KOSOVO PENSION REFORM: LESSONS LEARNED FROM THE CASE OF CROATIA

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Submitted to

Central European University

Department of Economics

In partial fulfillment of the requirements for the degree of Master of Arts in Economic Policy in Global Markets

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Budapest, Hungary

2013

ABSTRACT

Due to people's myopic saving behavior pension systems exist as a solution to this issue. However, they have proved to be harder to be sustained in the long-term. Pension system reforms must be conducted in order to create a robust pension system. Although change is sometimes positive, reforms must aim at being sustainable and face challenges that usually occur. Pension system reforms in Kosovo were necessary and Croatia is a good example of comparison. Lessons drawn from the case of Croatia will help in understanding the overall pension system reform sustainability in Kosovo. This thesis aims at showing the sustainability of reforms in Kosovo and uses the case of Croatia as a milestone for an institutional reform.

DEDICATION

I would like to dedicate my Master Thesis to my beloved family for their support and encouragement. Specifically, I would like to express my gratitude for my sister Lorika, for being a never-ending source of love and inspiration.

I wouldn't have been the person I am today without their love and support.

ACKNOWLEDGEMENTS

I would like to express my immense gratitude to Professor Lajos Bokros who has been tremendously helpful during my thesis preparation. His input is invaluable to the development of this thesis and I couldn't have done it without his support. He has been a great mentor and teacher and discussions during our meetings were extremely eye-opening. I would like to thank Professor David Ridout who has taken the time to read my thesis and help me with my writing and the structure of thesis.

Importantly, I would like to thank the Institute of Public Finance in Croatia and the Agency of Statistics in Kosovo that did not hesitate to provide me with needed information and support. From the Institute of Public Finance in Croatia I would like to thank Ms. Marijana Badun who has personally helped me with data gathering and publications done in Croatia. In the Agency Statistics of Kosovo I would like to acknowledge the help of Ms. Selvie Selimi and Mr. Muharrem Uka who have helped me gather data that otherwise are not available publicly.

Lastly, I would like to express my love towards my roommate Peonare Caka, who has been a great support during my thesis writing period and particularly in the past two years of living together.

LIST OF ABBREVIATIONS

ASK—Agency of Statistics in Kosovo

EU – European Union

GDP – Gross Domestic Product

GNP – Gross National Product

NATO – North Atlantic Treaty Organization

OECD – Organization for Economic Co-Operation and Development

PAYG -- Pay-As-You-Go

SFRY -- Socialist Federal Republic of Yugoslavia

TRUSTi – Kosovo Pension Savings Trust

UNMIK – United Nations Mission in Kosovo

USA – United States of America

WB -- World Bank

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CHAPTER 1: INTRODUCTION

Pension systems around the world seem to be a topic that has caught the attention of a lot of scholars and policy-makers due to their complicated nature. A notion that entails in itself a long-term phenomenon appears to be sustainable only in the short term. In other words, due to people's myopic saving behavior, pension systems, although existent as an alternative to this issue, proved to be harder to be sustained in the long-term. More importantly, the sustainability of the pension systems depends on a wide variety of elements. Starting from the people employed that pay the pension contribution up to the number of people already on the pension scheme. There are several pension systems that exist nowadays.

Kosovo and Croatia use different pension schemes and they operate different multi-pillar pension systems. The reason for this difference lies in the way that they emerged from Socialist Federal Republic of Yugoslavia (SFRY). After the fall of SFRY, a wave of wars and political uneasiness captured the Western Balkans. When each country separated from Yugoslavia, reforms and political stability were required to be established within each territory. In addition, the new states needed to create pension schemes such that they would include people that were already in the pension scheme and people that were left with injuries after the wars ended. This appears to be the reason why in each pensions system there is a group of people that are in the pension system due to their incapability to work after the conflicts ended in each country.

Another key factor is the demographic composition in terms of population and size. This will provide help in determining crucial differences between the systems and policy-making choices that each country has taken. Moreover, the countries budgets are directly affected from the existing pension systems and this comes as a result of the aging population and a lower number of younger people that pay pension contributions. Hence, pension system reforms are crucial for the above-mentioned countries and these reforms should be assessed frequently in order to create robust pension system and strong socio-political environment for the population of both countries.

The aim of this thesis is to assess the sustainability of the pension system reform for Kosovo which has only so far undergone one major pension system reform. When looked at each pension system at first glance the Kosovar pension system appears to be sustainable in the long run due to its private savings arrangement, whereas one element of the Croatian pension system might prove to be unsustainable, namely the pay-as-you-go (PAYG) scheme. Interestingly, while Croatia has moved away from a fully public pension system, Kosovo has done the opposite. But, what are the indicators used that fundamentally define a strong and sustainable pension system reform? Questions on how long can pension systems be sustainable and dilemmas whether fully public or fully private systems can prove to be sustainable are of utmost importance when undertaking a pension reform. In addition, pension system reforms are needed when indicators prove to lack sustainability of their own.

Measurement indicators of the pension system reform sustainability are grouped into two major categories. In my thesis I have used the model previously set up by Aaron Grech (2010) who makes an assessment of the pension systems in Europe. Indicators used in his paper are drawn under the assumptions that there is no private savings scheme but only the public pension arrangement. However, pension systems in Kosovo and Croatia are neither fully private nor public. They both contain multi-pillar pension system arrangements that entail public and private savings schemes. Two major groups of the measurement indicators are divided into reaching goals that the pension system sets and challenges the so-called restrictions that the pension system faces when reformed. In my thesis the Kosovo pension system reform that was undertaken in the early 2000s needs to be assessed in terms of sustainability and also it is important to define challenges that it can face in the future and draw recommendations based on the lessons learned from the case of Croatia which created a typical three-pillar pension system after the reform.

Measurement indicators of the pension system reform that I will use in my thesis are the indicators by Grech (2010) that he defines as suitable only for public pension arrangements. However, since my thesis takes into consideration countries with private pension arrangements then the same indicators can be used to determine the sustainability of the pension reforms in the pension systems with private pension arrangements as well. Firstly, indicators are divided into achieving the goals of the pension reform and restrictions that the pension system faces. The first group contains in itself indicators such as: poverty alleviation and consumption smoothing whereas the second group contains indicators such as: intergenerational balance and financial sustainability.

Old-age income support is important when assessing the pension system reform sustainability because the pension system itself is an income support mechanism that should contribute to old-age poverty relief. Since part of the old-age poverty alleviation depends on the culture of the nation and country, it is important that the country itself creates a welfare system that can support the elderly by providing for basic needs.

In Kosovo it is fairly common that children are primary care-takers of their parents and old-age income support is mainly offered by the family members. The pension system and the reform have taken into consideration the poverty alleviation of the whole older generation regardless of their contributions in the past. The Kosovar pension system and its parametric and paradigmatic structure will be explained later and there will be extensive explanation why the poverty-alleviation was aimed at when the reform was taken.

A second indicator of the pension system reform sustainability is *consumption smoothing.* While it is important that the system supports people with monthly income there is also immense need for the income to be of an acceptable level and not lead to a fall in consumption for the individuals after they retire. So, essentially what the consumption smoothing indicator is aiming at is a significantly high replacement rate which measures the income received in the post-retirement period as opposed to the wages received in the pre-retirement period. Since my thesis accounts for private saving pension arrangements it is important to draw conclusions for Kosovo based on which level of consumption smoothing should be aimed at from the pension institutions when reforming the already existing pension system.

In addition to the pension reform objectives, there are significant challenges that should be taken into account and restrictions that can play an important role in the pension system reform sustainability. The first and foremost important indicator is the *intergenerational balance* or in other words, *the balance between the active labor force and the rest of the society*, which is crucial in determining the financial sustainability of the pension system. The reason why this indicator is used is to make sure that the generations benefiting today from the pension system are aligned with the contributions of the past and future pensions should be aligned with current contributions and wages. The intergenerational balance creates a sustainable pension system in terms of the pensions that are dependent on the central budget but also the private savings scheme.

Last but not least, the fourth measurement indicator that helps in pension system reform sustainability is the *financial sustainability* indicator. The reason for using this measurement indicator is the need for the reform to aim at creating a financially sustainable pension system. We assume that the pay-as-you-go (PAYG) scheme is the hardest to sustain financially, but the other private savings schemes are just as difficult to maintain in the long-run. However, there will be thorough analysis of how each pillar is financed and then reforms are drawn in terms of financial sustainability in order to create a reform that will be sustainable in the long-run.

The reason why I chose to write about the differences between the above mentioned pension systems is due to the fact that Kosovo has just recently created a pension system that is at first glance a fully privately funded system. This pension system has proved to be sustainable for the past 13 years. However a thorough analysis of the current system as opposed to the reform in Croatia's pension systems will give a better understanding of the much –needed reform in case of Kosovo, as well.

Previous lessons drawn from the neighboring countries will help define major changes that need to be introduced in the Kosovo pension system. The existing demographics in Kosovo where the majority of the population is young, one would assume that Kosovo possesses a strong and sustainable pension system in the long-term. However, problems such as unemployment, lack of a clear definition between the war veterans and pensioners, mandatory pension contributions and tendencies to avoid its payment, can lead to a distortion of the pension system in Kosovo.

In contrast, Croatia has a multi-pillar pension system which follows a typical three—pillar arrangement. The first pillar is the unfunded public pension system which is called pay-as-you-go scheme. PAYG is an intergenerational income support scheme which is paid by the younger generation with the promise that the next generation will pay for their pension. The second pillar is a mandatory funded pension scheme where working people should pay contributions to a private pension fund. These contributions are accumulated and are therefore distributed to the payee in form of an income support when the person reaches the retirement age. The third pillar that both of the countries share is funded voluntary pension scheme which can be paid by workers on an independent basis and exists in the form of insurance.

Since Kosovo does not possess the typical PAYG pension scheme then the chosen countries can provide a good example if Kosovo ever decided to pursue a PAYG pillar in the future. However, the first pillar in the Kosovar pension system scheme is directly financed from the central budget so it is not a PAYG system. The other two pillars that Kosovo and Croatia seem to share and in the chapters to come, I will depict important characteristics and differences that these countries share in order to determine the pension system reform sustainability for Kosovo.

In order to assess the pension system reform sustainability for Kosovo I have conducted qualitative research analysis with a little help of quantitative data that will only be used to support the qualitative underpinnings. Qualitative research I have used in my thesis consists of mainly face-to-face interviews with major players in the pension systems of both countries. In Croatia I have conducted interviews with people who were involved in the overall pension reform in the late nineties. In Kosovo I have conducted interviews with heads of pension system policy-making offices inside the government. Although reasons why pension systems were reformed I was able to gather through the above-mentioned interviews, there was a handful amount of quantitative data that I had to select and gather in order to support my research. Data such as demographic composition, number of men and women retired in both countries, mortality rates, mass movement of people, contribution payers and the total number of retired people in each pension arrangements I managed to gather from the Statistical Agency of Kosovo and the Institute of Public Finance in Zagreb. However, my primary research consists of review of various publications, books, World Bank expert revised reports and publications, specific pension system essays, annual reports and bulletins. Most importantly, in my primary research I came across a model developed by Grech (2010) which I will use in my thesis but with significant adjustments in order to assess the pension system reform sustainability in Kosovo. I will use the case of Croatia in order to support the need for a pension system reform and to see the sustainability of the undertaken reform. Since Kosovo and Croatia share similar past in terms of pension system financing then it is good to see what lessons can be learned from the case of Croatia and its paradigmatic reform.

