

# Recommendations on Pension Reform Following the PWG Conference

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## Recommendations on Pension Reform, Following PWG Conference

**25 June 2007**

## **Recommendations on Pension Reform, Following PWG Conference** **David Snelbecker, USAID/SPSS**

As follow up to the Pension Working Group conference, we make the following recommendations. These recommendations are discussed more in depth in a separate paper, which was distributed before the conference.

### Institutional arrangements

- *Flows of contributions.* Administrative simplicity is critical for successful, cost-effective pension reform. Flows of contributions should be as simple and direct as possible. Contributions (from employers and employees) should flow directly from firms' bank accounts to the centralized account of the pension fund administrator. Funds should not flow through the treasury, and employee and employer contributions should not be separated. The treasury will not have the capacity to receive contributions, fix problems with improper information, and then re-send to individual accounts. Furthermore, it is critical for full individual-level information to be provided each time a payment is made. If a policy decision is taken to top up accounts from the state budget, this should be done yearly or at most quarterly, and separately from the process of collecting and reconciling contributions.
- *Collection and reconciliation.* The process for collection and reconciliation of contributions should be further analyzed by experts familiar with these processes in other countries that have successfully implemented funded pension reforms. The State Tax Service (STS) has limited capacity and limited resources. The business processes for collecting funded pension contributions are quite different from the processes for collecting personal income and other taxes. Consequently, it might make sense to create a separate institution responsible for collection and reconciliation of pension contributions. (This is how funded pension contributions are collected in most of the world; usually they are not collected by tax administrations.) This way, the STS could continue to dedicate full resources in coming years to ambitious targets for tax collection improvements. Another alternative, as a compromise between this proposal and that currently envisioned in the draft White Paper, would be for a separate institution to reconcile individual-level information and money flows, but for the STS to monitor and enforce aggregate payments of contributions by firms. In considering whether to assign this task to the STS, the following are important: to specify in great detail the business processes required for collection of funded pension contributions; to evaluate how similar these processes are to those of income tax collection; to ensure that STS has capacity to take on these responsibilities; to gain the commitment of STS that collection of pension contributions will be a top priority for STS resources and not de-emphasized compared to tax collections; and to make sure that collecting pensions will not prevent STS from making progress with an equally ambitious tax reform program.
- *Liaising with participants.* Clarification is needed regarding who will liaise with participants, collecting beneficiary information and information about portfolio selection and changes. In the White Paper proposal, this is to be done by "entry

points,” but it is not clear in what institution these “entry points” are supposed to be placed.

### Governance

- Governance of the funded pillar is weak, particularly regarding: *selecting, instructing and monitoring performance of asset managers; specifying default asset managers and portfolios; and generally assuming fiduciary responsibility* for managing the system. To some extent, these functions are proposed to be undertaken by the supervising entity (i.e., the Central Bank). Assigning implementation tasks to the entity responsible for supervision would be risky, since it would not provide the usual checks and balances that come from separating implementing and supervising functions. We recommend that there should be an implementing agency that is a legal entity, separate from the supervising entity, with strong governance rules and abilities. This implementing entity (which is not included in the current proposal) should be the core of the funded component, taking on responsibility for a number of tasks that are currently dispersed or unassigned to any particular entity. This could be a public-private partnership with participation of international private or multilateral institutions (such as the IFC). We suggest that this entity could be named the “Pension Savings Fund of Armenia (PSFA)”. If this proposal for creating an entity separate from the supervisor (the Central Bank) is not accepted, the issue of strengthening governance still needs somehow to be addressed. This is one of the greatest weaknesses in the proposal at present.

### Parameters

- The social and minimum pension levels need to be clarified, based on projections of future fiscal burden and impact on poverty alleviation. More emphasis is needed on raising minimum pensions than on increasing pensions for higher wage earners.
- Total contribution rates, including to funded accounts, should not be raised. It is important not to give further incentives to evasion. Increasing the total tax and contribution burden on wages by five percentage points would increase the size of the informal sector and decrease compliance.
- Fiscal costs of the reform need to be assessed. On the one hand, if fiscal costs are too low, the reform is not really achieving anything important. On the other hand, if fiscal costs are too high, the Government (and population) of Armenia will have difficulty in paying for it.

### Timeline

- Armenia seems to have a political window of opportunity now, to complete a White Paper over the summer, and to put comprehensive legislation through the Parliament by the end of this year, for implementation in 2009 or 2010. Much work remains to be done and issues need to be better addressed in the reform concept in order to meet this timeline. Nonetheless, we recommend trying to maintain the current planned timeline for now, and then revisiting this issue in the fall to see what progress is being made. The reform at present has political momentum, which is as important for reform success as many other factors.