEDONIAN PENSION SYSTEM**

Reformed pension system is composed of pension and disability insurance based on generational solidarity and fully funded pension insurance, thus allowing citizens of Macedonia the financial and social security.

The structure of the tiered pension system is based on three types (pillars) of insurance including:

- Mandatory pension and disability insurance based on generational solidarity (first pillar)
- Fully funded pension insurance (second pillar)
- Voluntary fully funded pension insurance (third pillar)(mapas.mk,2017).

Mandatory pension and disability insurance based on generational solidarity (first pillar) insurance is organized on the principle of current financing (pay-as-you-go), which means that current contributors pay for current retirees. This pillar provides defined pensions according to a predetermined formula, and the rest of the pension is provided by the fully funded pension insurance. Through this pillar provides the right to a pension and disability insurance in case of old age, disability and death, meaning that pays part of the old age pension, disability pension, family pension, and the minimal pension (mapas.mk,2017).

Mandatory fully funded pension insurance (second pillar) is insurance based on capitalization of the funds based on defined contributions, where there is a close correlation and interdependence between the invested funds - contributions and future pension benefits that exercise each person based on the market regularities. Namely, this type of insurance is based on the principle of collecting contributions

to individuals accounts which are being invested and profits reduced with the operating expenses of the system is added (accumulated) to individual accounts.

Voluntary fully funded pension insurance (third pillar) is also insurance based on capitalization of the funds based on defined contributions, but on a voluntary basis. The significance of this insurance is that it can include all persons who wish to provide a higher volume of material security despite compulsory insurance, and all persons who are not covered by compulsory insurance (first and second pillar). In addition, the third pillar allows the establishment and funding of occupational pension schemes (Apostolska, 2009:265).

The establishment and existence of multi-pillar pension system, combined with the currently funded and fully funded pension system provides benefits and advantages both for the individual, the pension system and the economy. In terms of the individual, this system provides greater safety because the financing of pensions will be from two or three sources. This will make the diversification of risks that each system carries itself.

#### **4. CONTRIBUTIONS IN THE MANDATORY PENSION FUNDS**

The taxpayer is obligated to pay the pension and disability contribution in the Republic of Macedonia where the employers pay the contributions on behalf of the employees. The Public Revenue Office is in charge of the integrated collection of the social insurance contributions (pension and disability insurance, health insurance and insurance in the event of unemployment), as well as of the personal income tax.

For those who are members only in the mono-pillar system, their contributions remain with the PDIF (which for 2015 was 18% of the gross wage). For those persons who are part of the two- pillar system, the PDIF divides the contribution between the first and the second pillar. The contributions transferred to the mandatory pension fund is 6% of the gross wage and the rest of the contribution for pension and disability insurance remains with the PDIF (for 2015 it was 12% of the gross wage ( $12\% = 18\% - 6\%$ )) (MAPAS,2015:29).

The PDIF transfers the contributions of the mandatory pension fund members to their individual accounts, immediately upon payment, or maximum within five working days after receipt of the contributions, under the condition that with the receipt of the contributions the PDIF received the relevant data that would enable the PDIF to perform such transfer.

## **5. INSTITUTIONAL REGULATION OF THE PENSION SYSTEM**

The three-pillar pension system is consisted of the following institutions:

- Ministry of Labour and Social Policy – responsible for creating and enforcing the policy governing the pension and disability insurance and for supervising the legality of operations within this insurance.
- Agency for Supervision of Fully Funded Pension Insurance (MAPAS) – regulatory and supervisory body, established to protect the interests of the current and retired pension funds’ members, and to enhance public awareness about the characteristics of this type of insurance and to promote the development of the fully funded pension insurance. MAPAS initiates and passes regulations and acts, grants licenses to pension companies and approvals for pension fund management, performs off site and on-site supervision of the pension companies, pension funds and custodians, organizes exams and registration of sales agents, performs pro-active controls over the activities of the pension companies, etc. (Apostolska, 2009:266)
- Pension Company – joint stock company founded by financial institutions with large capital and experience, whose sole activity is managing pension funds’ assets. The reformed pension system offers the opportunity for establishing three types of pension companies:
  - o Mandatory Pension Company - manages only mandatory pension funds
  - o Voluntary Pension Company - manages only voluntary pension funds
  - o Joint Pension Company - manages mandatory and voluntary pension funds
- Custodian of pension fund assets – safely keeps pension funds’ assets, on a separate account, apart from the assets of the Pension Company. Custodian of pension funds is a commercial bank that meets certain legal requirements. In the initial years as a transitional solution, custodian of mandatory pension funds was the National Bank of Macedonia.
- Public Revenue Office (PRO) – PRO undertakes centralized contribution collection and submits to the PDIF total contributions for pension and disability insurance.
- Pension and Disability Insurance Fund of Macedonia (PDIF) – allocates the pension insurance contributions between the first and the second pillar and allocates the data on membership to the selected mandatory pension fund.

## **6. THE ROLE OF THE FULLY FUNDED PENSION INSURANCE IN THE MACEDONIAN PENSION SYSTEM**

Fully funded pension insurance differs radically from previously pension insurance. In this insurance each member has an individual account, which recorded its assets and provides a correlation and interdependence between the paid contributions and future pensions of the members. This insurance is based on accumulation of assets from contributions to individual accounts that are being invested and the return on investments with reducing the net costs of operating of the system, accumulated in individual accounts. The future pension depends on the accumulated assets on the individual account and life expectancy at retirement, i.e. the expected period of retirement.

It is important to note that these pension savings are long, which are continuously increasing. Due to this, the insurer is young and savings are small, but in the future when the insurer reaches the age of retirement savings substantially grows.