Since it is important to understand initially how the pension system works, then in the following chapter I will explain how pension systems generally work and what kind of reforms exist as defined by Holzmann & Hinz (2005). Explanation of pension systems and the existing reforms are written in subchapter together with the pension system reform sustainability and the model used in theory. Chapter 3 is exclusively used to describe the institutional reform in the late nineties in Croatia and the description of the current pension system and the way it is financed. The reason why this chapter is solely given attention to the case of Croatia is since there will be significant usage of the decisions and existing pension system reform sustainability to support the case of Kosovo. Chapter 4 follows the same structure as chapter 3 in order to help understand the pension system in Kosovo, its parametric design and financial architecture in order to have a better understanding of the analysis of the pension reform sustainability using the model developed by Greich (2010) described in the next chapter. Thus, in chapter 5 I will conduct the analysis based on the four pension reform sustainability indicators under which I will concentrate mostly on the case of Kosovo and determine how sustainable the pension system reform in Kosovo is. Last but not least, the final chapter of the thesis will entail conclusions and policy recommendations in order to help with the further need to reform the existing pension system in Kosovo.

In conclusion, my thesis will give a brief overview on the necessity to reform pension systems in general, their long-term sustainability in terms of reforms and creation of a system that enhances individual welfare. The need to reform the pension system in Kosovo comes as a result of Kosovo being a transition country where even reforms within the existing framework can prove to be fruitful as opposed to no reform at all.

CHAPTER 2: THEORETICAL FRAMEWORK

An important behavioral characteristic that defines people is that they tend to be myopic in making decisions about savings. People's saving behavior depends largely on their preference of choosing larger consumption today rather than tomorrow due to the uncertainties that the future holds. Pension schemes were invented in order to help people with income support in the future, when people remain incapable of earnings as a result of work. So, a pension "is a stream of payments that starts when someone retires and continues in payment until [the individual dies]. In other words, a pension provides lifetime income security for how long the retiree lives" (Bodie, 1990 as cited in Blake 2006, p.1). Moreover, pensions help consumption smoothing in the long-term.

Pensions are a sophisticated area of economics that needs to be understood in detail. There are various types of pension systems. However, I explain the theory behind the three pillar system which is the most common pension system and it is relevant to my research since Croatia uses it. In contrast, Kosovo runs a fully private pension system and it is a specific kind of system which needs to be explained separately.

2.1 Pension Systems Explained

There are several pension system schemes, but, most importantly, each of the systems is divided between *unfunded* and *funded* pension arrangements. *Unfunded* are the pension arrangement in which usually the PAYG scheme falls into. These are schemes that can be best explained in terms of flows as opposed to stocks. Contributions are not accumulated but immediately distributed in the form of payment to the pensioners. This is the scheme where generations rely on promises that each younger generation will pay the pensions for each older generation. This scheme was invented by the German chancellor Otto von Bismarck in 1880s with the idea of supporting people who can no longer work but need some income support in the old age. The PAYG scheme was a very good idea during the 1880s when life expectancy of the people was much lower than it is today. Moreover, the number of retired people was much lower than the number of persons supporting the pension scheme, that is to say paying the pension contribution. So, under those given conditions, the PAYG scheme proved to be sustainable.

By contrast, *funded*, are the pension schemes in which pension contributions are accumulated in a fund throughout the working years of a person and then distributed as an income support from retirement until the person's death. The reason why this scheme is called funded is due to the fact that the contributions are given back to the payee in the form of an income from its own account of accumulated contributions. Each system can independently create rules under which the payee can withdraw the accumulated pension contributions. However, "there are two key features of [the unfunded and funded] pension arrangements: time and risk". (Blake, 2006, p. 1) Since people tend to have a myopic saving behavior, they might in the future receive less than what they expected in terms of monetary value. Moreover, the risk that the person will die before the contributions are exhausted is an important factor that should not be ignored. Figure 1 shows the chart of how the pension system is organized and it explains visually the way the pension system is divided between *unfunded* and *funded* pension arrangement.

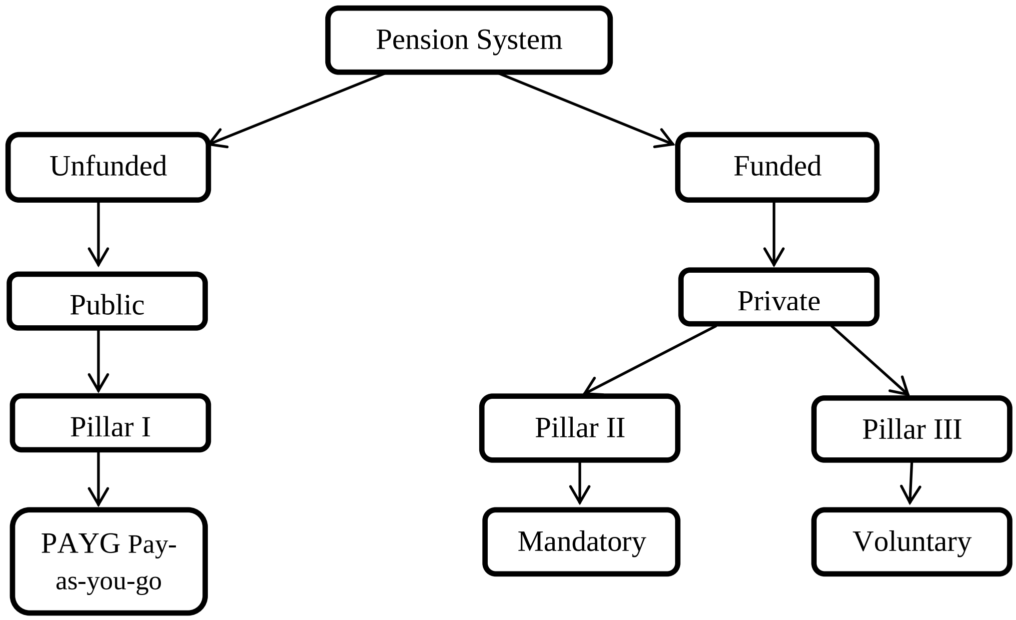

Figure 1 Pension System; *Source: Lajos Bokros Class Material*

When discussing the funded schemes, it is indispensable to refer to the investment factor. Institutions that accumulate contributions in the second pillar, usually engage in investments that yield return. Hence, the contributions are not only accumulated on individual accounts, but also invested as a pool. As a result, retired people get back not only what they have accumulated, but hopefully more.

Most common pension systems that exist now are the combination of the unfunded and funded pension arrangements in a multi-pillar pension system. Since the most common is the three-pillar pension system arrangements, the World Bank (WB) has come up with a definition of its own in which it adds two additional pillars to help alleviating poverty in developing countries. However, what remains important, are the first three pillars as defined by the WB: "[first pillar] a mandated, unfunded, and publicly managed defined-benefit system; [second pillar] a mandated, funded, and privately managed defined-contribution scheme and; [third pillar] voluntary retirement savings" (Holzmann & Hinz, 2005, p. 2)

Since there is a clear understanding of how the pension system can be divided into categories, there is an important need to create a pension system which is "adequate, affordable, sustainable and robust" in the long term. (Holzmann & Hinz, 2005, p. 6) For an obvious reason, creating an adequate pension system on individual country-specific basis helps avoid old-age poverty. The same holds for developed and developing countries when choosing the adequate policy-mix in order to create an affordable system, aiming at a long-term sustainable pension scheme.

Unfunded pension arrangements prove to be more difficult in assessing the long-term financial sustainability. Since the unfunded pension arrangements are subject to the so-called *dependency ratio* then they are highly conditional on the demographic structure of the country. The *dependency ratio* is the ratio of the number of pensioners over the number of working people. It shows the dependency between the younger generation and the older generation. More specifically, it shows how many young people should pay the contribution in order to support one older person who is already in retirement. The dependency ratio can be expressed mathematically as shown below:

$$\frac{\textit{number of people receiving income support}}{\textit{number of people paying pension contributions}} = \textit{dependency ratio}$$

When countries have a favorable demographic structure then the number of people relying in the younger generation is low. Then there can be a robust and sustainable unfunded pension arrangement. With a low dependency ratio the sustainability of the pension system is robust in the sense that it will not be a burden to the central budget. A high dependency ratio will create problems regarding the sustainability of the pension system. When pension deficits are experienced, the general central budget is used as a backstop. The problem with constantly experiencing pension deficits is that it can be supported only in the short-term but not in the long-term. The problem usually relies in the public unfunded PAYG scheme where these schemes are not designed in a way to withhold demographic changes and be financially sustainable. This means that the PAYG system cannot function fully without transfers from the budget to help in pension deficits. (Holzmann & Hinz, 2005) When deficits continue, there is a risk of them prevailing over and causing irreparable damage to the overall pension system. This is why reforms are crucial in helping the pension system of a given country gain sustainability. These reforms can be sometimes sustainable in medium-term and long-term timeframe.

Pension systems should be created in such a way that they do not jeopardize the wellbeing of other economic areas to the point of creating fiscal collapse. The pension system should be affordable in terms of finances. It is very important that in developing countries the pension system does not exhaust the general budget which is funded through tax revenue. Consequences can be hard to manage in the financing circle of the country. This is why the pension system should create pillars to help in old-age poverty relief and consumption smoothing. (Holzmann & Hinz, 2005) As a result of pillar design with the aim of income support the pension system can achieve poverty alleviation for the people who rely solely on the pension system scheme and do not receive other forms of income. The WB defines that pension systems should be manageable and they should aim at favorable replacement rates. Moreover, it is important that these systems do not require high contribution rates that can affect the accumulation of funds negatively. (Holzmann & Hinz, 2005) *Replacement rates* are usually defined as the percentage that the retiree expects in terms of first pension income as opposed to the last salary. In other words, the pension that the retiree gets in terms of how much it replaces the last salary or the best years of salaries of the retiree. As defined by the Organization for

Economic Co-Operation and Development (OECD), replacement rates are “the ratio of an individual’s average pension in a given time period and the average income in a given time period” Contribution *rates* are defined as “the amount typically expressed as a percentage of the contribution base that is needed to be pain in the pension fund. (OECD Publication , 2005) In other words, it is the percentage that each month is deducted from the salary of the person and paid to the pension scheme the person is assigned to.

In conclusion, financial sustainability of a pension system plays a crucial role in terms of the general long-term pension system sustainability. The financial sustainability of the pension system can be best explained in terms of stocks and flows. Funded pensions systems generate a pool of assets that are accumulated stocks. These funds are accumulated during the lifetime by the contribution payments of a worker. Usually, the second and third pillars of a multi-pillar pension system fall in the stock category. On the other hand, the first pillar, or the PAYG scheme can be viewed as a flow item. Since the PAYG scheme is an unfunded pension arrangement then the contributions are immediately transferred to the pensioners and are not accumulated. In order to have a credible pension system, it is important to create clear short-term and long-term financial projections and the rate of returns of investments in the cases of funded pillars. (Holzmann & Hinz, 2005). As a result, pension reforms are necessary to be introduced in order to adjust deficits and problems that might arise in the future in all three pillars of the pension system.

