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Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance

Background Paper
Macedonia Country Study

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Acronyms and Abbreviations

FYR	Former Yugoslav Republic
IEG	Independent Evaluation Group (formerly Operations Evaluation Department)
IMF	International Monetary Fund
NDC	Notional Defined Contribution
OED	Operations Evaluation Department (changed its name to IEG in December 2005)
PAYG	Pay-As-You-Go
SDR	Special Drawing Rights
USAID	United States Agency for International Development

Contents

Preface i

1. Evaluation Objectives and Methodology 1

2. Background 2
Pension System Prior to Reforms 2
Macroeconomic Scenario 2
Social Protection Scenario 4
A Two-Stage Reform Process 6
Earlier Interventions 7
Reforms in 2000–02 8

3. World Bank Assistance in the 1990s 13
Genesis of Bank Involvement 13
Description of Bank Assistance 16

4. Assessment of Development Impact 19
Outcomes 19
Relevance 19
Efficacy 21
Overall Outcome Evaluation 23
Institutional Development Impact 23
Sustainability 24

5. Results 27

6. Lessons Learned and an Agenda for Future Action 29

Appendix A: Bank Assistance Instruments for Macedonian Pension Reform 31

Appendix B: FYR Macedonia Statistical Summary 35

Appendix C: Interviews 37

References 39

Tables

4.1 Evaluation of Relevance 21
4.2 Evaluation of Efficacy 23
4.3 Overall Evaluation of Outcome 23
4.4 Overall Evaluation of Institutional Development Impact 24
4.5 Evaluation of Sustainability 26
5.1 Evaluation of Bank Performance. 27
5.2 Evaluation of Borrow Performance 28

Preface

This paper belongs to series of 19 country and regional case studies commissioned as background research for the World Bank's Independent Evaluation Group (IEG) report "Pension Reform and the Development of Pension Systems." The findings are based on consultant missions to the country or region, interviews with government, Bank, donor, and private sector representatives involved in the pension reform, and analysis of relevant Bank and external documents.

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1. Evaluation Objectives and Methodology

1.1 The goal of this report is to provide an external, independent evaluation of the role of the World Bank in promoting and supporting the pension reform process in the Former Yugoslav Republic (FYR) of Macedonia since the country's independence in 1991.

1.2 To perform our task, we based our analysis on both factual and qualitative assessment. In terms of the factual analysis, we considered the following:

- Overall design of the pension system in a steady state;
- Timing, costs, and features of the planned transition to the new regime;
- The degree to which the reform was needed, as well as the priority given to it relative to other reforms; and
- Efforts made by the Bank to adapt its approach to the specific characteristics and circumstances of the country.

1.3 For the qualitative assessment, we considered the following:

- The degree of transparency of the reform process;
- The degree of "ownership" of the reform by the Macedonian government; and
- Support from the Bank to develop the direct and indirect means to sustain the reform and to evaluate its performance (for example, developing an administrative and computer system, organizing the various institutions involved in the process, etc.).

1.4 In conducting our evaluation, we drew from three main sources: documents provided by the Bank (see references), interviews with representatives of various relevant institutions and organizations (see appendix C), working papers and journals articles.

1.5 The structure of this report follows a format suggested by the Bank, which we agreed was useful. Changes were made to the format wherever we thought it was necessary. The report starts with a brief presentation of the situation of the Macedonian pension system in the 1990s—before Bank involvement and before major reform attempts—followed by a description of the evolution of Bank assistance to the reform process and an assessment of the impact of Bank assistance. It concludes with an attribution of the results.

1.6 The final section discusses the lessons to be learned from the Macedonian experience in pension reform and from the Bank's involvement in the process, ending with an agenda for future action. Finally, the appendices include a listing of the Bank assistance instruments that were used, a statistical table for FYR Macedonia, and the names and positions of the individuals interviewed in connection with this evaluation.

2. Background

PENSION SYSTEM PRIOR TO REFORMS

Macroeconomic Scenario

2.1 In September 1991, the Republic of Macedonia achieved independence from the Yugoslav Federation. This historical change, however, did not immediately offer new prospects for progress and growth. Instead, a very difficult period followed, in both the economic and political arenas.

2.2 From an economic point of view, the collapse of Yugoslavia—in which FYR Macedonia was the least developed republic—meant the end of transfer payments from the central government and a sharp setback because the new country's trade flows, which had been directed towards a shrinking Yugoslav market, were now treated as exports rather than domestic production. Moreover, the Greek economic embargo—a consequence of a dispute about the country's constitutional name and flag—impeded economic growth at least until 1996. These events forced Macedonian companies to rely on a consumer market that was less than one-tenth the size of the previous one and much poorer. Many companies were unable to continue production, which contributed to a marked decline in GDP. The reduction was more pronounced for manufacturing, whose GDP share decreased, relative to services and, to a lesser extent, relative to agriculture. Despite the drop in economic activity, inflation soared, reaching 126.6 percent in 1994, while unemployment peaked at 38.8 percent in 1996. A phase of mild recovery followed but it was overshadowed by the country's political instability.

2.3 From a political perspective, independence coincided with the beginning of a period of institutional fragility and internal tensions, which culminated in the ethnic Albanian insurrection in 2001. Thanks to international intervention and surveillance, the conflict was kept under control, but the profound religious, ethnic, and social tensions that led to it are far from being solved.

2.4 This unhappy political development (10 years after independence) caused a sharp reduction in investment and trade (made worse by the intermittent closure of borders), an increase in public expenditures on security, and a general environment of uncertainty. A new, deep recession hit the country and caused a 4.5 percent contraction in GDP in 2001. The economic agenda included reforms, free trade, and regional integration. Growth hardly recovered at all in 2002, by only a tiny 0.3 percent, then rose to a more promising 2.8 percent in 2003. Unemployment—still at one-third of the workforce—remains perhaps the most critical economic problem.

