

# REPORT ON THE PENSION REFORM IN BOSNIA AND HERZEGOVINA:

First assessment

International Labour Office

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## Table of Contents

<b>1. Introduction.....</b>	<b>1</b>
<b>2. Current pension system in Bosnia and Herzegovina .....</b>	<b>3</b>
2.1 Pension and Disability Insurance Act of the FBiH in 1998.....	3
2.2 Amendments to the Pension and Disability Insurance Act of the FBiH in 2000.....	4
2.3 Effectiveness of the current Pension and Disability Insurance Act of the FBiH.....	5
2.4 The Pension and Disability Insurance Act of the RS.....	6
<b>3. Problem analysis of the current pension system in Bosnia and Herzegovina .....</b>	<b>7</b>
3.1 Coverage and enforcement .....	7
3.2 Benefit level.....	8
3.3 Sustainability .....	9
3.4 Administrative capacity and governance .....	10
3.5 Concluding remark .....	10
<b>4. Issues in the Pension Reform Strategy.....</b>	<b>11</b>
4.1 Pension models suggested by the Pension Reform Strategy .....	11
4.2 Further developments .....	12
<b>5. Perspectives of the pension reform in Bosnia and Herzegovina.....</b>	<b>13</b>
5.1 Rationales of the reform .....	13
5.2 Extension of coverage .....	13
5.3 Long-term sustainability and adequacy of benefits .....	14
5.4 The process of pension reform and the roles of social partners .....	14
5.5 Conclusion and the way ahead .....	15
<b>References.....</b>	<b>16</b>

## Table of Contents

Table 1. Payment coefficients in the FBiH, 2002-2008.....	5
Table 2. Payment coefficients and minimum pensions in the RS, 2001-2008 .....	6
Table 3. Summary of key indicators of the BiH pension system by entity .....	7



# 1. Introduction

The pension system of Bosnia and Herzegovina consists of two schemes in the two entities – the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS)<sup>1</sup>. The two entities have separate pension funds, and the pension schemes are regulated by separate legislations.

Recently there have been on-going discussions on the reform of the pension system. Pension Reform Working Groups have been established in FBiH in May 2007 and in the RS in February 2007. With a support from the Social Insurance Technical Assistance Project (SITAP), funded by the World Bank, the Pension Reform Strategies have been developed in both entities. These strategies have been adopted by the respective government. In addition, international organizations have conducted studies in pension system and related areas.<sup>2</sup>

The Pension Reform Strategies documents are intended to serve as a platform for further discussion on the pension reform. They only describe an outline of the new pension structure and detailed policy design was left to further discussions. However, after the completion of the SITAP project in 2007, follow-up activities on pension reform in the FBiH virtually come to a halt, whereas activities have proceeded in the RS and some draft legislation was prepared.

The current situation of pension reform in Bosnia and Herzegovina lacks clear direction. These notes aim to make a first assessment of the current issues on the pension reform from the perspectives of the ILO, and to place the issues in the actual context of Bosnia and Herzegovina.

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## *Country background*

The ethnic conflict in Bosnia and Herzegovina in 1992-1995 has left a deep scar on the country. The divided national system structure causes a number of complications in implementing national programmes including pension schemes. There are formidable challenges of harmonization and coordination at the state level.

The current economic and social situation is still fragile but improving steadily. Since 2001, Bosnia and Herzegovina has experienced growth of GDP between 3 and 7 percent, so that the total GDP in 2008 was some 40% higher than the 2000-level. However, it has not recovered the pre-war level yet.

In spite of the absence of reliable population data (as there has been no population Census since 1991), results of the Labour Force Survey show that the labour force participation rate (ratio of labour force to working age population) in 2008 was 43.9% (42.4% for the FBiH, 47.0% for the RS, and 36.8% for

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<sup>1</sup> Brčko district does not have its own pension fund.

<sup>2</sup> Reference is made to:

- WB: *Bosnia and Herzegovina Pension System Note*, 2007;

- UNDP: *Pension Reform and Social Protection Systems in Bosnia and Herzegovina*, 2007.

Brčko District), which remained unchanged from 2007. Also, according to the Labour Force Survey, the unemployment rate (measured by the ILO definition) was 23.4% (21.4% for men and 26.8% for women) in 2008, decreased from 29.0% (26.7% for men and 32.9% for women) in 2007. However, the decline in unemployment rate did not entail the increase in the number of contributors to social security schemes.

Though the participation rate in the formal employment is low, a large informal economy employs many workers. An estimated informal economy employment is between 33% and 50% of the formal sector employment.