2.2 Pension Systems Reforms

Reforms should be credible and they should try to improve stability in the long term. Reassuring the continuation of the PAYG scheme in countries where the majority of the population depends on it requires detailed, clear and implementable projections. Projections should be well-defined objections in terms of future benefits, contribution rates, income support and dependency ratio. Pension system reforms "have emerged [in two different styles]: *a parametric* design and *a paradigmatic* reform" (Holzmann, MacKellar, & Rutkowski, 2002, p. 8) Parameters such as: contribution rate, retirement age, pension indexation, and replacement rate can be changed in order to create a more robust and credible pension system. The parametric reform helps the country when "seeking more revenues and reducing expenditures while expanding *voluntary* private pension provisions." (Holzmann, MacKellar, & Rutkowski, 2002, p. 8) The paradigmatic reform on the other hand, is a structural change in the entire pension system. Usually, an introduction of private pension schemes, funded arrangements or the change in the first pillar in terms of its monopoly and encouraging private savings as explained by Holzmann, MacKellar, & Rutkowski (2002) can be viewed as a paradigmatic change of the pensions system. When paradigmatic reforms are adopted a handful of positive objectives can be reached in a given country. Countries of Central and Eastern Europe tend to benefit largely from the paradigmatic reforms. Due to these countries problematic past, reforms in the pension system were in most cases crucial. However, the reforms tend to be costly when moving from a pay-as-you-go scheme to a mixed pension system because of the transitional costs which can arise from the transition from one pension system to another. At the same time, the pension system is supposed to meets its obligations and pay pensions to the retired individuals. (Fultz & Ruck, 2001). However, important benefits that can incur from the paradigmatic changes are the returns yielded from investments carried out by private mandatory funds. Division of reforms can be best explained in the graph below where it is clearly depicted what changes occur in each of the reform styles:

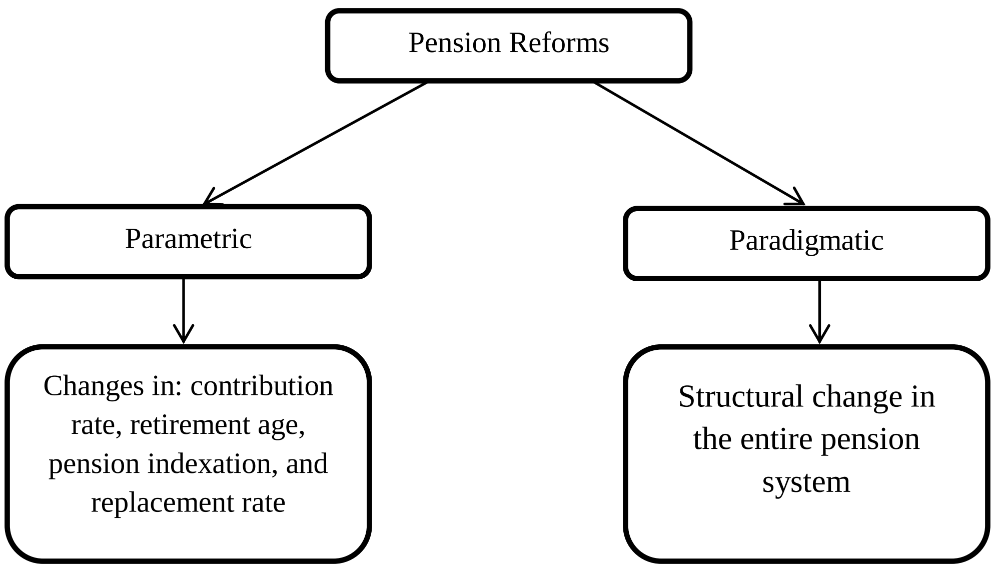

Figure 2 Pension Reforms; ***Source: Lajos Bokros Class Material***

Pension reforms should have clear and specific goals which are announced publicly in advance. Since pensions exist in order to support people with income they are also helpful in smoothing consumption. Important questions can be asked about the goals of the pension system reform. According to Chlon-Dominiczak & Marek (2002) survey on the pension reform consensus it appears that the main goal of the pension reform should be financial stability. Argued that most economists seek parametric reforms rather than paradigmatic, there are continuous problems that arise with the percentage that should be transferred from the mandatory pillar to the PAYG pillar in order to help the overall financing of the first pillar. (Chlon-Dominczak & Marek, 2002) Paradigmatic reforms are fundamental changes in an already existing system or they can have specific pension arrangements introduced in order to help raise capital. Encouraging the second and the third pillar, the paradigmatic change can be beneficial for most of the pension systems in the Eastern Europe, specifically, Kosovo and Croatia which both have undergone significant paradigmatic changes. There is a better way of saving income for the future than depending on future generation's contributions. Since the PAYG scheme depends highly on the employment opportunities and contribution payments of the future generations, then one can conclude that it is highly risky to depend fully on the PAYG scheme for the entire pension system.

Combined mandatory and voluntary pension arrangements have proven to work better in the long-run. Due to their nature of work in terms of saving incentive they are much more reliable in terms of future income, but most importantly, part of this funding can be used for payments in the current PAYG scheme which is called a *solidarization contribution*. PAYG on the other hand is important and cannot be eradicated completely from a pension system because it supports, not only the older generation, but also war veterans, disabled workers and helps in the overall consumption smoothing and alleviating old-age poverty.

2.3 Pension System Reform Goals and Sustainability

Pension systems should have clear goals and they should provide current and future older generations with income support. This income support should primarily aim at old-age poverty alleviation but it should also fulfill certain criteria which will also help in determining the degree of sustainability that a pension system achieves.

In this part of the chapter, I will explain clearly the goals that a pension system reform should aim at and also the constraints it faces when planning long-term. Moreover, I will use theory which supports the measurements under which sustainability can be stated and achieved. In order to assess the pension system reform, Aaron George Grech (2010) wrote about pension reform objectives in fulfilling long-term goals.

Pension system reform goals include in themselves: old-age income support and consumption smoothing. Old-age income support means that people when they reach retirement age should be able to sustain a basic living standard which will keep them healthy and give them income support until they die. Grech (2010) uses a threshold under which the poverty alleviation is used to be assessed. Grech (2010) uses the average pension as a percentage of the current income, net of all taxes, and uses this result to see if an individual can sustain himself during retirement. What the pension system should be aiming at is to see whether people who are paid below-average income at the current time will be able to sustain themselves after their contributions are paid back during retirement years. So, the primary goal of the pension system is to create a healthy condition for the retirees in the future in terms of income support and poverty relief. The second goal of the pension system reform is the consumption smoothing which is used to determine the level at which a replacement rate can be sustainable and favorable in the long run. Grech (2010), defines consumption smoothing as "net pension wealth, defined in terms of the [average] net wage on an individual basis, measured against a benchmark of an annual post-retirement income equal to 60%" (p. 140)

Pension system reform should take into consideration the overall changes in the future of the wages and it should be able to create proper indexation and help in consumption smoothing. Consumption smoothing in simple words can be described as keeping consumption for an individual at the same level as before the individual retired. So, the idea behind the consumption smoothing is to create such replacement rate so that the individual does not suffer drastic changes in consumption and overall personal welfare.

Pension system reforms are very sensitive areas in economic and public policy. It is important that certain challenges and restraints be taken into consideration. According to (Grech, 2010) restraints that generally pension system reforms face are intergenerational balance and financial sustainability. What theory supports as *intergenerational balance*, namely Grech 2010, that the pension wealth (or the average pension) is defined in terms of contemporary average wage. Intergenerational balance is a vague term, so in my thesis, I will call it a *balance between the active part of the labor force and the rest of the society*. The reason for this change of terminology is due to the nature of the pension systems in Croatia and Kosovo. In particular, the balance should be created such that average pension in the future should be subject to the average wage today. So the pension reform should be very careful in drawing necessary policies that lead the system itself towards an intergenerational balance in terms of income rather than creating social fiasco. Another measurement mechanism that is important towards measuring the overall pension system reform sustainability is the *financial sustainability* which according to Grech (2010) is calculated using average pensions of a generation and multiplied by the dependency ratio. Although the model in the Grech (2010) paper does not assume mandatory retirement pension arrangements, the same measurement indicators can be used in the case of Kosovo to underpin the overall pension system reform sustainability taken in early 2000s. In addition, lessons from the Croatian case can be used to support further the changes needed for the pension system. Croatia moved from a fully public to the classical three-pillar pension system at the same time when Kosovo conducted its first pension reform, hence the changes and challenges can be easily depicted. However, clear understanding of the Croatian and Kosovar pension system and their financing is crucial in order to use Grech (2010) and World Bank measurements in assessing the sustainability of the Kosovar pension system and draw lessons from the Croatian case.

CHAPTER 3: PENSION SYSTEM IN CROATIA

Croatian pension system is a typical three-pillar system which consists of the unfunded and funded arrangements. The first pillar is the classical PAYG scheme under which pensioners over the age of 65, war veterans and disabled workers are part of the income support payments. The second and the third pillar are the classical mandatory and voluntary pillars under which currently employed people of the labor force pay their contributions. Croatia runs yearly PAYG deficits and is financed through central budget and the mandatory pillar that pays a "*solidarization contribution"* in order to support the first pillar. Croatian pension system undertook certain parametric and paradigmatic reforms throughout the late nineties and aimed at a credible and sustainable long-term pension system. However, problems and mishaps still continue to burden the current flow of the system. The reforms that were implemented from the late nineties until today did not prove to be very efficient *per se*. Moreover, these reforms have created more burdens for the central budget and as such have pushed for alternative financing means such as the second pillar. Transfers of money from one pillar to the PAYG system came as a result of Croatia moving from a fully public pension system to the existing three-pillar pension system.

Croatia introduced its first pension reform with the aim of moving form a fully unfunded pension arrangement to a funded pension arrangement with "the objective to create an equitable, growth-oriented, and financially sustainable pension system, which would be achieved by gradual and partial substitution of the first-pillar PAYG system with an equally-sized fully funded mandatory ―second pillar" (The World Bank, 2011, p. 6). To this date Croatia has managed to create the three pillar pension system by conducting a very smooth transition throughout the early 2000s. However, the transition has faced a downturn from the beginnings of the financial crisis of year 2008. Since the crisis did not spare most of the world economies, Croatia was no exception either. The crisis slowed down the process of pension system reform “by amplifying fiscal problems, by shrinking the contribution base and increasing flows to retirement, which worsened the system dependency ratio to historical lows and worsened the pension system deficit.“ (The World Bank, 2011, p. 6) However, reforms were mandatory and I will try to explain the reason behind the changes that were crucial in the pension system in Croatia and the efficiency that the pension system holds.