2.5 Despite these difficulties, FYR Macedonia tried to move toward a market economy and, with the support of international institutions, starting a wide range of economic and institutional reforms aimed at achieving the double objectives of economic stabilization and structural adjustment.

2.6 A first stabilization plan was implemented as early as 1992, and was based on stricter fiscal and monetary policies, the adoption of a fixed exchange rate for the new currency (which had been pegged after an initial depreciation), and on a price freeze and a public-sector wage freeze. The plan was effective in stopping hyperinflation but was jeopardized by deficiencies in the control of the banking system (which over-expanded credit due to a scarce selection of enterprises and projects), by political pressures against the tight wage policies, and, finally, by increasing social security expenditures.

2.7 A second plan was introduced in 1994 in cooperation with the International Monetary Fund (IMF) and was successfully implemented within the same year. Apart from reestablishing the commitment to a strict fiscal policy and to wage and price controls as anti-inflationary measures, the plan relied heavily on the introduction of a market mechanism for credit allocation as well as credit ceilings.

2.8 As for structural adjustment, a program was drawn up with the support of the Bank to complement the 1994 stabilization plan, in an attempt to accelerate economic development through the establishment of conditions more favorable to the creation of firms and jobs.

2.9 In the view of both domestic and international institutions involved in the transition process, these programs were seen as a necessary first step in the emergency situation of the initial post-independence phase. Unfortunately, more emergencies were to unfold—and ones no less troubling—further delaying stabilization and recovery in the country. In 2001, before a collapse in the GDP, real per capita income had not yet regained its 1991 level.

2.10 In early 2004, after two years of relative calm, the Macedonian economy has somewhat stabilized but is still characterized by *profound structural weaknesses*. Production continues to rely heavily on agriculture (still accounting for about 12 percent of GDP), while the rather traditional manufacturing sector has not yet recovered from the sharp contraction (from 45 to 32 percent of GDP) since independence. The expansion of services as well as relevant government agencies that provide those services has not been sufficient in offsetting the gap.

2.11 The manufacturing sector consists of few large companies—a relic of the former Yugoslav Federation—characterized by low productivity and widespread inefficiencies, partly due to an ill-conceived privatization process—which simply handed over the companies to their employees, without any serious analysis of the viability of such a strategy—and, in particular, of management and incentive issues. Beside these companies, a number of small private firms have recently been established. Both domestic and foreign investment are very low, a consequence of political uncertainty (among other reasons). On the whole, the formal private sector is still a long way from being the dynamic backbone of the economy, which would consist of many efficient small and medium-size firms. However, without sustained and regular growth, it will be impossible to generate adequate demand for labor to substantially reduce (mostly long-term) unemployment. Given these conditions, it is only natural that people try to alleviate widespread and deep poverty, particularly in rural areas, by turning to the

informal sector, which gives some help to household budgets but hardly any help to public finances.

2.12 This unpromising macroeconomic scenario is complemented by the unpromising demographic of an aging population (common in Eastern Europe), owing to a sharp decrease in the fertility rate and to an increase in life expectancy. (Indeed, uncharacteristic of Eastern European countries, life expectancy in FYR Macedonia did not decline in the years immediately following independence.)

2.13 Given this outlook, the country's hopes for significant economic improvement rest mainly on attaining European Union membership.[1] This is more difficult for FYR Macedonia, however, than for other transition economies because of its highly disadvantageous initial conditions and greater political instability.

Social Protection Scenario

2.14 The economic and political difficulties of FYR Macedonia's transition period had great impact on the level of demand for social protection. The demand increased dramatically because of the Balkan crisis, in general, and of the Kosovo crisis, in particular, causing the inflow of large numbers of refugees.

2.15 In order to effectively measure poverty and assess the basic needs of the population (given the complete lack of local statistics), the 1999 poverty assessment carried out by the Bank identified three different groups of poor people:

(i) The traditional poor, represented by large agricultural households with many children and a very low level of education of household heads;

(ii) The new poor, that is, the unemployed and other recipients of transfers, which are typically urban households. The new poor have emerged as the segment of population with the highest incidence of poverty, surpassing in absolute numbers those of the first group;

(iii) The chronic poor are mainly non-pensioners who are elderly, disabled, do not have a family upon which to rely, or are members of a farm household with no fixed income.

2.16 According to data provided by the Central Statistical Office during our visit to FYR Macedonia, 22.7 percent of households were below the poverty line (70 percent of median equivalent income) in 2001. Common characteristics of the poor are: unemployment or lack of labor force participation, the absence of assets, low educational levels, precarious living conditions, and, very often, poor health status. Social programs include a public health care system, a public education

[1] The application was due on February 26, 2004, in Dublin. The tragic death of the president of the republic, on the very same day, prevented the ceremony from taking place. Macedonia is the only country of the former Yugoslav Federation that has an Association and Stabilization Agreement already recognized by all European Union members. Accession, however, is not to be taken for granted, given the precariousness of the political and economic stability.

system, and a system of cash transfers, including a pay-as-you-go (PAYG) pension scheme (by far, the main component), means-tested child allowances, unemployment benefits, and means-tested social assistance. Taken together, these systems account for a very high proportion of the public budget (see World Bank 1998c, tables 37 and 38).

2.17 In this situation, the challenge was twice as great. On one hand, a more efficient system of transfers was needed to conserve resources. On the other hand, the country had to avoid becoming economically dependent on (international) transfers, that is, it needed a chance at real growth.

2.18 Among welfare programs, the largest expenditure is for the pension system. The scheme is managed by the Pension and Disability Fund and is a compulsory, comprehensive, PAYG system, which has been in operation for more than 50 years. The system offers pensions for old age, survivorship, and disability, and is highly redistributive (based on a defined-benefit formula) and includes both a minimum and a maximum pension level.

2.19 Before the reforms, the pension payroll tax rate was at 18 percent. Benefits, however, were loosely connected to contributions paid, and no account was taken of actuarial factors. In this respect, although the level of benefits was very low in fact, in principle, they were overly generous because the benefit was computed according to the best 10 consecutive years of work.[2] The full-service replacement rate, corresponding to 35 years of seniority for women and 40 for men, was 85 percent, and the official retirement age was 55 for women and 60 for men. Early retirement, however, was quite common. Various privileges were provided for police and military personnel.