The pension expenditure is in the order of 7% of the GDP and is the largest component of the social protection expenditure<sup>3</sup>. The total social security contribution rate (paid by the employees and employers) in the FBiH is 43.5%, which comprises 24% for pension insurance, 17% for health insurance, and 2.5% for unemployment insurance. While, the total social security contribution rates in the RS is 42%, comprising 24% for pension insurance, 15% for health insurance, 1% for unemployment insurance and 2% for child allowances. It should be noted that in the FBiH the contribution rate is levied on gross wages, while in the RS the contribution rate is levied on net wages (i.e. gross wage minus employee's social security contributions and personal income tax). In addition to social security contribution, personal income tax, though at a low rate, is also levied to the wages.

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<sup>3</sup> The estimate of pension expenditures as percentage of GDP differs widely between sources. According to the World Bank, it is 5.5% in FBiH and only 2.4% in RS. The estimates provided in the UNDP report are higher: in 2006 these values were 8.69% in FBiH and 10.41% in RS.

## **2. Current pension system in Bosnia and Herzegovina**

The Pension and Disability Insurance (PDI) Act in each entity has established a basic legal framework for the pension system in the post-war Bosnia and Herzegovina. In the FBiH, the pension legislation was introduced in 1998 with the PDI Act (Official Gazette of the FBiH, 29/98), whereas in the RS, the PDI Act was promulgated in 2000 (Official Gazette of the RS, 32/00)<sup>4</sup>.

We will review the current pension systems in Bosnia and Herzegovina. In view of the similarity of the both schemes, we will mainly refer to the provisions of the FBiH scheme (due to the availability of information in English), but will explain different provisions of the RS scheme at the end.

### **2.1 Pension and Disability Insurance Act of the FBiH in 1998**

The scope of the PDI Act covers all employees in the public and private sectors in the FBiH, including army and police services. Self-employed workers and agricultural households are also compulsory coverage but the actual registration is low. The main features of the PDI Act are summarised as follows.

First, by this law, some forms of social benefits traditionally paid by the pension scheme have been eliminated. Consequently, the pension scheme focuses on the provision of old-age, disability and survivors' pensions.

Second, the normal retirement age is increased to 65 years by 2003. It should be noted that the retirement age in the previous legislation was 60 years for men and 55 years for women. In the case of early retirement, pensions are decreased by 0.5% for women and by 1% men for each year prior to 65. These reduction rates are considerably lower than the actuarial rates, which are estimated to be in the range of between 7% and 9% per year of anticipation.

Third, the law establishes the pension base used for the calculation of the pension. The pension base is defined as the average of the revaluated wages over the best 15 consecutive years of insurance. For this purpose, a table of the revaluation coefficients (koeficijent za valorizaciju) since 1966 has been established.

Fourth, the pension accrual rate is 45% for the first 20 years of insurance, increased by 2.0% for each year of insurance in excess of 20 years. Thus, for a newly retired worker with 40 years of insurance, the pension is 85% of the pension base.

Fifth, the law provides that the pensions are indexed in line with a rate up to the increase in the average wage.

In comparison, under the former Yugoslavian system, the pension accrual rate for men was 35% for the first 15 years of insurance, thereafter increased by 2% per year of insurance; and, the pension accrual rate for women was 40% for the first 15 years of insurance, thereafter increased by 2% per year of insurance. Thus, a rate of 85% is achieved with 40 years of insurance for men, and with 35 years of insurance for women. It should be noted that the pension base was based on the average wages of the best 10 years.

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<sup>4</sup> Subsequent revisions of the PDI Act have been made in the Official Gazette of the FBiH 49/00, 32/01, 73/05 and 59/06, and in the Official Gazette of the RS 106/05, 20/07 and 33/08.

## **2.2 Amendments to the Pension and Disability Insurance Act of the FBiH in 2000**

In 2000, the Office of the High Representative issued a Decision to amend the PDI Act<sup>5</sup>. This amendment introduced the following three major changes.

First, the period over which the pension base is calculated will be extended gradually from 15 years to 40 years by 2015.

Second, for the insurance year in excess of 20 years, the additional accrual rate will be reduced gradually from 2.0% to 1.5% by 2005. The basic accrual rate for the first 20 years remained the same at 45%. As a result, for a newly retired worker with 40 years of insurance, the pension would amount to 75% of the pension base.

Third, the pensions are indexed subject to the funds available for pension payments. This arrangement was introduced to preserve financial balance of the pension system at all times and to prevent the emergence of arrears.

