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MONGOLIA

PENSION POLICY CHALLENGES AND REFORM OPTIONS

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Human Development Unit
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List of Acronyms

CMP	Child Money Program
PIF	Pensions Insurance Fund
MOLSW	Ministry of Labor and Social Welfare
NDC	Notional Defined Contribution
SSIGO	Social Security Insurance General Office
SSMP	Social Security Master Plan
UIF	Unemployment Insurance Fund

Regional Vice President	James W. Adams (EAPVP)
Country Director:	David R. Dollar (EACCF)
Country Manager:	Arshad M. Sayed (EACMF)
Sector Director:	Emmanuel Jimenez (EASHD)
Sector Manager:	Christopher J. Thomas (EASHD)
Task Team Leader:	Cristobal Ridao-Cano (EASHD)

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Executive Summary

Mongolia inherited a pay-as-you go public pension system providing universal coverage and high levels of benefits (relative to pre-retirement income), consistent with the state provision of all forms of social insurance. The system was reformed in 1995, including the introduction of contributions for pensions and other social insurance, but it remained dependent upon Government transfers. The reforms improved the existing scheme but failed to achieve financial sustainability or address a number of weaknesses in the existing scheme's design, which created weak incentives for contributing to the system and benefit inequities between different groups of workers/cohorts.

In 1999 a Notional Defined Contribution (NDC) scheme was established for workers born after 1960, with the intention of gradually moving from notional accounts to partial funding. And the NDC scheme did not alter the parameters of the defined-benefit scheme for those born prior to 1960 and left an abrupt benefit reduction for those born in 1960. Also, the NDC system did not adjust key qualifying conditions such as the retirement age and provided for a minimum pension provision that will continue to require substantial fiscal subsidies over the long run.

Between 2002 and 2007 Mongolia received the advice of international experts on the design of the NDC scheme and measures to strengthen social insurance administration, as well as development assistance to support reform measures. In 2002 the Asian Development Bank (ADB) supported the development and implementation of a Social Security Master Plan (SSMP), which included substantial policy analysis and actuarial projections. But the social insurance reforms included in the SSMP were never quite implemented. More recently, the Government and the Parliament have become increasingly aware of the need to work together on a comprehensive reform of the old and newer pension schemes, and solicited advice from the World Bank in an effort to strengthen coverage, sustainability and overall equity of the current schemes.

This policy note responds to this request, and it is part of an ongoing broader collaboration with the Government and the ADB on pension reform that includes: (i) supporting the development of the policy framework for pension reform; (ii) improving the pension policy making capacity; and (iii) assisting in the identification of the institutional development needs to support the new pension system. This note identifies a number of challenges in the design and implementation of the current social insurance system that would need to be addressed to strengthen the system's ability to provide consumption smoothing and old-age income security for Mongolia's population. The core challenges include:[1]

(i) Minimum pension provisions under both the defined-benefit and NDC schemes create poor incentives for wage reporting and compliance, and are the primary cause of the long run projected deficit of 3 percent of GDP.
(ii) Early retirement provisions for special professions and mothers result in low retirement ages, which adversely effect costs of the defined-benefit scheme and adversely effect benefits under the NDC scheme.

[1] Table 1, at the end of the executive summary, provides a more detailed summary of reform needs and proposed policy options.

(iii) Five-year income averaging (without inflation adjustments) to determine pension benefits creates both uncertainty for workers and has substantially reduced replacement rates during periods of high wage growth.
(iv) Ad-hoc indexation has created substantial unpredictability of benefits, weakened credibility and therefore compliance and ultimately compromised basic old age income security.
(v) An abrupt benefit reduction for post-1960 cohorts which will shortly create substantial concern by affected parties.
(vi) Some parameters of the voluntary pensions savings scheme for herders and the informal sector do not have early withdrawal provisions in the case of severe hardship and therefore provide relatively weak incentives for participation.
(vii) Weaknesses in the institutional framework and governance structure lead to inefficiencies in the provision of promised benefits to the population.

To address these challenges, this note first recommends that the Government reviews more broadly the societal objectives of the combined public and private pension and social security system. On option is that such system should provide: (i) a minimum living subsistence to the elderly, permanently disabled and survivor/dependents; and (ii) mandatory consumption smoothing for most formal sector workers and voluntary contractual savings for informal sector workers. Second, consistent with these two broad objectives, this note recommends a possible architecture for a public pension system that should include the following reforms:

(i) Reduction of the minimum pensions and eventual substitution by a means-tested social pension.
(ii) Elimination of early retirement provisions and unification of retirement ages between men and women.
(iii) Extension of the periods of income averaging and application of price indexation for the wages during the income averaging period.
(iv) Automatic benefit indexation linked to prices.
(v) Benefit reductions to pre-1960 cohorts in order to smooth the transition to the NDC scheme.
(vi) Establishment of provisions for partial withdrawal of voluntary pension savings according to specified criteria such as for home purchase, subsistence in the face of loss of income or health difficulties.
(vii) Introducing provisions for herders and the informal sector for select withdrawals in the case of severe hardship.
(viii) Establishment of a targeted social pension as a means of extending basic support for the elderly poor.

Finally, the note recommends measures to improve the institutional support system for public pensions, including: (i) a thorough review of the institutional framework for the SSIGO, aimags and local offices; (ii) a similar review of the central and local information systems supporting SSIGO functions of financial and account management; (iii) development of improved disclosure methods and recourse for dispute resolution in order to improve accountability and public credibility; (iv) establishment of an investment management infrastructure and governance framework; (v) compilation and projections of more accurate data on mortality and life expectancy to support annuitized benefits; and (vi) improved coordination between the social insurance and tax authorities and, possibly in the medium-term unification of functions between the two agencies.

Table 1: Summary of reform needs and proposed policy options

	Proposed Design			
Issue	**Defined Benefit Scheme**	**NDC Scheme**	**Effect on Fiscal Costs**	**Effect on Retiree Benefits**
Minimum Pension	▪ The minimum pension should be determined based on a prescribed percentage of the Minimum Living Standard, not the minimum wage. ▪ Assuming that a social pension has been approved and the implementation framework in place, such a social pension could replace the minimum pension.	Minimum pension should be determined based on a prescribed percentage of the MLS not the average wage. Social pension could replace the minimum pension.	Reduction [2]	Reduction for most of those receiving the minimum pension as currently calculated.
Retirement Age (normal retirement age, women's retirement age and retirement age for special occupations (hazardous professions) too low to ensure a financial balance.	▪ Gradually eliminate early retirement for workers in hazardous occupations + women with 4 or more children. Phase in by increasing the applicable retirement age by 6 months every year until all workers have the same retirement age of 60. ▪ Unify the regular age for women with that of men at age 60 perhaps by increasing the applicable retirement age by 6 months every year; ▪ In the medium term, the overall retirement age also needs to be increased, possibly initially to age 65 in accordance with a careful assessment of life expectancy at retirement.		Reduction	Reduction in present value of benefits for retirees of the DB scheme; Increase in annual benefits for retirees in the NDC scheme but no change to the present value of all benefits.
Indexation and retroactive adjustments - indexation discretionary creating uncertainty for workers and retirees	▪ Change legal framework so that prospective adjustments are automatically adjusted in line with the growth in the CPI in four regions and Ulaanbataar on a weighted average basis. ▪ Undertake a detailed assessment of benefit erosion of earlier cohorts retiring since 1990 to determine a one-time retroactive adjustment to the extent that it is fiscally affordable.		Increase	Improved predictability and old-age income protection; Increase in benefits for DB scheme; No change in benefits for NDC scheme.
Income Averaging Period for Benefit Determination	▪ Increase the income averaging period from 5 years to the maximum number of years possible with existing historical wage and contribution data. ▪ Index the wages used in the calculation of benefits to the country weighted average CPI.	Not applicable	Small reduction	Effect depends upon wage trajectory while working.

[2] Wiese and Cohen in 2003 calculated the long-term annual cost reduction for eliminating the minimum pension as about 2.3 percent of GDP. See Patrick Wiese and Michael Cohen, *An Evaluation of Pension Reform Options for Mongolia*, p. 5.

	Proposed Design			
Issue	**Defined Benefit Scheme**	**NDC Scheme**	**Effect on Fiscal Costs**	**Effect on Retiree Benefits**
Inclusion of allowances in the wage base	In the medium-term, develop a framework for including non-wage compensation in reported income both for the purposes of determining pension contributions and benefits.		Increased for Govt. for contributions on behalf of public servants unless wages decreased to offset increase	Worker take-home pay reduced; Retirement benefits increased.
Disability pensions	Two options: ▪ Redesign to provide a lump-sum benefit which can be supported by an earmarked contribution. ▪ Provide annuitized benefits based on an actuarially-reduced benefit as a function of years of contributory service.		Reduction	Reduction
Survivorship pensions	Current framework OK but could be improved based on the principle that the accrued retirement benefit (with actuarial reductions prior to retirement age) is divided between eligible survivors.	Current scheme links benefits to the workers' wages and not benefit accruals. Option 1: Accrued retirement benefit based on the notional account accumulation divided between eligible survivors. Option 2 (which can be in addition) lump-sum benefit calculated based on contribution/premium rate.	Cannot be precisely determined	Increases and reductions in benefits depending upon the number of survivors and the age of death of the worker.
Abrupt reduction in benefits for those born beginning in 1960.	▪ Substantially reduce accrual rate for service rendered after enactment of the reform. ▪ Reduce some accrued rights for cohorts born after 1950.	None	Costs depend upon design. Likely some cost reduction.	Reduction for certain cohorts. Many options including reducing benefit accruals from those under the old scheme and reducing accrued rights
Social Pensions	Establish a social pensions instrument as follows: • Pre-1960 cohorts who meet means-testing criteria could also in principle receive the social pension either in the absence of qualifying for the standard defined-benefit pension or receive a top-up to ensure that their pension benefit is no less than the MLS.	Establish a social pensions instrument as follows: Post 1959 cohorts would have to register with the SSIGO to qualify. The Government contribution could require some level of individual contributions although this could discourage participation. Registered individuals would have a notional Government cont. made based on an actuarial valuation of the minimum contribution necessary per cohort in order to fund the anticipated MLS for the individual at retirement age.	Costs depend upon means-testing, efficiency of administration, and benefit levels.	▪ Substantial increase in benefits for those previously uncovered by formal pension provision such as herders and the informal sector; ▪ Potential reduction in pension benefits for retirees who would have otherwise been entitled to a minimum pension guarantee as currently calculated.
Voluntary Pensions	Modify voluntary pension provisions in order to enable withdrawals prior to old-age retirement according to prescribed conditions.			

