

POLITICAL ECONOMY OF OLD-AGE PENSION REFORMS IN GEORGIA

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Abstract

The paper¹ examines the factors that played a major role in development of the old-age pension system in Georgia. Based on data collected from 1991–2009, this analysis centers on the system's patterns of development and identifies four main attempts to reform the old-age pension system. Economic performance, demographic aging, domestic political constellations, and external influence are traditionally thought to be responsible for the pension system reforms. Qualitative data analyses and in-depth interviews have been used to test these explanations. This analysis did not confirm the hypotheses, but it revealed that fiscal constraints and international technical assistance were the main factors behind reforms during the first two chronological attempts to change the system. Political factors and liberal economic ideology influenced the patterns of old-age pension policy development from 2004–2008, while the negative outcomes of the Russian-Georgian War and World Financial Crisis are currently the major obstacles for comprehensive pension reforms. The limitations of this study suggest that in order to clarify the exact nature of old-age pension system, shorter time periods and separate reform initiatives should be investigated.

Keywords: transition, political economy, retirement, pension reforms, Georgian government

Introduction

In Soviet Georgia the old-age pension system had been gradually developing as an integral part of the state welfare policy. In accordance with the ideological and political goals, the pension system was born entirely of the state and retirement payments that were financed on a pay-as-you-go (PAYG) basis through the transfer of funds from state-owned enterprises to the USSR State Insurance Company, *Gosstrakh*, which had a department in Georgia. The Soviet retirement pension system consisted of two parts, a public component and a voluntary component, which together provided relatively generous old-age pension benefits.² To receive a pension, workers were required to have participated in the labor force for a minimum of twenty years for women and twenty-five for men.³ According to Castel and

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² Irakli Koplatadze, *The role of pension funds in macroeconomic regulation at the transition stage towards market economy* (Tbilisi, 2000), 206.

³ John B. Williamson, Stephanie A. Howling and Michelle L. Maroto, "The political economy of pension reform in Russia: Why partial privatization?" *Journal of Ageing Studies*, vol. 20 (2006): 165.

Fox, the pre-transition Soviet pension system was a complex and expensive mechanism, “combining elements of a Western European 1960s PAYG system with peculiar communist features.”⁴ In the late 1980s old-age pension coverage nearly reached a universal level, paying between 60 percent and 100 percent of the average wage.⁵

However, as almost all dimensions of economic and social life, the public pension systems had been challenged by the turmoil of the 1990s. After the first few years of transition, institutions of representative democracy have emerged, a new legal infrastructure has been installed, and the private sector has developed; whereas the question of fundamentally reforming the existing set of welfare policies, including pension arrangements, had attracted little attention.⁶ Although the problems facing Georgia were common to all transition economies, they were aggravated by the specific circumstances of the country. On the revenue side, shrinking contribution bases and poor administration of revenue-generating systems had destabilized resources for pension expenditure. On the benefit side, demographic aging, shrinking participation in the labor force, and growing informal employment had led to a marked increase in the number of pensioners compared to the number of contributors. Old-age pensions became low, unfair, and were not sufficient to protect the pensioners from falling into extreme poverty.⁷

The inability of the new socioeconomic environment to provide sustainable social security system was “one of the reasons for the general mistrust of democratic and market reforms.”⁸ After the Rose Revolution in 2003, the Georgian government made an unequivocal choice for the liberalization of economy with fundamental changes in existing social policies. These tendencies inevitably affected the old-age pension system. Therefore this paper seeks to answer what determined the development⁹ of the old-age pension system in Georgia, and whether policy changes and unimplemented reforms can be explained by economic and fiscal problems, by political limitations on available reform choices, by a combination of these factors, or by some other circumstances. To reach any conclusions about the relative validity of the arguments surrounding Georgia’s pension system reforms, it essential to establish the nature of the development of pension system from a specific starting point: the dissolution of the Soviet Union. This study also intends to reveal the problems the old-age pension system has faced and to evaluate the achievability of the reform endeavors.

⁴ Paulette Castel and Louise Fox, “Gender dimensions of pension reform in the Former Soviet Union,” in *New ideas about old age security: Toward sustainable pension systems in the 21st century*, ed. Robert Holzmann and Joseph E. Stiglitz (The World Bank, Washington, D.C., 2001), 426.

⁵ Cynthia Buckley, “Obligations and expectations: Renegotiating pensions in the Russian Federation,” *Continuity and Change*, vol. 13:2 (1997): 317.

⁶ Janos Kornai, “Editorial: Reforming the Welfare State in Post-socialist Societies,” *World Development*, vol. 25:8 (1997): 1183-86.

⁷ Marta De Castello-Branco, “Pension Reform in Baltics, Russia, and other Countries of the Former Soviet Union (BRO),” (International Monetary Fund Working Paper, 1998), <http://www.imf.org/external/pubs/ft/wp/wp9811.pdf> (accessed May 13, 2008).

⁸ Alexander Tvalchrelidze, “Part II. The social security system in Georgia and possible trends in its development,” in *Building Democracy in Georgia. Democratization in Georgia: Economic Transformation and Social Security* (Discussion Paper 8 by International Institute for Democracy and Electoral Assistance, May 2003).

http://www.idea.int/publications/georgia/upload/Book-08_scr.pdf (accessed June 10, 2008), 16.

⁹ Throughout this research the terms the “reforms” and “development” will be used interchangeably except when necessary to distinguish between specific circumstances.

In order to answer the research questions, the methodology of this study analyzes the scope of the changes that occurred and reveals the factors determining the old-age pension system's development. In addition to the nature of the research questions, the methodological approach was defined by time and resource constraints. There are substantial trade-offs between qualitative and quantitative analysis, the dependent and independent variables, the length and depth of the account, and the availability and reliability of data sources. Nonetheless, to achieve the research goals, this study consecutively applied the evaluation of relevant academic scholarship, qualitative data analysis, and in-depth interviews as complementary approaches. As a result of the field data collection, much of the information came directly from the Ministry of Labor, Health and Social Affairs (MOLHSA), Social Subsidies Agency (SSA), and the Parliament of Georgia. In-depth interviews were conducted with major stakeholders, including decision-makers at the Ministry on Reforms Coordination, MOLHSA, SSA, economic experts, and the representatives of private insurance companies and relevant civil society organizations.

