

## CHALLENGE FOR A NON-FINANCIAL DEFINED CONTRIBUTION SCHEME IN THE ALBANIAN RETIREMENT SYSTEM

Landi Gushi<sup>44</sup>

DOI: <https://doi.org/10.31410/eraz.2018.97>

---

**Abstract:** *The retirement system in Albania has gone through a series of important reforms. Actually, the retirement system in Albania is dominated by the public mandatory scheme managed by the Institute of Social Security. This paper discusses the potential role of a Non-Financial Defined Contribution scheme and its implementation in the Albanian retirement system relying on international theory and experience. In the present social and economic situation in Albania, the reforms in retirement system are needed immediately, so that the retirement system fulfills its intended functions. It should be an important element in reducing the poverty and enhancing the future social-economic developments; therefore the only alternative is to improve it further by reforming it.*

**Key words:** *retirement, reform, Non-Financial Defined Contribution Schemes, Albania*

---

### 1. INTRODUCTION

Nowadays, the issue of financial sustainability of the social security scheme is the center of discussions and debates among experts; it also is a constant concern for many governments. Such issue brought about the need for reforms in actual retirement systems in many countries. There are few countries where the reform in the current retirement system is not a part of the reform agendas. The managers behind the need for reforms change according to countries and regions, but they agree on the necessity of reforms on the actual retirement systems (Holzmann and Palmer, 2006). In fact, the retirement reforms, regardless of the differences between them, on one hand are performed through reforms affecting the contributors and those who actual and future beneficiaries on the other. A wide discussion related to reforms in retirement system has occurred and is occurring in many countries. The need for consolidating the social security systems and retirement funds that generate incomes for the elderly is also encouraged by pressures of global aging phenomenon, decline of informal and traditional systems of household support and weaknesses in managing and governing the existing retirement systems (Holzmann, Hinz and Dorfman, 2008). In circumstances when the old operating system PAYG adopted in many countries is failing (Augusztinovics, 1999) and anticipating the difficult social crisis which may come as result of this same scheme's failure, a question is raised: Would it be better to operate with a modified PAYG system, a private retirement system or a multi-columns system? The NDC scheme came as result of exchanging ideas and discussions among retirement experts and politicians who work for the retirement schemes in countries where the NDC scheme has been implemented. It is worth mentioning the fact that 10 years after its introduction as a scheme, the NDC scheme is applied in Sweden (Scherman 2003), Italy and Poland (OECD, 2012: 56) and no result has been obtained yet because of the short-term period of its implementation so that the effectiveness of its technical framework is ensured. It is the only way for expanding the list of countries that implement this scheme. It is too important that the application of this scheme is considered as an alternative

---

<sup>44</sup> Faculty of Economy, Marketing – Tourism Department, University “Fan S. Noli”, Korce, Albania

for reforming the retirement system in Albania as well. This is because the application of such scheme would financially stabilize the retirement system in Albania and would bring about changes that fit with increasing phenomena in our country such as population aging, high unemployment and immigration.

## **2. WHAT ARE RETIREMENT SYSTEMS?**

The retirement program called the retirement system is a specific scheme which generates incomes for those persons whose age makes it impossible to generate incomes through a job. This system is part of Social Security system, which is established to increase the wellbeing for individuals in cases of misfortunes caused by accidents, disabilities, etc.

Retirement schemes take the majority of Social Security system. Retirement systems have multiple goals: fight poverty, reduce consumption, provide safety and are a means for re-distribution within and among generations (Barr and Diamond, 2008). Generally, they are compulsory systems, applicable to all; they protect the citizens from diseases, invalidity and aging. These schemes are provided by the Government. Retirement is an agreement which enables people to generate incomes when they are older and unable to work. This is a saving means which allows tax free accumulation of an amount of money to be used later as an income from retirement (ILO , 2005: 25). Complete retirement payment is the most widely used profit that covers the retired population. Retirement, according to Williams and Windebank (1998), is the entirety of planned procedures and a legal process for creating a safe fund, fulfilling the social obligation that employers owe to their employees in the moment they retire.

