Pension Policy Reform

Afghanistan

Objectives of the Pension Reform

- Improve the financial sustainability of the pension scheme (Long term balance of the system based on the contribution [Govt + Employees] and pension expenditures),
- Improve fiscal affordability of the pension scheme for both short term and long term (Affordability of the fiscal transfers to the pension system by the Govt),
- Compliance of the pension system with the prevailing laws and regulations (establishing the Public Pension Fund)
- Provide strategic directions to pension coverage extension to the private sector employees

Effects of the Introduction of the Public Pension Fund on the Government Budget

Under the status quo the Govt receives Afs 4.2 billion as revenues from employees contribution and pays only Afs 3.2 billion on top of employee contribution towards current pension benefits as part of 2018 budget. However, if the pension fund is established, the government will pay ‘employer contributions’ (5.4 billion Afs) and it will no longer receive Afs 4.2 billion in revenues. So the total cost of the fund to the government is Afs 9.6 billion. However, the surplus in the pension fund, 2.3 billion Afs, could be borrowed back by the Govt to finance the budget.

Status Quo of the Pension System

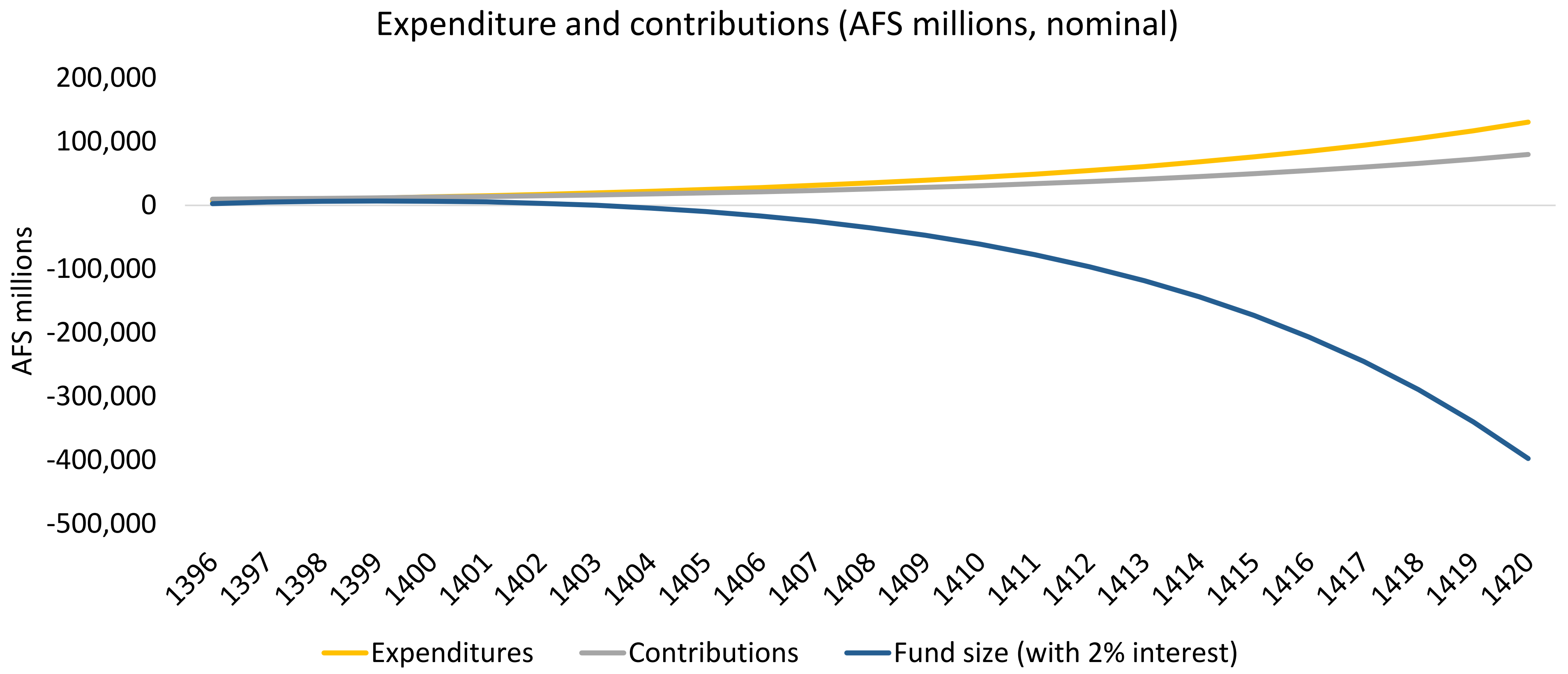
1. No pension fund in place and no related financial compliance with the pension laws and regulation;
2. The government is not paying its contributions, rather it only finances the current deficit of the system;
3. Accrual rates are high by international standards (100 % final salary with 40 years of service);
4. The pension system is financially not sustainable and fiscally not affordable (the system is generating pension promises that the government is not able to finance).