Hypothetical Explanations on Old-Age Pension Reforms

This section presents hypothetical explanations on both old-age pension policy change and the system's resistance to reforms given by various authors and observations mainly from the transition economies. On the one hand, economic recession and demographic aging are assumed to destabilize public pension finances and consequently create pressures for policy reform; while on the other hand, political actors and the environment can affect old-age pension system development.

Pressure Factors

Theories on the economic sustainability of old-age public pension systems assume that pressures for change derive from financial deficits.¹⁰ Chlon-Dominczak and Mora, through a survey of policymakers and pension experts, found that the scope of fiscal problems influences reform commitment and leads toward change.¹¹ Growing expenditure and decreasing revenues could create opportunity for reformers who were previously prevented from taking the initiative.¹² The recession, during the first years of transition, was associated with enormous shifts in production structures and a corresponding decrease in wages and increase in unemployment.¹³ As a response to this situation, governments often applied a policy of substituting open unemployment with early retirement programs at the expense of increased expenditure of public pension systems.¹⁴ The harsh recessions considerably deteriorated the revenue base of the old-age pension system and created imminent fiscal deficits.¹⁵ In line with the decline of the formal economy and employment, transition countries saw rapid growth in informal activity levels

¹⁰ John B. Williamson and Fred C. Pampel, *Old-age security in comparative perspective* (Oxford: Oxford University Press, 1993).

¹¹ Agnieszka Chlon-Dominczak and Marek Mora, "Commitment and Consensus in Pension Reform," in *Pension reform in Europe: process and progress*, ed. Robert Holzmann et al., (Washington D.C.: The World Bank, 2003).

¹² John Williamson, "In Search of a Manual for Technopols," in *The political economy of policy reform*, ed. John Williamson (Institute for International Economics, Washington, D.C., 1994).

¹³ Marie Lavigne, *The economics of transition. From Socialist economy to market economy* (Houndmills: Palgrave Macmillan, 1999).

¹⁴ Sabine Horstmann and Winfried Schmahl, "Explaining reforms," in *Transformation of pension systems in Central and Eastern Europe*, ed. Winfried Schmahl and Sabine Horstmann (Edward Elgar, 2002).

¹⁵ Emily S. Andrews, *Pension reform and the development of pension systems: An evaluation of World Bank assistance* (Washington, D.C.: The World Bank, 2006).

which was beyond the reach of old-age social security contribution agencies, further resulting in a loss of revenues for financing public pension benefits.¹⁶

The economic stagnation and fiscal deficits represented the immediate pressures on the consecutive governments in transition economies to adjust the pension system, but the intensifying long-term strains also resulted from the impact of demographic aging, as the proportion of the elderly in populations had been rapidly rising.¹⁷ As benefits paid out were rising accordingly, outflow from the old-age pension systems were exceeding contributions, requiring increases in employees' or employers' contributions or budget transfers.¹⁸ The old-age dependency ratio, measuring the share of the population aged 65 years or over to the population aged 15–64, most noticeably increased in the Baltic States and Croatia.¹⁹ In turn, this rise could be explained by the changing life expectancy and mortality patterns, the decreasing fertility rates below the replacement rate,²⁰ and the intensifying trends of the negative net migration.

Despite the severe socioeconomic situation, life expectancy had been increasing among the elderly during the 1990s, creating a strain on old-age pension systems.²¹ Simultaneously, mortality rates among the working-age population, which had increased in the majority of transition countries, might also have had an immediate effect on old-age dependency ratios. Also, a pattern of changes in fertility rates affects the old-age dependency ratios and creates strong pressure for reforms within several years because the current fertility rates are typically employed for the extrapolation of future trends as a rationale for changes.²² In less than a decade after 1989, total fertility in transition economies had fallen from a replacement rate to about two-thirds of this level, making Eastern Europe the region with the lowest fertility rate in the world.²³ In the short term the most important demographic factor creating pressure for public pension policy reform could be negative net migration, because it led to the outflow of a predominantly working-age population.²⁴

Political Factors

An account of the political set of hypothesized relationships is a more challenging task than considering the effect of pressure factors on pension system development. Most political economy

¹⁶ Elaine Fultz and Markus Ruck, "Pension Reforms in Central and Eastern Europe: Emerging Issues and Patterns," *International Labour Review*, vol. 140:1 (2001): 19.

¹⁷ Mukesh Chawla, Gordon Betcherman and Arup Banerji, *From red to gray. The "Third Transition" of Aging Populations in Eastern Europe and the Former Soviet Union* (Washington D.C.: The World Bank, 2007).
http://siteresources.worldbank.org/ECAEXT/Resources/publications/4547631181939083693/full_report.pdf (accessed July 26, 2008).

¹⁸ Sheetak K. Chand and Albert Jaegar, "Aging populations and public pension schemes," International Monetary Fund, Occasional Paper No. 147 (Washington, D.C.: International Monetary Fund, 1996).

¹⁹ United Nations, "World population prospects: the 2006 revision population database" (United Nations Population Division, 2006) <http://esa.un.org/unpp/index.asp?panel=3> (accessed May 20, 2008).

²⁰ Replacement rate means 2.1 births of children per woman.

²¹ United Nations, "World population prospects: the 2006 revision population database," 2006.

²² Henning Finseraas, "The politics of pension reform: An empirical analysis of pension reform intensity in 23 OECD-countries" (Paper prepared for presentation at the International Social Security Association's meeting in Warszawa, 5-7 March 2007), http://www.ecpr.visionmd.co.uk/paper_info.asp?paperNumber=PP651 (accessed July 11, 2008).

²³ UNECE, "Fertility Decline in the Transition Economies, 1989-1998: Economic and Social Factors Revisited," *Economic Survey of Europe*, vol. 1 (2000): 189-207.