3.1 Croatian Pension System Reform

Croatia is one of the countries that emerged from the fall of Yugoslavia and gained its independence in the early nineties and thereafter fought the war of independence for four consecutive years. When the war ended, Croatia was left with a lot of socio-economic problems that required immediate attention. Problems and issues that Croatia inherited after its secession from Yugoslavia pushed the government of Croatia to act rapidly in one of the most important issues at that time: the pension system. Croatia continued for several years after the war ended under the PAYG system and the pension system in Croatia continued to be fully public and subject to a deteriorating dependency ratio. Since Yugoslavia was a communist country, pension system did not have private arrangements. Rather, the pension system all across Yugoslavian territory was of public nature. Most of the countries have inherited the first pillar (PAYG). However, Croatia is one of the countries that could not sustain the entire pension system based only on one pillar; hence reform was inevitable. Although, the unsustainability of the pensions system started showing its first signs in the mid-nineties, the first reform in Croatia took place in late nineties. The Croatian government undertook a significant upturn in policy-change and introduced a paradigmatic change to the pension system.

Similarly to the other areas of economic development, pensions were also subject to privatization. Just like other transition countries, Croatia suffered from economic downturn during the transition. Dramatic changes were part of transition and the most important "paradigmatic turning-point is marked by an international conference on pensions held in Opatija in November 1995, attended by José Piñera and other prominent experts. It was at this conference, sponsored by the World Bank, that the Prime Minister publicly endorsed the introduction of a mandatory funded tier." (Muller, 2003, p. 28) Although Croatia was running fully on public pension arrangement, for the time being there was a significant low and favorable dependency ratio and replacement rate. Croatia during the early years of post-war period had a favorable but unsustainable replacement rate which reached up to 90% of the working-wage. (Muller, 2003) The dependency ratio on the other hand, which is one of the most important indicators of the sustainability of the PAYG scheme, appeared to be sufficient and resilient at the beginning of the post-war period. Additionally, there was no significant need to introduce mandatory private schemes or put the system through privatization. However, this environment was not sustainable in the long-term and according to Puljiz (1999), the number of retired people at the beginning of 1991 was 719,868 whereas at the end of 1998 it reached 955,352. So during the early years of the post-war period the number of retired individuals increased significantly and almost one-quarter of the population was on the pension system. (Puljiz, 1999) Important to note, the number of individuals who retired during the 1990s were highly dependent on the dependency ratio which was deteriorating significantly throughout the years. So, the worsening of the situation did not end with just the number of the pensioners increasing, but rather with the deterioration of the dependency ratio and the pension expenditures that were financed by the central budget. The situation went from expenditures of 7.71 % of Gross National Product (GNP) in 1992 to 12.19% of GNP in 1998. (Puljiz, 1999)

Croatia has suffered from a destruction of the market right after the war and as a result unemployment increased. Croatia lost most of its market share in the former Yugoslav market after its secession and production costs sky rocketed. Privatization was one of the key features of deterioration of the economy of the country in the short-term period. Most of the economic entities that were state owned, changed their production and a lot of employees remained unemployed. Since a lot of people remained unemployed, most of them were pushed into early retirement and became dependent on the pension system. With high unemployment and privatization, the pension system suffered a deterioration of the dependency ratio that led to, as previously mentioned, high pension expenditure from the state. Although the pension system was the primary source of income for the unemployed people, after a legal dispute between the retired people and the government of Croatia, the expenditures went even higher. The reason for this increase in expenditure was that the constitutional court ruled in favor of the retired people who did not receive their pensions in time and that the pensions were too low. (Puljiz, 1999)

Since most of the unemployed people were part of the pension system, expenditures reached unsustainable levels. The government had to act upon and maintain levels of expenditure that would not create fiscal collapse. Reform was necessary and inevitable. Thus, the government of Croatia created the legal framework and the first steps towards a pension system reform which would be sustainable in the long-term. The first changes that occurred in the pension system in Croatia were aimed at using capitalized savings in order to create a second pillar that would be fully private. There would be a reduction in the first pillar in terms of people that were highly dependent on it. (Puljiz, 1999) The three-pillar pension system was the most common pension system that would triumph in the world of transitory countries, so Croatia was no exception to this phenomenon either.

People's tendencies to be myopic regarding their own future savings can create distortions in the PAYG system and create the need for a paradigmatic change with which the people would be more aware of their personal social security. (Puljiz, 1999) It is important that in the PAYG system there is a weak link between benefits and contributions at the level of the individual. More specifically, there is no guarantee that the contributions today will yield a favorable or sustainable replacement rate in the future. These are the most important reasons for paradigmatic shift. Croatia introduced one mandatory and another voluntary pillar which were fully funded and private. The reason for these pillars was to create a more sustainable pension system reform. Since pension expenditures reached the very high levels and the dependency ratio increased further then it was believed that the mandatory pension arrangements would help in shrinking the expenditures in the long-run. In addition, it would help in creating a mechanism of income support for the old-age retirement that would be sustainable in the long run. Since Croatia started facing decreasing fertility rates even since the beginning of 2000s, then the PAYG pillar suffered from yet another problem in addition to the aging population itself. So, in the need to recuperate the pension system itself introduction of the mandatory pension arrangements was a result of necessary changes.

The reform included parametric changes that were introduced in the last decade. Specifically, people who were granted pensions 'under more favorable conditions' account for the majority of the deficit and the pension system itself proved to be more generous than it could initially sustain. As a result, reforms were introduced in the Croatian pension system in order to offset the existing deficit in the PAYG scheme. These changes included: "i) suspension of pension indexation in 2010; ii) imposition [of a progressive crisis] tax of 2% and 4%; and a reduction on the privileged pensions by 10%" (The World Bank, 2011, p. 7) Although these changes did not tackle the most important issues such as replacement rates, then further changes were necessary to create a sustainable pension reform. Initially the government of Croatia introduced The Economic Recovery Programme which was aiming at the long-term sustainability of the pension system with major short-term changes. In this phase of the reform the pension system in Croatia aimed at increasing the women retirement age from 60 to 65 years old and the early retirement from 55 to 60. (The World Bank, 2011)

3.2 Description of the Current Pension System

It is important to know and understand the parameters under which a country has designed its pension system. Specifically, pension systems that have undergone a major reform are much more affected by the parameters it has chosen as opposed to non-reforming pension systems. Ageing population and lower birth rates in Europe have created a need for pension system reforms and made its financial sustainability questionable. Croatia is no exception when it comes to fast ageing population vis-à-vis Europe. This issue brings to my attention that the retirement age should be aligned with the life expectancy and it should take into account the falling birth rates. The composition of the population in Croatia has changed in the last decades. Average age of population in 1953 was of 31.9 years for women and 29.3 years for men as compared to today's composition of 43.4 years and 39.9 years for women and men respectively. (Aranjos Borovac & Bursic, 2013). It is evident that the population is aging in Croatia as supported by (Udrijan, 2013), who claims that Croatia is amongst the ten oldest countries in the world. In addition, the pension system is highly dependent on the life expectancy of the people, especially, the PAYG scheme.

Croatian pension system is characterized by the following parameters: The retirement age is 65 years for men and 60 years for women. Early retirement age is 60 and 55 years old for men and women respectively. The contribution rate is 20% of the monthly income out of which 15% go to the first pillar (PAYG) and 5% go to the second mandatory pillar. (The World Bank, 2011)

The first pillar is the longest existing pillar in the Croatian pension system. It consists of several groups of people who get income support from this scheme. Generally these groups of people are elderly persons over the age of 65, war veterans and people with disabilities. However, the first pillar in Croatia is important because it covers people who are granted pensions under very favorable conditions. Persons that fall under the category of the 'privileged pension' are: "National Liberation War participants, members of the Croatian Home Guard, former political prisoners, members of the Yugoslav National Army, […] members of the Croatian Parliament, constitutional court judges and the Auditor General, Croatian homeland veterans and members of the war veterans. " (Badun, 2009, S. 2) Although throughout the years the number of the people on the 'privileged pension' was lowered, the numbers on the other pension schemes increased so the number of the overall pension beneficiaries did not change. However, financially the pension expenditures have increased the burden on the central budget, since all of these people are part of the first pillar. The most problematic group of people in the privileged pension scheme is homeland war veterans whose number has doubled in the last decade. According to (Badun, 2009), one third of the beneficiaries that received pensions were part of the homeland war veterans who in percentage account for 15.5 % of the entire number of pensioners in Croatia. These are pensioners that are part of the individuals that were granted pensions under more favorable conditions. However, individuals under the "privileged status" work shorter periods of time and retire early under better conditions, whereas the rest of the individuals are obliged to work longer until they reach their retirement age. In terms of equality these more favorable conditions pose problems within the pension system and create a burden to the central budget. Moreover, it is much more difficult to create an all-inclusive and supportive pension system if there are extreme differences between the parametric requirements of a single pension system. Drastic differences between individuals that fall under the same pensions scheme, can lead to controversial social equity problems. More uniform requirements for the first pillar pensioners can lead to more tax revenue and willingness to pay contribution. According to (Badun, 2009, p. 8) “the problem of early retirement consists not only in the reduced contribution revenues but also in the outflow of the working-age population from the economically active population”, ageing faster the population and pension-dependent strong labor force.

The first pillar consist of people who are over the age of 40 up to the age of 65 who were on the PAYG scheme before the reform in the mid-nineties. This group of people comprises the main part of the contributors to the pension system fund. However, out of 20% contribution rate that is collected on the second mandatory pillar, 15% are transferred to the first pillar. In addition, this percentage helps finance partially the first pillar and helps in terms of intergenerational income support scheme. However, the number of pensioners on the first pillar is in total 1,217,692 people, from which 659,476 and 558,216 women and men respectively. In addition, 54.6% are women and 45.84% are men. (Aranjos Borovac & Bursic, 2013) This breakdown of people in terms of gender shows that the majority of pensioners are women. Considering that women retire earlier than men, then the retirement age and longevity are not smoothed in order to create a more financially sustainable pension fund. According to (Aranjos Borovac & Bursic, 2013), the number of women that died in 2011 at the age of 80-89 was 11,409 whereas the number of men was 6,342. However, women that died from age 70-79 were 7,185 as opposed to 8,276 men, which figures show that women live longer than men. Since, women retire earlier and live longer then it is clear that they are longer in the pension system and they are a group of people that can create a burden to the overall pensions system, more importantly the secondary source of financing, the central budget.

The breakdown of the mandatory pension system in terms of age and gender is showed in the table below, which shows the contributors of the second pillar only. From this table we can depict partially the number of contributors in the Croatian Pensions system. The following chart shows clearly that most of the contributors in the mandatory pension system pertain the ages 30-34 and 35-39, whereas other group ages are lower in number. (Croatian Financial Services Supervisory Agency, 2013) However, this comes as a result of reform change where persons that turned 40 years old after the reform, were offered the choice whether they would like to contribute to the second mandatory pillar as well. However, people who turned 40 and were beforehand contributing to the second pillar, then they continued contribution to the assigned mandatory second pillar.