To make the system financially sustainable and fiscally affordable, we propose a set of reform options.

Details - Baseline

	Civil Servants	Security Forces
Contribution	CS: 8 % Govt:8%	SF: 5% Govt: 11%
Accrual Rate	CS: 4% for 1st 10 Years of Service (YoS), 2% for other YoS;	SF: 4% for 1st 10 Years of Service (YoS), 2.3% for other YoS;
Retirement Age	65	52 till 62 – base on rank and LoS
Wage Measure	Last month salary	Last month salary
Inflation Indexation	Identical to the indexation of salaries	Identical to the indexation of salaries
Interest Rate on Pension Fund	Currently not applicable	Currently not applicable
Harmonization in Survivors Benefits	100% of pension for survivors on regular basis	100% of pension for survivors on a regular basis
Ceiling for the Pension Benefits	100%	100%
Penalty on early retirements	No penalty	No penalty

Baseline



Expenditure and contributions (AFS millions, nominal)
200,000
100,000
0
-100,000
-200,000
-300,000
-400,000
-500,000
AFS millions
1396
1397
1398
1399
1400
1401
1402
1403
1404
1405
1406
1407
1408
1409
1410
1411
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1420
Expenditures
Contributions
Fund size (with 2% interest)

Reform option #1

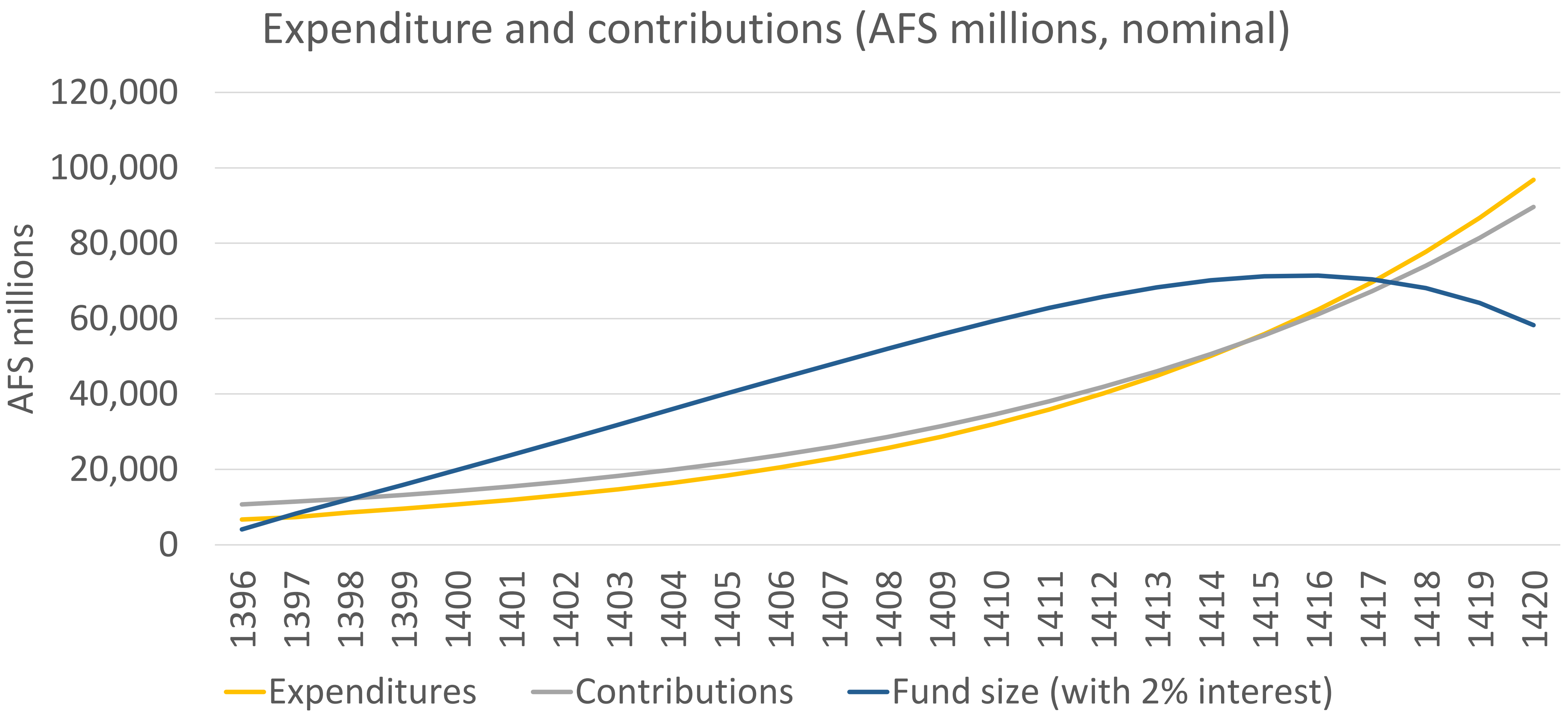
To make the system financially sustainable and fiscally affordable, we propose the following reform options:

1. Reducing the accrual rate to 2% and 2.1% for civil servants and security forces personnel respectively for every year of service by eliminating the extra accrual for the first 10 years of service;
2. Employee contribution rate is increased by 2%