I. Background and Objectives

1. **Like many other post-socialist economies, Mongolia in the early 1990s inherited an extensive social welfare system that included support for old-age retirement, disability and survivorship.** With the dismantling of some of the state socialist infrastructure, the Mongolian pension system underwent substantial reforms including becoming a contributory scheme in 1994. In the meantime, the number of contributors to the scheme had fallen dramatically with the restructuring of the economy. In an effort to reduce the fiscal burden and better align contributions and benefits, in 1999 a Notional Defined Contribution (NDC) scheme was established for workers born beginning in 1960. However, reforms were not enacted to the existing defined-benefit pension scheme to reduce the legacy costs and, at the same time, remove existing inequities. In 2003 the Government completed the Social Security Master Plan (SSMP), which included multiple social insurance policy reforms and institutional strengthening. But the actual implementation of these reforms has been rather limited. More recently, the Government and the Parliament have become increasingly aware of the need to work together on a comprehensive reform of the pension system. Moreover, The Millenium Development Goals Based Comprehensive National Development Strategy of Mongolia passed in January 2008 indicated the Government's commitment to a series of pension and social insurance system objectives and policies. In this context, the World Bank has been asked to provide policy advice to strengthen coverage, sustainability and overall equity of the current schemes.

2. **This policy note responds to this request, and it is part of an ongoing broader collaboration with the Government and the ADB on pension reform**. This collaboration includes (i) supporting in the development of the policy framework for pension reform; (ii) improving the pension policy making capacity; and (iii) assisting in the identification of the institutional development needs to support the new pension system. Subsequent to the drafting of this report, additional collaboration included attendance by a high-level Mongolian team at the World Bank's Pensions Core Course, publication of a draft report under ADB TA project "Strengthening the Pension System in Mongolia" and training of a counterpart team in the use of the Pensions Reform Options Simulation Toolkit (PROST). This work is also part of the ongoing Public Expenditures and Financial Management Review that the World Bank is conducting in collaboration with the Government. We look forward to the opportunity to future dialogue with the Government on these important pension reform issues.

3. **This policy note identifies the challenges in the current social security system and suggests policy and institutional reform options for consideration by the authorities.** It aims to contribute to and inform the ongoing debate on pension reform**.** The report is organized as follows: Section II reviews describes pension system design parameters; examines the recent evolution of public expenditures on social insurance; and reviews the current environment in terms of demographic and labor market trends. Section III reviews key reform issues and suggests policy and institutional reform options. Section IV recommends a policy and institutional reform program.

II. Current schemes and the enabling environment

A. Description of current schemes

4. **With the process of economic liberalization in the early 1990s, Mongolia inherited a non-contributory public pension scheme with virtually universal coverage.** With the major

economic restructuring that began in the early 1990s, the public pension system no longer was in a position to ensure universal coverage and the benefit levels became unsustainable in the new fiscal context. In 1994, pensions and other social insurance legislation was enacted which modified the existing legal provisions, broadly established the administrative framework and made social insurance contributory. The 1994 legislation set out contribution requirements for social insurance which remain today as well as revised the qualifying conditions and benefit parameters (Table 2 and Appendix 1). A national health insurance scheme was added in 2001.

5. **The Notional Defined Contribution (NDC) scheme was established in 1999 in an effort to reduce the fiscal burden and better align contributions and benefits.** The scheme applied to all cohorts born after January 1, 1960. The Government envisioned the introduction of the NDC scheme as an interim step designed towards moving to a partially-funded defined-contribution scheme in the context of largely undeveloped capital markets and limited governmental fiscal resources. The policy documents of the period set as a goal that by 2005, 3 percent of the 19 percent total contribution rate would be actively managed and invested in securities and, over time, more funding would be permitted. Since 1999, disbursements to retirees under the earlier scheme have exceeded contributions. Thus no reserves have been actively managed, nor is it likely that movement from notional to partially-funded accounts will happen any time soon because continued net deficits are projected for the near future.

6. ***Contribution rate*. The 19 percent contribution rate for pensions insurance and 29-31 percent rate for all social insurance is a heavy tax on formal labor which inhibits competitiveness and creates strong incentives for wage underreporting.** The combined contribution rate includes contributions to short-term, work injury, unemployment and health (Table 2). Under the NDC scheme, 15 percent is applied toward an individual's account and the remaining 4 percent is to be used to fund the costs of administering the system, provisions for survivor and disability pensions, and provision of a minimum pension guaranty. Previous work has found that high taxes are one of the top three constraints to job creation by the private sector. High social security taxes also induce firms to hire workers without a contract and to overuse (and misuse) temporary contracts (World Bank 2006, 2007).

Table 2: Social insurance contribution rates
(in percent of covered wages)

	Employer	Employee	Total	Self-Employed (voluntary
Pensions	13.5	5.5	19.0	9.5
Short-term benefits	1.0	1.0	2.0	1.0
Work injury benefits	1.0-3.0		1.0-3.0	1.0
Unemployment Benefits	0.5	0.5	1.0	
Health Insurance	3.0	3.0	6.0	800 Tg/month
Total	19.0-21.0	10.0	29.0-31.0	11.5 + 800 Tg/month

Source: Social Insurance Legislation, 2001.

7. ***Benefits.*** Old-age pension benefits for members of the defined-benefit scheme are based on an accrual rate of 2.25 percent per year for the first 20 years of eligible service and 1.5 percent for each year of service after that (Appendix 1). For an average full-term worker under the defined-benefit scheme, calculations in 2003 suggested that the replacement rate upon

retirement would be about 46 percent under the defined-benefit scheme.[3] With over 70 percent of retirees estimated to be receiving the minimum pension and with substantial growth in the minimum wage, the average old-age pension has been increasing. In 2003 the average old-age pension as a percent of average gross wage was 39 percent.[4]

8. **Benefits under the NDC scheme for workers born after 1960 would be significant lower than those provided by the defined benefit scheme**. Under the NDC scheme**,** the benefit is determined based on 15 percent of the 19 percent contribution rate credited to an individual account, the rate of return applied to the notional balance (the three-year rolling average rate of growth in average reported wages), and life expectancy at retirement using unisex retirement tables.[5] Calculations in 2003 suggested that benefits for full career workers would be about 28 percent of pre-retirement income for average wage workers born after 1960, a substantial reduction from the replacement rate provided by the defined benefit scheme.

Table 3: Social insurance contributors, beneficiaries, economically active population
(in percent of covered wages)

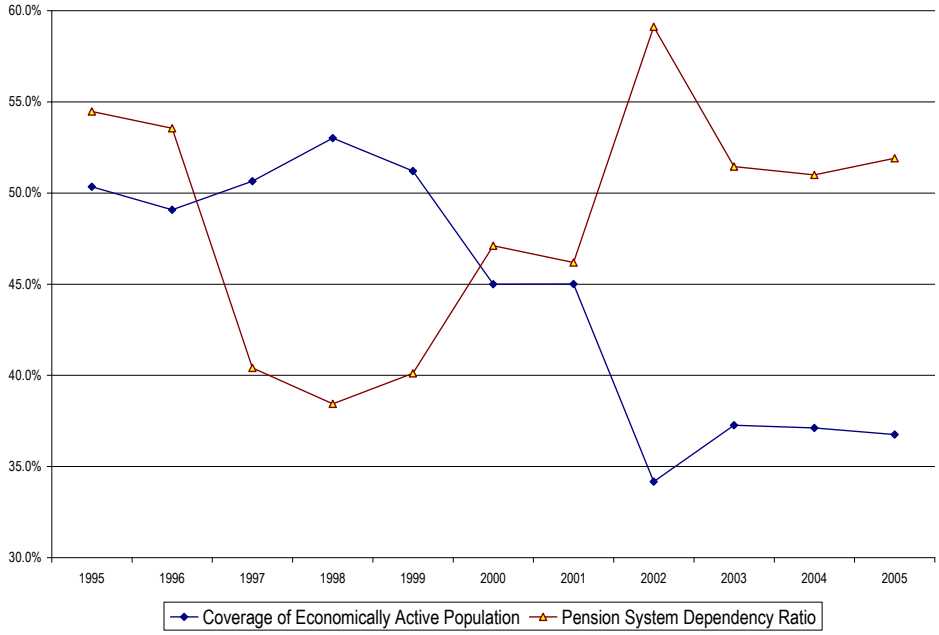
	Individuals										
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Number of insured people covered by pension, unempl. & ins. against employment injury and occupational diseases	409,100	415,800	431,500	455,500	437,000	381,400	392,700	308,100	357,600	366,000	367,900
Compulsory insured	395,400	402,300	419,400	439,600	422,300	363,900	370,200	285,800	332,000	336,800	338,900
Voluntary insured	13,700	13,500	12,100	15,900	14,700	17,500	22,500	22,300	25,600	29,200	29,000
Number of insured people covered by health insurance	1,992,400	2,017,400	2,160,800	2,217,400	1,977,800	2,030,200	2,019,700	1,963,200	1,984,700	1,990,000	1,959,400
Total of beneficiaries	284,277	287,227	237,911	242,094	245,045	254,394	259,607	262,948	268,638	277,179	283,651
Pension beneficiaries	222,816	222,653	174,330	175,077	175,256	179,668	181,382	182,137	183,968	186,618	190,939
Population, labor force											
Population /in thousands/	2,251,300	2,347,100	2,379,600	2413000	2,373,500	2,407,500	2,442,500	2,475,400	2,504,000	2,533,100	2,562,400
Economic active population /in thousands/	812,700	847,200	852,000	859,300	853,400	847,600	872,600	901,700	959,800	986,100	1,001,200
Employed	767,600	791,800	788,300	809,500	813,600	809,000	832,300	870,800	926,500	950,500	968,300

Source: Statistical Yearbook of Social Insurance, 2006.

9. ***Coverage* has fallen substantially since 1995, with an estimated 368,000 active members who contributed to the pensions insurance fund at end-2005 or about 37 percent of the economically active population in the same year having fallen from almost 55 percent in 1995** (Table 3) (Figure 1)**.** Herders, who in 2002 represented 43 percent of the labor force and the self employed, who represented 15 percent of the labor force, are both exempted from making contributions.[6] An estimated 29,000 herders and members of the informal sector made voluntary contributions during 2006, about eight percent of the total. Although some of the decline in participation can be attributed to changes in the labor force composition, this limited voluntary participation along with suspected wage underreporting suggests that the social insurance and pension insurance schemes have weak credibility.[7]

[3] This assumes nominal wage growth of 10% per year and 30 continuous years of service from age 30 to age 60 and a life expectancy of 16.3 years at retirement. See Patrick Wiese and Michael Cohen, *An Evaluation of Pension Reform Options for Mongolia*, p. 10 and Wiese, Patrick, *An Evaluation of Pension Reform Options for Mongolia*, December 25, 2006.
[4] See Wiese and Cohen, op. cit. p. 14
[5] At this writing, no workers born after January 1, 1960 have reached the regular or early retirement age and are unlikely until at least 2010, although it was technically possible for someone to reach early retirement age of 45 in 2005.
[6] Ibid., p. 6.
[7] The IMF reported that in 2003 the average monthly wage on which PIF contributions were paid was about Tug 65,000 while the average wages in institutions under the Government budget and public enterprises reported by the NSO were Tug 71,000 and 94,000, respectively. See IMF, *Options for Expenditure Savings and Efficiency Improvements*, p. 38.