Characteristic of this insurance is that the assets are privately managed and contributions are invested by specialized licensed pension companies that manage the pension funds. This ensures economic goals to determine the investment policy, creating an opportunity to maximize the overall yield in the interest of members. Diversification of investment risks (including international diversification) is one of the important features of this system.

Furthermore, the important feature of the fully funded pension insurance is the right of personal choice and individual initiative. All employees prior to January 1, 2003 were given the opportunity to decide whether to join the second pillar of the pension system and the right to choose a pension fund to participate and they have the possibility to choose a pension fund of their choice. Also in the voluntary pension fund, membership is by choice of the individual person or through participation in a pension scheme funded by the employer or an association.

The possibility (portability) of assets is also an important right in a system of fully funded pension insurance. All members of mandatory or voluntary pension funds have the right to transfer their savings to another pension fund. Also in case of participation in an occupational pension scheme, the member has the right to transfer his accumulated assets to another insurer or in another occupational pension scheme.

Fully funded pension insurance provides a high degree of transparency, which is one of its most important features and novelty in the pension system. Companies have a legal obligation to regularly inform the members of the pension fund about the balance on their individual accounts, dates of contributions, transfer of assets during the relevant period, the fees for converting contributions, transferred assets into accounting units and the balance of their individual accounts. At least once a year, companies have to inform the members about the value and proportion of the assets of the funds invested in certain types of assets, including data publishers and data on transaction fees. Companies also annually publish informational brochures that contain information about the fund company, which among other things contains data of the supervisory and management board of the

company, the basic principles of investing, fees that are charged, investment, net assets of the pension fund, etc.

## **7. CHALLENGES FOR THE FUTURE**

Finally, any reform improvements and additions to the pension system are made in order to make a higher comfort in retirement years for the members of the second and third pillar pension system. The assets of the member should be higher compared with the same period of their lives without proposed reforms. Security is the main argument for the multifunds. The financial crisis is affecting the pension funds on a large scale, and the worst affected in such periods are members who retire. Each crisis has its own corrective period when prices of the securities are returned to the previous trend, once in 2-3 years, sometimes for 5-6 years, but this period will not affect the members who will retire. Therefore, for their security, such a system is designed by gradation of the risk depending on the age of the members.

Higher contribution is a side effect of the composition of the system. In Multifunds, taking higher risk in the early years of membership generates more funds that can multiply in the future. Certainly there would be possibility for higher contributions if we always stay on aggressive portfolios, but returns are correlated to risk or possible loss of funds. The main objective of this project is to provide security, but the increased contribution is additional benefit that justifies all positive inputs. Multifunds are project which will largely achieve the required goals for its acceptance by the state and will undoubtedly affect the increase of the pensions of insurers and their stability in retirement years.

## **8. BIBLIOGRAPHY**

1. Annual Statistical Report for 2015 (Agency for supervision of fully funded pension insurance MAPAS)
2. Apostolska, Zorica, Preparing the Financial Market for an Aging Population: The Case of the FYR Macedonia, Pension reform in South Eastern Europe, Worldbank, 2009
3. Bolok Volin, Isak, Chalanges in launching multifunds in Mexico, FIAP, 2005
4. Cortez, Joaquin, The chilean experience, Pension Funds Investment, FIAP, 2005
5. D. Pfau,Wade, Lifecycle Funds and Wealth Accumulation for Retirement: Evidence for a More Conservative Asset Allocation as Retirement Approaches” Associate Professor National Graduate Institute for Policy Studies (GRIPS), 2009)
6. Funded systems: Their role in solving the pension problem (FIAP, international organization of pension fund administrators, 2007)



7. Multifunds the cases of Chile, Mexico and Peru (FIAP, international organization of pension fund administrators, 2007)
8. Mustafai, Habil (2014), Perspective of application of the multifund system in fully funded pension insurance of the Republic of Macedonia, unpublished doctorate thesis, University of Cyril and Methodius.
9. Report of the Pension and Disability Insurance in 2015 (Pension and Disability Insurance Fund of Macedonia)
10. Ramos, Jorge, Chalanges in launching multifunds in Peru, FIAP, 2005
11. Report on the developments in the fully funded pension insurance, 2015 MAPAS
12. Whitehouse, Edward, Administrative Charges for Funded Pensions: An International Comparison and Assessment, June 2000
13. Law on Pension and Disability Insurance (Official Gazette of the Republic of Macedonia 80/93, 3/94, 14/95, 71/96, 32/97, 24/2000, 96/2000, 50/2001, 85/2003, 50/2004, 4/2005, 84/2005, 101/2005, 70/2006, 153/2007, 152/2008, 161/2008, 81/2009, 156/2009,
14. Law on Mandatory Fully Funded Pension Insurance (Official Gazette of the Republic of Macedonia No 29/2002, 85/2003, 40/2004, 113/2005, 29/2007, 88/2008, 48/2009, 50/2010, 171/2010, 36/2011, 98/2012, 13/2013, 164/2013 and 44/2014),
15. Law on Voluntary Fully Funded Pension Insurance (Official Gazette of the Republic of Macedonia No 7/2008, 124/2010 and 17/2011)
16. [www.mapas.gov.mk](http://www.mapas.gov.mk) , 10.04.2017
17. [www.piom.com.mk](http://www.piom.com.mk) , 12.04.2017
18. [www.mtsp.gov.mk](http://www.mtsp.gov.mk), 13.04.2017
19. [www.kbprvo.com.mk](http://www.kbprvo.com.mk), 15.04.2017
20. [www.nlbnpf.com.mk](http://www.nlbnpf.com.mk), 15.04.2017