2.20 Although the number of pensioners (about 180,000) was manageable with respect to the number of workers (about 537,000) at the time of independence, the role of the pension system as a shock absorber during the economic crisis that followed changed the picture considerably. Early retirement, in particular, became an easy way to accommodate the large-scale layoffs undertaken during the early transition period. Consequently, the total number of pensioners grew very rapidly to more than 210,000 in 1993. This solution was generally effective, in the short term, preventing many elderly people from falling into extreme poverty and, indeed, even improving their relative position compared to current workers;[3] but it came at a high fiscal cost. As shown by one indicator, the deficit of the Pension and Disability Fund went from one percent of revenues in 1991, to 20.3 percent in 1993.

2.21 The premature entrance of workers into the pension system was not, however, the only problem. Many young workers became unemployed and many

[2] The earnings-based pension formula was of the general type, P=KW, where the "pension base" W is the average of the contributor's monthly wages during a specified reference period, and K is a function of seniority and gender. Wages entering the calculation of the pension base are usually subject to some form of indexation. The full service level of K is the maximum achievable fraction of the pension base.

[3] Although the real average pension benefit fell by 9 percent in the period 1991–93, it rose with respect to the average net wage: in 1991 the ratio was 1.07, in 1993 it was 1.21.

new entrants into the labor force could not find jobs, which caused the number of contributors to shrink. Within a few years, the ratio of workers to pensioners went from 3.19 in 1990 to 1.53 in 1996. If one adds to this development the fact that, in the absence of a proper indexation mechanism, the high inflation rate in the early transition years resulted in a great erosion of taxable revenues, the conclusion that the system had to be reformed was unavoidable (although probably it was the economy, rather than just the pension system, which could not be maintained on that path).

2.22 The country was confronted with both the weaknesses of its pension system as well as the need for a better-designed system to provide for future economic development. The scheme at the time seemed much more a mechanism for transfer payments than a properly designed insurance program. It was also inefficient in addressing its social goals, since instead of allowing for a positive discrimination in favor of the poor, it granted various kinds of privileges, as mentioned earlier, to public employees and military personnel. It also provided households and firms with a "wrong" incentive structure and imposed a large tax burden on current workers and, even more so, on future generations.

2.23 The determination that the system was inconsistent with the workings of a modern market economy was neither externally imposed nor only a qualitative judgement. Quite the contrary, although the assessment of consultants counted for much (see, for example, World Bank 1994b and 1995a), this determination relied to a great extent on data provided by the Pension and Disability Fund. In particular, actuarial simulations provided by the newly established "simulation unit" (which had developed a member-based macro-simulation model) showed that a contribution rate of 35 percent would have been needed in 2004, to meet expenditures in a scenario with an increase in the effective retirement age—to 61 for men and 58 for women—as the only reform measure. Long-run projections indicated that, with population aging and without other reforms, the equilibrium payroll tax rate would rise to more than 70 percent. These data clearly indicated that reforming the system was a real priority.

A Two-Stage Reform Process

2.24 As in many other transition economies (see Gillion and others 2000, p. 561), the reform process was initially characterized by a short-term approach directed at fixing the major flaws of the public system and consolidating its finances. These parametric measures were indeed successful in reducing expenditures on old-age and disability pensions, improving the regularity of pension payments and the collection of contributions.

2.25 In a second phase, the reform took a long-term, structural approach, directed at changing the basic design of the welfare system as a whole and at enhancing its contribution to economic development. In this phase, the Bank had a conspicuous role.

Earlier Interventions

2.26 The first comprehensive reform of the PAYG system was approved in 1994, with the goals of (i) reducing the system's financial imbalance; (ii) abolishing the previous privileges; and (iii) strengthening the link, on an individual basis, between contributions and benefits. The payroll tax rate was raised to 20 percent from the previous 18 percent. Eligibility requirements were tightened: retirement ages were increased by six months per year (starting from January 1994) to 63 for men and 60 for women; the years of contributions necessary to obtain the benefit were raised to 20 (with the exception of 63-year-old women, for whom the minimum was fixed at 15 years).

2.27 The level of benefits was directly reduced: the full-service replacement rate was cut from 85 to 80 percent of the pension base; the indexation of benefits was also restricted, from the wage to the price index; and the levels of both minimum and maximum pensions were lowered.

2.28 The reform also attacked privileges. First, early retirement schemes and special eligibility rules were abolished. Second, the earnings used for calculating the pension base for police and military personnel changed from the highest annual earnings to the average of the highest 10 years.

2.29 As for the objective of having a closer link between contributions and pensions, a new pension formula was introduced, which computed the pension base by taking into account the individual's whole working career, instead of considering only the highest wages. In particular, the earnings profiles were reconstructed up to January 1, 1970 (with the previously mentioned exceptions for police and military personnel). This measure reduced the perverse redistribution that normally arises when only the best segment of the profile is taken into account. It also contributed to the sustainability of the system because of the resulting lower levels of expenditures. This change should not be underrated. In fact, it needs to be noted that when the whole earnings profile is taken into consideration in a defined-benefit formula, the resulting pension level may be quite similar to the one obtained, for the same working career, from a (notional) defined-contribution formula, provided that adequate indexation is applied for past wages and proper accrual is attributed for each service year (see Disney 1999).[4]

2.30 From this viewpoint, the relative efficacy of FYR Macedonia's past bureaucratic organization can be appraised. Indeed, the lengthening of the reference period in determining the pension base was particularly compatible with the Pension and Disability Fund's computer system, which could fully track an individual's career up until 1970. The difficult problem—not uncommon in Eastern European countries—of assigning an (inevitably arbitrary) "initial capital" to each worker could thus be avoided.