Figure 1. Coverage and pension system dependency ratios
(percent)



Source: SSIGO Statistical Yearbook, 2006.

10. **The ratio of retirees and beneficiaries to contributors, or pension system dependency ratio has improved from 1995 to 2005, dropping from about 51 percent to about 37 percent** (Figure 1**).** To the extent that this continues, this suggests very modest demographic pressure on the system's finances.

11. **Although from 1995 to 2005 the total population and economically active population both increased substantially, contributors to the SSIGO decreased by almost 10 percent** (Figure 2). Coverage has thus been declining with the restructuring of the economy.

Figure 2. Pension contributors, beneficiaries and economically active population
(individuals)

Source: SSIGO Statistical Yearbook, 2006.

12. **Basic social assistance provided for the elderly poor through the *Social Welfare Pension Benefit* is very small** with about 2,670 of the elderly poor assisted under this program in 2005, a number that has dropped each year since 1997 (Table 4). This form of assistance is provided for the elderly who do not qualify for regular pension benefits and have a self-reported income that is 40 percent or less of the Minimum Living Standard (MLS). The benefit is small, at 26,500 Tugrugs per month or about US$25 per month, accounting for about 48 percent of the Minimum Living Standard (Table 5). But the elderly poor only account for 6 percent of the beneficiaries of social welfare pensions. About 70 percent of recipients of social welfare pensions are disabled people, and their numbers have grown over time. The elderly poor also receive other forms of social assistance in the form of nursing home services (for single elderly) and other social welfare services (e.g. meals, bathing, cleaning, and assistance in fuel collection), but these services only reach about 2,600 people.

Table 4: Social assistance for the elderly poor
(Individuals in thousands)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Social welfare pensions	6,400	6,200	6,230	4,720	4,270	3,730	3,290	3,046	2,667
Nursing home services	1,510	1,170	3,110	--	--	--	1,050	1,424	1,096
Other social welfare services	--	--	--	10,510	300	2,680	2,390	2,866	2,489

Source: State Social Welfare Office Annual Report (2006).

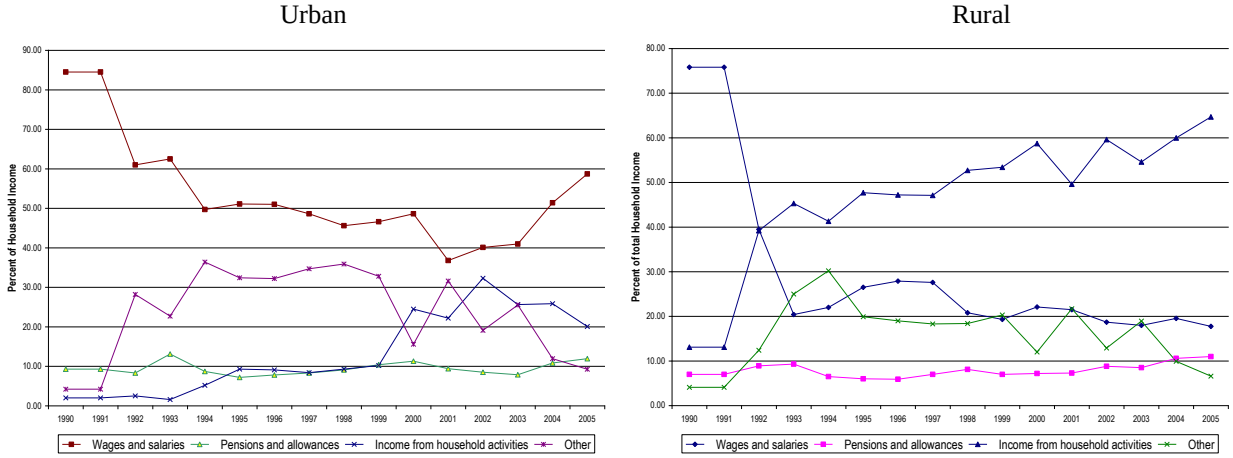
Table 5: Benefits provided by social assistance
(Tugrugs per month)

	1999	2000	2001	2002	2003	2004	2005	2006
Social welfare pension	10,000	10,000	10,000	12,000	14,400	14,400	14,400	20,480
Minimum living standard	17,600	19,600	23,600	25,400	25,400	25,400	--	42,800

Source: State Social Welfare Office Annual Report (2006).

13. **Historical household survey data suggests that mandatory pension benefits provide an important source of income for rural and urban households alike** (Figure 3). Pensions have traditionally been the main source of social welfare payments to households in Mongolia, although this prominent role has been replaced by Child Money Program (CMP) in recent times. On average, pension benefits have accounted for about 7 to 12 percent of urban household income since 1990 (Figure 3). Pension income has contributed somewhat less to rural incomes—6 to 11 percent since 1990, as such individuals have not been able to benefit from such formal sector programs.

Figure 3. Household income composition
(in percent of total household income)



Source: Household Income and Expenditure Survey, various years.

14. **The Pension insurance fund** (PIF) administers three schemes for providing old age pensions: (i) Social Insurance Pensions f*or non-uniformed individuals born before 1960*: (ii) the NDC Scheme for *non-uniformed individuals born in or after 1960*; and (iii) a non-contributory scheme for *uniformed personnel*. Operational administration is carried out by the State Social Insurance General Office (SSIGO). The current management structure for Social Security in Mongolia is that the Ministry of Social Welfare and Labor (MSWL) is responsible for setting out policy parameters for social security and the Social Insurance Office (SIO) is responsible for carrying out that policy. Within the SIO are the State Social Insurance General Office (SSIGO) and local offices and units.

15. **The PIF is responsible for administering the defined-benefit and notional defined-contribution schemes described above as well as the non-contributory pension insurance scheme for uniformed personnel**. In addition, the Social Welfare Fund (SWF) provides non-work related sickness, maternity, and funeral insurance. The Work Injury Fund (WIF) provides sick leave, disability, and survivor insurance for work-related injuries. The Unemployment Insurance Fund (UIF) provides unemployment insurance. Finally, the Employment Promotion Fund (EPF) established in 2001 provides services to the rest of the unemployed.

B. Review of public expenditures

16. **Social insurance expenditures have increased substantially since 2001while social insurance contributions have declined.** Budgeted social insurance expenditures for 2007 are estimated to be about 6.5 percent of 2007 GDP, having risen substantially from about 5.8 percent of GDP in 2001 and 5.1 percent of GDP in 2006. Old age pension benefits represent the largest single category of social insurance expenditure, anticipated to be about 4.3 percent of GDP during 2007 or about 66 percent of all social insurance expenditures having risen from 3.8 percent of GDP in 2001 to 4.3 percent in 2007 (Table 6 and Figure 4). Taken together, old age, disability, survivors and military pensions represented about 88.6 percent of all social insurance expenditures. Disability pensions were anticipated to be about 0.8 percent of GDP during 2007 or about 9.9 percent of all social insurance expenditures.

Table 6: Social insurance benefit expenditures

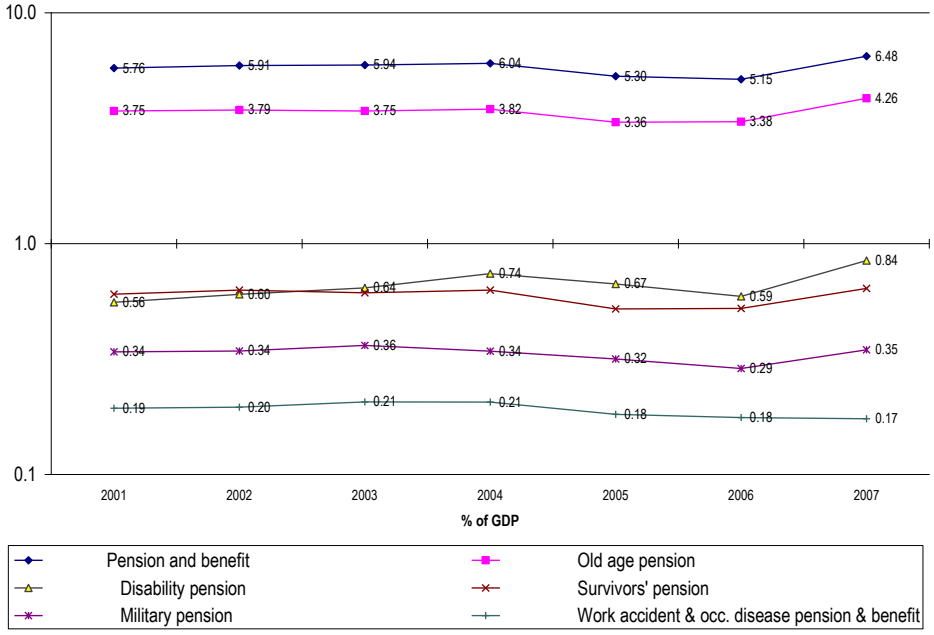
(in percent)

	Percent of GDP							Percent of Total						
	2001	2002	2003	2004	2005	2006	2007	2001	2002	2003	2004	2005	2006	2007
Total Pension and benefit	5.8%	5.9%	5.9%	6.0%	5.3%	5.1%	6.5%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Old age pension	3.8%	3.8%	3.8%	3.8%	3.4%	3.4%	4.3%	65.1%	64.1%	63.2%	63.3%	63.3%	65.5%	65.7%
Disability pension	0.6%	0.6%	0.6%	0.7%	0.7%	0.6%	0.8%	9.7%	10.2%	10.8%	12.3%	12.6%	11.5%	13.0%
Survivors' pension	0.6%	0.6%	0.6%	0.6%	0.5%	0.5%	0.6%	10.5%	10.6%	10.3%	10.4%	9.8%	10.2%	9.9%
Military pension	0.3%	0.3%	0.4%	0.3%	0.3%	0.3%	0.3%	5.9%	5.8%	6.1%	5.7%	6.0%	5.6%	5.3%
Sickness benefits	0.1%	0.1%	0.1%	0.1%	0.1%	0.0%	0.0%	1.4%	1.6%	1.5%	1.3%	1.2%	0.8%	0.8%
Funeral benefit	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.0%	1.9%	2.1%	2.0%	1.6%	1.4%	1.2%	0.8%
Pregnancy and maternity benefit	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	1.2%	1.2%	1.2%	1.0%	1.2%	1.1%	1.0%
Work accident & occ. disease pension & benefit	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	3.4%	3.3%	3.5%	3.4%	3.4%	3.4%	2.7%
Support to Professional disease center	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Unemployment benefit	0.0%	0.0%	0.1%	0.1%	0.0%	0.0%	0.0%	0.8%	0.8%	1.2%	0.8%	0.9%	0.6%	0.7%
Training cost	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%
Expenses of employment regulation office	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Memo Item: Social Welfare Expenses	1.2%	1.4%	1.3%	1.2%	1.7%	2.3%	2.4%							

Source: Ministry of Finance and National Statistical Office (2007 figures are based on projected budget, and GDP).