²⁴ Silke Uebelmesser, *Unfunded Pension Systems: Ageing and Migration* (Elsevier, 2004).

theories consider the political environment, such as the fragmentation of political power²⁵ and differences in governing bodies and institutions,²⁶ as a central explanation for policy development. State-centered theories recognize the state and its policies as more than neutral, influencing pension system development as an autonomous agent;²⁷ while the new-pluralism assumes that public pension systems are determined by patterns of democratic political competition among different non-class based interest groups.²⁸ It is assumed that the politicians in the beginning of transition enjoyed a “honeymoon” period and greater freedom for maneuver in policies, as difficult decisions could simply be blamed as being part of the outgoing government’s legacy.²⁹ According to Wagener, however, during the first years of transition, social policy reform seldom deserved “[its] own chapter either in reform literature or in reform policy program.”³⁰

In addition to reformers, other domestic actors in pension policy development were the political parties, the ministries and other governmental agencies, the experts and trade unions, public opinion, and representatives of financial and capital markets. The impact of political actors on pension system development may be illustrated by the electoral competition among parties in the Czech Republic for the 1996 elections, when five main political forces designed their own approaches and included public pension system development in their electoral programs,³¹ while in Estonia trade unions successfully opposed employers’ organizations which were suggesting taxing both employers and employees.³² According to Crepaz, parliamentarianism arguably creates more opportunities for policy development because it establishes stronger party discipline, greater legislative power, and the centralization of accountability.³³ On the contrary, Brooks argues that presidential systems generally mean lower incomes and smaller social security system – two variables that simplify policy change.³⁴ Political environments in which these institutions function also matter. In a democracy, parties which decrease old-age benefits can expect to face the wrath of the old-age population, while authoritarian governments are granted more freedom to conduct policy adjustment.³⁵

²⁵ Sarah Brooks, “Social Protection and the Market: Pension Reform in an Era of Economic Integration” (Paper presented at the annual meeting of the American Political Science Association, Atlanta, GA., September 1999).

²⁶ Michael J.G. Cain, “Globalizing Tendencies in Social Policy,” *Emergo: Journal of Transforming Economies and Societies*, vol.7:2 (2000): 6-19.

²⁷ Katharina Müller, *The Political Economy of Pension Reform in Central-Eastern Europe* (Edward Elgar Publishing, Inc., 1999).

²⁸ Morris Janowitz, *Social control of the welfare state* (Chicago: University of Chicago Press, 1977).

²⁹ John Williamson and Stephan Haggard, “The Political Conditions for Economic Reforms,” in *The political economy of policy reform*, ed. John Williamson (Washington, D.C.: Institute for International Economics, 1994).

³⁰ Hans-Jurgen Wagener, “Social security – A second phase transformation phenomenon?” in *Transformation of Social Security: Pensions in Central-Eastern Europe*, ed. Müller et al. (Physica-Verlag, 1999), 13.

³¹ Jiri Kral and Martin Macha, “Transformation of old-age security in the Czech Republic,” in *Transformation of Pension Systems in Central and Eastern Europe*, eds. Winfried Schmahl and Sabine Horstmann (Edward Elgar, 2002).

³² Lauri Leppik and Georg Mannik, “Transformation of Old-Age Security in Estonia,” in *Transformation of pension systems in Central and Eastern Europe*, eds. Winfried Schmahl and Sabine Horstmann (Edward Elgar, 2002).

³³ Markus M.L. Crepaz, “Inclusion versus Exclusion: Political Institutions and Welfare Expenditures,” *Comparative Politics*, vol. 31 (1998): 61-80.

³⁴ Sarah Brooks, 1999.

³⁵ Paul Pierson and Kent Weaver, “Imposing Losses in Pension Policy,” in *Do Institutions Matter? Government Capabilities in the United States and Abroad*, ed. Kent Weaver and Bert A. Rockman (Washington D.C.: The Brookings Institution, 1993).

Another explanation on pension policy reforms is the direct and indirect influence of external economic, political, and ideological factors in shaping the old-age pension policies.³⁶ According to Deacon and Hulse, the making of transitional pension policy was a “testing ground for the future of social policy elsewhere in the industrialized world.”³⁷ Throughout the 1990s the analysis of pension systems, the design of recommendations and reform strategies, and assistance in various forms for the reformer countries have been the central issues on the agenda of the influential international and regional organizations.³⁸ Since its main interest stemmed from the macroeconomic and fiscal policy implications of public pension development, the World Bank specifically addressed in its seminal report the public pension systems in the transition economies.³⁹ Contrary to this position, an underlying assumption of the European Union and the Council of Europe’s policy for transition countries was the duty of the state to protect the vulnerable regardless the concerns of the economic efficiency.⁴⁰ The International financial institutions also frequently discussed old-age security systems in the transition states in connection to the financial sector, capital markets, and domestically available sources for long-term investment.⁴¹

First Stage of Development: Economics of Pensions

Reforms of the pension system are the changes in the totality of institutions, procedures, and resources drawn on to ensure a replacement income during retirement age. Four attempts of initiating systemic changes in the old-age pension system can be distinguished: the first two were made consecutively in 1998–99 and 2002–03, while from 2004 the reforms continued in two different directions.

Emergence of a Reform Agenda

The socioeconomic collapse associated with the dissolution of the Soviet Union in Georgia was reinforced by the civil wars, which sparked the national macroeconomic crisis, precarious fiscal conditions and completely destroyed the inherited old-age pension system. Simultaneously, Georgia unsuccessfully tried to recover its share of the *Gosstrakh*’s funds, approximately 550 million USD, which had been seized by the Russian Federation.⁴² Throughout the first half of 1990s the tax system malfunctioned, and in 1994 the amount of pensions became nominal. In 1995 the Government turned down the system of differentiated pensions and replaced it with flat payments. The pension benefits were determined by simple arithmetic: the number of those formally employed in the population was multiplied by the average salary and tax tariff, and then revenues were divided by the number of pensioners.⁴³ This meant that equal pensions were granted to all retirees regardless of their salaries during employment, length of service, or differences in pension type. In 1996 the parametric

³⁶ Bob Deacon, *The new Eastern Europe: Social Policy Past, Present and Future* (London: Sage Publication, 1992).

³⁷ Bob Deacon and Michelle Hulse, “The making of post-communist social policy: The role of the international agencies,” *Journal of Social Policy*, vol. 26:1 (1995): 43.

³⁸ Monika Queisser, “Pension Reform and International Organizations: from Conflict to Convergence,” *International Social Security Review*, vol. 53:2 (2000): 31-45.

³⁹ World Bank, *Averting the Old Crisis: Policies to Protect the Old and Promote Growth* (Washington, D.C.: The World Bank, 1994).

⁴⁰ Deacon and Hulse, 1995.