[4] We have not been able to precisely ascertain the kind of indexation that is actually applied to wages entering the pension calculation. An important difference still remains, however, with respect to notional defined contributions (NDC) because no flexibility of retirement age is allowed, while NDC systems may provide it on the basis of an actuarially fair mechanism.

2.31 The establishment of an actuarial unit within the Pension and Disability Fund, specifically for supplying background data and projections needed for policy analysis and reform implementation, was further evidence of a reform-minded attitude, as were measures aimed at improving the overall efficiency of the scheme (financial management, contributions collection, and transfer payments).

2.32 On the whole, these parametric reforms were quite courageous, particularly in the sense of redirecting the pension system toward its insurance role, improving its financial sustainability while maintaining it strictly in the public sector. The price of these restrictions was a weakening of its scope as a social protection device, which was meant to alleviate poverty in the first instance. To fill the resulting gap, a program for social protection was prepared in 1996 with the help of the Bank, on the basis of a new study on poverty, carried out in accordance with generally accepted international concepts and standards. In the new program, social benefits are means tested and calibrated to discourage "rent-seeking" behavior and provide appropriate incentives instead, along with economic support. The poor could thus be more effectively targeted and the level of expenditure somewhat reduced by increasing efficiency in a situation where the two programs are combined.

Reforms in 2000–02

2.33 In 1998, FYR Macedonia abandoned the path of parametric reform to embrace a more structural intervention. The Pension Steering Committee was created within the Ministry of Labor and Social Policy. The committee was composed of members from that ministry, the Ministry of Finances, the Pension and Disability Insurance Fund, the central bank, and the Securities and Exchange Commission. The Pension Steering Committee, which was technically supported by the actuarial unit created within the pension fund, acted in strict cooperation with World Bank officials.

2.34 The committee ended its work in July 1999 and presented a reform proposal supporting two main pieces of legislation: the first was the so-called *Framework Law*, approved by Parliament in March 2000; the second, the *Law on Mandatory Fully Funded Pension Insurance* was approved in April 2002.

2.35 The new laws completely endorsed the multi-pillar conceptual framework. The plan for the new system had the following:

- (i) A first pillar, reflecting a generational compact and consisting of a further modified version of the existing public, PAYG scheme; it was also meant to convey a certain amount of inter-generational dependence and kinship through the establishment of floors and ceilings and the disability scheme.
- (ii) A second, mandatory, fully funded pillar to be financed out of the overall payroll tax rate.
- (iii) A third pillar made up of voluntary private pensions and financed by personal savings.

2.36 The essential steps needed for this construction were:

(i) Further parametric changes in the PAYG component to enhance its solvency.

(ii) Further corroboration of the insurance principle—already established in 1994 through the lengthening of the reference period for calculating the pension base—by which the benefit level is determined by the flows of contributions during the individual's whole working career.

(iii) The setting up of a funded component, financed through a partial diversion of the public payroll tax rate. An important step in this direction was the creation and implementation of a supervisory authority for pension funds—the Agency for Supervision of the Mandatory Fully Funded Pension Insurance.

2.37 For the first step, it was established that retirement would be based only on age conditional upon at least 15 years of seniority, which was to be increased by six months per year up until age 64 for men and 62 for women. Transitional rules allowed elder members to retire (specifically, contributors who by September 2000 had at least 35 years (men) and 30 years (women) of service), irrespective of age after reaching 40 years (men) and 35 years (women) of seniority. This measure was, of course, meant to recognize the "acquired rights" of the older generations, who had started working very early in life. Replacement ratios for a full working career were not further reduced, while the indexation of benefits was set at 80 percent of the inflation rate plus 20 percent of the (net) wage increase, thus accommodating a small allowance for productivity growth.

2.38 The second step was a reinforcement of the 1994 commitment to distinguish insurance from redistribution and to give a more solid economic base to the pension system.

2.39 The more structural feature of the 2000 reform was the third step, that is, the provision of a compulsory funded pillar, financed out of a partial diversion of the payroll tax rate already targeted for the first pillar. According to law, workers covered under the new system had to pay a payroll tax of 13 percent to the PAYG component and seven percent to the second pillar, which was to be directly credited to the worker's individual account. Official projections calculate that the retiree will obtain, upon retirement, a replacement ratio of about 30 percent from the PAYG scheme, which implies a cut of up to 50 percentage points of the ratio previously promised (80 percent for a full career). In addition, the retiree will enjoy a pension generated by converting the funds accumulated in the second pillar into an annuity. Under the assumption of a real annual rate of return from financial markets at two percentage points higher than the growth rate of the wage bill, replacement ratios from the second pillar should be in the range of 40–50 percent, so that the original ratios of 70 – 80 percent would not be lost, but acquired instead by way of the mixed system.

2.40 The rationale is that, although nothing would really change from an individual point of view, from a macroeconomic perspective the adoption of a mixed system would mean that future pension promises will not be built by piling on new debt, and furthermore, a partial redemption of the previous implicit debt would be attained. Of course, the conditions required for this objective to be met in the future are quite demanding. One should perhaps only mention the transition burden and the difficulties of achieving a rate of return permanently two points

higher than the growth rate. It is not only that the country has a very thin financial market of its own, which could be overcome by investing in international portfolios; it is that the population has scarce knowledge of even basic financial concepts, and great uncertainty and institutional fragility still characterizes the country.

2.41 It is our view that the challenge was accepted, without proper preparation, as mild "medicine" that would cure many illnesses. It was a mix of illusion and technical assessment, without the "cultural" component.