3. Indexation (automatic increase) of pension benefits introduced replacing current linkage to public servant salary adjustments; new indexation: 1.5% annually for 10 years, to inflation afterwards
4. Changing the wage measure in the pension benefit formula from last wage to the average of last five years' wages;
5. Introducing penalty on early retirement, 3% reduction for each year prior to retirement age;
6. This scenario applies to only civil servants and security forces who retire after the reform, current retirees are not affected.

Details of Reform Options #1

	Civil Servants	Security Forces
Contribution	CS: 10% (+2%) Govt:8%	SF: 7% (+2%) Govt: 11%
Accrual Rate	CS: 2% for every year of service	SF: 2.1% for every year of service
Retirement Age	65	52 till 62 – base on the ranks and LoS
Wage Measure	Average of last 5 years' salary	Average of last 5 years' salary
Inflation Indexation	1.5% for 10 years, inflation afterwards	1.5% for 10 years, inflation afterwards
Interest Rate on Pension Fund	2% + inflation on the fund size	2% + inflation on the fund size
Survivors Benefit	Age limit is introduced for survivor children at 18, 23 if she/he is a student	Age limit is introduced for survivor children at 18, 23 if she/he is a student
Ceiling for the Pension Benefits	80%	84%
Penalty for early retirement	3% penalty for each year before the retirement age	3% penalty for each year before the retirement age
Scenario Application	Only to new pensioners	Only to new pensioners

Reform Option #1



Advantages and Disadvantages of Reform Option #1

Advantages:

- Simple to implement
- Reasonable short-term financial position improvement, and long-term financial sustainability which is dependent on the well management of the pension fund.
- Current pensioners are not affected (political risk reduction)
- The introduction of guaranteed pension increases (indexation) by 1.5% a year for 10 years and to inflation afterwards makes the reform more acceptable (political risk reduction)

Disadvantages:

- Net salaries of civil servants and security forces personnel are reduced (political risk addition)
- Current civil servants and security forces personnel bear the burden of the reform and they (especially those close to retirement) will see their pension rights reduced (political risk addition)

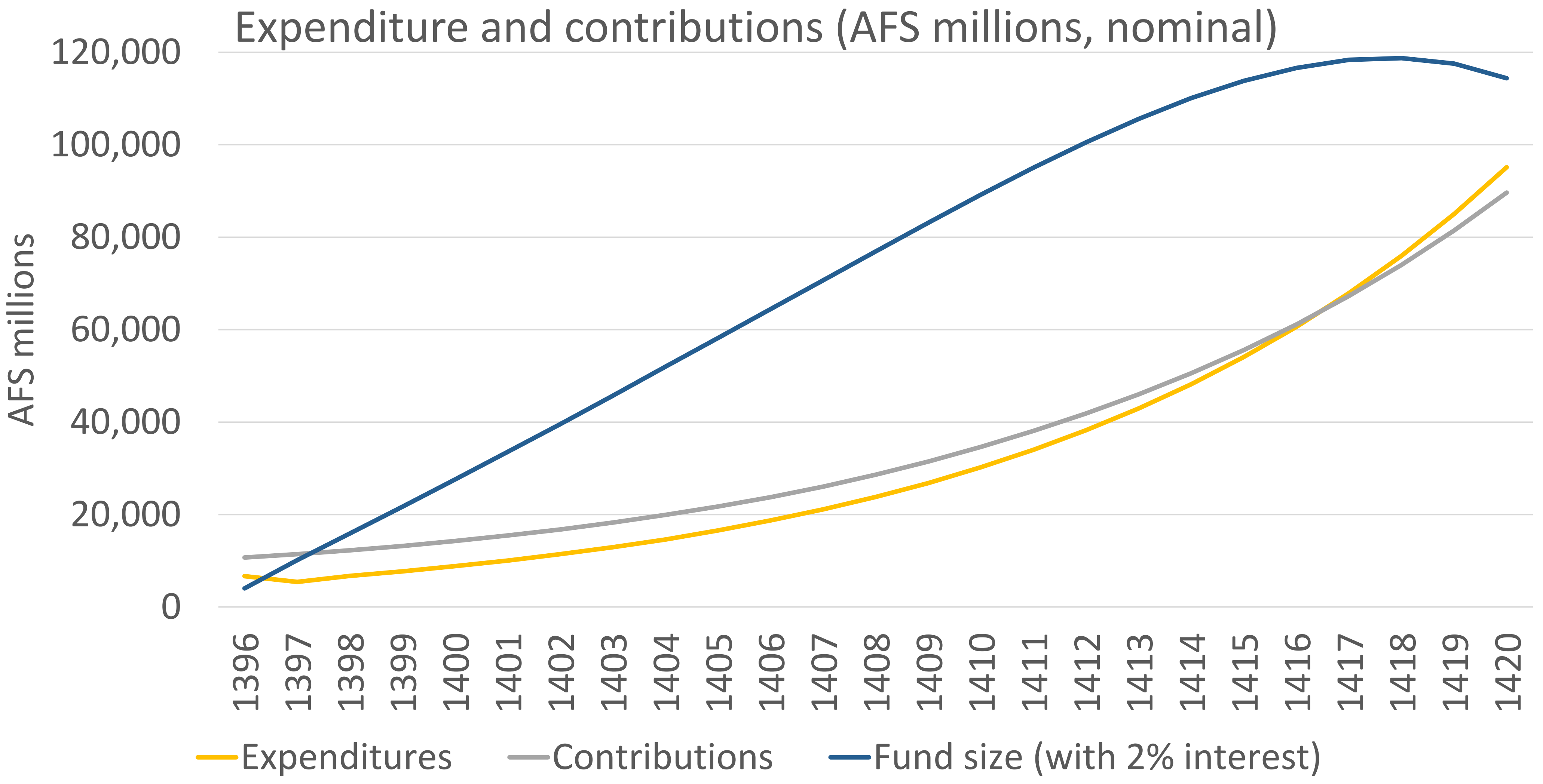
Reform Option #2

- Identical to Reform Option 1, other than
- New pension parameters are applied across the board including current pensioners (retrospective pension adjustment)

Details of Reform Option #2

	Civil Servants	Security Forces
Contribution	CS: 10% (+2%) Govt:8%	SF: 7% (+2%) Govt: 11%
Accrual Rate	CS: 2% for every year of service	SF: 2.1% for every year of service
Retirement Age	65	52 till 62 – base on the ranks and LoS
Wage Measure	Average of last 5 years salary	Average of last 5 years salary
Inflation Indexation	1.5% for 10 years, inflation afterwards	1.5% for 10 years, inflation afterwards
Interest Rate on Pension Fund	2% + inflation on the fund size	2% + inflation on the fund size
Survivors Benefit	Age limit is introduced for survivor children at 18, 23 if she/he is a student	Age limit is introduced for survivor children at 18, 23 if she/he is a student
Ceiling for the Pension Benefits	80%	84%
Penalty for early retirement	3% penalty for each year before the retirement age	3% penalty for each year before the retirement age
Scenario Application	Applied across the board including current pensioners	Applied across the board including current pensioners

Reform Option #2



Advantages and Disadvantages of Reform Option 2:

Advantages:

- Simple to implement
- Significant short-term financial position improvement
- The introduction of guaranteed pension increases (indexation) by 1.5% a year for 10 years and to inflation afterwards makes the reform more acceptable (political risk reduction)
- Long term financial sustainability is significantly better than under Option #1,

Disadvantages:

- Benefits of current pensioners are reduced (political risk addition)
- Net salaries of civil servants and security force personnel are reduced (political risk addition)
- Current civil servants and security forces personnel bear the burden of the reform and they (especially those close to retirement) will see their pension rights reduced (political risk addition)