⁴¹ Queisser, 2000.

⁴² This matter was closed when, following international pressure in the late 1990s, Georgia agreed to the so-called zero option of interstate debt restructuring with Russian Federation.

⁴³ David Kodua, “Description of Georgian Social Security System” (The document was drafted within the framework of the Project on Social Security Reform of Georgia, Tbilisi, 2004).

adjustments of the system resulted in the retirement age being increased by five years for men and women respectively, cancellation of the early retirement provisions and introduction of a right on old-age pension benefits only for those who previously contributed to the system.⁴⁴

The problems of the pension system were further aggravated by a serious economic crisis at the end of the 1990s. This critical situation created by the poor collection of tax revenues was transformed into the large-scale financial crisis, mainly as a result of the economic problems that developed in the CIS countries.⁴⁵ The economic reforms, including privatization, were in their early stages, and the inefficient public sector remained large. At the same time, the country had one of the lowest tax collection rates (9 percent of GDP) among the transition economies, and the government had been reluctant to initiate taxation reforms.⁴⁶ The non-compliance with the plan for the state budget occurred, and was followed by the growth of arrears in state liabilities. The National Bank, however, reported that the final outcome only came to 68 percent of what had originally been projected.⁴⁷ Economic reform produced significant changes in the employment structure, while the number of self-employed significantly exceeded the number of those in formal employment. The economic hardship also determined that many Georgian citizens decided to leave the country. The demographic burden was intensified by the growing mortality and decreasing fertility rates. At the end of the 1990s the population over age fifty-nine made up 18.6 percent, up from only 14.4 percent in 1989.⁴⁸

The impact of fiscal constraints on the old-age pension system was first recognized by the officials of the Ministry of Labor and Social Security who initiated an initial agenda on old-age pension reforms. It was assumed that the first step for changes had to be part of a well-drafted legislative framework to give to ultimate decision-makers a clear picture what needed to be done. After the introduction of a new state constitution in 1995, all Soviet laws, including those on social security, were annulled.⁴⁹ Therefore, every reform attempt of the old-age pension system was associated with changes in the broader concept of social security in the country. The legislative package that was developed in line with the Act on State Pensions involved the Acts on State Social Insurance and Medical Examination. Although the bills envisaged the differentiation of old-age pensions according to amounts of contributions and period of payments, they did not imply any pension formula or other means to calculate differentiated pension benefits.⁵⁰

Ultimately, the bill was not approved, and in 1999 the government established a working group with a more ambitious initiative in which the influence of the World Bank, with its retirement pension orthodoxy, became apparent. According to this reform project, the three pillar old-age pension system was considered as a suitable option for Georgia. The proposed model envisaged the establishment of the mandatory state pension fund, providing payment of minimal old-age pensions, the mandatory non-state pension insurance, and the voluntary private old-age pension insurance. The actors behind the

⁴⁴ Gia Jandieri, Interview by author (Bakuriani, Georgia, July 10, 2008).

⁴⁵ National Bank of Georgia, *Annual Report 1998* (Tbilisi: National Bank of Georgia, 1999).
<http://nbg.ge/uploads/publications/annualreport/2003/nbg7.2annualreport1998geo.pdf> (accessed August 17, 2008).

⁴⁶ International Women's Rights Action Watch, *Georgia: Country Report* (1998).
<http://www1.umn.edu/humanrts/iwraw/georgia.html#24> (accessed September 6, 1998).

⁴⁷ National Bank of Georgia, *Annual Report 1998, 1999*.

⁴⁸ Mzia Shelia, "Population Ageing in Georgia under Conditions of Economic Crisis (working paper, 2004).

<http://epc2006.princeton.edu/download.aspx?submissionId=60107> (accessed Jul 3, 2008).

⁴⁹ Vakhtang Megrelishvili, Interview by author (Tbilisi, Georgia, September 1, 2008).

⁵⁰ Kodua, 2004.

proposed scheme hoped that it would attract a reputable international insurance company that would assume repayment of the existing arrears and provision of old-age pensions benefits by assigning to it the exclusive right to administer 13.5 percent of social taxes.⁵¹ However, the implementation of reforms was problematic mainly because the government was still engaged in broad political and economic reforms. The political environment was fragile, with the president's assassination attempt and the hotly contested parliamentary elections. Other obstacles were systemic corruption, poor administration of the pension system, high social taxes, and ongoing underperformance by the tax administration. In addition, there were no strong leaders who would project the future benefits of pension reforms.⁵²

“Revolutionary Victim”

A new, ambitious initiative on reforming the state's social assistance schemes was declared in 2002–03. This period turned out to be very hard on the pension system. At the end of 2003 the ongoing pension arrears amounted 14 percent of the central budget, while the average pension equaled 19 percent of the minimum subsistence level of an adult.⁵³ The beginning of the 2000s was characterized by the low level of economic growth, moderate rates of inflation, and permanent sequestering of the state budget. As a result, the employment level, labor productivity, and real income of the population remained unchanged. Internal demand failed to become a stable factor of economic growth.⁵⁴ The vast majority of the population was forced to engage in poorly paid, temporary jobs and was unable to secure minimum living standards. The negative net migration remained high, while fertility levels continued to decrease.⁵⁵ The government was unable to fulfill its core budget parameters, mainly due to the fiscal authorities' ineffectiveness, and deficiencies in the tax legislation. In addition, after the suspension of financing under the IMF-supported financial program, external sources became unavailable.⁵⁶ In 2003 expenditures constituted only 77 percent of the initial plan, leading to growing pension arrears. The precarious condition of the budget sector drove the country to the real threat of default.⁵⁷

These developments had a twofold impact on the old-age pension system. On the one hand, it generated the understanding that the old-age pension policy had to be amended, but, on the other hand, the stakeholders realized that in order to implement paradigmatic reforms, the administrative and parametric mechanisms of the system had to be fixed. These constraints created a vicious circle, though in the light of upcoming parliamentary elections, the government announced the systemic pension reforms to establish a new multi-pillar and financially sustainable old-age pension system.⁵⁸ At the same time, the World Bank actively engaged in the process, trying to advocate its own vision of pension reforms, and helped the government to draft new bills and design tax incentives for voluntary pension accounts. The authorities believed that their initiative was a compromised model of pension

⁵¹ Ibid.