2.42 According to our interviews, the rationale for the particular choice of the payroll tax rate allocation (13 percent to the PAYG pillar and seven percent to the funded pillar) came from a simulation exercise, which provided a variety of replacement ratios given different levels of financial returns and different levels of payroll tax rates diverted to the funded pillar. In fact, there are no limits to what capitalization can provide, even with a relatively low level of contributions, given sufficiently high interest rates and long accumulation periods. Not that the choice was taken without mitigating the numbers' optimism with an application of "good common sense." On the contrary, it resulted from successive adjustments to the 50/50 composition, adopted as some kind of benchmark. It was calculated that diverting half of the payroll tax rate to the second pillar would have been inconsistent with the basic philosophy of the new design, given that a rate of 10 percent would have been practically absorbed by disability benefits, leaving old-age pensions to be entirely financed out of the funded component. It was thus judged that the chosen combination looked "more reasonable" in terms of the composition of pension wealth and assumed capital market returns. The impression is, however, that despite the rather good technical basis of the discussion, the conceptual framework had not been completely grasped, perhaps veiled by an excessive optimism in the financial markets.

2.43 Under other macroeconomic scenarios, the PAYG component would achieve a steady surplus of 1.1–1.3 percent of the GDP in the long run. Assuming a GDP real growth rate of three percent and a real rate of return of five percent, the flows of contributions to the second pillar would reach 2.5 percent of GDP annually, and the stock of funds would reach a steady 100 percent of GDP in the long run (see bulletin of the FYR Macedonia Ministry of Finance, July–August 2001).[5]

2.44 As for the transition to the new system, it was established that, while the new entrants into the labor force would be compulsorily enrolled, individuals already employed could choose whether to participate or not. Seniority already accrued in the PAYG component is, however, taken into account for the pension calculation only up to a maximum of five years, which means making the switch interesting for young workers (with less than five years of accrued service) and less attractive or clearly penalizing older workers.

[5] We are not aware, however, of a provision requiring formal checks of these expected results. Moreover, three percent real GDP growth, as well as a five percent return from the financial market, appears to us, to some extent, optimistic with respect to European countries' performances, even for a fast growing economy. This concern is much truer if these rates are to be sustained in the long run, especially considering the political instability of the region.

2.45 In any pension reform the transitional rules are particularly important because they define the time horizon needed to reach the new steady state, the specific features of the phasing in of the reform, and the allocation of its costs, which are higher when the initial conditions imply a very large debt. These costs have to be distributed among current and future generations. Current members are of course affected mainly by the way their "accrued rights" are evaluated. In Palmer and Holzmann (2003), "transitional fairness" may be defined according to two different principles: in terms of the rights accrued in the old system or in terms of the contributions an individual has paid to it.

2.46 As previously mentioned, in the Macedonian case, the transition to a multi-pillar system was accompanied by a severe reform of the PAYG scheme. The 1994 extension of the reference period for calculating the pension base, applied irrespective of seniority, meant recognizing paid contributions instead of "accrued rights," and the same is true for the modification of the indexation mechanism, as well as for the increase in retirement age (although with exceptions). This implies a wide distribution of the transitional burden, which does not spare even the older generations, without taking into consideration the better opportunities that the young will likely achieve from political and economic stabilization of the country and, above all, from possible membership in the European Union.

2.47 Further reform of the PAYG component in 2000 could imply a "manageable" deficit arising from the diversion of resources to the second pillar. Projections confirm this, under the same hypotheses already discussed for growth and interest rates and for the length of the transition. Opinions collected during our interviews suggest that the problem attracted due attention in the preparatory work, even though in formulating the assumptions, the balance was more optimistic than prudent.

2.48 The initial switching process, in particular, should not cost more than 0.5 percent of GDP, in terms of lower contributions to the PAYG, a cost that is figured to be completely offset by the cut in expenditure that will derive from the completion of the payment of pension arrears in 2005. For the longer term, assuming 3 percent real growth rate of the economy, the deficit of the PAYG scheme should slowly rise during the transition at 1.4 percent of GDP in about 20 years, and then rapidly decline and become a surplus. If the rate of growth of the economy reaches a yearly 4.5 percent, the deficit will shrink in the short term and the transition will be almost painless.

2.49 Apart from the optimism of these projections, legislation on pension reform is hardly a one-time event. A process of trial and error is often required in response to social demands and pressure, as well as trade unions' and political parties' interference, which normally characterize the difficult years of the transition. Unforeseen shocks and a lack of prerequisites may further complicate the process.

2.50 The Macedonian case is no exception and, despite the law, the timing of the introduction of the compulsory second pillar is still a high-attention issue. A date was originally planned for 2004 but multiple reasons led to its postponement. At the time of our visit in November 2003, a bill was under discussion to delay the

introduction of the second pillar to within six months after the first issue of government bonds, thus very likely shifting the implementation to mid-2005. As a matter of fact, many of those interviewed stressed that a lack of preliminary study had led to the underestimating of three potentially disruptive factors:

(i) The rather precarious state of financial markets, which were hardly sustained by the privatization of state-owned enterprises. Although the process of privatization started immediately after Macedonia's independence, it proved to be lengthy and inefficient, taking the form of employee buyouts, with poor management and little financing.

(ii) The absence of foreign investments, which were discouraged by the political instability of the region.

(iii) The delay in the organization of the supervisory agency, not yet fully operational, and slightly behind in the preparation of the tender for the first two pension fund licenses.

2.51 These factors depict an incomplete framework for the development of a pension market and strongly suggest reconsideration, if not of the whole process, certainly of its timing. This prudential attitude, which seems simply necessary to an external observer, can certainly appear as a major breakdown of the reform process to politicians and officials who are enthusiastic about the funded pillar. Moreover, this criticism should be interpreted in a positive light, not as a rejection of the basic design, but as a further step toward building all the prerequisites for a less risky, more effective and more carefully considered reform.[6]

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[6] In addition, see World Bank 1995a, pp. 8–11; World Bank 1997, pp. 2, 4; World Bank 1995b, pp. iii, 13–16, 24–27; World Bank 1998b, pp. 2, 3, 8; World Bank 1998c, pp. 5, 6, 13, 14, 64, 65; World Bank 1999 pp. iii, v–vii, xi, 5, 35, 36, 49–58; and the 2002 *Law on Mandatory Fully Funded Pension Insurance*.