Figure 4. Long-term social security expenditures

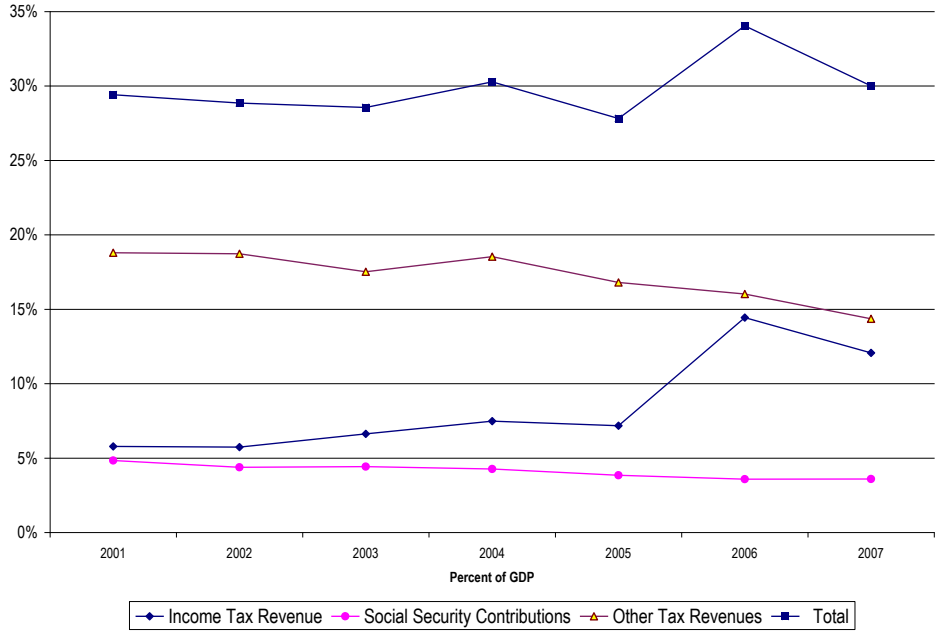
(% of GDP)



Source: Ministry of Finance: Central Government Expenditures: 2001-2007.

17. **As a revenue source, security contributions have declined from about 4.8 percent of GDP in 2000 to 3.6 percent of GDP in 2007 while at the same time income tax revenues more than doubled from 5.8 percent of GDP to 12.1 percent of GDP** (Figure 5). Social security contributions therefore have gradually lessened in importance as a revenue source.

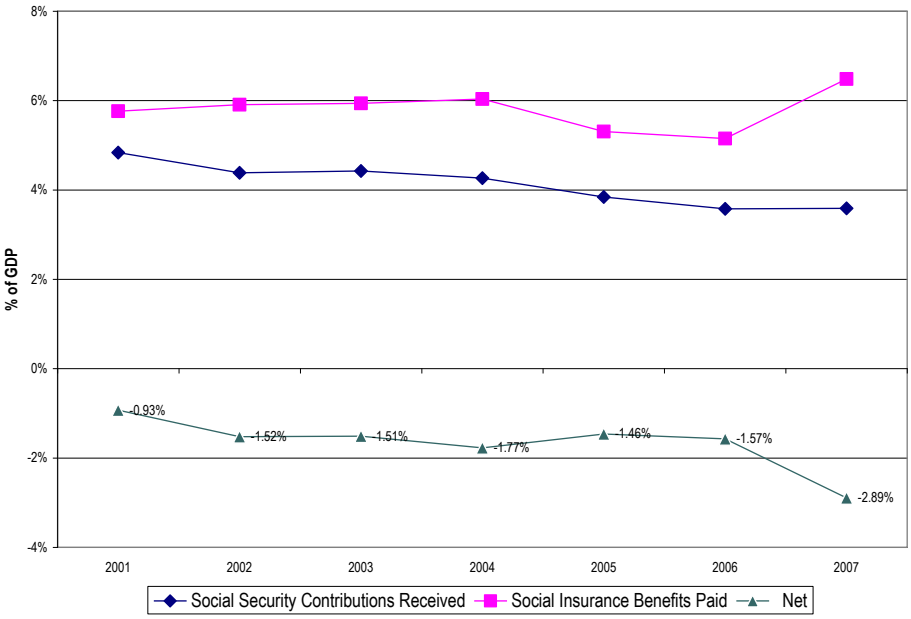
Figure 5. Composition of total government revenues



Source: Ministry of Finance: Central Government Expenditures: 2001-2007.

18. **The difference or deficit between contributions and benefits has grown from less than one percent of GDP in 2001 to almost three percent of GDP budgeted for 2007** (Figure 6). As suggested, since about 73 percent of social insurance benefits are for long-term benefits such as pensions, disability and survivorship; this means that the Government subsidy of the social insurance system has had to increase substantially since 2001 primarily to support the shortfall between pay-as-you-go contributions and long-term benefits. Since a majority of pension beneficiaries receive the minimum pension, pension expenditures are closely linked to changes in the minimum wage, which increased by 20 percent, 42 percent and 26 percent in 2004, 2005 and 2006 respectively (Table 7). Although average wages also increased substantially during this period, the minimum wage grew even faster—from 30.7 percent of average wages in 2003 to 42 percent in 2006. The projected long-term deficit of the PIF is about 3 percent of GDP.

Figure 6. Social insurance contributions and benefits
(% of GDP)



Source: Ministry of Finance: Central Government Expenditures: 2001-2007.

Table 7: Average wage, minimum wage and minimum living standard
(Tugrug per month, percent)

	2003	2004	2005	2006
Average Wages and Salaries	81,500	93,100	101,200	127,700
Legal Minimum Wage	25,000	30,000	42,500	53,600
Minimum Living Standard (Ulaanbataar)	25,300	26,500	30,000	42,800
Average Insurable Earnings of Contributor	n.a.	n.a.	n.a.	n.a.
Maximum Insurable Earnings	300,000	400,000	425,000	530,000
	Percent of Average Wages and Salaries			
Legal Minimum Wage	30.7%	32.2%	42.0%	42.0%
Minimum Living Standard (Ulaanbataar)	31.0%	28.5%	29.6%	33.5%
Maximum Insurable Earnings	368%	430%	420%	415%
	Annual Change			
Average Wages and Salaries	14.3%	14.2%	8.7%	26.2%
Legal Minimum Wage		20.0%	41.7%	26.1%
Minimum Living Standard (Ulaanbataar)		4.7%	13.2%	42.7%
Maximum Insurable Earnings		33.3%	6.3%	24.7%
Average Annual Inflation	5.1%	8.2%	12.7%	5.1%

Source: National Statistical Office, Statistical Yearbook 2006.

C. Country demographic and labor market characteristics

19. **The financial burden of Mongolia's elderly population has not worsened in recent years by an aging process nor is it likely to be in the near future.** Indeed, the old age dependency rate (those aged 65 and over those aged 15-64) *declined* substantially from 6.4

percent in 1996 to 5.7 percent in 2005 (Table 8). The current population is estimated to be about 2.6 million of which about 3.8 percent is estimated to be over age 65, and 30.5 percent aged 14 and under. This can be attributed to a modest growth in the 15-64 age group during this period while at the same time the population share of those aged 65 and over remained at a stable 3.7-3.8 percent. The population aged 0-14 fell during this period due to lower fertility rates resulting from the economic effects of liberalization in the early 1990s, as well as the effects of drought and climate shocks later in the decade. The stability of the relative size of the old-age population was the result of a relatively flat population pyramid for the cohorts moving into old age. During the 1996-2005 period, overall aging of the population has been minimal, although aging will gradually increase in the future as suggested in Figure 7.

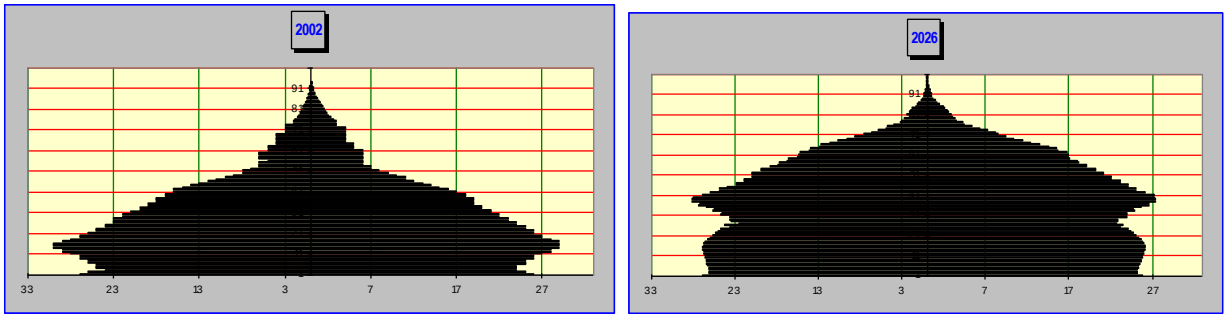
Table 8: Population age distribution

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Population ages 0-14	881,353	875,497	867,434	856,586	842,714	827,929	812,766	798,424	786,482	778,060
Population ages 15-64	1,337,531	1,369,274	1,400,487	1,432,099	1,464,578	1,501,874	1,543,411	1,587,930	1,633,741	1,679,704
Population ages 65 and above	85,477	86,655	88,187	89,639	90,708	91,557	92,332	93,214	94,456	96,236
Total	2,304,360	2,331,426	2,356,108	2,378,324	2,398,000	2,421,360	2,448,509	2,479,568	2,514,678	2,554,000
					Percent of Total					
Population ages 0-14	38.2%	37.6%	36.8%	36.0%	35.1%	34.2%	33.2%	32.2%	31.3%	30.5%
Population ages 15-64	58.0%	58.7%	59.4%	60.2%	61.1%	62.0%	63.0%	64.0%	65.0%	65.8%
Population ages 65 and above	3.7%	3.7%	3.7%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Old Age Dependency Ratio	6.4%	6.3%	6.3%	6.3%	6.2%	6.1%	6.0%	5.9%	5.8%	5.7%

Source: World Economic Indicators.

Figure 7. Current and projected age structure of the population

(2002) (2026)



Source: UN/World Bank Estimates.