⁵² David Gelashvili, Interview by author (Tbilisi, Georgia, August, 25, 2008)

⁵³ GEL 14, which at that time was approximately 6.40USD.

⁵⁴ National Bank of Georgia, *Annual report 2003* (Tbilisi, 2004),

<http://nbg.ge/uploads/publications/annualreport/2003/nbg7.2annualreport2003geo.pdf> (accessed August 18, 2008).

⁵⁵ Department of Statistics, *Statistical Yearbook of Georgia: 2003*. (Department of Statistics under Ministry of Economic Development of Georgia, Tbilisi, 2004), <http://statistics.ge/main.php?pform=39&plang=2> (accessed July 5, 2008).

⁵⁶ Global Security, “Georgia – Economy,” *GlobalSecurity.Org*, <http://www.globalsecurity.org/military/world/georgia/intro-econ.htm> (accessed August 5, 2008).

⁵⁷ National Bank of Georgia, 2004.

⁵⁸ Devi Khechinashvili, Interview by author (Tbilisi, Georgia, September, 1, 2008).

reforms; however, virtually no parties lobbied for these amendments through formal or informal consultations. The stakeholders only agreed on the necessity of repayment of pension arrears and on the introduction of the three-pillar pension model in principle, while a unified approach could not be reached on a transition to the mandatory private schemes, reduction of taxes for pension savings, and differentiation of public pension benefits.⁵⁹

Nevertheless, the pension reforms had become one of the mainstream policy issues for the government. In particular, a package of draft bills was drawn up by the State United Social Insurance Fund together with the MOLHSA and the World Bank. It included bills on Mandatory Social Insurance, Mandatory Pension Insurance, and Introducing Individual Registrations and Individual Accounts for Mandatory Social Insurance System.⁶⁰ Old-age pensions were comprised of two components: a minimal base part, which would be warranted and common for everybody who satisfied the requirements for retiring, and an insurance part, the amount of which would be differentiated and dependent upon the insurance service length and the amount of individual payments put into the account.⁶¹ The main characteristic of the 2003 initiative was that the mandatory second pillar had to be nominal in nature, which meant that the contributions would not be invested through real funded accounts.⁶² The retirement age for both men and women had to be changed to sixty-five⁶³ and minimum insurance longevity to fifteen years. The pensions granted had to be increased on an annual basis in accordance with the consumer price index. This package of bills was passed by the Parliament and had to enter into force on January 1, 2004.

However, the implementation of this reform was canceled due to the fundamental political changes in late 2003 when a new government came to power. Initially, the introduction of the draft bills was postponed until the beginning of 2005, and later the proposal was completely rejected. The opponents of this reform initiative criticized its economic rationality. Their own financial projections showed that individuals had to save all their working lives and then it would be reflected in extremely low replacement rates. These calculations were based on the existing socioeconomic variables, including economic growth rates, employment levels and dependency ratios⁶⁴. The model did not consider potential external shocks of an economic, a political, or a military nature. Furthermore, the central justification of the reforms – that people would be interested in legalization of their incomes – was criticized on the grounds that individuals would not be motivated to participate in a system which was ineffective from an economic point of view.⁶⁵

⁵⁹ Open Society Georgia Foundation, *Annual Report 2001* (Tbilisi: Open Society Georgia Foundation, 2002).

⁶⁰ Tsiuri Antadze, “Social Protection System” in *European Neighbourhood Policy and Georgia: Analyses of Independent Experts*, Friedrich-Ebert-Stiftung et al. (Tbilisi, 2007), <http://www.enp.ge/?l=1&i=117> (accessed July 7, 2008).

⁶¹ *I-News*, “New Social Insurance Principles to be Introduced from 2004,” September 29, 2003, http://archiveinews.internet.ge/stat_relatives.html?date=2003-09-29&stat=11 (accessed May 24, 2008).

⁶² This element is also known as the NDC (Notional defined contribution) framework, which explicates the actuarial mathematics and trade-offs inherited in any PAYG system. Employees pay a certain percentage of their earnings into notional individual accounts, and governments also credit these accounts with notional interest rates according to their fiscal capacity that, in turn, is affected by aging trends.

⁶³ Retirement age for women would gradually increase by half a year in each calendar year up to 65 years of age.

⁶⁴ Soso Bregvadze, Interview by author (Tbilisi, Georgia, September 4, 2008).

⁶⁵ Megrelishvili, 2008.

Second Stage of Development: Politics of Pensions

From 2004 two dimensions of the pension system development can be distinguished. On the one hand, the changes sought to fight poverty among the elderly, while the government also aimed to create an environment for consumption smoothing during the retirement.

Retirement without Poverty

The new government improved the welfare of elderly by improving the public pension system and developing a general means-tested social assistance program. The old-age pension system was greatly affected by the measures to establish economic and financial order in the country. In 2004 the total revenues of the state budget grew by 91.3 percent, while the share of tax revenues of GDP increased to 18.5 percent. It became possible to redeem salary and pension arrears from previous years.⁶⁶ The authorities also largely managed to eradicate corruption, identify database falsifications, and dismantle the special preferences among and within the different groups of pensioners. In December 2005 a new Act on State Pensions was adopted. All citizens of Georgia were granted a right to receive the old-age pension benefits any time after the age of sixty for women and sixty-five for men. The legislative changes were accompanied by the administrative amendments on which the SSA was founded.⁶⁷ At first sight, the introduction of the new legislative framework had to be considered as a major change in the old-age pension system, but in reality, the fundamental elements were not amended. The system was still based on the principles of solidarity payments and equal pension benefits, and did not anticipate the differentiation of pension benefits.⁶⁸

On the revenue side, the old-age pension system was also affected by new changes to the tax code. With regard to social policies, a decision was made to abolish the personified social insurance contributions and introduce a common social tax at a rate of 20 percent of all salaries and wages.⁶⁹ After this consolidation, the maintenance of records on individual employees and their taxable incomes was abolished, which meant that the possible future differentiation of old-age pension became technically unfeasible. From 2008 further major changes to the Tax Code were introduced. The social tax was annulled, and individuals became responsible for the payment of income tax, at a rate of 25 percent of their gross earnings.⁷⁰ Moreover, pension benefits were financed by the general revenues line of the state budget. Previously, these contributions were separately accounted for in the state budget, and the Tax Department paid less attention to administrating these collections. After their inclusion in the central budget, there was an increased incentive for the Tax Department to enhance the collection performance of the social contributions.⁷¹

⁶⁶ National Bank of Georgia, *Annual report 2004* (Tbilisi: National Bank of Georgia, 2005), http://nbg.ge/uploads/publications/annualreport/2003/141.04.2004_1.pdf (accessed September 22, 2008).