## **3. TYPES OF RETIREMENT SYSTEM SCHEMES.**

Institutions that manage the retirement schemes in itself do not include only the retirement scheme identified habitually with the social security. There are other schemes that operate in such institutions, such as temporary disability, maternity leaves, job accidents and occupational diseases, unemployment, income compensations for household, child compensations, schooling compensations, etc. Based on different criteria, retirement schemes are divided into some groups:

### **According the financing means they are divided into:**

*Schemes financed by incomes collected by the Government (Beveridge).*

Based on this model, employees pay fixed contributions and get retirement payment for meeting their vital needs. Participant in this model is the Government that contributes with the payment of benefits being provided. According to this model, all citizens are protected and have a right to benefit regardless the level of contributions. In this model, the re-distribution level for the incomes is too high.

*Schemes that are financed by contributions paid by anyone (Bismark).*

Based on this model, the system is financed by contributions paid by individuals and the contributions level is related to incomes being generated from employment. Benefits are related to incomes and paid contributions. This model has lower level of income re-distribution than Beveridge model. (Ludwig and Winter 2005: 10).

### According the management method they are divided into:

#### *Public schemes*

The management is public here, made by Government or its structures, such as boards, councils, etc. In such schemes, the role of Government is essential and enables these schemes through financing and managing them. These schemes are universal and protect the society with social security elements.

#### *Private schemes*

These concern the schemes that are not universal, but offer advantages to certain groups. These schemes are based on the principle of pure safety and the re-distribution level is too low. They operate based on the principle of individual accounts and everyone benefits from the contributions paid through the years based on actuarial estimations.

#### *Public schemes managed privately*

These schemes are a mix of the above schemes. They are public and include everyone, but in order to increase the effectiveness and well-management they are managed privately. Public schemes managed privately are self-capitalized. Their priority lies in increasing the profit from investing the accumulated funds.

### According the capitalization level the contributions are divided into:

#### *Non-capitalizing schemes or Pay as you go (PAYGO)*

These schemes do not capitalize the paid contribution and they invest it, but the paid contributions are used to pay the benefits of the same period. In other words, the contributions paid by participants in the scheme, one month or year, are used to pay the retirees that same month or year. This type of scheme is called *pay as you go* and has a high re-distribution level among generations, within generations and among genders. In cases when the paid contributions are higher than benefits to be paid, the surplus goes to reserve fund, which is a fund used when incomes lack and serves as a guarantee for the scheme and already determined benefits.

#### *Schemes with capitalization or capital accumulation.*

### **LANDI GUSHI**

*Faculty of Economy, Marketing – Tourism Department, University “Fan S. Noli”, Korce, Albania*

#### **Education and qualifications:**

*1992-1996; University studies, Faculty of Economy*

*University “Fan S. Noli”, Korce, Albania; Branch: Marketing; Title: "Economist for Marketing"*

*2007-2011; Master studies, Faculty of Tourism and Hospitality, Ohrid, University St.Kliment Ohridski-Bitola, Republic of Macedonia; Title: "Science Master in Insurance", 2011*

*Equivalent to MES "Scientific Master in Insurance"*

*Microtease: "Compensation of Non-Material Damages European and Macedonian Experiences"*

*Scientific leader: Prof. Dr. Miladin Kerstanofski*

*October 2012 - PhD student at the European University of Tirana.*

#### **Employment experiences:**

*1996 - 2005: Administrator of the company "Agro-Dimizal", Korçë.*

*March 2005 - February 2006: Credit Analyst at the WorldVision Albania Foundation, Korça.*

*March 2006 - January 2010: Regional Director at the Regional Social Insurance Directorate, Korça.*

*February 2010 - March 2012 Regional Director of the Regional Health Care Directorate, Korç.*

*April 2012 - May 2014: President of the Regional Council, Korça.*

*October 2014 - Continuation: Lecturer at Faculty of Economics University "Fan S. Noli", Korça*

In such schemes the contribution paid is personalized and is managed in individual accounts. All individual contributions are accumulated and invested through the years. Even interests provided by investments are added to individual accounts. The profit is estimated based on contributions and investment interests in individual accounts based on actuarial calculations.

**According to the way of delivering the benefits, they are divided into:**

*Schemes with defined benefit (DB)*

Benefit provided through these schemes is estimated as part of incomes from employment for period provided by law. This means that benefit is a part of the salary on which social security contributions are paid. Generally, the amount of benefit is calculated as a percentage of salary for the last year or the average salary for the last three or more years. For example, 70% of the average salary for the last three years or the average salary of the vest three years in the last 10 years in employment. This scheme is good for the beneficiaries, but creates difficulties in the financial stability of the scheme. This is because salaries in the last years are higher than when the carrier just started.