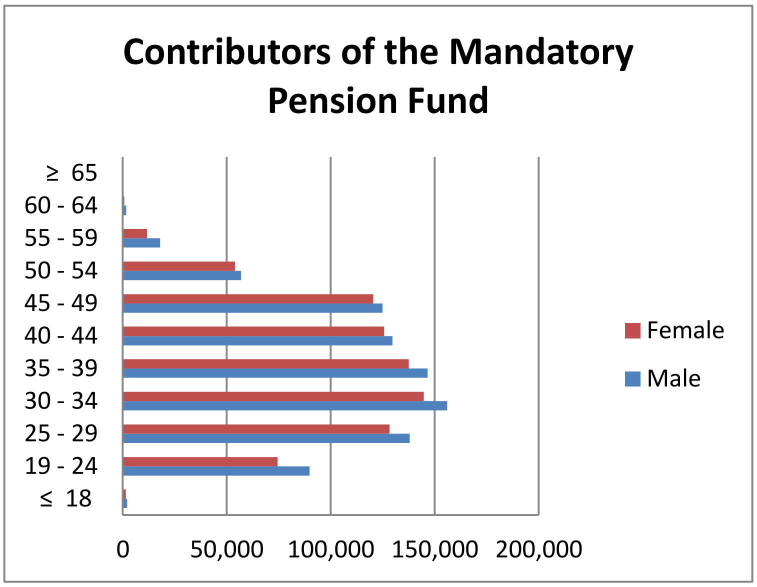

Figure 3 Contributors of the Mandatory Fund - Gender and Age breakdown; *Source: Croatian Financial Services Supervisory Agency*

The third pillar is the voluntary pillar in which most of people are not obliged to pay a contribution and no percentage of it is transferred to the first pillar. Individuals are encouraged to accumulate savings that will be later used in the form of an income support. According to Croatian Financial Services Supervisory Agency (2013) the chart below shows clearly the number of people contributing to the voluntary pension system which is a mechanism used to create more funds for people that can afford to pay the voluntary pension contribution now. In terms of group-age, in the case of voluntary pensions system, the picture changes as opposed to the mandatory pension fund. People aged 50-59 tend to pay more the voluntary contribution and the gender difference is very apparent. Women are more prone to paying the voluntary contribution rate much more than men and this comes as a result of women staying longer on the pension system due to their life expectancy. This difference in gender starts becoming very visible right after the age of 40, where women tend to engage in the third pillar and accumulate funds ahead.

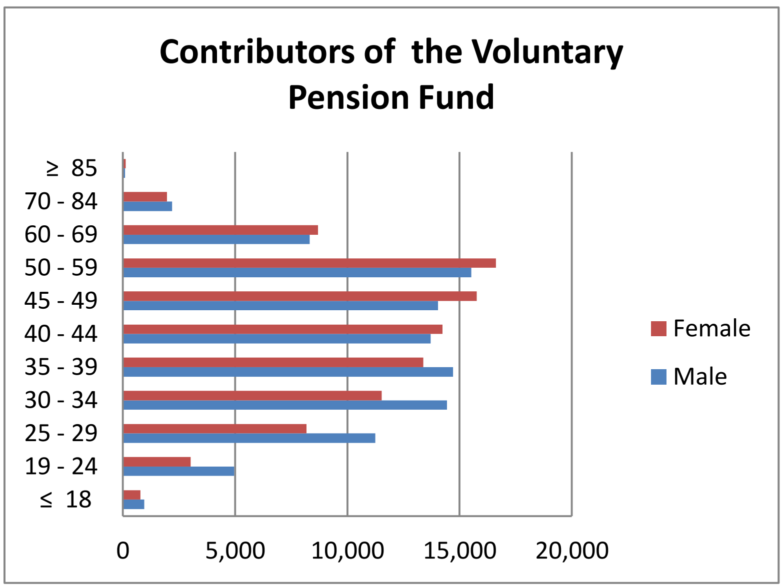

Figure 4 Contributors of the Voluntary Fund - Gender and Age Breakdown ***Source: Croatian Financial Services Supervisory Agency***

Another important factor that influences the pension system is the international migration flow of people in and out of the country. Since people that immigrate for working purposes to Croatia contribute to the pool of pension fund accumulation, the people that emigrate out of Croatia do not contribute to this pool. Suffice to say that people who are young and work in the country are crucial to the pension system and the economy overall. Croatia has a decline in immigrants and a significant increase in the number of emigrants. In year 2000 the number of people immigrating to Croatia was 29,385 whereas at the end of 2011 this number dropped to 8,534. Emigrants on the other hand have almost tripled from 5,935 in year 2000 to 12,699 in 2011. (Aranjos Borovac & Bursic, 2013) Apparently, the change in migration throughout the years can pose a different threat to the PAYG scheme and the mandatory scheme. These declines create a high dependency ratio for pensioners who are in the PAYG scheme as they depend significantly from the transfers from the secondary pillar. According to (Badun, 2013), during the 1990s the dependency ratio was 3 contributors per 1 pensioner, whereas in year 2013 this number has declined to 1.3 contributors per 1 pensioner. The contribution rate did not change, but the problem relies on the labor market which has worsened over time. There has been forecasting that there will be emigration after Croatia becomes a member of the European Union and the current situation will worsen even more. (Badun, 2013)

Given the parameters under which the Croatian pension system works, chances are high that this multi-pillar system faces difficulties in terms of finances. According to Institute of Public Finance in Croatia, the PAYG scheme is financed 55% by the contributions paid and 45% from the central budget. These number show that there is need to reform and move towards a strong policy-making decision that will help improve the overall pension system without damaging other economic areas.

3.3 Financial Description of the Pension System

Financial description of the pension system in Croatia is very important due to its complicated nature and different groups of people that fall in certain categories. The first pillar is the most complicated pension scheme and its long-term financial sustainability is a debatable issue. However, since it does receive a transferrable contribution rate percentage from the mandatory pillar, there is a tendency of having a pension system which can financially be sustainable in the medium-term rather than long term period.

As previously mentioned, Croatian pension system suffers from yearly deficit and as such it is obliged to collect and finance it from the central budget. Croatia is a high-income country which is not part of the OECD with a GDP of $ 62.49 billion (€ 48.51 billion) and a population of 4.403 million. (World Bank, 2011) In the last decade it has showed positive annual growth rate and an overall sustainable economic environment and it will become a new member of the European Union in July 2013. Since the expenditure for the pension systems and its financing are relative to the size of the economy and its robustness, then my research shows the following financing flow for the three pillars in Croatia.

According to (Badun, 2009, p. 8), "In 2008, total spending on pensions amounted to HRK 32.8 billion, which accounts for 25% of the consolidated general government expenditure or 9.6% of GDP". However, this number today is HRK 35.2 billion (~ € 4.62 billion) which shows a significant rise in the total expenditures in the pension system. (HrZMO, 2012) The change in the expenditures captures the different environment that the pension system faces in different years. This change makes evident the problems that one pension system cannot be sustainable in the long run, namely PAYG. Since Croatia faces the issue of the 'privileged pensions" where a significant part of the expenditures flows towards this group of people then there is high probability that this group of people can stagnate the financing of the pension system. By stagnating I mean that this group of people has emerged right after the reform and it makes the Croatian pension system less inclusive and much harder to sustain financially. As "privileged pensions" are one problem in terms of financing, numbers in 2008 show that HRK

6.9 billion were given to this group and the revenues from contributions totaled to HRK 20.15 billion (Badun, 2009). In 2012 the revenue from contributions was HRK 19.0 billion, creating yet another discrepancy between the revenues and expenditures and the dependency ratio. With a decline in the collected contribution revenues and an increase in expenditures, the pension system faces more financial difficulties and becomes a burden to the central consolidated budget.

As mentioned before, the pension system deficit is financed partially from the central budget amounting to almost 45% of total expenditures. The average pension in Croatia, depending on the type of the pension, is HRK 2,383.25 (~ € 315.06), with a difference of HRK 2,106.83 for women and HRK 2,709.83 for men. Generally, this average captures only the amount of income support that is given to regular people on the pension system, rather than the special groups of people who are entitled to an above average income support.

Central budget is the most important financing tool for the pension system deficit. It supports approximately annually HRK 16.2 billion in deficits and helps in income support for the old age and primarily the PAYG scheme. Since, the PAYG scheme suffers from yearly deficits, the income that is transferred from the mandatory pillar fails to meet all obligations to pay the income support. Central budget transfers the money to the PAYG scheme in order to help sustain the deficit for the time being. The problem relies, however, on the sustainability of this deficit and how long can the government of Croatia support the challenge. Financial architecture of the pension system in Croatia is created in such a way as to help the PAYG system primarily through transfers and secondarily through central budget. According to the interview with Potocnjak, (2013), "transfer costs are too expensive and the state pays for them" which means that these costs are covered from the central budget as well, and it only increases the burden towards the budget. Moreover, administrative costs of the mandatory pension arrangement proved to be unsustainable for the time being which adds to the financial problems of the current pensions system in Croatia.

Public expenditures relative to the country's GDP are an important factor in the overall economic performance of the country itself. Fiscal fiasco can lead to major financial crisis and it can create problems that are irreparable in the short and medium-term. Pension expenditures are crucial in determining the fiscal impact that it can have in the ageing population. Since, tax payers are determinants on constituting a pool of funds that can be used to support pensioners then the overall financial flow of money should be supportive enough to provide desirable old-age income. In Croatia, pension expenditures have worsened over time creating a tremendous burden on the central budget. Even with the current replacement rate of 40%, the pension system faces difficulties in long-term sustainability. (Nestić, 2006) Since the replacement rate is low and the dependency ratio is relatively high, it makes financially the pension system unsustainable at first sight. However, further detailed analysis should be conducted to understand which parameters are determinants of the unsustainability of the Croatian pension system reform.

Although Croatia faces difficulties, I have described of the current Croatian system and its financing scheme in order to understand more thoroughly the reform and its sustainability. It is only by this description that I can explain and define the reform sustainability in Kosovo according to Gresch (2010) model. In the next chapter, I will explain the Kosovar pension system, its reform and the way it is financed in order to draw analysis that will lead to better policy-making alternatives.

CHAPTER 4: PENSION SYSTEM IN KOSOVO

Kosovo is one of the most interesting cases when it comes to pension systems and its paradigmatic design. Since Kosovo is yet another country to emerge from Yugoslavia, its socio-political structure enhanced the need to reform several economic and political areas. Pension system was one of them and it was designed by then United Nations Mission in Kosovo (UNMIK). The system holds a similar design even today. The existing pension system is fully private for the currently employed labor force. At first sight, it can be easily deceiving to think that this pension system is sustainable in the long run since it is fully private and funded. Kosovar pension system is designed to fulfill basic obligations for the labor force in Kosovo.

The pensions system is a three-pillar system with the aim of alleviating poverty and securing old-age income for the future pensioners. The first pillar is a '*social pension"* which includes individuals that are over the age of 65 regardless of their previous contributions. The second pillar is a funded *defined contribution* pension arrangement which is fully private and is paid by everyone who is currently employed. The third pillar is a voluntary pension system and it is designed completely on individual basis or on arrangements between the employer and the employee and is financed on personal choice.

Currently existing Kosovar pension system is in need of a reform which will be sustainable in the long run. The first pillar resembles a PAYG system in terms of flow rather than a stock item since the pensions are given to pensioners from the tax-revenue money. With Kosovo's small consolidated budget it would be naïve to think that the central budget can sustain the social pension in the long-run.

Since, Croatia is a good example of a pension reform that moved slowly from a fully public pension system to a multi-pillar pension system, it can serve as a good example for Kosovo to see the reforms that can be done in the pension system.