Reform option #3

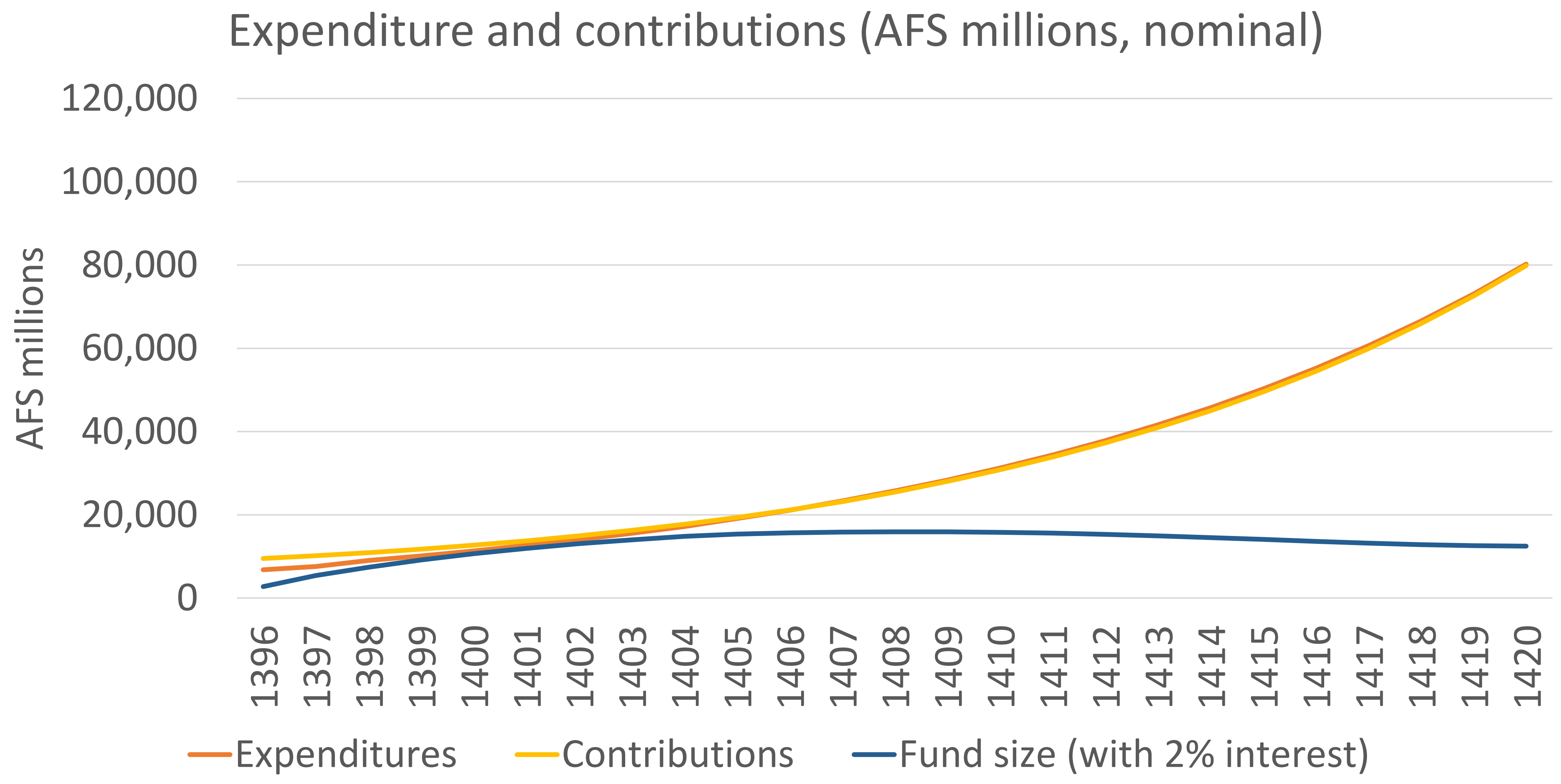
To make the system financially sustainable and fiscally affordable, we propose the following reform options:

1. Preserving earned pension rights: pension benefits are calculated with prior to reform accrual rates for all years of service prior to the reform and at a reduced rate to 1.5% for civil servants and 1.6% for security forces personnel for all years of service of after the reform;
2. Retirement age is adjust to increasing life expectancy by 1 month every 6 months (or 2 months every year)
3. Indexation (automatic increase) of pension benefits introduced replacing current linkage to public salaries; new indexation is 1.5% annually for 10 years, to inflation afterwards
4. Changing the wage measure gradually representing career average wage; introduction 3 years after to reform (allowing system readiness) adding 1 year to the wage averaging period by 1;
5. Introducing penalty on early retirement, 3% reduction for each year prior to retirement age;
6. Current pensioners are not affected by the reform

