**Why Serbia's Pension System Needs Reform Now (by Albert Jaeger and Bogdan Lissovolik)**

Many countries around the world, and particularly in Southeastern Europe, are undertaking politically difficult reforms of their pension systems. Why? The answer is always the same. Governments, but also workers and pensioners in these countries, are increasingly realizing that their pension systems are unaffordable and could trigger future economic crisis.

Why are so many pension systems in trouble? Much of the problem is rooted in (predictable) demographic trends—lives are ever so longer and birth rates lower. As a result, more pensioners have to be supported by fewer workers. In addition, overly generous pension rules, for example on early retirement, often imply unrealistic pension promises for current and future pensioners. For example, a recent IMF working paper estimates that the unfunded future pension promises of all EU countries amount to at least 150 percent of their GDP.

Is Serbia's pension system also unaffordable and risky? It is. While average pensions in euro terms may not be high, their burden on the economy is heavy. For example, Serbia's pension spending (even excluding military pensions) was over 13 percent of GDP in 2009. In the EU, only Italy had a higher pension spending ratio.

Serbia's particular problem is the large and growing number of retirees (some 1.4 million excluding agricultural pensioners) relative to the registered employees who pay pension contributions (also 1.4 million, once we exclude government employees, whose contributions are anyway financed by the budget). Thus, effectively, each contributor has to share his or her wage income with a pensioner, both through pension contributions and taxes.

If Serbia's pension costs keep rising, they coulduld trigger two vicious circles for the economy and the budget. First, higher pension costs will require higher contributions and taxes, which will undermine growth and formal-sector employment, causing pressure for yet-higher contributions and taxes. Second, the fact that the young in countries like Serbia have the option to emigrate could further undermine Serbia's contribution and tax base.

What can Serbia learn from international experience with pension reforms? It has two basic options. First, a "wait and hope" approach with little reform action and much rhetoric about low contribution collections being the root of all (pension) evils. Countries that have taken this route in the past usually ended up doing pension reforms under emergency conditions, with Greece perhaps the most visible recent example. The other option is to do the reforms when pressures are still manageable, and when reform measures can be phased in over time, giving both workers and pensioners time to adjust.

Serbia's amended pension law, currently in parliament, is in truth a relatively modest step in the right direction. It reduces some options for early retirement, increases the *minimum* retirement age by 5 years, to 58, tightens survivor benefits, and raises years of contributions for women to 38. But these changes are to be phased in very gradually, some by the year 2023. Financial savings from the above steps are estimated to be small and delayed--gradually rising to only 0.1 percent of GDP by 2015. The maximum retirement age for women would remain at 60 and there would be no reduction in pension levels for retiring below this age. Finally, the law helps the most vulnerable by raising the minimum pension.

Other countries in Europe, including Germany, Sweden, Slovenia, have done or are doing much more in terms of reforms. But take Greece to illustrate the risk of a "wait and hope" approach. The new law there sets the *minimum* age of retirement at 60 for all (men and women) by 2015; requires 40 years of contributions for full benefits; and reduces benefits by 6 percent a year for those retiring before 65 without 40 years of contributions. And from now on retirement ages will be increased further in line with rising life expectancy.

As Serbia's reform of retirement ages and contribution periods will generate savings only slowly, the proposed law also includes an indexation formula that compensates pensioners fully for inflation plus a portion of GDP growth. This indexation rule needs to be faithfully followed and would help avoid periodic "extraordinary" adjustments, which aggravated the pension system's finances in the past.

How to offer a reasonable and clear protection to current and future pensioners? Some in Serbia continue to argue for targeting a fixed number for the average of old-age, disability, and survivor pensions as a percent of average wage. This is a rare approach internationally: in fact, we know only of one country (Russia) that uses it. Instead, to increase the transparency of what a worker can get in return for contributions, most countries target a replacement ratio for a "standard pensioner," i.e., a pensioner who contributed for say 40 or 45 years and earned the average wage during that period. Our calculations suggest that, with the proposed indexation formula, the ratio of the pension to the average wage for such a "standard pensioner" in Serbia would remain relatively high in international comparison, even after pension costs would fall to the present medium-term target of 10 percent of GDP.

In sum, Serbia's proposed pension reform law is a step in the right direction. In fact, it could well be seen as the bare minimum of reforms needed. A failure to implement these reforms would raise the likelihood that much harsher pension reforms may have to be implemented down the road.