This chapter aims at describing the pension system in Kosovo and its main characteristics in order to create a clear understanding of the reasons why there is need for further reform. Given the Kosovar demographic composition of the population in Kosovo and high unemployment it is hard to design reforms that will make the pension system sustainable in the long-run. Rather, it is better to create reforms that are strong in the medium term and help in enhancing the overall economic activities. Although certain parameters can be considered robust solely in the short-term, it is important that there is pension reform sustainability in the long run. Pension system as a whole could prove to be unsustainable if certain changes occur such as changes in demographic composition, employment rates and public deficit. However, the reforms should aim at making the pension system resistant to these changes and they should aim at creating such a system that can withhold and offer sustainable old-age income support.

Kosovo requires certain characteristics to be fulfilled from the individuals in order to be included in the pension system. Social protection is amongst the most important aims of the Kosovar government since most of the people were left with high damages after the armed conflict with Serbia in 1999. The reason why the first pillar exists is due to the overall aim of the social protectionism wave of the post-conflict period. Clear understanding of the reforms that took place in Kosovo in the early 2000s and the pension system's parameters and financing means are crucial in determining the sustainability of the pension reform in Kosovo. However, initially I will explain the reform itself and the existing pension system in terms of its parameters and financing which are clearly divided into subsections of this chapter.

4.1 Kosovar Pension System Reform

In order to have a clear understanding of how the pension system changed in Kosovo, it is important to divide the period of time between pre-conflict and post-conflict period. Since Kosovo was part of the Yugoslav federation, its pension system used to function on the PAYG basis during the pre-conflict period. Contributors of the pension system paid their contributions in an "autonomous pension fund" which after the conflict dispersed and stopped functioning. Kosovo moved towards a more modern pension system, making funded pension arrangements within its system, namely, the privatization of the second and third pillars of the pension system.

Kosovo worked with an "autonomous pension fund" in the early 1980s and functioned in pure PAYG basis. The entire pension system was dependent on intergenerational contribution of income support for the elderly. However, financial imbalances of the pension system started becoming noticeable in the nineties when the high unemployment hit the territory of Kosovo. Although back then a territorial part of Serbia, Kosovo was highly centralized to the offices in Belgrade. Additionally, all the employees that were of Albanian nationality were forced out of their jobs during the nineties and the economic well-being of the region faced tremendous difficulties. Unemployment skyrocketed and people that were in employment were aware that their income support during the old age was deteriorating. Although, after the conflict ended, the problem with institutions remained an ongoing issue for the Kosovar part. Initial institutional building was important for Kosovo and it was achieved with parallel governing structures between the United Nations Mission in Kosovo (UNMIK) and the Government of Kosovo. Amongst institutional reform and establishment, the reform of the pension system began in early 2000s. As one of the most important issues that came as a result of older individuals requiring their own rights, the reform of the pension system began in 2001.

During the end of nineties pensions stopped being paid to older individuals in Kosovo and post-conflict period called for an institutional change. The elderly individuals required in post-conflict period that their rights be fulfilled from the side of the government. Hence, international organizations helped policy-making and institution building. The pension system reform in Kosovo was successful in terms of its paradigmatic shift from the previous system to the new one. Kosovo achieved to build a three-pillar pension system which was not what is considered today as a typical three pillar system. Due to challenges and problems that existed in Kosovo at the time being, the first pillar aimed at creating an all-inclusive scheme that would initiate a social protection scheme. This scheme was created in order to help old-age individuals on need-basis and avoid old-age poverty. Although this was the initial aim, people that were previously contributors to the Yugoslav pensions system, remained without any social assistance. The number of people that were 65 and needed pensions was more than the actual number of people who received income support. Thus, the existing coverage that prevailed during those times reached only half of the retired individuals and it was significantly low. (Gubbles, Snelbecker, & Zezulin, 2007) The problem came as a result of the data that was available and meaningfully inconsistent. Most of the data was lost during the conflict when a NATO missile hit buildings that were in the vicinity of the Social Insurance fund that contained all the data of the pensioners. (Gubbles, Snelbecker, & Zezulin, 2007) Even though the data was missing, the need for the reform prevailed and thus the newly formed Kosovar government created the first pillar which offers support to the old-age individuals irrespective of their contribution in the past to the PAYG scheme. In addition to social protection, the first pillar was created to help consumption smoothing which was calculated using a food basket that covers minimal consumption needs. (Gubbles, Snelbecker, & Zezulin, 2007)

The second pillar was a more important paradigmatic change in the pension system in Kosovo as it was based on a free-market basis. The second pillar followed the typical *defined contribution* funded scheme which would provide pensions for the members entering the labor force. In addition, individuals that were already employed and returned to their working positions during post-conflict period started paying contributions to the second pillar, namely, people that were born after 1946. Typically the second pillar is managed by several institutions that are fully private in order to enhance competitiveness on the free market. Kosovo proves to be a different case when it comes to second pillar administration and management. The Kosovo Pension Savings Trust (TRUSTi) was created in order to help manage the second pillar and open accounts for each individual that became a contributor. This institution is fully functional and the only one that manages the second pillar entirely. The idea was to help create a pension system that would be fully independent from the first pillar and the central budget. Hence, the second pillar began its functioning with the highest coverage rate in the pension system. The majority of the contributors shifted their contributions to the TRUSTi institution which aims at helping with old-age income support, consumption smoothing and financial sustainability.

The third pillar in Kosovo is of a voluntary nature and it was created in order to help the population in further savings that would be used in the future in form of an income support. During the reform years, the third pillar was created in such a way that it would be administered by pension funds, insurance companies and banks. The third pillar started operating as a way of collecting savings of currently employed people and it was encouraged to be defined either by contributions or by arrangements between the employer and the employee.

Kosovo pension reform at the time being was successful and it proved to be sustainable in terms of consumption smoothing. Although it faces several challenges, the indicators that I will use to evaluate this reform will also give an idea of what changes should be pursued in the future. Pension reform should not only tackle consumption smoothing, but rather other elements such as intergenerational balance, financial sustainability and poverty alleviation.

4.2 Description of the Current Pension System

Kosovo has a three-pillar pension system which aims at providing income-support primarily for the old-age retired people, consumption smoothing and security on non-discriminatory basis. Although a non-typical pension system arrangement, it does aim at being all-inclusive, financially sustainable and provide social protection. The first pillar includes people who are over the age of 65 and early-retired people who worked in the Trepça mine. The first pillar is very interesting in the case of Kosovo compared to other countries in the region, because it does not resemble a typical PAYG system although it is fully public. The first pillar includes everyone aged 65 and over irrespective of their contributions in the past. These are people who have been entitled to an income support in the post-conflict period. Other than the people who fulfill the requirement to be a part of the system, there are war veterans and permanently disabled people who cannot participate in the labor force and are part of the first pillar. This is the reason why under the first pillar, the early retirement scheme was introduced due to the difficulty of the job. People that retire earlier fall on the first pillar and have been granted ever since year 2004 the amount of € 50 whereas in 2011, this amount was increased to € 70 monthly. (Ministry of Labor and Social Welfare as cited by Loxha 2012) The idea is that these people worked in difficult jobs that require them to retire early and the first pillar ensures that they get income support for the remaining time after they finish working. The early retirement age is 50 -60 years old and the normal retirement age is 65 years old which is the same for men and women.

The second and third pillars are funded defined contributions pension arrangements that are available for the people who are currently on the labor force and employed. The contribution rate in Kosovo is 10% of the overall salary. However, 5% is paid by the employer and 5% by the employee. The body responsible for the second pillar is the TRUSTi fund which is an independent body licensed from the Central Bank in Kosovo to act as a public fund and accumulate contributions. The second pillar is mandatory for all employed persons aged 18 and over and people born after 1946 with the aim of having people contribute more than 10 years to the funsd. According to Loxha (2012) if a person works less than 10 years, then there is a high probability that the contributions would not be enough to generate a favorable income support in the future. The contributions are accumulated in TRSUTi and they are distributed in terms of income support after the person reaches the retirement age of 65. In this case, TRUSTi acts as a private fund and invests domestically and abroad to help in fund raising.

Kosovo has almost 1.8 million people with a life expectancy of 70 years old and a population growth rate of 0.6% annually. (Bertelsmann Transfromation Index , 2012) At the end of year 2011 the overall population was divided into 875,900 and 863,925 of men and women respectively. (ASK , 2013) The retirement age is uniform for men and women. As a consequence, for my research the number of pensioners as a whole is important rather than emphasis on the gender difference. So, the number of people currently in the first pillar who are paid an income support in Kosovo is 165,296 persons. Whereas people on the second pillar amount to 13,672 pensioners that receive income support. However, people that contribute to the second pillar are 388,483 who have accounts open in the TRUSTi fund generally, but on the annual report the number until the end of 2011 shows significantly different numbers due to unknown reasons.

According to the annual report of TRUSTi published in 2011, the number of people that are active contributors to the pension fund arrangement has increased from 2004. Data on the report shows that from 181,123 individuals that were contributors has jumped up to 251,510. The majority of the contributors are people who are employed rather than self-employed. The chart below shows that TURSTi fund had suffered from a decrease in contributors in 2008 due to malfunctioning of the election system, some of the workers were not paid pension contributions from the side of the employee. However, in the consecutive years, the fund was capable of accumulating the necessary funds. Figure 5 captures the increase during years 2004 to 2008 and the significant fall on the contributor's rate during 2008. However, this contribution rate picked up its pace back in 2009 and has been showing an increasing trend ever since. This chart depicts a very positive phenomenon in the world of pensions as it is prominently a good feature if the system experiences rise in the number of contributors.

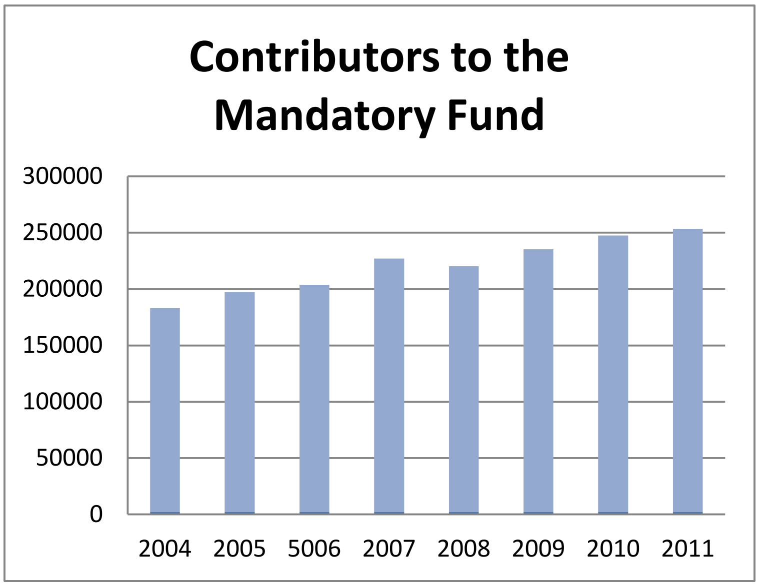

Figure 5 Contributors to the Mandatory Fund; *Source: TRUSTi*

Important to note, the number of people that are contributors to the second pillar in Kosovo are mostly of the "arithmetic age" of 39 as the annual report of TRUSTi shows. The most important feature is that although the contributors are predominantly male and the number of female participants in the labor force and pension system is also increasing. The report shows that participation of female individuals has increased from 27.9% to 28.3% of the overall number of contributors. (TRUSTi, 2011). As the report shows, in Kosovo despite the fact that most of the contributors are men, it does not influence the overall accumulation of funds since the retirement age is the same between women and men. The third pillar data is not available as most of the voluntary pension arrangements are done privately between the employer and the employee or completely on individual basis. These savings are administered through insurance firms and banks and as such are hard to be public and they remain completely private.