*Schemes with defined contributions (DC)*

The advantage for these schemes is calculated by considering the entire contribution paid during the working carrier or the regular working years. Therefore, the contribution paid during the whole life is primary, and not just the last years. According to this scheme, the benefit is related to the level of paid contribution and initiatives are put in place for paying high contributions during the whole working carrier so that retirement benefits are higher. This scheme is related directly to paid contributions with benefits received.

#### **4. HOW DOES A NDC RETIREMENT SCHEME WORK?**

Retirement schemes in different countries of the world have gone through major modifications as result of several phenomena, which have come to develop in different periods. These changes brought the necessity for modifying these schemes. Initially we notice those phenomena which brought the need for reforms.

Fiscal pressures continue to be the main cause for starting with retirement reforms. Reforms are inevitably initiated by the results of short term budget pressure. The most important problems for the long term budget are related to sustainability because of population aging.

Social-economic changes are another important reason for reforms. Public dispositions from incomes of retirement for employees in the private sector originate from XX century and continue even today in developed countries, as a political response to urbanization and industrialization. For a certain period, schemes were based on the model where most of the time, the husband worked, while the wife remained at home taking care of house chores and kids, with a high probability of turning into a widow. Therefore, the first aid provided by retirement schemes is to assist children and widows. In the end of XX century, two important social-economic modifications occurred by changing the situation.

First, the increasing participation of women in the labor market and change of household structure. Another factor which reformed the retirement schemes is the globalization. Because of it, reforms are important not only for globalization benefits, but to face difficulties as well caused by globalization, including huge issues from innovation or displacements, which are made for being adapted with the production increase in companies and production plants.

To solve these problems, establishment of NDC retirement systems has been a solution. What are the NDC retirement schemes?

A NDC scheme is a pay-as-you-go scheme with determined contributions. In this scheme individual contributions based on fixed contributions rate are determined in imaginary individual accounts. These accounts are credited with the capital return rate. They continue to be accumulated for as long as the person owning it works and contributes. There is no age limit for being a full beneficiary in the scheme, but all contributions increase the size of individual annual retirement payment, when the persons does request it or after he/she is aged enough to retire. Annual retirement payment is calculated by dividing the account balance with the price of retirement longevity. (Palmer, 2004:18).

Compared to DC schemes, NDC schemes have major differences.

First, the internal rate of return in a NDC scheme is the function of the increase of productivity, labor force and factors related to contribution and payments of benefits are in contradiction with the financial market rate of return.

Secondly, the only financial saving that may occur comes in the form of a reserve fund which is in contradiction with the DC schemes. NDC schemes require a higher level of contributions in order to receive the same payment as DC schemes. Therefore, NDC scheme is the second best one on economic terms. On the other hand, one “positive” side of NDC scheme is that NDC scheme does not involve the transition costs which are related to presentation and establishment of DC scheme, because during this period some forms of pay-as-you-go scheme still persist. What is worth mentioning about the NDC schemes is the fact that participants in this scheme or the self-employed pay contributions on their profits during their whole carrier. Although, there is a minimal age limit when people benefit retirement payment, this scheme does not provide such age. For as long as people are employed and make profit from their job, they may generate the incomes in contributions for their individual accounts. (Holzmann and Palmer 2003: 3).

NDC scheme of retirement payments does combine PAYGO financing which is characteristic for DC schemes with defined contributions of DC schemes. It should be emphasized that NDC scheme provides benefits for individual contributions, but it is attributable to contributions with the imaginary interest rate related to salary increase, rather than ensuring the return of specific financial assets. The main idea of NDC scheme is to divide the public PAYGO scheme into two components: one actuarial strict element (NDC retirement payments) operating in PAYG scheme, but imitating the defined contributions scheme. The second element is a re-distributing element, financed by contributions paid by actual generation. Thus, NDC scheme imitated schemes with defined contributions, by paying valid incomes for the rest of their life. (Barr, 2004: 58).

## **5. ADVANTAGES OF A NDC SCHEME**

NDC scheme is one which is applied in different countries of the world. This is because its application brings many benefits for the social security system and the economies of the countries. Advantages of NDC schemes are many; let us mention as following:

NDC scheme is compulsory. Also, it is an actuarial scheme, because it has access in the individual account for as long as they live. The portability of the right to retire among different

jobs, professions and sectors, is allowed in such schemes. This scheme “promises” to face the aging effects of the population in an automatic way.

Avoiding the arbitrariness in the rules of benefit indexing and regulatory factors makes up another advantage of this scheme. (Palmer, 2004: 19).