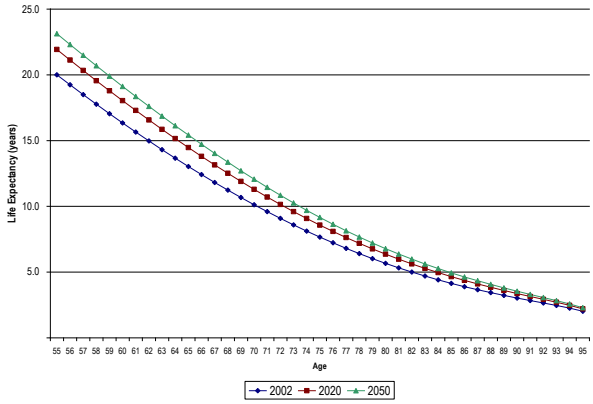
Note: Males are on the left and Females on the right of each diagram; the vertical axis is age cohorts.

20. **Life expectancy at retirement is projected to increase substantially in the years ahead as a result of improved health conditions**. For males aged 60, for example, life expectancy is projected to increase from 16.3 years in 2002 to 19.1 years in 2050 (Figure 8) As discussed below, this would increase the length of retirement by about 17 percent, resulting in a greater cost of providing retirement benefits and potentially a lower benefit for the retiree.

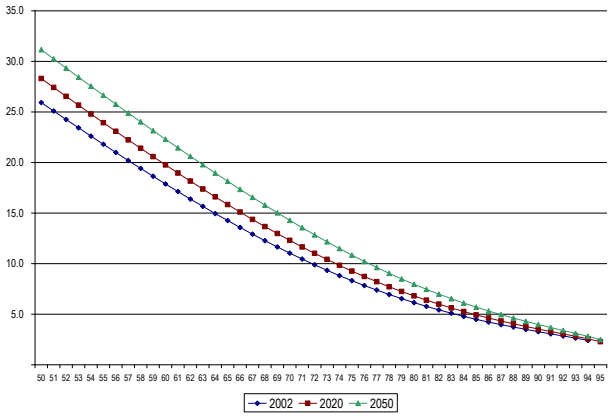
Figure 8. Male and female life expectancy by cohort

(Number of years of life expectancy at each age)

Males



Females



Source: UN/World Bank Projections.

III. Diagnosis of key reform issues

21. **Putting the PIF on a sustainable footing and addressing the challenges of the pension system in terms of predictability, equity and affordability requires a comprehensive program of parametric adjustments reinforced by the strengthening of institutions.** Although by establishing the NDC scheme, the authorities reduced long-run deficits of over 9 percent of GDP to projected deficits of 3 percent of GDP, this reform did not put the Pension Insurance Fund on a sustainable basis.[8] Just as important, the scheme is left with substantial weaknesses in the equity of treatment between different workers, lacks the level of predictability in the benefit parameters sufficient to ensure public credibility and compliance, and creates an unaffordable burden to the Government, employers and employees alike. It should be noted that these reform issues have been raised by earlier observers of the Mongolian pension system and in Government strategy documents. [9]

A. Design Parameters

22. ***Contribution rates and the management of legacy costs***. As discussed above, the current 19 percent contribution rate is sufficiently high to create strong incentives for evasion and underreporting; and the 15 percent contribution allocated to individual notional accounts for younger cohorts provides for a low pension benefit relative to the contribution.

- An optimal strategy for financing the legacy costs of previous pension schemes should not only use the contributions of current workers but also tax and other fiscal revenue sources. In this way, current workers and employers who comply with the contribution requirements should not overly share the burden of past liabilities accrued by older workers and retirees.

- An optimal strategy for managing the legacy costs involves not only improving the financing strategy but also having workers themselves bear some of the burden through reforms to parameters, such as increasing the retirement age for regular workers and hazardous professions. Other changes to parameters suggested below, such as benefit

[8] These figures are cited in IMF, *Options for Expenditure Savings and Efficiency Improvements*, p. 18.

[9] See Strategy (2001), Fox (2002), Thompson (2003), IMF (2005), and Wiese and Cohen (2003) and Wiese (2006).

indexation and increasing the period for determining the reference wage, will not likely reduce the legacy costs.

- In order to improve benefits relative to contributions for younger cohorts, an optimal strategy for reducing the contribution rate for contributors born after 1960 needs to also include: (i) increases in the retirement age; and (ii) a reduction in the 4 percent of wages allocated to disability, survivorship and administrative expenses. Together, these measures can result in a reduction in the contribution rate while not materially reducing the anticipated benefit. Of course, just doing one measure without the other will not achieve the intended objective.

23. ***Minimum pension guarantee.*** **The minimum pension guarantee for the defined-benefit and NDC schemes, as well as the disabled and survivors, is substantially too high**, which creates very weak incentives and is the largest contributor to the fiscal burden of Pension Insurance**.**[10]

24. **An estimated 70 percent of the recipients of old-age pensions under the defined-benefit scheme receive the minimum pension** equal to 75 percent of the minimum wage because:[11] (i) in those cases where the 5 year average for determining the reference wage for benefits is taken from a period of rapid inflation and/or wage growth (such as in the early 1990s), the entry replacement rate was particularly low; (ii) under-indexation of benefits after retirement have depreciated the real value of benefits such that many individuals who were not near the minimum pension at retirement soon found themselves subject to the minimum years later; (iii) some individuals such as herders or those in the informal sector may have had limited work histories prior to 1994 so also have had low replacement rates at retirement; and (iv) substantial real growth in the minimum wage in recent years has made the minimum pension guarantee binding for many pensioners where in the past it wasn't.

25. **For workers in the NDC scheme, the minimum pension guarantee is also sufficiently high relative to the distribution of wages,** so that many of the retirees will be entitled to the minimum, creating poor incentives as well as a mismatch between cumulative contributions and benefits**.** The NDC scheme promises a minimum pension equal to 20 percent of the economy-wide average wage, plus an additional 0.5 percent of the average wage for each additional service year beyond the minimum of 15 years. Since the average service period for recent retirees is about 25 years,[12] this would result in a minimum pension equal to 25 percent of the economy-average wage. Since the projected retirement benefit for a man after 25 years of service is only about 116 percent of the average wage, this means that *most male workers with wages less than the average or with years of contributions less than the average, have an incentive to under-report wages in anticipation of receiving the relatively generous minimum pension*.[13]

26. Since the projected retirement benefit for the average woman after 25 years of service is only about 80-90 percent of the average wage, this means that all female workers with wages less than the average wage or years of contributions less than the average also have an incentive to under-report wages in anticipation of receiving the relatively generous minimum pension. In

[10] See Wiese and Cohen, op. cit., p. 5.
[11] Ibid., p. 4.
[12] This is based on data indicated in Wiese, 2006.
[13] These are the projections indicated in Wiese, 2006, p. 10.

addition to creating substantial incentives for underreporting of wages for a majority of wage-earners, the level of the minimum pension relative to the anticipated regular pension benefit also increases pension expenditures above revenues, thus compromising the system's financial sustainability.[14]

27. **The minimum pension provision for the NDC scheme also suffers from other weaknesses.** First, the minimum pension benefit formula is a function of the average reported wages and not minimum subsistence. As with the defined-benefit scheme, *if the objective of the minimum pension is to keep those who have met the vesting period out of poverty during retirement, then the linkage to the average wage (as opposed to the Minimum Living Standard (MLS)) has mismatched the instrument from the core objective*. Second, the financing formula provided for the NDC scheme (a portion of 4 percent of covered wages) is entirely insufficient to finance the anticipated costs of the difference between the old-age pension generated by the Notional account accumulation and the minimum pension guarantee in the future. Finally, the generosity of the NDC scheme minimum pensions guarantee creates segmentation in the labor market, whereby those workers who reach the minimum vesting requirement receive a relatively generous benefit while those not meeting the vesting requirement receive nothing other than the means-tested *Social Welfare Pensions Benefit*.

28. **The linkage to the minimum wage is not consistent with the objective of the minimum pension guarantee.** If the objective of the minimum pension is to keep those who have met the vesting period out of poverty during retirement, then the linkage to the minimum wage (as opposed to the Minimum Living Standard (MLS)) is not the most appropriate .

29. **Thus the minimum pension in the NDC and defined-benefit schemes should, in the short-run, be de-linked from the minimum wage, linked to the MLS according to a common framework and gradually reduced.[15] And it should be replaced in the medium-term by a means-tested social pension**. Using the MLS as the anchor for basing a minimum pension guarantee requires that the MLS be objectively determined and routinely and rigorously revised in accordance with surveys of the costs of a minimum consumptions basket. The dramatic increases in the MLS from 2003 to 2007 suggested in Table 9 are, however, pause for concern.

30. **If the minimum pension guarantee is substantially reduced and other parametric adjustments adopted (such as adjustments to the retirement age), in principle the vesting period could also be reduced.** If benefits for post-1959 cohorts are designed in a way to be consistent with contributions over the long-term, then the rationale for a 15 year vesting period is substantially reduced.

[14] Under the assumption of a normal distribution of wages, Wiese, ibid, projects long-run expenditures as a percent of covered wages as 18.5 percent verses the 15.0 percent of covered wages allocated to the NDC benefit.

[15] It should be noted that proposed amendments were submitted to the Government and Parliament suggesting that the minimum pension be linked to the minimum living standard instead of the minimum wage. We understand that it is the Government's intention to gradually separate the minimum pension from the minimum wage.

Table 9: Minimum Living Standard

(Tugrug per month)

	2003	2004	2005	2006	2007	
West	19,500	20,200	23,200	37,000	54,700	
East	20,500	21,200	25,000	34,800	51,800	
Central	19,800	20,600	22,300	39,000	56,700	
Khangai	19,900	20,600	22,600	38,300	54,600	
Ulaanbaatar	25,300	26,500	30,000	42,800	60,100	
		Annual Change				**Cumulative Change**
West		3.6%	14.9%	59.5%	47.8%	180.5%
East		3.4%	17.9%	39.2%	48.9%	152.7%
Central		4.0%	8.3%	74.9%	45.4%	186.4%
Khangai		3.5%	9.7%	69.5%	42.6%	174.4%
Ulaanbaatar		4.7%	13.2%	42.7%	40.4%	137.5%
Average Annual Inflation	5.1%	8.2%	12.7%	5.1%		

Source: National Statistical Organization, Statistical Yearbook 2006.

31. **Moving forward the agenda for the reduction in the minimum pension guarantee and establishment of social pension requires additional work, including projections to assess the sustainability of different design options.** Key areas that need further work include: (i) assessment of the most appropriate means-testing criteria for the elderly poor; (ii) projections of the fiscal cost and social insurance sustainability implications of different social pension benefit levels; (iii) assessment of the operational requirements and anticipated administrative costs for managing a social pension; and (iv) establishment of a calibrated minimum pension guarantee for the contributory pension scheme which both ensures that vested retirees are shielded from poverty during retirement while also retaining strong to work and contribute to the mandatory scheme.