⁶⁷ Social Subsidies Agency (SSA), "The objective of Social Subsidies Agency," Description of Social Subsidies Agency, <http://www.ssa.gov.ge/index.php?id=31> (accessed July 13, 2008).

⁶⁸ Antadze, 2007.

⁶⁹ Vakhtang Megrelishvili, "Social sector reforms," in *Georgia Human Development Report 2008, Background Papers* (Tbilisi: UNDP, 2008).

⁷⁰ Ministry of Finance, "Basic Data and Directions," Tbilisi, 2008.

⁷¹ USAID, *Georgia Fiscal Assessment* (The publication produced for review by the United States Agency for International Development, 2005). <http://georgia.usaid.gov/pdf/2.pdf> (accessed August 4, 2008).

On the benefit side, from 2004 the amount of minimal flat old-age pension was initially increased by GEL 28 per month, and then by GEL 38 in 2006. After the social unrest in November 2007,⁷² the government increased the old-age pensions by GEL 55. Before this political stalemate, however, the increase initially applied only to those pensioners who qualified as being extremely poor in the unified social assistance database.⁷³ During the 2008 presidential campaign,⁷⁴ the opposition coalition proposed designing an old-age social security system in which pensions would be calculated based on the years of service and individual accomplishments.⁷⁵ Nonetheless, the existing government remained in office, with a consequential announcement that the parametric pension reforms would be one of the central elements of its “50-day Program”.⁷⁶ Since March 2008 minimum pensions have increased by GEL 70. The pension replacement rate, however, remained at a very low level, which further highlighted the inadequacy of the existing old-age pension system.⁷⁷ In 2009 the authorities planned to increase pensions by USD 100,⁷⁸ which, for the first time in recent history, would be more than the minimum subsistence level of an average consumer.

After effectively dealing with the main technical problems of the public pensions, the government realized there were still many obstacles that would burden the system. Senior government officials believed that the PAYG scheme was not sustainable in a country which had a shrinking and aging population, a negative net migration, and high life expectancy rates.⁷⁹ Negative trends in the labor market, such as high unemployment and informal employment rates, were also weighing the system down. At the same time, high levels of poverty in the population required “increasing the efficiency and effectiveness of state measures against poverty.”⁸⁰ According to prevailing logic, growing pension expenditure and anti-poverty social assistance had to be financed from the same source of revenues, which meant that prioritizing one would come at the expense of the other. Concentrating on the increasing universal pension benefits would mean that the government was oriented toward segments of the population with medium income, while the most poor would still remain in precarious conditions. The trade-off for the government was clear, and the political decision was made to prioritize the general means-tested poverty reduction measures over the pension policy.⁸¹

From 2004 to 2006 intensive work was performed to introduce properly functioning means-tested social assistance system, and in 2008 its database included 41 percent of Georgian households and 38

⁷² In November 2007 the government dismantled opposition parties’ rally using the force. This development eventually resulted in political crisis and snap presidential and parliamentary elections.

⁷³ Vakhtang Baramidze, Interview by author (Tbilisi, Georgia, August, 28, 2008).

⁷⁴ The political leaders, however, did not define any clear strategy on pension reforms, any exact meaning, or the form of the calculation of the pensions according to the years of service and individual accomplishments.

⁷⁵ IATP, *Levan Gachechiladze, IATP-Forum, 2008 presidential elections*, Question presidential candidate, (December, 2007), <http://forum.iatp.ge/lofiversion/index.php/t53.html> (accessed May 20, 2008).

⁷⁶ Open Society Georgia Foundation, “50-day Program” of the government of Georgia: Analysis and conclusions,” *Policy Paper N15: Report, Analysis, Recommendations* (Tbilisi: Open Society Georgia Foundation, 2008).

⁷⁷ Irina Badurashvili, “Generational Relations and Intergenerational Solidarity in Modern Georgian Society,” *CRRC Research Paper*, No. 9, Tbilisi, 2008, <http://www.crrc.ge/index.php/en/8/999/183> (accessed June 6, 2008).

⁷⁸ But there is a misunderstanding regarding this amount of pensions promised from 2009: the government’s initial action plan declared that “as a result of pension reforms, social pension amount and quality will be increased – the pension package will grow by USD 100 and will be one of the central elements of overcoming poverty.” The pension package logically can include not only cash payment but also other services. Ideally, the government would need twenty-one months to deliver on its promises.

⁷⁹ Kakha Bendukidze, 2008, Interview by author, Bakuriani, Georgia, July 10 (in Georgian).

⁸⁰ Megrelishvili, “Social Sector Reforms,” 204.

⁸¹ Khechinashvili.

percent of the population of Georgia. The idea was that the government, based on proxy means-tested mechanisms, had to spend tax-payers money on those unable to care for themselves by giving them cash and different in-kind benefits, such as compensations for communal services, health care, and education scholarships.⁸² Simultaneously, the program has also included about 240,000 of the poorest old-age pensioners, almost a third of all retirees. The scheme had potential, if accordingly financed and developed, to drastically reduce extreme poverty in the general population. The government also presumed that it could maintain the old-age pension system without substantially increasing of the universal pension benefits.⁸³ Nevertheless, after the November 2007 unrest, a political decision was made that the scarce resources had to be devoted to increasing the general pension benefits for the entire aged population, which in turn reduced resources for the effective implementation of the means-tested social assistance program.⁸⁴

Achieving a Decent Retirement

From 2004 the authorities started to consider a transition to private pension schemes in order to create an environment in which people would be able to independently secure a decent retirement. The old-age pension reforms were originally at the centre of the political agenda⁸⁵, but, in fact, there was no sound policy framework developed, and no special task force or working group was engaged in pension issues on a full-time basis. The government began to argue, however, that within the existing environment, current consumption might be more effective than depositing savings for retirement.⁸⁶ In defense of this argument, three main points were emphasized: first, if individuals would deposit savings into pension funds, their real benefits from pension annuities would be roughly five times less than their pre-retirement incomes due to the existing high economic growth and inflation rates;⁸⁷ second, the government was reluctant to bear the costs of any guarantees of protecting workers' savings if a mandatory system was introduced;⁸⁸ and third, the introduction of an obligatory system would mean, as in the Soviet era, that individuals would not know what was in their best interest.⁸⁹ Based on these notions, the government preferred to withhold the final pension reform decisions and simultaneously worked on tax incentives to stimulate general savings.