The key variable of this indexation method is the so-called “payment coefficient” (or “coefficient of disbursement” – isplatni koeficijent). For this purpose, the base pension is calculated for each pensioner in the first place. For the pensioners who retired prior to 1 January 2002, the base pensions are their last drawn pensions before that date. For the workers who retire after 1 January 2002, their base pensions are equal to the initial retirement pension in 2002 prices. For this purpose, the revaluation coefficient is fixed at 1.00 from 2000 onwards so that the wages earned after 2000 are taken in nominal terms.

The payment coefficient is defined by dividing the expected total revenues by the total base pensions for all eligible pensioners. Each year, the value of the pension is determined by multiplying the payment coefficient to the base pension. Thus, if the coefficient is greater than 1, each pensioner gets an increase over his/her base pension; if the coefficient is less than 1, each pensioner gets less than his/her base pension. Although this indexation method can maintain the financial balance, simply applying this adjustment in the future ageing population would result in a significant decrease in the benefit level.

Table 1 presents the payment coefficients and their increment in FBiH for 2002-2008. In comparison, during the same period, the Consumer Price Index increased by 22.4% and the GDP per capita increased by 70.6%. Thus, the resulting pension indexation closely followed the increase in the average wage.

As pointed out by pension experts<sup>6</sup>, this indexation method – more precisely the revaluation of past wages – involves certain inconsistency which entails inequality between generations. Namely, for future pensioners, the wage growth after 2000 is reflected in their pension basis and thus in their base pensions. Thus, if we compare workers with the same wage history but different age, under this method the younger one with a longer period of insurance after 2000 has a higher base pension than the older one. To resolve this inconsistency, the RS took a step by setting the revaluation coefficients for recent years at less than 1.

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<sup>5</sup> At the same time, in 2000, the Office of the High Representative issued a Decision to merge the Sarajevo-based PDI fund and the Mostar-based PDI Fund which had been separated since the war period.

<sup>6</sup> See, for example, page 11 of the World Bank Pension System Notes.

**Table 1. Payment coefficients in the FBiH, 2002-2008**

Period	Payment coefficient	Increase (percentage)
from 01.01.2002 to 31.08.2003.	1.00	
from 01.09.2003 to 30.06.2004.	1.06	6.0
from 01.07.2004 to 31.12.2004.	1.10	3.8
from 01.01.2005 to 30.09.2005.	1.16	5.5
from 01.10.2005 to 31.12.2005.	1.18	1.7
from 01.01.2006 to 31.05.2006.	1.21	2.5
from 01.06.2006 to 30.09.2006.	1.25	3.3
from 01.10.2006 to 30.11.2006.	1.31	4.8
from 01.12.2006 to 31.03.2007.	1.35	3.1
from 01.04.2007 to 31.05.2007.	1.42	5.2
from 01.06.2007 to 31.07.2007.	1.45	2.1
from 01.08.2007 to 30.09.2007.	1.49	2.8
from 01.10.2007 to 31.12.2007.	1.53	2.7
from 01.01.2008 to 30.04.2008.	1.57	2.6
from 01.05.2008 to 31.07.2008.	1.61	2.5
from 01.08.2008 to 31.10.2008.	1.65	2.5

### **2.3 Effectiveness of the current Pension and Disability Insurance Act of the FBiH**

As a result of these reforms which severely tightened the benefit design, the face values of the key parameters of the pension system in the FBiH have been at the level comparable with the OECD countries, except for the significantly low reduction rates for early retirement.

However, the severance of qualifying conditions for pension has been considerably relaxed by transitional measures. Article 137 of the PDI Act of the FBiH provides that women can still retire at age 55 with 30 years of insurance, whereas men can retire at age 60 with 35 years of insurance. This was effective till the end of 2005; however, amendments to the PDI Act in 2005 have extended this period up to the end of 2008. This provision, coupled with the considerably small reduction rates, still allow workers to retire earlier than the normal retirement age. Results of the Living Standard Measurement Survey indicate that 36.4% of the male pensioners and 57.6% of female pensioners were below 65 years of age. The increase in the statutory retirement age to 65 for both men and women will certainly contribute to the fiscal sustainability of the system. However, the continuous postponement suggests that there exists a question of social acceptability in applying such a drastic reform.

Furthermore, as mentioned earlier, despite the introduction of indexation according to the funds available for pensions, pensions are *de facto* indexed in line with the increase in the average wage.