32. ***Retirement Age*. The retirement ages for regular retirees (aged 55 for women and 60 for men) and those in special occupations (as low as age 45) are too low** to enable a financial balance in the defined benefit scheme and a meaningful replacement rate at retirement in the NDC scheme**.** Further, these low retirement ages will create a financial burden to the Government for some time to come as a result of deficits in the defined-benefit scheme and the minimum pension benefit for early retirees in the NDC scheme. With the average age of retirement for women being about 52 such workers would, on average spend 27 years working and 23 years in retirement (Figure 9). If data on the health and longevity effects of work in certain occupation support the provision of special benefits to workers prior to the normal retirement age, then the industries involved should provide separately-funded top-up benefits for their workers outside of the state social insurance system. There are three types of increases in the retirement age that are needed:

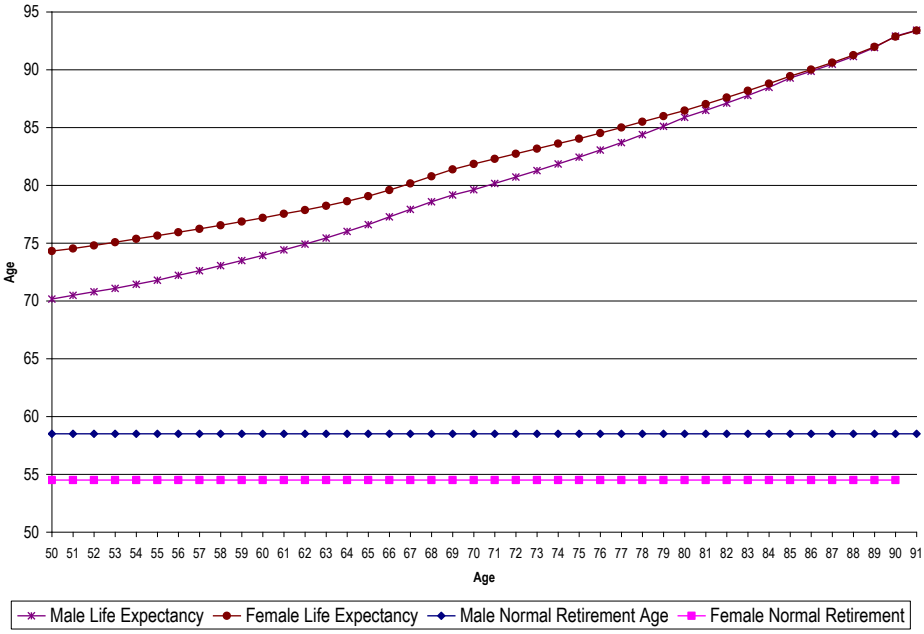
(i) Early retirement should be eliminated for workers in hazardous occupations, working underground or in high heat, as well as special treatment for women who have raised 4 or more children. This could be undertaken through a process of increasing the applicable retirement age perhaps by six months every year until all workers, men and women have the same retirement age of 60. This is a process that will take 30 years to complete for women

who work underground or in high heat and would not be binding for many workers since the phase-in of the increase will happen after they retire.[16]

(ii) The regular retirement age for women needs to be unified with that of men at 60 which could be accomplished by increasing the applicable retirement age by 6 months every year.

(iii) In the medium term, the overall retirement age also needs to be increased, possibly to age 65, in accordance with a careful assessment of life expectancy at retirement (paragraph 52.[17]

Figure 9. Life Expectancy and normal retirement age



Source: Patrick Wiese, Mortality and Average Lifetime Data, in Wiese, 2003.

33. ***Benefit indexation and retroactive adjustments.*** **Although current legislation suggests that benefit adjustments should be in line with inflation, actual indexation has in many cases resulted in a depreciation of the real value of the benefit.**[18] This creates uncertainty for pensioners and is fundamentally at odds with the objective of providing old-age income security. This can and should be remedied through the indexation of all new social insurance benefits to a weighted average increase in the consumer price index. Benefit adjustments are also needed for current retirees that have had insufficient indexation during their retirement and thus have had substantial real depreciation in the value of their benefits.

34. ***Income averaging period and indexation.*** **The use of the best 5 year average covered wage base as the basis for determining a retirement benefit under the defined-benefit scheme is too short a period to be equitable across different income groups, and should be**

[16] For example, all workers under the defined-benefit scheme will be at least 48 years old in 2008 so that increasing the retirement age by 6 months per year for women working underground or in high heat will not affect a single one of these workers.

[17] If a reform program was enacted in 2008, a gradual reduction in the overall retirement age could begin in 2018 when the gender differences in the retirement age would have been unified and most of the adjustments in ages for those working in hazardous professions would be complete. Patrick Wiese has noted the importance of focused survey work to strengthen the mortality statistics; something that is important not only in the context of increasing the retirement age but also essential for the operability and balance of the NDC scheme.

[18] For example, the IMF reported that pensions were increased by between 15 and 20 percent in October 2002, and again by 15-42 percent in January 2004, although inflation in 2004 was only 4.7 percent. See IMF, op. cit. p. 42.

adjusted by an index so as to control for the effect of inflation.[19] In those cases such as workers retiring in the early 1990s during and after high inflation levels, the 5 year average for determining the reference wage for benefits substantially reduced the effective replacement rate at retirement. Further, it created substantially different benefit levels for different workers subject to different inflation levels during their income averaging period. Many individuals who were not near the minimum pension at retirement, soon found themselves subject to the minimum years later. In addition, using a longer income averaging period can improve the equity between income groups since, on average, those with higher incomes at retirement tend to have had steeper income growth trajectories than lower income workers and thus tend to receive higher replacement rates at retirement. So increasing the income averaging period and indexing the income during such a period improves the equity and predictability of retirement benefits.

35. ***Invalidity/permanent disability pensions.*** **Invalidity benefits are fiscally burdensome and generate weak incentives under the defined-benefit scheme, and are inappropriately financed in the case of the NDC scheme.** Those workers with 20 years of service having been determined by medical examiners as having lost 50 percent of capacity receive the same accrual rate for service as they would have received for an old-age pension. So for example, an individual who starts work at age 19 and is found to be 50 percent disabled after 20 years of work at age 39 would receive a benefit equal to 45 percent of the best 5 years' salary for life. Even more important, since the minimum invalidity pension is equal to the minimum retirement full pension (75 percent of the minimum wage), all those meeting the qualifying criteria will receive the minimum pension for life. High annuitized (defined) disability benefits without re-certification of the disability create inordinate pressure on the medical examiner to certify individuals as disabled in an effort to achieve labor shedding, bankruptcy etc. In addition, because there is no actuarial reduction for the benefit, there are strong incentives for people prior to retirement age to try to get certified in order to extend the period of their service retirement.

36. In the case of the NDC scheme, the worker losing more than 50 percent of capacity is entitled to an annuitized benefit for life equal to an average of the last three years' wages, regardless of age and the notional accumulations in his or her account. There are no actuarial projections indicating what proportion of the 4 percent of covered wages earmarked for this and other benefits would be earmarked towards providing such a benefit or indeed if such an earmark would be sufficient. With the assistance of actuarial projections, a dedicated disability fund could supplement the benefit provided by one's notional individual account. With detailed data on disability incidence for the covered population, an appropriate contribution rate could be identified consistent with a modest benefit that tops-up that provided by an individual account.

37. Two kinds of options for disability benefits can be considered: A lump-sum benefit and an annuitized benefit. A lump-sum benefit can be supported by an earmarked contribution. For example, for a 1.0 percent contribution rate, a lump-sum benefit can be made available to the insured based on anticipated disability incidence rates, anticipated covered wage growth, and rates of return on reserves. The advantage of such an option is that it is relatively easy to design and calculate. The disadvantage of such an option is that the insured bears investment and longevity risks after becoming disabled. Such a benefit should not have the same long vesting period as for old-age pensions and no minimum benefit provision would apply. At normal retirement age, the individual would still be entitled to a deferred pension.

[19] Many schemes also adjust or "valorize" according to real covered wage growth instead of inflation. In the case of Mongolia, however, this would be too costly.

38. An annuitized benefit would be based on the accrued years of service with an actuarial reduction factor to reflect the longer benefit period. Financing either benefit under the NDC scheme should happen through an earmarked contribution allocated to a disability reserve fund that would manage the relevant contribution, investment and disbursement flows. The lump-sum and annuitized benefits would need to be revised based on an annual actuarial valuation. Finally, the entire process of disability certification through medical examiners, and recertification, would need to be strengthened.

39. ***Survivorship benefits.*** **There is room for improving the survivorship benefit formula under the defined-benefit and NDC schemes.** Both schemes offer very different benefits and therefore require different modifications**.** Benefits under the defined-benefit scheme are provided based on the benefit accrual of the worker and the number of survivors. The benefit formula could be strengthened by providing 100 percent of the accrued retirement benefit (with actuarial reductions prior to retirement age) divided equally between eligible survivors. In addition, there should be dependency criteria applied, namely that when a widow or widower remarries, he or she is no longer eligible for survivorship benefits. Similarly, when children or grandchildren reach a certain age such as 18 or 22 if in college, they too would lose eligibility.

40. The NDC scheme links benefits to the workers' wages and not benefit accruals. A more advisable approach would be to provide a survivors' benefit which reflects: 1) the notional account accumulation; and 2) possibly in addition to formulate a pooled insurance provision which adds additional benefits on a pooled basis and for which a dedicated premium (contribution rate) of perhaps one percent of covered wages. Such an insurance provision would require additional analysis as well as annual actuarial reviews in order to adjust the benefit level, particularly if the aim is for the benefit to be annuitized. The criteria for receipt of survivorship benefits should be spelled out in regulations.

41. ***Abrupt reduction in benefits for those born beginning in 1960.*** **The lack of a transition mechanism in the 1999 law establishing the NDC scheme will result in a substantial reduction in the replacement rate between those born in 1959 and those born in 1960.** Such a dramatic adjustment in the benefits of a mandatory public pension scheme between those born in 1959 and those born in 1960 will clearly create substantial pressure for a benefit top-up for those younger cohorts. A number of good policy options have been suggested in the past.[20] One option would be to reduce the accrual rate under the defined benefit scheme for certain cohorts, such as those born after 1950. Yet changing the marginal accrual rates for such cohorts beginning perhaps in 2008 would have very limited impact on their overall replacement rate because most such individuals would already have worked and accrued rights at the old accrual rate.