In early 2008 the parliament approved the government's package of draft bills, which implied the gradual reduction of income tax and the introduction of tax reliefs for incomes stemming from various types of deposits.⁹⁰ The authorities considered this decision as a step toward pension reform because it made all investments, including pension savings, more profitable,⁹¹ though it did not imply any special treatment of retirement accounts. This decision was partially justified by the earlier experience in 2004

⁸² Bregvadze.

⁸³ Jandieri.

⁸⁴ Megrelishvili, "Social Sector Reforms," 204.

⁸⁵ For instance, during the Georgia–Italy business forum in March 2007, then-Prime Minister Nogaideli stressed that in spite of the fact that the government paid the flat rate pensions to individuals who have achieved the pensionable age, a transition to funded pension arrangements was planned.

⁸⁶ Baramidze.

⁸⁷ Bendukidze.

⁸⁸ Jandieri.

⁸⁹ Megrelishvili, Interview.

⁹⁰ At the same time, the government declared that private insurers would invest their funds in businesses and receive profits which are taxed again; however, since the resources which are used in these activities are already taxed when they enter the pension funds, then the profit of pension funds should be tax free.

⁹¹ Baramidze.

when the introduction of special tax incentives for private insurance failed to generate a boom in pension accounts, although the licensing of the voluntary pension funds substantially increased.⁹² The size of annual old-age public pension payments for 2007 was roughly 300 times larger than the size of combined private old-age pension savings since 2001.⁹³ Despite the argument by those who supported the tax reliefs that the initiative required a longer time-span before the financial institutions, insurance companies and the population would adjust to the new environment: from 2005 the amendments in the Tax Code eliminated all tax preferences and depreciated the positive prospects in the private pension schemes.⁹⁴

To counterbalance the government's approach toward the old-age pension reforms, an initiative was taken by parliament in 2006 to establish the Pension Task Force, which was facilitated by the EU delegation in Georgia.⁹⁵ The Pension Task Force saw that the worst option was merely retaining the existing pension structure and enabling the increase of pension benefits as the government resources allowed.⁹⁶ After the extensive public consultations, the Pension Task Force proposed the introduction of a contributory funded pension system in which currently workers would have the option to join such a system. Future pensions would have two components: a monthly pension for life, from age sixty-five, equivalent to a capital reserve which would have been built up in a contributor's personal pension account; and second, a transfer to the contributor's personal pension account of the value of the proportion of the current state pension. The pension account would be administered in an autonomous pension fund, the assets of which would be managed by private-sector investment managers.⁹⁷ The calculations indicated that with the contribution of 10 percent of earnings, annuities in constant GEL 2007 would grow from GEL 38 to GEL 100 in some twenty years' time,⁹⁸ and in forty years would exceed GEL 250.⁹⁹

In spite of being the most elaborate and up-to-date pension reform plan, the executive government disregarded the proposal based on the abovementioned arguments. Among others, the Ministry of Finance strongly opposed this initiative due to the projected reduction of current revenues during the transition period. It was also argued that the statistical calculations employed in the model were not reliable.¹⁰⁰ This confrontation indicated that senior executive officials had not only a better understanding of the political economy of pensions but also more leverage on the final decision-making process, which meant that the Pension Task Force reform initiative could hardly succeed even if its approach had been completely credible.¹⁰¹ After the government effectively blocked the proposed initiative, the Pension Task Force was forced to adjust its agenda to the government's line. The idea on partially mandatory pension insurance was dismissed, and the work continued just on the development

⁹² USAID, 2005

⁹³ GPI, "Private Pension Insurance," Description of the Company, Tbilisi, 2008, http://gpi.ge/Default.aspx?sec_id=680&lang=1 (accessed May 20, 2008).

⁹⁴ Niko Rijamadze, Interview by author (Tbilisi, Georgia, August 6, 2008).

⁹⁵ The Task Force functioned within the framework of the Policy Advice on Pension Reform in Georgia project which was funded by the European Union. David Callund was the team leader and served as a consultant under the chairmanship of MP George Tsereteli.

⁹⁶ Manana Vardiashvili, "Quasi-reform," *24 Saati*, June 13, 2008, N131, B3.

⁹⁷ David Callund, *Pension Task Force: Final Report*, Tbilisi, Georgia, 2007.

⁹⁸ Over the same period, the pension, as a percentage of final earnings before retirement, and the replacement rate would grow from around 15 percent to some 40 percent of final pay.

⁹⁹ Callund, 2007.

¹⁰⁰ Jandieri.

¹⁰¹ Baramidze.

of voluntary pension schemes. The new model intended to enhance and formalize private pension mechanisms and create incentives for people to save in these schemes.¹⁰²

Was Momentum Lost or Gained?

The implementation of systemic pension reforms, as commonly agreed upon, would have been most plausible between 2004 and 2007 when the country had excellent fiscal standing. But the reforms still would have required substantial financial resources since the government would lose the portion of tax revenues redirected to mandatory private pension funds.¹⁰³ These transition costs could then be financed through grants from international organizations and privatization of public assets.¹⁰⁴ The systemic reforms most likely would also have worsened the government's political stance by affecting the well-being of those cohorts who would not have had the opportunity to save accordingly for their retirement.¹⁰⁵ Instead, the government preferred to increase the flat-rate pension benefits regularly and, as such, contributed to the transformation of the old-age pension expectations into the old-age pension liabilities, which not only assumed sustainable provision of benefits but also their ever-increasing nature. Furthermore, during the last presidential campaign, the increase of old-age pensions system became a way to win the votes of pensioners, a large and politically active group of the population. Taking into account the projected demographic and employment characteristics, it will gradually become even more difficult to increase pension benefits, whereas subsequent governments might occasionally experience heavy pressure from the elderly requiring a decent increase of pension benefits.¹⁰⁶