3. World Bank Assistance in the 1990s

GENESIS OF BANK INVOLVEMENT

3.1 Involvement with reforming the social insurance systems has been a prominent feature of the role played by the Bank in transition economies. The reasons for this priority are twofold:

- Social reasons—the immediate need to protect the weakest segments of the population from the consequences of the breakdown of the previous regime and, in the longer term, the relevance of a well-functioning social security system;
- Economic reasons—the necessity to limit the share of welfare expenditure in the overall state budget and in GDP, leaving room for investment, particularly in infrastructure, and the perception of the obstacles that the typical distortions of badly designed schemes would impose on economic development.

3.2 In December 1993, FYR Macedonia became a member of the World Bank Group's International Bank for Reconstruction and Development, the International Development Association, and the International Finance Corporation. Before the 1995–99, Bank country assistance strategies were mainly concerned with the country's economic recovery, and with "clearance" of the country's position toward the Bank itself for past aid. The Bank clearly recognized the enormous challenges that the republic faced, which were exacerbated by a number of political and economic factors.

3.3 Within this framework, both sectoral and structural strategies were pursued. The sectoral strategies were meant to revitalize the productive capability of the economy and to diversify trade flows, while at the same time to restructure the health sector, which was badly in need of it. The structural strategy was aimed at supporting the government's efforts to strengthen the economy based on market principles by supporting the business and financial sectors, the labor market, and a new social safety net.

3.4 These priorities were tackled by the Bank in cooperation with a broad support group, including the government of the Netherlands, the IMF, the European Investment Bank, and the European Bank for Reconstruction and Development (particularly involved in infrastructure-related projects).

3.5 The Bank was particularly sensitive to the reform of the social safety net and strongly supportive of the need to build local capacity in this area. In the 1995–99 country assistance strategies, the social safety net was proclaimed as a key priority, and both lending and non-lending instruments were programmed to properly identify and address social emergencies and to shelter the vulnerable segments of the population, as well as to design and implement a major reform of the pension system. Within this context, the Bank—jointly with other institutions, in particular, the United States Agency for International Development (USAID)—not only played a relevant role in providing financial resources, but performed a

prominent function in conveying the conceptual framework and in building local capacity in the pension area.

3.6 Our interviews suggest that the Bank presented the transition to a multi-pillar system as a global trend, in accordance with the recommendations in its 1994 publication, *Averting the Old Age Crisis*. This analysis, which also attracted much criticism (see Orszag and Stiglitz 2001), had indisputable merits too, such as:

- Clearly stating the problem (how to provide adequate income support in retirement for a rapidly aging population, not only in rich countries but in more general terms);
- Providing a rather neat conceptual framework for identifying a "good" pension system (based on the concepts of a mixed public/private intervention, of long-term affordability, of risk diversification); and
- Formulating recommendations for reform clearly translatable into policies (the "three pillar" recipe).

3.7 The Bank's diagnosis of the problems faced by the welfare systems of transition European countries strongly influenced both the debate and the course of action. In the view of the Bank, obvious factors led to the conclusion that these systems were simply not sustainable: large, public PAYG systems constituted the only retirement provisions; high payroll tax rates boosted an already large informal sector and exacerbated the financial problems of the pension schemes; a stagnant or falling GDP, coupled with unfavorable demographic projections; and relatively high replacement ratios reflecting unbalanced intergenerational transfers. They also presented serious problems in guaranteeing decent protection to the elderly poor and to other weak segments of society. While inadequate for maintaining the purchasing power of pensions and other benefits in the presence of a rising inflation, imperfect indexation mechanisms enhanced the system's fragmentation and the benefit formulas allowed for perverse redistribution in favor of privileged groups. The overall picture was made worse by rapidly changing demographic scenarios, characterized by falling birth rates and a prospective increase in longevity, highlighting the risk, for these countries, of "getting older before getting richer."

3.8 In the Bank's view, the social security system is conceived, not as a separate institution, but as a fundamental component of the macroeconomic framework, implying potential harmonization with the goal of economic growth, which is the ultimate driving force toward welfare improvements. To contribute to economic growth, a good pension system should, on one hand, provide both the right incentives for the individual to transfer resources from the active to the inactive part of his/her life, and the proper vehicles to do so; guarantee a safety net for the elderly who only have low permanent income; and supply adequate insurance against risks specific to the old age. On the other hand, the system should be sustainable in the long run; be transparent so as to reduce the risk of undue political manipulation; and be relatively immune from savings and labor-market distortions.

3.9 As a consequence, the course of action recommended by the Bank was based on the idea that savings, insurance, and redistribution should be elements of

the overall welfare design, with further provision of a differential scope for government intervention according to the country's initial conditions, preferences, and cultural factors.

3.10 The three-pillar system proposed by the Bank included the following:

(i) A public pillar, with the general aim of preventing poverty among the elderly and of providing insurance, both across and among members, against aggregate risks such as low returns, inflation, recession, and market failures; this pillar should be limited, in order to leave room for a privately funded component, and financed on a PAYG basis, both to create a generational compact and to avoid "the problems associated with public management of national provident funds" (World Bank, 1994b, p. 16)[7];
(ii) A second, mandatory, funded and privately managed pillar (in the forms of either occupational plans or personal accounts) allowing for the "income-smoothing" of savings for the population at large;
(iii) A third pillar, consisting of voluntary occupational or personal plans, providing supplementary benefits for households with good savings capacity and a correspondingly high propensity to save.

3.11 The interplay of first two elements seems to be at the root of the Bank role in shaping the pension system—the Bank's interest in putting into practice the welfare model described in *Averting the Old Age Crisis* (World Bank 1994b) and the actual demand for advice by the Macedonian government, which faced the critical choice between devoting its resources to either fostering development or stemming the sharp increase in poverty. The economic "dynamic efficiency" hypothesis (the rate of return being greater than the rate of growth) was particularly appealing because it promised to simultaneously achieve a reduction in pension expenditure, a (future) higher level of pensions, and the establishment of a healthy financial market.