42. A means of further reducing such benefits is to develop a sliding scale of retroactive reductions in the accrual rate for certain cohorts close to those born in 1960. In addition, to further smooth benefits, a top-up or supplementary benefit could be provided for select cohorts under the NDC scheme such as those born between 1960 and 1970. An alternative option suggested by Thompson (2003) would be that certain cohorts could also have benefits determined based on a combination of accruals under the old scheme and under the new

[20] In particular, see Laurence Thompson, *Analysis of Social Security Options*, 2003, Wiese and Cohen, op. cit. and IMF op. cit.

scheme.[21] More substantial reforms, such as the adoption of a points system for the defined-benefit scheme or the NDC scheme, would also address the transition problem, but at the risk of further undermining the credibility in the pension system so soon after the 1999 reform.

43. ***Inclusion of allowances in the wage base***. **The current practice of excluding some allowances from the wage base for pensions contributions and benefits has the effect of both reducing contributions and, more importantly, reducing effective the replacement of total pre-retirement income including allowances.** It also may result in substantially different effective replacement rates between retirees depending upon the ratio of allowances to covered wages. Thus the inclusion of all components of compensation in the calculation of contributions and benefits substantially improves benefit adequacy. However, such inclusion would increase the fiscal burden for the defined-benefit scheme and would increase the employer contributions the Government makes on behalf of its employees. This is a material change in the defined-benefit scheme that could increase the unfunded pension liability. In the medium-term, the Government could review the scope of compensation subject to contributions in conjunction with a similar review of the same for the purposes of treatment for corporate and personal income taxes.

44. ***Income Tax Treatment of Pension Benefits.*** The current practice of exempting from income taxes contributions and accumulations, as well as benefit distributions, is too generous. It creates a tax advantage that does little for creating positive incentives for compliance in the mandatory pension scheme, and results in forgone fiscal revenues. If contributions and accumulations are exempt, then distributions should be subject to personal income tax when received.

B. Social pensions and modifications to voluntary savings vehicles

45. **Given Mongolia's per capita income, the large size of its rural economy, large number of informal sector workers, and relatively high levels of economic volatility, it is unlikely that this mandatory pension scheme will achieve large increases in coverage in the near future.** International evidence shows strong correlation between per capita income and coverage by public pension schemes. Most workers in Mongolia are informal (60 percent) and most informal workers (92 percent) are low skilled self-employed workers in agriculture (mainly herders), who lost the universal 'right' to a pension in 1995.[22] The increased informality among salaried workers (19 percent in 2006) is partly explained by high social security taxes which induce firms to hire workers without contracts and overuse (and misuse) temporary contracts (World Bank 2007), which carry no social security benefits. So lowering contribution rates could increase coverage for some groups insofar as this is a binding constraint. But international experience suggests that these measures may still be insufficient to improve coverage significantly unless the benefits provided relative to the contributions made are also improved.

[21] Suppose that the marginal accrual rate of 1.5 percent/year was cut to 0.75 percent beginning in 2009. A 60 year old worker born in 1959 with 30 years of contributions would retire in 2019 with an entry replacement rate of 52.5 percent, assuming that the last 10 years accrued at the lower rate and no nominal wage growth. The same worker with 30 years of contributions born in 1960 is projected to have only a replacement rate of only about 28 percent. Similarly, if workers born before 1960 were to receive account accumulations under the NDC scheme beginning in 2008, then the impact on their replacement rate would also be modest and the transition between cohorts still abrupt.
[22] Informal workers are defined as those in low productivity jobs with no social security benefits. See World Bank (2007).

46. **Although the adoption of an NDC scheme in 1999 improved the inter-generational sustainability, equity and predictability of the PIF, the design did not accommodate the needs of herders, informal workers, and formal workers with insufficient lifetime contributions to support a pension.** There is considerable concern amongst the authorities over the limited coverage of the formal contributory schemes over these populations, yet limited options for improving such coverage have been explored. More generally, minimum subsistence by the elderly is almost entirely linked to 15 or 20 years of contributory work experience. Given the nature of the Mongolian economy, it is unlikely that the majority of workers can or will meet such a requirement for some years to come. As currently designed and implemented, the *Social Welfare Pension Benefit* only provides benefits for the very poor and is therefore inadequate as a basic support mechanism for the elderly in poverty**.**

47. **Two additional instruments could be used to increase the proportion of the elderly that has a formal source of old income support:**

(i) ***A voluntary NDC scheme with early withdrawal provisions****:* Measures could be taken to leverage the collection, account management and disbursement network of the SSIGO to accommodate a wider scope of the population currently not contributing to the mandatory pension system. This could be achieved by providing benefits similar to those under the NDC scheme to contributors and by establishing provisions for early withdrawal of accumulated funds in the case of severe hardship

(ii) ***A non-contributory, targeted and means-tested social pension*** could be designed in such a way as to supplement the contributory pension scheme, extend basic assistance to a wider scope of the elderly poor, and serve as an alternative to the current minimum pension guarantee.[23] The objective of a social pension would be to provide a minimum living subsistence (MLS) to the elderly, disabled and survivors. Selection of beneficiaries would not be based on self-reported income, as it is currently done, but rather on an proxy-means test, whereby potential beneficiaries would be 'tested' on a set of indicators that are highly correlated with the subject being above or below the poverty line (e.g. housing conditions, assets, education level etc.).[24] Such test was used during the targeted phase of the Child Money Program (CMP).

[23] It should be noted that the *social pension* concept presented here is similar to the *demogrant* suggested by Wiese and Cohen (2003) and Wiese (2006), although we are suggesting mean-testing

[24] The precise means-testing criteria, procedures and levels qualifying for benefits would require additional work.

Table 10: Entry Pension/Individual's Wage[25]

(Percent)

Years of Contributions	Ratio of Individual's Wage to Average Wage								
	50%			75%			100%	125%	150%
	Assuming life expectancy at retirement is 15 years								
	NDC	Social Pension	Total	NDC	Social Pension	Total			
15	17.5%	15.0%	32.5%	17.5%	10.0%	27.5%	17.5%	17.5%	17.5%
20	23.3%	15.0%	38.3%	23.3%	10.0%	33.3%	23.3%	23.3%	23.3%
25	29.1%	15.0%	44.1%	29.1%	10.0%	39.1%	29.1%	29.1%	29.1%
30	34.9%	15.0%	49.9%	34.9%	10.0%	44.9%	34.9%	34.9%	34.9%
35	40.8%	15.0%	55.8%	40.8%	10.0%	50.8%	40.8%	40.8%	40.8%
	Assuming life expectancy at retirement is 20 years								
	NDC	Social Pension	Total	NDC	Social Pension	Total			
15	13.8%	15.0%	28.8%	13.8%	10.0%	23.8%	13.8%	13.8%	13.8%
20	18.4%	15.0%	33.4%	18.4%	10.0%	28.4%	18.4%	18.4%	18.4%
25	23.0%	15.0%	38.0%	23.0%	10.0%	33.0%	23.0%	23.0%	23.0%
30	27.7%	15.0%	42.7%	27.7%	10.0%	37.7%	27.7%	27.7%	27.7%
35	32.3%	15.0%	47.3%	32.3%	10.0%	42.3%	32.3%	32.3%	32.3%

Assumptions: (1) notional interest rate = growth of the average wage; (2) pensions are indexed at the rate of inflation, (3) the notional interest rate is 2% greater than inflation, and (4) an actuarially fair annuity factor based on the notional interest rate is used to convert notional capital into pensions; because the notional interest rate is greater than the rate of pension indexation, the annuity factor is slightly smaller than life expectancy at retirement

48. **The cost of a social pension scheme depends on size, design and the efficiency of its delivery.**[26] Over time the cost of, for example, a social pension of 1.5 percent of GDP would be more than offset by the cost savings realized by replacing the minimum pension with such a social pension. It is also possible to realize additional benefits through the social pensions, such as improving the welfare of the children and grandchildren of social pensions' beneficiaries.

49. **Changes in the existing voluntary contributory pension scheme for herders and the self-employed can increase savings mobilization.** In particular, the enactment of provisions for the early withdrawal of partial savings accumulations to cope with risks such as droughts, loss of income, health, disability or death could make the voluntary savings scheme more attractive. In addition, contributors to the NDC mandatory notional accounts could also be enticed to contribute additional savings, also with the incentive of early withdrawal under specified conditions. The notional interest rate (average 3-year growth in covered wages) on these savings would be attractive provided individuals are confident they can have access to their funds quickly and efficiently. Additional efforts would also be needed to ensure prompt, accurate and accountable disclosure of account information and efficient processing of withdrawal requests.

[25] Source: Wiese (2006), op. cit.

[26] Wiese and Cohen estimated the cost of a demogrant equal to 12.5 percent of the average gross wage to rise from 0.02 percent of GDP in the first year to 1.55 percent of GDP in 50 years, assuming that coverage rates remain low. If coverage rates in the contributory scheme increase (thus pre-funding more of the benefit) then the cost could be reduced. See Wiese and Cohen, op. cit., p. 6.

C. Governance and institutional reform

50. **Given the importance of data and financial administration systems for the functioning and credibility of social insurance, a thorough review is needed of the institutional framework for the SSIGO, aimags and local offices**. Governance structures and incentives are essential to each part of the provision of pensions and social security including collections, compliance monitoring, account management, investment management, annuitization and disbursement. An essential element of ensuring proper functioning and credibility of pension systems is therefore ensuring that strong incentives for governance exist for each part of the process. This includes proper accountability, information disclosure and oversight for the institutions responsible for each stage of the process.

51. **If the SSIGO is to manage investments in the future, then there will be substantial requirements for investment management infrastructure and improvements in the governance structure**. In particular, there needs to be a publicly disclosed investment policy replete with an investment strategy, strategic and tactical asset allocation guidelines, and accountability mechanisms for investment managers. In the case of holdings of treasury securities, special guidelines are needed in order to ensure proper market incentives. The authorities' earlier commitment to partial funding of the NDC accounts has created unclear incentives for SSIGO staff which should be remedied. If there are to be funded defined-contribution accounts, then the policy framework should be clear.[27]

52. **An essential part of ensuring the fairness of benefits under the NDC scheme is to have accurate data on life expectancy at retirement for those cohort members seeking a benefit.** Although this has not been at issue to date because NDC retirees have not yet come on stream, in a few years this will be an important issue. In anticipation of retirement from the NDC scheme, institutional capacity needs to be further developed so that credible mortality data can be produced and longevity monitored.

53. **Substantial improvements in efficiency and compliance are possible by improving coordination between the social insurance and tax authorities and, possibly in the medium-term, unifying the collections functions between the two**. Coordination could include information exchange about payment declarations to the two agencies and thus create a lever for scrutinizing over-reporting to the SSIGO and underreporting to the GDNT.

54. **A thorough assessment is needed in to ensure that the central and local information systems are sufficiently operable to adequately support the SSIGO functions of financial and account management.** All pensions and social security systems require information systems that can accurately track work histories, wages and contributions. Defined-contribution schemes (funded or notional) also must have the ability to accurately track individual account accumulations, whether real or notional. We do not have a good idea as to how well the current administrative and information systems are functioning or whether institutional improvements or even redesign is necessary in order to ensure that the promised benefit provision in the proposal can be provided efficiently.