## 2.4 The Pension and Disability Insurance Act of the RS

Though the pensions systems of the FBiH and the RS are broadly similar, there are some differences. The PDI Act of 2000 in the RS introduced a swift increase in retirement age for men from 60 years in 2001 to 65 years in 2006 but allowed women to retire at 60 years of age. Unlike the FBiH, this provision for men's retirement age was not put "on hold". It should be noted that any worker with full insurance period can retire regardless of age.

According to article 46 of the PDI Act of the RS, men can currently retire

- at age 65 with 20 years of insurance;
- at age 65 with 25 years of conferred pension rights<sup>7</sup>; or
- at any age, provided he has 40 years of insurance.

Similarly, women can retire

- at age 60 with 20 years of insurance; or
- at any age, provided she has 35 years of insurance.

The basic accrual rate is 45% for 20 years of insurance. Since 2004 the accrual rate for each additional year of insurance in excess of 20 years is 1.5%. It should be also noted that in calculating the pension base, the complete working period of the insured person is taken into account, i.e. all years from 1970 onwards.

Table 2 presents the payment coefficients and minimum pensions in the RS for 2001-2008. Compared with the FBiH, more fluctuation of the payment coefficient is observed. It should be noted that the sudden decrease in the payment coefficient in March 2007 from 1.00 to 0.77 is due to the increase in the wage revaluation by 36% effective in the same month. The actual increase in pensions in that month is thus 4.7%.

**Table 2. Payment coefficients and minimum pensions in the RS, 2001-2008**

Period	Payment coefficient	Minimum pension (KM)
from 01.10.2001 to 30.06.2003.	0.558-0.71	80.00
from 01.07.2003 to 31.12.2005.	0.64-0.85	90.00
from 01.01.2005 to 30.11.2005.	0.85-0.94	90.00
from 01.12.2005 to 31.12.2005.	1.00	90.00
from 01.01.2006 to 31.12.2006.	1.00	103.00
from 01.01.2007 to 28.02.2007.	1.00	105.30
from 01.03.2007 to 30.09.2007.	0.77-0.88	105.30
from 01.10.2007 to 31.12.2007.	0.88-0.92	135.00
from 01.01.2008 to 29.02.2008.	0.95	150.00
from 01.03.2008 to 31.08.2008.	1.00	150.00
from 01.09.2008 to 31.10.2008.	1.06	160.00

<sup>7</sup> This is broader than "years of insurance", as it also includes some non-contributory periods.

### 3. Problem analysis of the current pension system in Bosnia and Herzegovina

The major problems with the pension system in Bosnia and Herzegovina can be summarised as follows:

- Limited coverage and low compliance, particularly in respect of workers in the informal economy;
- Inadequate level of pension benefits;
- Concern on the financial sustainability of pension system; and,
- Problems with limited administrative capacity and governance of the social security organisations.

**Table 3. Summary of key indicators of the BiH pension system by entity, 2006**

		<b>FBiH</b>	<b>RS</b>	<b>BiH</b>
A	Population aged 15 and 64 years (in persons)	1,579,875	1,080,946	2,660,821
B	Employee (in persons)	399,465	255,200	654,665
C	Pensioners (in persons)	313,917	195,069	508,986
D	Coverage rate (as a % of population aged 15-64) (B/A)	25.3%	23.6%	24.6%
E	System dependency rate (C/B)	78.6%	76.4%	77.7%
F	Contributions (in millions KM)	929.4	386.1	1,315.4
G	Pension expenditure (in millions KM)	929.4	576.6	1,506.0
H	Average monthly contribution (in KM)	193.9	126.1	167.4
I	Average monthly gross wage (in KM)	807.8	735.4(*)	779.6
J	Average monthly pension (in KM)	246.7	246.3	246.6
K	System replacement rate (J/I)	30.5%	33.5%	31.6%
L	PAYG cost rate (as a % of gross wages)	24.0%	25.6%	24.6%

Note (\*): In RS, contributions are paid from net wages. The gross wages are estimated to be 1.4 times the net wages.

Table 3 above summarises key indicators of the current BiH pension system. Keeping in mind the deficiencies of accurate data, we will analyse major gaps in the current pension system.

#### 3.1 Coverage and enforcement

In spite of the constitutional requirement to provide basic income for all citizens, the coverage of the statutory contributory pension scheme is virtually limited to the formal employment sector.