3.12 The interviews conducted during our visit to the country confirmed the important role played by the Bank in building awareness and competence among policy makers and in shaping the reform. It was not, however, a "take-it-or-leave-it" process. On the contrary, more so than in other cases, the Bank was particularly prudent about suggesting specific steps; it preferred to promote awareness and competence among policy makers and to finance government tenders for foreign consultants, sometimes also receiving criticism for not providing ready-made solutions. The pension reform approved in FYR Macedonia in 2002, however, shares the basic philosophy of the Bank model.

[7] The World Bank Europe and Central Asia Region comments that an absolute poverty line rather than a relative poverty line, which Macedonia and the Bank implemented, would be needed to address the role of poverty reduction that a first public pillar could play.

DESCRIPTION OF BANK ASSISTANCE

3.13 The documents made available by the Bank mark the various stages of the Bank's involvement in the Macedonian transition toward a market economy and, specifically, in the pension reform process.[8]

3.14 Before the 1995 country assistance strategy, social protection was already recognized as a critical issue: the economic recovery loan and the economic recovery credit of 1994 were aimed at enhancing fiscal consolidation and supporting measures to foster efficiency and sustainability of the social safety net. The projects basically achieved their objectives, with some shortcomings owing to delays in the privatization and enterprise-restructuring programs, and in reforming the banking sector.

3.15 However, the specific attention to the pension reform can be traced back to the 1995–99 country assistance strategy, which made it a key priority to establish and maintain an effective and efficient social safety net, not only as a means to avoid social dislocation, but also to meet the human resource requirements for long-term growth.

3.16 These issues were initially addressed by the 1995 Social Reform and Technical Assistance Project (SDR 9 million, equivalent to US$ 14 million), which targeted the following:

- To develop a more financially sustainable social-benefits program,
- To introduce objective poverty criteria,
- To improve payroll tax collection, and
- To develop a good practice of actuarial-based pension planning.

3.17 It is partly because of the resulting improved capacity and increased sensitivity to prudent budget management, as well as to the need to achieve a more focused approach to poverty issues, that both the Bank and the Macedonian government became convinced of the need for further pension reforms, despite the profound parametric changes already introduced in 1994. The preparation of a comprehensive redesign, dealing with all the relevant issues and based on a thorough review of reform options under different economic and demographic scenarios, was thus warranted.

3.18 The problem was tackled mainly with two complementary operations: the Social Sector Adjustment Credit and the Pension Reform Technical Assistance Credit, both approved in 1998.

3.19 The first credit, in the amount of SDR 21.6 million (equivalent to US$ 29 million), was granted in support of not only the pension reform, but also reorganization of the health insurance system, reform of the unemployment insurance system, and strengthening of the social assistance system.

3.20 As for pension reform, the project aimed at a structural change (as opposed to only parametric changes), through the development of a framework for a

[8] For a synthesis of the projects that have some relation to the pension issues see, appendix A.

mandatory, funded, privately managed scheme. The objective was achieved, and the government amended the pension law with further parametric changes to the PAYG component, while appointing a steering committee for the preparation of a detailed proposal for the funded pillar.

3.21 The Pension Reform Technical Assistance Credit was approved as a necessary supplement to the Social Sector Adjustment Credit, in order to meet the requirements for an effective technical assistance. The actual cost of the project, US$ 1.24 million (a little lower than the planned cost of US$ 1.4 million), was relatively small when compared with the Social Sector Adjustment Project. The credit covered about 80 percent (US$ 1 million) of the cost, thus requiring government co-financing of US$ 0.24 million.

3.22 Despite the modest financial commitment, however, the operation constituted a very important step in the pension reform process, because it aimed at financing technical assistance and training for pension reform design as well as for the information campaign, and at facilitating the implementation phase, that is, a development of public and private pension legislation and the launch of the information campaign.

3.23 Our interviews confirmed that the Bank was supportive of all the institutions that participated in the realization of the project, particularly the Ministry of Labor and Social Policy. The project was regularly monitored by the Bank, with very good cooperation with the local team in finding solutions to unforeseen obstacles.

3.24 The Bank's cooperative attitude clearly contributed to the achievement of the objectives, in terms of implemented legislation and capacity building. In particular, the reformed pension law (the so-called *Framework Law*, which included several means to improve the solvency of the public system, was approved by Parliament on March 22, 2000, and the *Law on Mandatory Fully Funded Pension Insurance* was approved in April 2002. As for capacity building, the organizations and the staff involved in the reform clearly appear to have improved their abilities, in particular, in the fields of policy design, actuarial analysis, and reporting to the government.

3.25 The same operations were priorities for the 1999–2001 country assistance strategy, and the reforms were introduced, with some delay, despite political instability (particularly caused by the Kosovo crisis in spring 1999 and by the Macedonian crisis in spring 2001). Although the latter event meant the interruption of the country assistance strategy and the adoption of a transitional support strategy, the government's commitment to the pension reform remained strong.

3.26 The Bank's lending strategy was not narrowly limited to pensions but included a broader macroeconomic and sectoral view and provided a framework for policy debate, in addition to disseminating economic information among supporting institutions; in particular, through the Introductory Economic Report of 1995 (World Bank 1995b), the Country Economic Memorandum of 1998 (World Bank 1998c), and the Report on Poverty of 1999 (World Bank 1999).

