



## ***Twinning Project AZ/13/ENP/SO/24***

# **Support to the State Social Protection Fund on the introduction of funded element within the insurance-pension system, establishment of non-state pension funds and development of legal framework for regulating their activity**

## **Lessons learned from Activity 4.1.**

### **In-depth presentation of the state pension system of the EU MS to relevant SSPF staff and other stakeholders**

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#### **1. Risk for financial stability of the state social insurance system**

The budget of the State Social Protection Fund (SSPF) is notionally balanced since revenues are approved in the amount of 2 928 452 000 AZN and expenditures equally of 2 928 452 000 AZN for 2014. Expenditures for labour pensions make up 2 500 291 000 AZN or 95% of total state social budget.

Total expenditures increased by 11.2% and labour pensions expenditures by 11.5% in 2014 compared with 2013.

Despite its notional balance, the SSPF budget is highly dependent on dotation from the State Budget. Mandatory state social insurance contributions cover only 61% of all necessary expenditures in 2014 (59% -2013). The support ratio from the state budget for financing the social insurance system amounts to 39% in 2014 and was 41% in 2013.

Social-insured persons pay a mandatory social contribution rate of 25% levied on gross salary, where employees pay 3% and employers 22%.

Since 2006 half (or 50%) of total contributions (12.5% from gross salary) have been accounted for social insurance pensions in individual accounts. Of the total workforce of 4.5 million persons, 2.8 million (equivalent to 62%) are enrolled in Individual Pension Accounts registered with SSPF, and are thus covered by pension insurance in Azerbaijan. The uncovered part of the workforce mainly consists of self-employed persons and farmers.

Labour pensions consist of two parts: base part (54% of total pensions payments) and insurance part (46% of total pensions payments) (in 2013-2014).

Regarding to Bloomberg Business Week publication (which is quite close to official statistical data for 2013):

[http://images.businessweek.com/ss/10/07/0729\\_worlds\\_biggest\\_shadow\\_economy/4.htm](http://images.businessweek.com/ss/10/07/0729_worlds_biggest_shadow_economy/4.htm)):

Labour force by occupation: Agriculture 38.3%, Services 49.6% and Industry 12.1%. Per cent of GDP in Shadow Economy is 3rd largest rate in the world: 69.6%



(international researches - 50-70% from GDP- and official statistical data - 9% from GDP - are differs in wide range).

### Main conclusions:

1. Although the State Social Protection Fund budget is set on a separate budget status (non-budget fund), current state social insurance contributions (25% from gross salary) cannot cover all expenditures necessary for social protection needs. The State Social Protection Fund budget is not operating on self-financing system without the state budget dotation and as a result high dependency on state basic budget exists.
2. Although from 2006 individual labour pensions accounts have been introduced, only 62% of total workforce in Azerbaijan is covered by individual pension insurance. Main uncovered occupations regarding to statistical data could be self-employed persons in service sector and farmers in agricultural sector.

### Follow up questions and issues for consideration to develop sustainable state social security system in long run:

1. Revising the state social insurance budget (SSPF budget) structure regarding to high dependency on the state budget (oil production revenues) and coverage of individual contributions. **Long-term strategy for state social insurance budget balancing** - balance between social insurance contributions and expenditures for existing and future social insurance pensions and benefits - should be developed.

Social insurance system on self-financing basis would build financially stable state social insurance system in the long run, which would be less dependent on oil industry.

2. To review **adequacy of state social insurance contribution rate** for pension insurance (12.5% from gross salary) to cover pension payments (provide adequate replacement rate) regarding to age structure of population, existing employment rate, shadow economy and other economic criteria.
3. In order to provide adequate state social protection and pension insurance in the future for all population groups taking into account that main labour force (approx. to 90%) is working in agriculture and service sectors, there is an **obvious need to create special pension savings and social protection vehicles for self-employed persons and farmers**, for example, farmers pension scheme with mandatory and voluntary savings component.



## 2. Public awareness and communication with potential beneficiaries

From 2006 onwards, SSPF has introduced Individual Pension Insurance Accounts (based on unique Personal Insurance Number) where state social contributions of 12.5% from gross salary (or 50% from total state social contributions made) are accounted in.

For each account, SSPF has issued an electronic plastic card which can be used for checking information on contributions paid into the individual account and thus gives an opportunity to control fiscal compliance of the employer regarding their obligation to pay state social contributions into the state social budget.

Contributions accounted in Individual Pension Accounts are not kept separated from the state budget cash flow and in line with pay-as-you-go method of funding, the payments made to Individual Pension Accounts are used to pay for the pensions of current pensioners.

Accrued pension contributions in personal accounts are indexed to the rate of inflation on an annual basis.

Existing pensioners can apply for old-age pension benefits via telephone in SSPF, which is an innovative approach for customer servicing.

### Main conclusions:

1. Individual accounts and accessibility of personal data of social contributions in these accounts increases population awareness of state social system and personal responsibility as well. This situation stimulates personal participation in state social insurance system and helps to cover social insurance needs from the state budget funds – old age pensions and other social benefits covered by state.

At the same time it appears problematic when particular occupations, like farmers (38% from total workforce), are excluded from electronically based information and communication channels.

2. Personalized data availability on pension accruals in state insurance system could help diminish the shadow economy in the country by understanding of social systems operation basic principles.

### Follow up questions and issues for consideration to develop sustainable state social security system in long run:

Taking into account that 38% from total workforce is not covered by Individualised Pension Insurance Accounts, some special communication campaign for self-employed persons and farmers would be necessary.



As well as different approach for specific occupations and their savings account administration could be applied (*for example, like special farmers accounts in SSPF - partly mandatory & partly voluntary or private savings scheme*).

### **3. Funded Pension products development and Financial and Capital Market Accessibility**

The “New concept of Pension System Reform in Azerbaijan” that has been developed together with Ministry of Finance includes the development of private pension funds and funded elements in state labour pensions.

Among the obstacles to a swift and immediate implementation of those fully funded schemes is the current state of the financial market and the fragmented financial and capital market supervisory institutions. Financial market supervision is carried out by 3 separate institutions – Central Bank of Azerbaijan for banking sector supervision, State Insurance Supervision Agency (under Ministry of Finance) for insurance market supervision, State Committee for Securities (under President of Azerbaijan) for securities market supervision.

Public trust to financial institutions appears to be low and long-term savings market is undeveloped. Only short-term bank deposits are used as financial savings instrument.

Given these circumstances the development of fully funded pension schemes should be based on a comprehensive plan to develop a broad range of financial market regulations that cover the whole delivery process of fully funded pensions. Such a comprehensive plan calls for the involvement of all the agencies and stakeholders interested in fully funded pension provision in due time after consultation with the project beneficiary.

**Follow up questions and issues for consideration to develop sustainable state social security system together with financial market development will be included in Study Report after mission during August 4-8, 2014.**

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