A large part of the elderly population does not receive any pension, at the same time, a large part of the working age population never pay contributions. Results of the Living Standard Measurement Survey indicate that only around 30% of the population over 65 years of age receive the old-age pensions. Table

3 indicates that the number of employees represents only 24.6% of the working age population (25.3% in FBiH, 23.6% in the RS). In 2008, according to the Labour Force Survey, the percentage remains almost constant at 24.4%.

*Ad hoc* administrative efforts to increase the number of active insured persons cannot produce a lasting improvement, as seen by the recent large increase of insured persons in the FBiH, only to be followed by a large decrease several months later.

Under-reporting of the contributory wages is wide spread. It is reported that only the public sector and large-sized (mostly foreign) private companies report the actually paid wages. For a large part of private sector employers, it is a common practice to pay only the minimum wage through official channel (e.g. bank transfer) to their employees and pay any others in cash.

Tax authorities in both entities are responsible for the collection of social security contributions, and social security organizations have a limited power in the enforcement of contribution collections. It is reported that there is a lack of coordination mechanism between tax authorities and social insurance institutions (pension fund and health fund).

Big arrears in contribution payment are present among a number of large employers in the steel and iron works, mining and paper and pulp industry. Also, there is no formal procedure for regulating the payment of arrears. High officials of the Pension and Disability Fund (*Fond PIO*) stated that the procedures for extracting payments of arrears from non-compliant employers are mostly informal.

Non-payment of contributions places the workers in a vulnerable position, as they cannot assert their pension rights. In April 2005 the Constitutional court of Bosnia and Herzegovina ruled that individuals could sue their employer for unpaid contributions. Prior to this ruling, only the Pension and Disability Fund could take legal action to the employers.

### **3.2 Benefit level**

In 2006, the average monthly pension (including old-age, disability and survivors pensions) was KM 246.6 (Euro 126). The amount of average pension is almost same between the FBiH and the RS. In relative terms, the average pension is 31.6% of the average gross wage. By entity, this rate (system replacement rate) is 30.5% in the FBiH and 33.5% in the RS. Owing to the data limitation, it was not possible to obtain the average pensions by old-age, disability and survivors' pensions. However, in view of the pension formula and the fact that the average year of insurance for old-age pension is 33 years, the above replacement rates suggest that there are certain pensioners who have short contribution periods but managed to be eligible for pensions.

The pension system provides two types of guarantee for pensions. First, all pensioners are entitled to receive at least the minimum pension. The minimum pension should not be less than 60% of the average pension<sup>8</sup> in the case of the FBiH, and 50% of the average pension in the case of the RS. Needless to say, this minimum is not a universal benefit for all elderly persons but paid only to the elderly persons who have been insured at least 20 years. Second, persons who have completed a full insurance period,

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<sup>8</sup> The average pension refers to the average pension disbursed in December of the previous year and indexed according to the growth of pensions in the year in which the minimum pension is disbursed. The average pension is computed taking into account all pensions – old-age pensions, disability pensions survivors pensions and pensions achieved under favourable conditions.

i.e. 40 years of insurance, are entitled to receive at least a guaranteed pension<sup>9</sup>, which amounts to 80% of the average pension in the case of the FBiH, and 100% of the average pension in the case of the RS. In December 2007, some 42.5% of all pensioners in the FBiH received the minimum pension, whereas only 3.3% of all pensioners received the guaranteed pension<sup>10</sup>. In July 2008, more than 50% of pensioners in the FBiH received the minimum pension. The percentage of the pensioners receiving the minimum pension in the RS is lower than the FBiH. In December 2007, about 11% of the pensioners in the RS received the minimum pension<sup>11</sup>.

Bosnia and Herzegovina has ratified the ILO's Social Security Minimum Standards Convention No. 102 since 1993. The Convention 102 stipulates that the minimum rate of old-age benefit is 40% of the average wage after 30 years of contributions. Although the accrual rate in the pension formula in Bosnia and Herzegovina apparently exceeds this level, the actual amount of average pension is far from sufficient to maintain the family of the pensioner in health and decency.

### 3.3 Sustainability

Currently, both pension schemes are financed on the pay-as-you-go basis. It should be noted however that there is a significant difference in revenue structure between two entities. In the FBiH pension scheme, the benefit expenditure (including health insurance contributions for the pensioners) and administrative expenses are financed solely by the contributions collected from the payroll of the employed. On the other hand, in the RS pension scheme, contributions cover only two-thirds of the total expenditure and the difference is covered by the transfer from the general budget.