Since Kosovo is a low-income country and highly isolated country in terms of free movement of people, migration tends to be a very important feature that can affect the pension system scheme. According to the ASK data, the majority of the population, reaching up to 70%, is between ages 15-35. This demographic composition of the population shows that the pension system can be sustainable in terms of contributors. However, since the general economic growth in Kosovo is not high and its development is not moving rapidly, high unemployment rates prevail. According to the report on Kosovo conducted by Bertelsmann Stiftung (2012), unemployment rate is currently 45% and one of the highest in the region. Due to high unemployment rate, younger generation is prone to emigration and the effects of this migration can be felt severely in the pension system. The reason is because there is no data that shows that Kosovars that work outside of Kosovo send their contributions back to TRUSTi fund. However, since Kosovo is not part of the European Union and still suffers from not being granted visa liberalization from the EU, the country is still fairly isolated. Although facts remain, the actual number of people that migrated shows that only 1% of the working population emigrated in 2007, which was also the year emigration peaked in Kosovo. (World Bank, 2011) Hence, migration should be taken into consideration when assessing risks that might occur in the future if Kosovo becomes a member of the European Union.

Although the number of individuals that participate on the pension system is important, the way the system is financed shows clearly flaws and problems that might arise in terms of reforms. Financial sustainability of a pension system is very important and it can be affected from different factors. Hence, in the next sub-chapter I will describe the way the pension system in Kosovo is financed and the flow of money in the system.

4.3 Financial Description of the Pension System

As previously mentioned, the first pillar of the Kosovar pension system is fully financed through the central budget. Since the majority of the people on the first pillar are war veterans who are incapable of work it is important to note that the first pillar is a social protection arrangement rather than a typical pension system. Yearly, the consolidated budget of Kosovo gives away € 69 million in social protection support. Although the data shows such a huge number, there is no distinction on how much is given in form of a pension. Thus, the total amount of social protection that is given amounts to € 69,204,080.00. (ASK, 2012) However, if the number of beneficiaries and the average pension is multiplied, roughly € 11 million Euros are used on pension system support. It becomes evident that one of the major problems on the pension system, specifically the first pillar, is the problem of not having a definite distinction between who needs social assistance and who needs to be paid a pension.

The second pillar is entirely dependent on the contributions that are paid monthly to the TRUSTi fund. Since there is only one institution that manages the entire second pillar then the data obtained from the annual report are strongly accurate. Average contributions that are paid to TRUSTi fund differ across ages and wages. The data shows that people that are between ages 55 and 64 pay the highest contributions and there is no specific reason why this phenomenon exists. (TRUSTi, 2011). The following chart depicts clearly the average contributions that are paid in terms of ages. However, besides the group age of 55-64, it becomes evident from Figure 6 that the highest contributors to the pension system mandatory pillar are people aged 35-44 who are also the majority of the employed people on Kosovo. Average contribution for this group of people is € 39.23 monthly and they are primary beneficiaries of the pension system reform of the early 2000s. However, the number of retired people from 2004 to 2011 amounts to 13,672 and they are paid in the total amount of € 19,515,886 throughout the years. (TRUSTi, 2011)

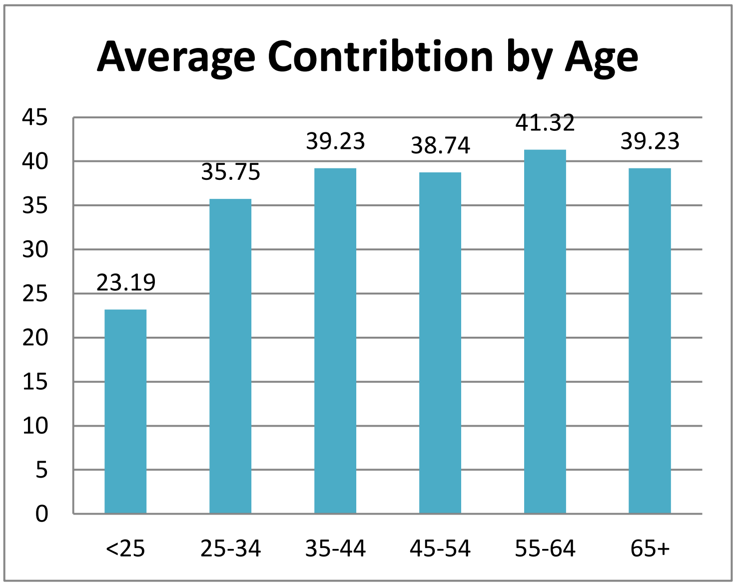

Figure 6 Average Contribution by Age; *Source:TRUSTi*

Rules that exist in terms of withdrawal of accumulated funds during the years also play a role in the financing of the overall mandatory pillar. People who have accumulated less than € 2000 can withdraw their money in a lump sum. If the person dies before he reaches the retirement age, the funds are immediately passed on to the families of the deceased who gain complete access to the funds without restrictions. Moreover, people who wish to withdraw their accumulated funds before they reach their retirement years and they have an accumulated fund of more than € 2000 but less than € 10,000 then this amount shall be given to the individual in monthly income support rather than a lump sum.

Although the accumulated funds on the second pillar are highly dependent on the contributions, TRSUTi fund engages in domestic and foreign investment which can be highly beneficial for the functionality of the second pillar. At the end of 2011, TRUSTi fund managed to retain return on investment up to € 33.1 million, which was helpful in covering the majority of the operational costs and as such not rely on transfers from the central budget. (TRUSTi, 2011)

The way funds are managed in terms of their finances plays a crucial role on how strong a reform is in terms of financial sustainability. Since the second pillar emerged due to the reform that took place in post-conflict period, its financing means and coverage of operation costs can play an important role on the overall pension system sustainability.

CHAPTER 5: PENSION SYSTEM REFORM SUSTAINABILITY

5.2 Pension System Design Findings

Pension reform sustainability is important when aiming at a pension system which will in the future prove to be sustainable. Kosovo and Croatia have both undergone significant changes in their pension systems. My research shows that both countries have shifted from fully public pension systems to introducing the second mandatory and third voluntary pensions system. The idea was that both countries have faced significant economic and political problems in the past and as such they had to engage in state building. The countries share a similar history in the past two decades in terms of economy and social-political changes. They both resemble typical cases of transition countries. Starting from forming new national institutions up to privatization of the state owned economic entities, there were significant changes within Kosovo and Croatia.

Croatia was pushed into changing their PAYG system due to specific changes in the economic wellbeing of the country. Moreover, the change in demographics caused the dependency ratio to grow higher. Deteriorations in the first pillar became very hard to sustain financially and the central budget was the only way to finance the deficits. During the nineties the Chilean “advocate of the private pension system”, Jose Pinera, gave the idea to the Croatian government to reform their pension system. Thus, in the mid-nineties the Croatian government decided to introduce a reform in their pension system. At the end of the nineties Croatia moved from a fully public pension system to a three-pillar pension system, introducing the second mandatory pillar and the third voluntary pillar. This paradigmatic change was more than necessary during the times when the PAYG was becoming unsustainable. However, the change in the pension system did not favor the retired people very much. The second mandatory pillar is believed to favor future generations rather than the older generations that are already retired.

Since, the secondary pillar is entirely based on personal accumulation of fund, thus, the older generation who is already retired depends largely on the PAYG system and the central budget. A very interesting feature of the pension system in Croatia is the transferred funds from the second pillar to the first one. Croatia uses 15% of the 20% of contributions from the second pillar to help finance the PAYG system and uses the 5% for the private accumulation. In addition, the central budget covers 45% of the PAYG system.

The first pillar in Kosovo is an all-inclusive social protection of the elderly population who receive income support irrespective of their previous contributions. The first pillar in Kosovo does not resemble an intergenerational income support, but rather depends entirely on the central budget. The problem with this pillar is that it is not financially sustainable in the long run. There is also a non-existent division between people who are unemployed and need social protection and people who have contributed and receive a contribution. Hence, Kosovo is a perfect case of the poor link between the contribution and the pensions received in the retirement years. On the other hand, the second pillar is fully private and is based on accumulated funds. There is only one institution that manages the second pillar entirely in Kosovo. This is a public institution that is managed as a private entity. The third pillar is a typical voluntary pillar that is very easily managed in Kosovo by pension funds that are authorized from the Central Bank to operate within the territory of Kosovo.

My research shows that there are similarities between Kosovo and Croatia in terms of the second mandatory pillar. Both countries have introduced the second pillar in roughly the same time and have shifted the pension system toward a private fully funded pension system. In addition, they have both introduced the voluntary pension system simultaneously with the mandatory one. The private pension system savings can be very easily sustainable in the long run if the system does not experience drastic changes in the demographic composition of the contributors who do not wish to pay their contributions in their home countries. Thus, the accumulation of funds will be lower and the return on investments will be significantly lower. In the case of Croatia, for example, if there is a significant level of migration, the pension system can experience further deficits. Hence, the second pillar can be hard to sustain and the first pillar will be fully dependent on the central budget. Since the first pillar in Kosovo is already fully dependent on the central budget, these two countries will share the same characteristic.

There are several differences in Kosovo and Croatia's pension systems. These two countries do not share the same burden in terms of dependency ratio. While Croatia's dependency has been increasing, Kosovo has not been subject to dependency ratio. Although Kosovo has a very favorable demographic composition, it does not play a role on the sustainability of the pension system for the time being. However, due to high unemployed youth, the pool of accumulated funds is low. Hence, the investments are lower and the return is significantly lower.

The second pillar in Kosovo is managed entirely by one institution whereas in Croatia, the situation differs. In Kosovo TRUSTi fund is responsible about accumulation, management and investing the pension funds. In Croatia, there is more than one institution that manages the mandatory pillar and there is a more competitive market. In Kosovo on the other hand, the market is highly monopolized and there is no competitiveness.

The third pillar in both Kosovo and Croatia is mostly managed by various banks, insurance firms, pension funds and is highly competitive. There are no significant differences in terms of the voluntary pension system in both countries.

In terms of design the pension systems in both countries seem to be very different, but when analyzed closer there are more similarities than initially anticipated. Since the Croatian PAYG system is highly dependent on the central budget and the dependency ratio is significantly high, this pillar resembles less and less every day the typical PAYG system. With a ratio of 1 retired individual per 1.3 contributors, it will become almost impossible to sustain financially the first pillar. Thus, eventually this pillar will resemble the first pillar in Kosovo and a significant amount of pensioners will be highly dependent on the central budget.

However, reforms that were undertaken in the early 2000s should prove to be more sustainable and they should be assessed in detail in order to see further changes that should be introduced. In the next sub-section I will assess the sustainability of the pension reform in Kosovo and use Croatia to determine if the reforms are sustainable or not.