The military confrontation with Russia in August 2008 and the intense effects of the international financial crisis had their consequences on old-age pension reform prospects. The slowing economic growth rates and shrinking budgetary revenues substantially affected the country's fiscal health.¹⁰⁷ The crisis made it much more difficult not only to implement comprehensive pension reforms with an introduction of any kind of mandatory private pension provision,¹⁰⁸ but it also, at least for several years, disrupted accomplishing the promised increase of the flat-rate general pensions benefit by USD 100.¹⁰⁹ However, the recent developments could be also viewed from a different perspective. The crisis can boost the position of those who think that a completely privatized pension system is the only feasible solution to the problem. Indeed, in the beginning of 2009 the government announced that the country needs the promotion of voluntary private pension schemes in which individuals will be able to independently secure their best possible retirement prospects.¹¹⁰ The only threatening aspect, though, in this development is the potential for a final decision that is made abruptly, without adequate consideration of other policy alternatives.

¹⁰² Gelashvili.

¹⁰³ USAID, 2005

¹⁰⁴ Mirzashvili.

¹⁰⁵ Rijamadze.

¹⁰⁶ Jandieri.

¹⁰⁷ Ministry of Finance, "Act on State Budget of Georgia 2009," Tbilisi, 2009, http://mof.ge/default.aspx?sec_id=3159&lang=1 (accessed August 22, 2009).

¹⁰⁸ Gelashvili.

¹⁰⁹ *Civil.Ge, Daily News Online*, "Cabinet Wins Confidence Vote," February 6, 2009

<http://civil.ge/eng/article.php?id=20385&search=new%20government> (accessed August 2, 2009).

¹¹⁰ *Commersant.Ge*, "President Saakashvili Talks about Necessity of Reforms," January 24, 2009, <http://www.commersant.ge/index.php?pg=nt&id=4435&ct=2> (accessed July 26, 2009).

Conclusions

The purpose of this account was to clarify what factors have been affecting the old-age pension system's development in Georgia after the dissolution of the Soviet Union. Through the method of evaluation of the selected scholarly literature mainly on the transition economies, there are specific hypothetical determinants – economic, demographic, political and international factors – that explain pension system development. In order to examine these theoretical explanations, an assessment of the changes in old-age pension provision, and two consecutive and chronological attempts of systemic amendments as well as two simultaneous and ongoing reform agendas are identifiable. In the first stage of development, the bottom-up reform initiative stemming from the Ministry of Labor and Social Security was blocked by the political indifference in the upper echelons of executive power; and when the fiscal problems intensified, the government became interested in gaining political dividends through the top-down reform initiative mediated by the World Bank. Demographic aging worsened the scope of the pension problem and, therefore, affected reform initiatives, but not in such an illustrative manner as did the international influence that played a significant role in all major reform preparations. Since 2004, old-age pension reforms have been upgraded to a more mature policymaking level, though the government was not able to exploit the post-election “honeymoon” period to conduct systemic pension reforms. Thereafter, the state's priority deviated from the universal old-age pension system to the development of universal means-tested social assistance program and presented the general tax reduction trend as a component of broader pension reforms, successfully blocking parliamentary attempts to introduce mandatory pension savings. On this reform stage, the unbalanced fragmentation of political power played a decisive role for the reform outcome. This specific event can also be seen in light of the confrontation between the EU-backed reform approach, endorsed by the parliament, and the executive government's position, which was more closely associated with the World Bank's ideology. The military conflict with Russia and the world financial crisis, contrary to expectations, might facilitate rather than postpone reforms, though not within the best possible scenario.

Old-age pension reforms in Georgia were only marginally determined by the pluralistic style of democratic competition among stakeholders. The reforms were almost exclusively shaped by the ministerial, legislative, and government agencies. The political economy of this approach is more in line with a state-centered logic of pension policy development, which is mostly shaped by the structures that the state imposes. In addition, it is difficult to evaluate a role of democracy in Georgia's old-age pension reform process; however, the government's drive to introduce a new pension model before the 2003 parliamentary elections and the new government's promise to almost double flat-rate old-age pensions during the last presidential campaign may have some implications for committing to a policy option preferred by the average voter. Overall, one general observation from this paper is the contradictory fact that despite creating political justification for reform, the radical fiscal crisis did not lead to the systemic old-age pension changes, while the conducive fiscal environment dampened political aspirations toward important paradigmatic reforms.

Clearly, these findings are preliminary and deserve further examination. In spite of an attempt to access the most comprehensive data sources, apparently this paper considers a very broad time span, with some incomplete sources of information that we unavailable at the time of writing. Further, many key stakeholders did not have full information on up-to-date developments. Even the parliamentary Task Force and the team at the Ministry on Reform Coordination could not fully coordinate complementary activities. Therefore, it is important to promote debate on pension policy through sound research

practices. Although definitive answers as to what factors determined pension reforms are difficult to pin down, all economic, demographic, political, and international factors matter. The question is still how their constellations determine policies in different time periods. Considering this constraint, future efficient research designs should ideally concentrate on the analysis of a single reform attempt within a shorter research timeframe.

Appendix

List of Interviewees

Monika Ambrishevska-Khechinashvili – Employee of the Parliamentary Committee on Health and Social Affairs; member of the Parliamentary Pension Task Force;

Vakhtang Baramidze – Employee of the State Ministry on Reforms Coordination;

Kakha Bendukidze, Former State Minister and Head of State Chancellery of Georgia;

Soso Bregvadze – Deputy Head of Social Subsidies Agency;

David Gelashvili – Former Actuary of GPI Holding; member the Parliamentary Pension Task Force;

Gia Jandieri – Vice-President of the New Economic School of Georgia;

Khatuna Jishiashvili – One of the founders of the Association of Actuaries and Financial Analysts (AAFA); Member of the Parliamentary Pension Task Force;

Devi Khechinashvili – Head of the Insurance Association of Georgia;

Vakhtan Megrelishvili – Former Deputy Head of the Ministry of Labor, Health and Social Affairs,
Guram Mirzashvili – Chief Actuary of the Aldagi-BCI; member of the Parliamentary Pension Task Force;

Nika Rijamadze – Head of the GPI's sales department.