In the context of a rapidly ageing population and growing out-flow of migrant workers, the present BiH pension scheme is faced with a concern on the long-term sustainability. In general, the PAYG cost rate is a product of the system demographic dependency rate (the ratio of the pensioners to the insured workers) and the system replacement rate (the ratio of the average pension to the average gross wage). Both pension schemes have already achieved a matured population structure. The system demographic dependency rate attained 77.7% for total BiH, 78.6% for FBiH, and 76.4% for the RS. Therefore, further deterioration of demographic dependency rate as a consequence of ageing will result in a need for a higher contribution rate or more budget transfer, or result in the reduction of the benefit level.

The Pension Reform Working Groups, as well as the studies cited earlier by UNDP and by the World Bank, have carried out long-term forecasts and concluded that the pension schemes in both entities are not sustainable in the long run. However, all the existing forecasts faced difficulties in collecting reliable data and setting plausible assumptions for the future demographic and economic development. Moreover, the projection method used in the Pension Reform Strategy and the UNDP study appears to be over-simplified and does not take into account the cohort dynamics. To assist the sound policy decision, there is a need to develop a robust financial projection model and local expertise which will enable the decision makers to assess the sustainability of the current system and to evaluate the implications of various reform options<sup>12</sup>.

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<sup>9</sup> It is noted that the "guaranteed pension" is a remnant of the former Yugoslav pension system. It was formerly called the "minimum pension for a full contribution period".

<sup>10</sup> In the FBiH, the average pension was KM 299.85 (Euro 153), the minimum pension was KM 235.85 (Euro 120), and the guaranteed pension was KM 314.48 (Euro 160) in December 2007.

<sup>11</sup> In the RS, the average pension in December 2007 was KM 255.41 (Euro 130) and the minimum pension for 2008 was KM 150 (Euro 77) and was increased to KM 160 (Euro 82) in September 2008.

<sup>12</sup> The RS Pension Reform Working Group is developing a long-term projection model based on demographic and economic assumptions, as well as a model for simulating the impact of different policy options on individual households.

### **3.4 Administrative capacity and governance**

Weak administrative capacity is a major problem prevailing in Bosnia and Herzegovina. Both pension funds are suffering from inefficiency and operational difficulties. Enhanced customer service is essential to create a greater sense of confidence in the pension system, in particular to encourage participation in the system. There is a need to review the administrative procedures, to ensure that these are streamlined, simplified and integrated with an up-graded and unified data-base. In addition, there is a need to strengthen the institutional capacity so that the risk of corruption and the mismanagement of members' contributions be minimised.

Unlike other countries in South Eastern Europe, the Pension Fund Management Board does not have a tripartite structure. Many social partners stated in the interview that workers and employers should be represented in the Pension Fund Management Board, as well as in the Pension Reform Working Group.

### **3.5 Concluding remark**

The problems with coverage, compliance, benefit and financing are interlinked with each other. Without addressing the gap in the coverage and compliance, an improvement in the benefit level requires further increase in the contribution rate which is already at 24%. An even higher contribution rate will act as a disincentive for compliance with the legislation and will entail further growth of informal economy. The pension reform policy should primarily address the measures to break this vicious circle.

## 4. Issues in the Pension Reform Strategy

In view of the problem analysis, we look into the key issues in the Pension Reform Strategy.

### 4.1 Pension models suggested by the Pension Reform Strategy

Learning from good practices in both industrialized and transition countries, the Pension Reform Strategy proposes to restructure the BiH pension system in the following manner.

- First public pillar is a compulsory pension insurance consisting of social pensions, and earnings-related pensions;
- Second pillar consists of voluntary funded pensions on occupational basis, and pensions under more favourable retirement conditions under separate regulations; and
- Third pillar is voluntary long-term savings on individual basis.

The following observations are made:

- The social pensions are supposed to provide a minimum pension. The Pension Reform Strategy presents two levels, namely KM 100 and KM 50 per person per month, approximately corresponding to 20% and 10% of GDP per capita. These amounts are much lower than the current minimum pension.
- In the long-term, it is proposed to extend the social pension to all population while securing its resources. At this stage, no clear decision has been made whether the social pension will be a universal benefit (for all persons aged 65 and above) with or without a means-test, or a benefit available only for certain groups of uninsured or insufficiently insured persons (with less than 20 years insurance period). The total annual expenditure of the universal social pensions is estimated to be KM 300 million if the monthly social pension is KM 100, and KM 150 million if the monthly social pension is KM 50.
- The Pension Reform Strategy proposes price indexation for social pensions. It is not clear how to apply price indexation if the social pension is determined as a certain percentage of GDP per capita.
- The benefit design of the earnings-related pensions of the first public pension pillar is not specified. The Pension Reform Strategy mentions that this component will be a defined contribution scheme, presumably meaning a NDC scheme<sup>13</sup>. The pensions are indexed in line with the average wage adjusted by system demographic dependency rate.
- The proposed second pillar scheme is a fully funded occupational pension plan based on agreements between the employers and employees. Subject to a ceiling (suggested 40 Euro per worker per month), contributions are treated as deductible income from corporate tax. It is expected that initially only large enterprises and public services would establish such pension plans. However, the Pension Reform Strategy does not recommend the introduction of a mandatory second pillar in