Besides, NDC scheme brings many benefits on social and economic aspect for several reasons. One of them lies with the fact that this scheme ensures a life retirement payment. It could be benefited since the moment when the person is minimally old enough to retire.

Basic incomes of NDC materialize the rate of return based on the same internal rate of return, which are credited accounts during the accumulation stage. Therefore, NDC scheme distributes individual resources during the life cycle, but with the structure of universal security PAYGO scheme.

Another benefit for the NDC scheme includes the fact that it faces the effects of changes of demographic and economic factors. (Borsch-Supan, 2003: 6).

## **6. LACK OF AN NDC SCHEME IN THE ALBANIAN SYSTEM**

Social security system in Albania operated according to PAYGO scheme, therefore the system does not capitalize the paid contribution so as to invest it. Such way of operation for a long period of time, in Albanian system as in other countries caused many problems. Therefore, the retirement system today is facing a lot of problems requiring solutions from retirement experts and policy makers. Many of these problems come because of implementing the PAYGO scheme in the social security system. So, the retirement scheme suffers from a high deficit, which makes it financially unaffordable. Also, another problem is the low level of benefits from retirement; slow pace of real size of increase and the regressive turn on their 1997 level, which took almost 3 years to recuperate. In 1999, real average retirement payment in towns was only 12% higher than in 1993, whereas the average salary for the same period has increased with an average annual pace by 38%. The retirement scheme in Albania is not financially balanced. Such financial instability is the result of fast increase of retirement rate a few years ago. Other reasons are: low number of contributors, non-declaration of real salary, relatively high number of retirees compared to a young age of population, young age of retirees resulting from early retirement in the beginning of 1990s and young age of retirement for some specific categories, demographic changes, unemployment level and high emigration level for the labor force. Also, the substitution coefficient results in an aggravating tendency in towns as well in villages. From 60,2% in towns in 1994, today is 43.4%. Meanwhile there is another tendency in villages. Until 2000 there is a decline up to 15.78% from 27.34% in 1994. Later on, there is an increase of this rate and now it is 26.9%. This tendency was affected by the higher increase rate of average retirement level in villages against minimal contributing payment. (Ministry of Social Welfare and Youth, 2014: 4).

## **7. WHY A NDC SCHEME IS IMPORTANT IN THE ALBANIAN SYSTEM?**

The retirement reform is in its third year of implementation. Although it is still the beginning, it faces challenges of emigration of young labor force, fast pace of population aging phenomenon, decline of contributors who work in agriculture and increase of deficit in net values; since 2013 the scheme has involved about 157 thousand new contributors. The retirement scheme in Albania is not financially balanced. Such financial instability is the result

of fast increase of retirement rate a few years ago. Other reasons are: low number of contributors, non-declaration of real salary, relatively high number of retirees compared to a young age of population, young age of retirees resulting from early retirement in the beginning of 1990s and young age of retirement for some specific categories, demographic changes, unemployment level and high emigration level for the labor force. In 2016, the deficit among incomes from contributions and expenses for benefits was more than 44 billion Lekë (ISSH 2017). The deficit has put at risk the financial sustainability of the retirement system. Another challenge which the system should face with is of course the fact of population aging phenomenon, which causes a sharp and sensitive rate of dependency. For this reason it is necessary to establish a scheme based on contributions. Such a scheme would be very profitable for the social security system and the economy in Albania. Advantages start from the increase of financial sustainability of the scheme; decline of informality in labor market, a closer relation between contributions made during the working years and the obtained retirement; as well as a more suitable retirement level since they would be based on contributions. It should be emphasized the fact that the main objective of retirement supervision is that the retirement fund should be able to meet the expectations of members, related to benefits and risks. Besides, the low level of development for the third backbone in Albania should be set aside since it is a voluntary scheme. This and the lack of the second level is accompanied by a high opportune cost of supervisory involvement capacities from the Financial Supervisory Authority (AMF). During the last years, AMF has determined the necessary standards for an effective management and supervision of voluntary private retirement funds, thus, creating a new experience according to European standards. This scheme is created with defined and capitalized contributions aligned with the last global tendencies. The contribution of the third backbone is inconsiderable in the Albanian economy, so that a reform adopting the NDC scheme would revive the retirement system by addressing the long-term challenges. The stronger the role and importance of NDC in retirement system, the more sensible the reform benefits, increasing the pressure toward reducing the system's deficit as a whole.