[27] A MOLSW policy proposal which we reviewed in June also suggested a gradual transition from notional to funded defined-contribution accounts. We don't support this approach but instead suggest that the policy framework be specified at the outset.

55. **Additional institutional strengthening is also needed,** including: public disclosure of the operating costs of the SSIGO, establishment of service standards and monitoring indicators to ensure that the SSIGO is responsive to contributors and beneficiaries, and the establishment of stronger dispute resolution procedures for workers or retirees in an effort to ensure that members' needs are acted upon in a fair and judicious manner. These measures will aid in improving accountability and public credibility.

IV. Conclusions and recommendations

56. **This policy note identifies a number of challenges in the design and implementation of the current social insurance system** that would need to be addressed to strengthen the system's ability to provide consumption smoothing and old-age income security for Mongolia's population. To address these challenges, this note first recommends that the Government reviews more broadly the societal objectives of the combined public and private pension and social security system be to provide: (i) a minimum living subsistence to the elderly, permanently disabled and survivor/dependents; and (ii) mandatory consumption smoothing for most formal sector workers and voluntary contractual savings for informal sector workers.

57. **A possible architecture for a public pension system is then proposed to strengthen fiscal sustainability, affordability, predictability and equity of benefits.** The suggested proposal involves largely retaining the design characteristics of the current system but modifying provisions for retirement age, benefit indexation, minimum pension provisions, the wage base for determining benefits, as well as the formulation and financing of the disability benefit. The proposed architecture also includes a proxy means-tested social pension, which would provide for minimal subsistence for the elderly poor and could replace the current minimum pension guarantee. And the voluntary pension provisions of the PIF need to be strengthened to increase voluntary savings for retirement.

58. **A number of measures are recommended to improve the institutional framework for pensions.** These include: (i) a thorough review of the institutional framework for the SSIGO, airmags and local offices; (ii) a similar review of the central and local information systems supporting SSIGO functions of financial and account management; (iii) development of improved disclosure methods and recourse for dispute resolution in order to improve accountability and public credibility; (iv) establishment of an investment management infrastructure and governance framework; (v) compilation and projections of more accurate data on mortality and life expectancy to support annuitized benefits; and (vi) improved coordination between the social insurance and tax authorities and, possibly in the medium-term unification of functions between the two agencies.

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Appendix 1: Mandatory pension parameters[28]

	Defined-Benefit Scheme (pre-1960 Cohorts)	NDC Scheme (post 1959 cohorts)
Old Age Insurance	**Law on Social Insurance and Law on Pensions and Benefits Provided by the Fund of Social Insurance 1994** (as amended)	**Individual Pension Insurance Contribution Accounts Law of 1999**
Applicability		All contract employees born after January 1, 1960.
Contribution Rate	19% of wages (13.5% employer and 5.5% employee)	19% of wages(13.5% employer and 5.5% employee)
Minimum Wage subject to Contributions	National Minimum Wage (revised periodically)	National Minimum Wage (revised periodically)
Maximum Covered Wage	none	None
Benefits - Accrual rate	2.25%/year for the first 20 years of eligible service and 1.5%/year for each year of eligible service after that.	Based on Notional Account balance for 15% contribution rate for years of contributions, accrued notional returns for each year (average growth in the last three years' average wages), and average life expectancy factor.
Wage base for benefit determination	Best 5 years' consecutive wages out of the final 20 years wages reported.	Not applicable.
Minimum Pension	75% of the minimum wage.	20 percent of the national average wage, plus an additional 0.5 percent of the average wage for each additional service year beyond the minimum of 15 years
Indexation	In practice, pension increases are determined by Parliament on an ad-hoc basis, although the law states that pensions should be increased in "relation to changes in the cost of living".	"in direct relation to the inflation rate" The pension adjustment index and the procedure for its application shall be determined by the National Statistical Office based on the suggestion of the Social Insurance National Council.
Taxation of benefits	Tax exempt	Tax exempt
Qualifying Conditions		
Vesting Requirements	• 20 years	• 15 years of service and contributions
Retirement Age	• 60 for men and 55 for women not subject to special early retirement rules. • 55 for men with 20 years of service, 12 of which in hazardous conditions. • 50 for women with 20 years of service, 10 of which in hazardous conditions. • 50 for men with 20 years of service, 10 of which underground or in high heat. • 45 for women with 20 years of service, 7 of which underground or high heat. • 50 for women who have brought up 4 or children.	same
Invalidity/Disability		
Enabling Legislation	Law On Pensions & Benefits Provided By The Social Insurance Fund Enforced on 1/1/1995, Amended in 1995, 1996,1997 and 1999	Law On Individual Pension Insurance Contribution Account. Effective 7/1/1999
Contributions	Contained within the combined 19% contribution rate.	Contributions for invalidity, survivorship, minimum pension guarantees and administrative costs all contained in 4% contribution.
Benefit Formula	DP = W* Percentage of capacity loss(I) DP = W* Percentage of capacity loss(II) DP = Disability pension W = Insured person's monthly average wage	Note: This law is not applicable to injury related benefits.

[28] This table has been reprinted from Louse Fox, *Cash Transfers and Social Protection Programs, 2002.*

	PCL(I) = 10% (up to 10 per cent) PCL(II) = Percentages over 10 per cent	
Formula	Total invalidity = same formula as retirement Partial Invalidity = (retirement formula)* percentage of loss of capacity for work	Total invalidity = W*60% Partial invalidity = (W*.6) * (percentage of loss of capacity for work) W = monthly average wage in the last three years,
Length of pension	From the date of commencing invalidity and ending with the day of rehabilitation, or with the following month in which the beneficiary dies	Same as under the Current Law
Minimum pension	Same as the minimum retirement pension	Same as the minimum retirement pension provided from Individual Account
Qualification	Not less than 50 per cent loss of capacity for work permanently, or for a long duration due non-occupational disease or injury	Same
Classification of invalidity	Total invalidity (70% and more loss of working capacity) and partial invalidity (from 50 to70%)	Same
Minimum length of service for qualification	Not less than 20 years insured service, or three years out of five, immediately preceding the date of commencement of invalidity	Same
Incomplete service (minimum 3 years)	Disability benefit is reduced proportionally to the period of pension insurance, but its minimum is equal to minimum reduced retirement pension	Not allowed
Minimum pension	Not less than 75 per cent of the wage in case of working capacity loss over 30% and more	
Length of pension	From the date of commencing disability and ending with the day of rehabilitation, or with the following month in which the beneficiary dies	
Qualifying service	While discharging employment duties at work place or other places; before the commencement of the general working hours or after the general finishing time in the course of arranging the work place & equipment; travel to or from an insured person's place of work	
Certification	Determined by Medical Labor Accredited Commission, whether cases are relevant to employment injury determined by Employer's Investigating & Registering Commissions.	Same
Dependent's/Survivorship Pension		
Applicable Legislation	Law on Benefits Provided By The Fund Of Social Insurance Against Employment Injury & Occupational Diseases. Enforced on 1/1/1995, Amended in January 2000	Law On Individual Pension Insurance Contribution Account Effective 7/1/1999
Benefit formula	Same benefit formula as old age retirement; Survivors receive pension in proportion to certain percentages depending upon the number of survivors: for three or more -100%, two - 75% and one - 50%.	40% monthly average wage in the last three years for one dependent increased by 10% per each member over two and more. But pension should not exceed 60% monthly average wage
Eligibility	Family dependents determined as survivors under the Law On Pensions & Benefits Provided By The Social Insurance Fund	
Length of pension	Same as survivor's pension under the Law On Pensions & Benefits Provided By The Social Insurance Fund	
Credit for period of invalidity pension	Pension increased by 1 per cent pension amount for each year of total invalidity, if the deceased was on the receipt of invalidity pension	No credit
Minimum pension	50% minimum wage for one dependent, 75% for two dependents and 100% for three dependents; reduced pension should not be less than 50% same wage.	Same as the minimum retirement pension provided from Individual Account
Length of service	Not less than 20 years insured service, or three years out of five, immediately preceding the date of breadwinner's death due to non-occupational disease or accident.	Same
Incomplete service (minimum 5 years; continuous in last year)	Pension is reduced proportionally to the period of pension insurance.	Not allowed
Eligible survivors	Born or adopted children under 16, if student children to age 19;	Same

	grandchildren, brothers and sisters under 16 without caregivers; grandchildren, brothers and sisters disabled or got disabled prior attaining age 16; parents over retirement age or disabled parents, spouse or grandparents, brothers and sisters without caregivers; any of parents or spouse not working and caring for children under 8, or grandchildren and younger brothers and sisters, also family dependents of the deceased who was on receipt of retirement or invalidity pension and who totally lost capacity for work in months preceding the death; step-parents; step-children not receiving alimony from their own parents; family dependents of the disappeared;	
Length of pension	From the date of death up to the day on which surviving children attain age 16, if student children to age 19, incapacitated persons for period of loss of working capacities, survivors who have attained the pension age up to the end of the following month in which the insured breadwinner's dies	Same
Social Assistance Pension		
Enabling Legislation	Law On Pensions & Benefits Provided By The Social Assistance Fund, 7/1/1996	Social Welfare Law, enforced on 1/1/1999
Pension Rate	Minimum living level for a given period	Same
Eligibility	▪ Men aged 60, women aged 55 whose income is less than the minimum subsistence level; ▪ persons suffering from total invalidity, born incapacitated or become incapacitated prior to age to 16, ▪ family dependents on death of the breadwinner, ▪ blind, dumb, deaf persons and dwarves; totally disabled in prosecution of civilian duties such as saving human lives, or in the fight with natural calamities, ▪ family dependents of those who died in prosecution of duties described above, ▪ single mothers aged 45 (father aged 50) whose income is less than the minimum subsistence level and who have 4 and more children	Persons ineligible for social insurance pensions such as: men of 60, women of 55 unable to make living on his/or her own, without children and relatives to maintain them, or if legal caregivers are elderly or disabled who are unable to support them; and the ultra poor; disabled persons who have lost 70 per cent working capacity; born incapacitated over age 16, or become incapacitated prior to age to 16 due to loss of more than 50 per cent working capacity; family dependents on death of the breadwinner; blind, dumb, deaf persons and dwarves; disabled in prosecution of civilian duties such as saving human lives, working in extremely dangerous infectious foci or in the fight with natural calamities; and their family dependents in case of death; extremely poor single mothers of age 45 and more, fathers of age 50.
Indexation of benefits	In relation to the movements in the minimum living level	Same

Source: State Social Insurance General Office, Social Insurance Legislation, 2001, in Louise Fox, Cash Transfers and Social Protection Programs.

Mark Dorfman
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