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<sup>13</sup> According to the local expert Amil Kamenica, the NDC concept has been discarded and is not considered a viable option.

view of the problem of financing the emerging transitional costs<sup>14</sup>.

- In addition, the second pillar would also include all pensions which were acquired under special (more favourable) conditions. It is understood that this measure was proposed in order to separate the payment of these pensions<sup>15</sup>. This portion of benefits is financed by the government budget but the payments from the government budget to pension funds are made with a considerable delay.

It can be seen that the pension model proposes a framework of the future pension structure but does not specify detailed benefit design and transition process from the current system. This makes it difficult to assess the impact of the proposed pension model on the aggregate scheme level as well as on the individual level. It is unclear whether the implications of these measures are fully recognized by key stakeholders. Moreover, the model borrows many innovative concepts from other countries experience, but their feasibility in the context of Bosnia and Herzegovina is not fully supported by firm evidences.

## 4.2 Further developments

As a follow-up to the adoption of the Pension Reform Strategy, both entities have carried out further activities. In the RS, the pension reform working group is contemplating a different design of the first public pension pillar, which is based on a point system<sup>16</sup>. No concrete step in that direction has been taken so far. The RS Pension Reform Working Group is currently preparing a new detailed document on the pension reform which will be presented to the government by the end of 2008.

In the RS, a Law on the Pension Reserve Fund has been passed. The assets of this reserve fund came from 10% of the proceeds of the privatization of state enterprises<sup>17</sup>, amounting to some KM 400 million. The reserve fund will be used as contingency reserves for the first public pension pillar. In view of the RS pension fund's heavy dependence on budgetary transfer, the reserve fund is expected to contribute to the timely payment of the benefit. A draft Law on Voluntary Pension Funds in the RS is in parliamentary procedure; this law is to cover individual and collective pension schemes.

In contrast to the RS, there has been almost no substantial progress in the FBiH with regard to pension reform. It is reported that a draft Law on Voluntary Pension Funds is under preparation.

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<sup>14</sup> It is noted that the World Bank report does not recommend this option either. The proposed short-term measures in the World Bank report consist of tightening of key pension parameters by raising retirement age to 65 for both sexes, changing accrual rate to 1.5% per year of insurance (without maximum), and introducing price indexation. In the long-term, it proposes the introduction of the Social Pension from 2025, payable at 65 years of age at 10% of per capita GDP and further reduction in the benefits (retirement age 68 years, accrual rate 1% per year of contribution).

<sup>15</sup> More precisely, the difference between their "privileged pension" and the pension calculated under general social insurance conditions.

<sup>16</sup> The consideration of the point system may be motivated by the fact that Croatia and Serbia have also opted for the point system.

<sup>17</sup> As a matter of fact, this was not state property but "social" property (*drustvena svojina*) – a consequence of the specific form of Yugoslav self-managed socialism.

## **5. Perspectives of the pension reform in Bosnia and Herzegovina**

### **5.1 Rationales of the reform**

The BiH pension system is facing a number of complex challenges. From the problem analysis made above, it is apparent that the *status quo* is not sufficient and steps are needed to improve the system.

One may question the need of another reform, in view of the fact that the full implementation of the 2000 amendment of PDI Act in FBiH has already been postponed twice by extending the moratorium period for raising the retirement age. Before the advent of yet another reform that requires extensive efforts and inputs, the first step in reform strategy should consist of more stringent application of the existing legislations through an enhanced enforcement mechanism.

It should be stressed that considerable extent of problems in the current system can be resolved by improvements in administrative capacity and governance. In addition, any reform of pension system can only be achieved with concurrent improvement of its administrative capacity and governance. It is also imminent to correct the inconsistencies and inequities existing in the current system and to harmonise the legislations of the two entities.