5.3 Analysis of the Pension System Reform Sustainability

Pension reform sustainability is important because it helps in assisting policy-makers with certain changes that need to be introduced. Although the pension system can sometimes prove to be sustainable for the time being, there is always space for improvement. Pension systems in particular tend to create more complications and they are a very sensitive area of economics. Pension system reform sustainability should be assessed in terms of old-age income support, balance between the active part of the labor force and the rest of society, consumption smoothing and financial sustainability. The indicators used are not mainly aiming at showing how sustainable is the pension system in Kosovo and drawing lessons from the case of Croatia, rather, these indicators can be used to see what kind of aims and goals should a reform aim at in order to help in creating a sustainable pension system.

Old-age income support is one of the most important indicators that show if a reform is sustainable. The pension itself is an income support mechanism and this should be the foremost important goal of a reform. In Kosovo, the primary reason why the first pillar exists is to help old generation with income support. Since the PAYG system that existed in times of Yugoslavia ceased to exist, Kosovo's primary goal to create a pension reform was to help the elderly with a monthly income that would cover their basic needs, irrespective of their contributions. This sum was based on a basic basket of goods that each older individual needs. So, the first pillar aimed at a high coverage and could only be financed through the central budget. This coverage is not significantly well designed, because a lot of people who did not contribute to the previous system benefit from the pension system in Kosovo. However, as a system itself, the aim to provide old-age income support was completed. The majority of the individuals that reached the retirement age receive income support monthly, but the problem seems to be more complicated. The lists of the people who receive income support are not clearly divided between pensioners and socially protected people.

The case of Croatia on the other hand helps in understanding better the old-age income support idea. Croatia is a high-income non-OECD country that provides a significant amount of retired people with generous pensions. Income support should be the aim of the pension system, however, it should not help in deteriorating the system and creating a fiscal collapse. Similarly like the case of Croatia, Kosovo can very easily damage the pension system and the old-age income support can then be questionable. The old-age income support should be a primary aim of the pension system, but up to the point of not deteriorating financial sustainability and fiscal prudency.

Although with significant problems, old-age income support in both countries has been achieved and completed. The reform has aimed at offering the population with an income support that would help in consumption smoothing which is the second indicator of the sustainability of a pension reform.

The reason why consumption smoothing is used as a pension reform sustainability indicator is not only as an expression in terms of replacement rate. It is rather an expression of a consumption smoothing in a dynamic life span. In other words, the wages that are received today and the contribution rate paid should help in consumption smoothing of an individual throughout their lifetime. Reforms should be designed in such a way as to create a contribution rate and a minimum of years in employment that would later in time generate a favorable and sustainable replacement rate. Kosovo for example has a very low replacement rate and one of the lowest in the region. The replacement rate in Kosovo supports consumption smoothing but it is in a very low level when compared to Croatia. Although the reform in Croatia led to a very favorable replacement rate of 90% the pension system started facing significant difficulties. Hence, the replacement rate should be firstly sustainable and then favorable. It is very hard to create such a replacement rate in Kosovo that would be favorable since the country is a low-income country. Kosovo's reform does not prove to achieve a favorable replacement rate that would help in consumption smoothing. Moreover, it proves to create such a system that the replacement rate cannot even cover the basic basket of goods given the prices and the living standards in Kosovo. The second pillar however, is much more sustainable in terms of consumption smoothing and replacement rate. The replacement rate in Kosovo in the second pillar varies and it is not the same for all individuals. But it assumed that Kosovo […] has replacement rate of 20% if the average wage is 240 Euro per month. The pension is on average 45 Euros per month. (Xhumari,

2010) However, with the prevailing contribution rate of 10%, there is a minimum of ten years that a person should be in employment in order to reach a favorable replacement rate. (Loxha, 2012)

The reform in both countries proves not to have created a favorable replacement rate that could be sustainable and help in consumption smoothing. Two extremes have proved that neither Croatia with 90% replacement rate, nor Kosovo with 20% replacement rate could be sustainable in the long run. Hence, pension reforms should target consumption smoothing with the help of contribution and replacement rates.

If there are no clear and specific objectives that a pension reform aims at, there is a high probability that there will be significant problems in terms of balance between the *active part of the labor force and the rest of society*. A well designed pension reform should create a balance in terms of wages and pensions and there should be a close link between contributions and pensions. In the case of Croatia, the link is very low and unclear, while in Kosovo this link does not exist at all. This is due to the fact that Kosovo does not have a PAYG system, but rather depends highly on the contributions that are paid to the accumulated mandatory fund.

The rationale behind this balance is that a given pension system should be reformed in such a way as to create an average pension for the individuals which will be the same across generations. So, in a given country the accumulated contributions of an average wage should generate pensions of the same scale across generations. Otherwise, if in a given generation accumulated contributions generate more pensions now and for the future generations the pensions are less, then there is a misbalance in the pension system. The link between the contributions and the pensions should be stronger. More specifically, computations should be done in such a way as to help the generations hold a similar level of consumption throughout the individual's lifespan and longer income support. This indicator is mostly true for the PAYG system which should aim at creating an intergenerational balance of income support. But, in Kosovo, the first pillar is fully dependent on the active part of the labor force who by paying taxes helps the tax revenue and thus help finance the first pillar. Moreover, a majority of the retired individuals that receive income support from the first pillar are mostly people who did not contribute in the past. So in Kosovo, this indicator shows that the reform did not fulfill the aim of creating the balance between the active part of the labor force and rest of society. On the other hand, in Croatia, the country supports its retired individuals from the central budget up to 45%, so, the reform did not prove to be very efficient either. The problem of societal equity is obvious in this case as the people from the "privileged pensions" are getting more pensions as compared to the rest of the retired individuals. Both countries have to reach a balance between the active part of the labor force and the rest of the society in order to create a sound pension system in the future which will not be so highly dependent on the central budget.

The last indicator that helps in determining sustainability of a reform is the foremost important element of the pensions system, *financial sustainability*. It is of utmost importance that any reform taken form any country seeks financial stability in the long-run. It is very hard to provide income support, help in consumption smoothing and provide a balance between the active part of the labor force and the rest of society if there is no financial sustainability. Kosovo created the reform and introduced the private pension system which aimed at reassuring the society that there will be financial sustainability in the long run. There is significant attention given to the investments that are done by the TRUSTi fund. However, the problem with the pension reform is that the second pillar is highly monopolized and there are mostly foreign investments done from the part of TRSUTi. According to the annual report of TRUSTi, 32.6% of investments are conducted in USA whereas in Kosovo they only invest 6.2% of assets. But, the real problems remain in the first pillar which if continued at the current pace, it will be unsustainable in the long run. So far the government has proposed to create changes in the first pillar which would engage some transfers from the second pillar to the first one which would help in financial sustainability of the first pillar and increasing of the pension average. However, the case of Croatia shows that even with a high transferring rate the dependency from the central budget is inevitable. Financial stability runs the risk of more than just depending from the central budget and creating fiscal collapse. There are changes in demographics such as birth rate, migration and life expectancy that can directly affect the financial sustainability of the reform and the pension system. Hence, the reform should be highly concentrated at aiming financial sustainability. This indicator shows that the reforms taken in the early 2000s in both, Kosovo and Croatia have not achieved to fulfill the financial sustainability.

CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

Pension reforms once again prove to be much more difficult to manage and create as they entail in themselves a lot of socio-economic factors that influence them directly. Pension reforms should be designed and implemented in order to help the well-being of the working part of the labor force and the retired individuals. Since Kosovo and Croatia have both introduced pension reforms, it is important to note that these reforms were done under difficult circumstances and during transition years. Although Kosovo is still under the transition process, both countries privatized partially their pension system in the early 2000s. However, the problem with both countries is that both pension systems nowadays do not fulfill some of the main objectives of the reform. Croatia and Kosovo share both the same problem on the first pillar. While Croatia claims to have a PAYG pension system, Kosovo supports its first pillar entirely from the central budget. Croatia on the other hand finances its first pillar 45% from the central budget. It is incorrect to say that Croatia does not possess a PAYG system as long as there are individuals contributing to the system. However, when the deficits are as high as in Croatia, then it is slowly approaching and resembling the first pillar in Kosovo. Hence saying that the first pillar in Croatia is a typical PAYG would pose conceptual questions as to whether the first pillar is sustainable enough or not. The government of Kosovo, in particular the opposing political party, has proposed a 6% increase in the contribution rate (3% employer and 3% employee) in order to help finance the first pillar. (KosovaPress , 2012) Moreover, it is very important that the lists of people that are part of the first pillar be divided clearly between the people who need social assistance and the ones that need pension support.

The second pillars in Kosovo and Croatia are designed similarly. They are both private and are managed by pension funds that are fully private. Individuals who are currently employed should open up an account with a certain institution where their funds will be accumulated during the years and then distributed in terms of income when the individual retires. Interestingly, the private pensions system proves to be sustainable in the long run as most of the people who have accounts can accumulate funds that will prove to be sufficient for their retirement years. In an average of 40 years of work per individual there will be sufficient fund accumulated for the rest of the individual's life. In Croatia, there are several funds that manage the mandatory pension system, whereas in Kosovo there is only one institution. The problem with this design is that, the entire market is highly monopolized and there should be more institutions engaged in the market to increase competitiveness. In Kosovo the second pillar should be changed in terms of its market and the government should encourage new entrants on the market that would encourage people to pick their saving institution. Moreover, a positive difference between Croatia and Kosovo is that in Croatia, the transfer costs from the second pillar to the first are financed from the central budget, whereas Kosovo does not have such transfers and the investment returns are used to cover operation costs and increase further the pensions for future generations. It might be argued that the second pillar only favors current and future working generation, hence future retirees, but the case of Croatia tells us that it can be used to benefit current retirees as well.

The third pillars in Kosovo and Croatia are fully voluntary and they are decided on individual basis between the employer and the employee. However, there are cases when people pay retirement contributions which are based on their own preferences. In both countries the markets are highly competitive and they are mostly managed by private fund and banks. The third pillar once again shows that a competitive market helps increase efficiency in the pension arrangement funds market.

Reforms that should be introduced in Kosovo should take into account the previously mentioned indicators and work towards achieving them. In practice creating a sustainable pension system is hard. However, reforms should always be implemented in such a way as to help the system in achieving a financial sustainability, old-age income support, consumption smoothing and create balance between the active part of the labor force and the rest of society. Kosovo is a very interesting case when it comes to pension reforms. Although the country has tried to create a resilient pension system, its institutional design will not be sustainable in the long run. Being a low-income country the pension system should aim at alleviating old-age poverty and try to maintain favorable replacement rates. Although replacement rates are assessed on individual basis, and collecting such data to conduct analysis is hard, the second pillar can help in aiming at alleviating old-age poverty. Importantly, with a clear division of people that are on the pension system and people that are on social protection platform, it will become easier to offer the first pillar a favorable income support. In addition, a new contribution rate of 16%, out of which 6% would be transferred to the first pillar, there would be shifting towards creation of a more financially sustainable pension system.

Finally, pension reforms in Kosovo that were introduced in the early 2000s have not proved to be fully sustainable. There are problems that need government attention and should be solved continuously. This proves that Kosovo can help in creating sustainable reforms for the future and aim at a financially favorable pensions system.

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