## **8. CONCLUSIONS**

Many countries around the world have lived the transition from an actual to a reformed system. Some of them have reformed the retirement system to pass on to NDC system. NDC retirement system is a pay-as-you-go scheme with defined contributions. In such a scheme, individual contributions based on fixed contribution rate are determined in individual accounts. These accounts are credited with the rate of return. They continue to accumulate as long as the person works and made contributions. This scheme is ideal for dealing with different economic issues if the country, because it faces the financial instability and population aging. It provides a framework to deal with the greatest needs in modern retirement systems.

NDC schemes require a high level of contributions in order to receive the same payment as DC schemes; therefore NDC scheme is the second best in terms of economic benefits. On the other hand, "a negative side" of DC scheme which are related to introducing and establishing the DC scheme is that NDC scheme has no high transition costs because some forms of pay-as-you-go scheme still persist.

NDC scheme brings a lot of advantages in the social and economic aspect for several reasons. One of them lies with the fact that this scheme provides a life retirement. It could be obtained since the moment when the person is minimally aged to be retired. Basic incomes of NDC materialize the rate of return based on the same internal rate of return, which are the credited

accounts during the accumulation stage. Therefore, NDC scheme distributes the individual resources during the life cycle, but with the universal scheme structure of PAYGO security.

As in other transitional economies, the system of social security in Albania is directly related to the developments of transition from a centralized to market economy. They include a decline in employment rate as result of the decline of public sector and the fast increase of informal economy and an increase of early retirement as related to enterprise restructuring. As a result, from 1990 to 2016 there is noticed a considerable decline in the number of contributors from 100% of the labor force to its 1/3. It was because of these issues that the reforms in the system were necessary.

The retirement reform is in its third year of implementation. Although it is still the beginning, it faces challenges of emigration of young labor force, fast pace of population aging phenomenon, decline of contributors who work in agriculture and increase of deficit in net values. Therefore it is necessary the establishment of NDC scheme in our country. It would bring many advantages for the social security system and the country's economy.

The benefits of a NDC scheme start with the increase of the financial sustainability; decline of informality in labor market through a strong relation between contributions made during the working years and obtained; and a more suitable retirement level based on contributions.

## BIBLIOGRAPHY

- Holzmann, R. and Palmer, E. (2006) Pension Reform Issues and Prospects for Non-Financial Defined Contribution (NDC) Schemes, Washington, DC: World Bank..
- Pension Systems and Reform Conceptual Framework. Robert Holzmann, Richard Paul Hinz and Mark Dorfman <http://siteresources.worldbank.org/SOCIALPROTECTION/Resources/SP-Discussion-papers/Pensions-DP/0824.pdf>
- Augusztinovics, M. (1999) Pension systems and reforms in the transition economies, *Economic Survey of Europe*, No. 3: 89-114.
- Scherman, KG. (2003) The Swedish pension reform: a good model for other countries? *Scandinavian Insurance Quarterly*, Issue Nr 4/2003: 304–318.
- OECD (2012) Pensions Outlook, OECD, 56.
- Barr, N. and Diamond, P. (2008) Reforming Pensions: Principles and Policy Choices, Oxford Scholarship Online.
- International Labour Organisation (ILO) (2006) Social Security Spending in South Eastern Europe: A comparative reviews, Budapest: ILO
- Williams, C. C. and Windebank, J. (1998). Informal Employment in Advanced Economies: Implications for Work and Welfare
- Williams, C. C., & Windebank, J. (1998). Informal employment in the advanced economies: Implications for work and welfare . London: Routledge.
- Aging, Pension Reform, and Capital Flows: A Multi-Country Simulation Model Axel Boersch-Supan, Alexander Ludwig, Joachim Winter NBER Working Paper No. 11850 Issued in December 2005.
- Barr, N. (2004) Pension reform: issues and prospects for NDC schemes, *The Economics of the Welfare State*, OUP, 4th ed. 57 – 69.
- Borsch-Supan, A. (2003) What are NDC pension systems? What do they bring to reform strategies? MEA discussion paper series 03042, Munich Center for the Economics of Aging (MEA).

- Holzmann, R. and Palmer, E. (2006) The Status of the NDC Discussion: Introduction and Overview, Washington, DC.: World Bank.
- ISSH , [http://www.iss.gov.al/wp-content/uploads/2014/02/Perb\\_12\\_17-web1.pdf](http://www.iss.gov.al/wp-content/uploads/2014/02/Perb_12_17-web1.pdf)