Details Reform Option #3

	Civil Servants	Security Forces
Contribution	CS: 8% Govt:8%	SF: 5% Govt: 11%
Accrual Rate	Earned pension rights preserved; CS:1.5% for all YoS after the reform	Earned pension rights preserved; SF 1.6% for all YoS after the reform
Retirement Age	Adjust to changing life expectancy:+1 months every 6 months	Adjust to changing life expectancy:+1 months every 6 months
Wage Measure	Gradual adjustment to career average wage(from 3 years after the reform)	Gradual adjustment to career average wage(from 3 years after the reform)
Inflation Indexation	1.5% for 10 years, inflation afterwards	1.5% for 10 years, inflation afterwards
Interest Rate on Pension Fund	2% on the fund size	2% on the fund size
Survivors Benefit	Age limit is introduced for survivor children at 18, 23 if she/he is a student	Age limit is introduced for survivor children at 18, 23 if she/he is a student
Ceiling for the Pension Benefits	Gradually decreasing from 80% to 60% over 40 years	Gradually decreasing from 94% to 64% over 40 years
Penalty for early retirement	3% penalty for each year prior to retirement age	3% penalty for each year prior to retirement age
Scenario Application	No change for Years of Service before the reform, only YoS after the reform will subject to new measures	No change for Years of Service before the reform, only YoS after the reform will subject to new measures

Reform Option #3



Advantages and Disadvantages of Reform Option 3:

Advantages:

- Benefits of current pensioners are not affected (political risk reduction)
- Earned pension rights are not affected (political risk reduction)
- Long term financial sustainability
- The introduction of guaranteed pension increases (indexation) by 1.5% a year for 10 years and to inflation afterwards makes the reform more acceptable (political risk reduction)

Disadvantages:

- Complex to implement; system improvements are need to report current public employee wages to the pension MIS
- Short run financial pressures are significantly moderated, but not as sharply as under Options #1 and #2
- Young, close to labor market entry, civil servants and security forces personnel bear disproportionate burden of the reform; there may be political pressures for reform reversal by younger generations in the future
- The automatic adjustment of the retirement age in likely to be unpopular (political risk addition)

Comparison of Reform Options

Reform Option	Short-Term Financial Position Change	Long-Term Financial Position Change	Political Risk	Implementation Complexity
#1	Significant short term financial position improvement	Long term financial sustainability is dependent on the better management of the pension fund	- Current public employee pension benefits are reduced - Net public employee salaries are reduced by 2%	simple
#2	Sharp short term financial position improvement	Improved over Option #1,	- Pensions benefits are reduced across the board including the pensions of current pensioners - Net public employee salaries are reduced by 2%	simple
#3	Moderate short term financial position improvement	Long term financial sustainability is secured without need for frequent reform interventions	- Earned pension rights are preserved, but going forward pension accumulation is significantly reduced - The burden of the reform is disproportionally taken by young generations	complex

Extension of Pension Coverage to Private Sector Employees

- Reform rationale:
  - the Govt should offer saving opportunities for old-age income security for all regardless of sector of employment
  - the potentially increased national saving through pension coverage extension could be utilized for accelerating national development progress
- Type of Pension Scheme:
  - Proposed Defined Contribution (DC) scheme as opposed Defined Benefit (DB) scheme:
    - individual contributions (and those of the individuals employer’s) are registered on individual accounts (like a bank account);
    - investment return on contributions are added to the account balances;
    - the value of the pension benefit is set to be equal to the individual account balance at retirement
    - therefore, the DC scheme is financially sustainable by design
    - in contrast, DB schemes, like the current civil service and security forces pension schemes in Afghanistan, do not automatically secure a balance between lifetime contributions and pension benefits on the individual level. Benefit determination via a function of wages, years of service, and the accrual rate (DB formula) could yield significantly different results from the value of the individual’s contribution performance over the life cycle

Architecture of the Pension System after Coverage Extension to Private Sector Employees

Functions	Civil Service and Security Forces Pension Scheme – Reform Now!	Pension Scheme for Private Sector – Strategic Decision Now for Detailed Reform Design Decision Later
Policy-making	MoF / MoLSAMD	MoF / MoLSAMD
Type of Pension Scheme	Defined Benefit	Defined Contribution
Participation in the Pension Scheme	Mandatory	Voluntary
Financial Management	Public Pension Fund	Public Pension Fund (different portfolio)
Service Delivery / Payment of Benefits	an Integrated Social Transfer Agency	an Integrated Social Transfer Agency

Thanks