The pension model proposed by the Pension Reform Strategy does not effectively respond to the substantial problems inherent in the current system. What is missing in the current discussion on pension reform is an in-depth analysis of root causes of the problem with the current system. Lack of reliable data and tools to estimate the impact of policy changes adds huge obstacles to conduct such an analysis. The reform options should be formulated based on the comprehensive diagnosis of the current system and in the light of the capacity constraints.

The following descriptions attempt to make general remarks in three key areas of the prospective pension reform, namely coverage, benefit level and sustainability, and reform process.

### **5.2 Extension of coverage**

In general there is no single solution to extend the coverage; every policy must be designed to suit national and local needs and resources. Further, the effort to increase the size of the formal economy requires a broader scope than pension policy. The pension policy should go in tandem with the effective labour market policy and labour administration policy.

There is a considerable room for improvement of the compliance with the current contributory scheme. The strategy to extend the coverage of the pension scheme should address this gap in the first place. An integrated approach to enforcement in close collaboration with tax authority and labour inspectorate would be a key to the success. At the same time, the benefit should be designed so as not to give disincentive for employers and workers to participate in the scheme. Transparency in the administration is also important for creating a sense of confidence in the pension system thereby encouraging the participation.

Introduction of non-contributory universal basic pensions, such as social pensions, is a viable option and would probably be the fastest way to achieve the universal coverage. Creating and sustaining a

sufficient fiscal space would be the foremost issue to be addressed. Clear benefit rules should be defined to avoid political influence. The introduction of non-contributory social pensions will imply the shift of the source of funding from workers' payroll to the general tax, therefore the benefit entitlements will be de-linked from contributions. Due considerations should be paid to the overall shift in the incidence of pension costs at individual level and the impact on incentive for the contributory component of the public pension pillar.

The greater flow of migrant workers and more diverse forms of migration are creating new challenges, including lack of social security. To ensure the equality of treatment in social security for migrant workers, there is an emerging need for international and regional coordination, by multilateral and bilateral agreements.

### **5.3 Long-term sustainability and adequacy of benefits**

In general, cost containment measures consist in increasing income and decreasing expenditure. Therefore any measures to restore the equilibrium of the system would likely to ask all the relevant stakeholders to share such burdens either by paying more contributions or receiving less of benefits. At the same time, the pension system should meet basic minimum standards, consonant with the ILO's Social Security Minimum Standard Convention 102, to ensure adequate level of income to the protected workers and their families.

The basic dilemma facing the BiH pension scheme is to ensuring the long-term sustainability of the system in the face of rapidly ageing population, while at the same time providing adequate benefits at affordable costs.

Pay-as-you-go pension schemes, such as the ones in Bosnia and Herzegovina, are based on the intergenerational transfer mechanism. Their sustainability critically depends on whether the working generation is committed to pay contributions for the elderly generation. When planning the pension reform, due considerations must be paid to the fact that proposed reform should be supported by the future contributing generations.

Based on the diagnosis of the current scheme, several policy options should be formulated and presented with their financial implications. Extensive reforms require a sufficiently long transition period for implementation in order to avoid abrupt changes which may negatively affect the life plans of workers near retirement age. With a view to the long-term nature of pension reform, pre-emptive measures should be taken to ensure the long-term sustainability of the scheme.

### **5.4 The process of pension reform and the roles of social partners**

Managing the process of reform is an important aspect of the strategy. With respect to decision making process in pension policy, transition countries are facing a common challenge to change from "top-down" approach to the one based on the consensus building involving various groups of stakeholders, including workers and employers.

A well-informed and participatory policy dialogue lays the foundations for democratic process in the policy making, and assists in making rational decisions based on a broad consensus. The government's role is crucial in leading the process and building a consensus by a broad range of relevant stakeholders. At the same time, the role of workers' and employers' organisations should be strengthened, so that the voices of these stakeholders are properly heard in the discussion of the future pension policy. In

particular, it is critical that the social partners are represented in the Pension Reform Working Group and the Pension Fund Management Board, as direct contributors and beneficiaries of the pension scheme.

## **5.5 Conclusion and the way ahead**

Pension is a long-term system, and pension reform is a long-term process. A well-managed reform process supported by strong long-term commitment and continuous efforts of all the key stakeholders is critical for the successful implementation of the pension scheme.

On the basis of this first assessment, the ILO is prepared to carry out further analytical work on the pension and provide support to its tripartite constituents. In particular, the ILO stands ready to provide technical assistance in further development of the pension policy and to conduct capacity building and trainings for improvements in governance and administration.

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