3.27 However wide-ranging, the role of the Bank was not seen as crucial. From the individuals we interviewed and representatives of the main Macedonian institutions involved in pension reform, we did not get the impression that the Bank was seen as the decision maker, but rather as the main lending institution, providing financial resources for the government to hire consultants, to diagnose problems and find solutions, and to implement and monitor the reform processes. Perhaps this attitude can be explained by the fact that the Bank's intervention in FYR Macedonia differs from its approach in other countries, where the Bank provided direct technical assistance, by bearing the costs of its own experts, with little or no transfer of money. Another possible explanation could be the turnover of personnel within the Bank's country office, which made it more difficult to establish continuity during the reform process. After completion, however, the fact that the adopted reform reflects, more closely than in other countries, the approach proposed in *Averting the Old Age Crisis* (World Bank 1994b) suggests another possible explanation, that is, a different "pedagogical strategy" was taken up in FYR Macedonia, possibly motivated by the country's lesser degree of coherence and greater instability.[9]

[9] In addition, see World Bank 1995a, p. i, 10, 12–14, 20, 21, 28, 31; World Bank 1997, p. 4; World Bank 1995b, p. 29; World Bank 1998a, pp. 2–7, annex 2; World Bank 1998b, pp. ii, iii, 14, 15, annex B1- p. 5; World Bank 2000, pp. 7, 8, 15, annex B1- p. 3; World Bank 2001a, p. 3; World Bank 2001b, p. 2; and World Bank 2002, pp. 2, 4–6, 10.

4. Assessment of Development Impact

OUTCOMES

4.1 The focus of the following assessment will be in terms of both the relevance and the efficacy of Bank assistance to the Macedonian pension reform. *Relevance* indicates the extent to which the objectives of the overall assistance and of individual projects were consistent with the country's initial conditions, needs, and development priorities. *Efficacy* indicates the extent to which the objectives were achieved.

Relevance

4.2 The core point under this heading is whether the pension reform was really a priority in the context of the early years of the Macedonian transition toward becoming a nation and a market economy. Before discussing the specific relevance of projects, the following questions need to be considered:

(i) Is the reform supportive of economic development?

(ii) Does it provide adequate social protection, and does it reduce the distributional disparities between households and genders?

(iii) Does the reform strike a good balance between efficiency and redistribution, between financial equilibrium and equity?

4.3 Regarding the first question, it should be remembered that FYR Macedonia had to make not only the transition toward democratic institutions and a market economy, but the more radical one of transforming itself from a region into an independent country. The initial conditions were particularly difficult not only because of the usual economic deficiencies—an undeveloped economy, a slow privatization process, absence of entrepreneurship, rising inflation and unemployment (see appendix B)—but, above all, because religious and ethnic differences made it much more difficult to develop "a shared view" of the future. Indeed, the presence of an international peacekeeping force is still necessary a decade after independence.

4.4 Given this situation, it is clear that restructuring the social security system could be seen as a priority only insofar as the main political conditions were also met, which was not always the case. On theoretical grounds, the concept that the social insurance and social protection systems are considered important factors in the determination of the overall economic performance, and ultimately a precondition for social peace, is hardly disputable. In the Macedonian case, however, other, perhaps even more fundamental, conditions were required to create a democratic society and a self-sufficient economy. It is not the aim of this report to evaluate the progress achieved by the country in these respects. However, it is our impression that advancement is slow, making it difficult to judge the pension reform in and of itself because it is clear that *no reform can work well if the economy does not work well and, more fundamentally, if the very bases of the society are precarious*.

4.5 So while credit has to be given to the successive Macedonian governments for ranking the pension issue high in the overall reform agenda, and to the Bank for sustaining and supporting this view, the impression that both the political and economic contexts should have been given more consideration in order to build a strategy tailored to the peculiar Macedonian situation cannot be ruled out.

4.6 With these caveats, the planned reform rightly tried to reduce the burden deriving from the pension system imbalances, and to redesign the social safety net in order to achieve more efficient targeting of the poor.

4.7 The introduction of a funded pillar, with its potential positive feedback on capital markets, savings, and investment, can also be seen as a relevant objective. With respect to such a policy, however, the provisos are even more stringent than those for reforming the first pillar. In the Macedonian case, both the Bank and the government paid attention to the issue of risk allocation, which is the basis of the multi-pillar system prescription, and to the preconditions necessary to support its development. However, as already stated, this "contextual awareness" was somewhat caught up in the wish to proceed rapidly with the reform process, and both the content and the timing of the construction were dominated by the tendency to adopt optimistic rather than prudential scenarios. Indeed, the very decision to start almost immediately with the second pillar is probably attributable to these optimistic scenarios.

4.8 Regarding the second question—on providing social protection to the poor—it is again hard to dispute the belief that a democratic society should not forget its less fortunate members. In this respect, socialist societies (theoretically based on egalitarianism) were not equipped to recognize and assess poverty as a social problem. With the change of regime, however, it was abundantly clear that the country was very poor, and that proper definitions and indicators were needed to address the issue.

4.9 The Bank correctly identified and gave priority to this objective under the Social Reform and Technical Assistance Project. Within the project, the social benefits program was aimed at developing objective criteria as a basis for targeting social assistance, as well as at implementing a "labor relocation strategy" for communities affected by large-scale enterprise restructuring. Analogous tasks were among the priorities of the Social Sector Adjustment Credit, which addressed social protection, labor market, and health insurance issues. The need to improve the cost effectiveness of the involved sectors was made more stringent by the very limited resources available; achieving adequate standards of protection was then crucially dependent on not wasting any resources. Measures were taken to improve the effectiveness and fairness of the social assistance, also pointing to the need for a proper incentive structure and adequate enforcement against fraudulent claims.

4.10 The third question—on the trade-off between efficiency and distribution—constitutes the foundation of the efforts to effectively separate social insurance from social assistance and to strike a good balance between the two.

4.11 The economy can gain by financing social assistance through progressive income taxation and not through earmarked payroll taxes. In principle, if the

programs are efficiently designed and managed, the amount of resources devoted to the schemes is not necessarily lower. On the contrary, because the separation (between insurance and assistance) represents another important element in the effort to strengthen economic development, it possibly means increasing the size of the pie,[10] that is, the overall resources. Reforming the public PAYG scheme certainly reduced unfair redistribution, notwithstanding the persisting privileges for military personnel and other groups. It did not go, however, as far as adopting the notional defined contribution (NDC) system, which in some ways represents the benchmark for the separation between insurance and redistribution. The PAYG scheme is based on a defined-benefit formula. Although a defined-contribution formula would have provided a more explicit link between contributions and benefits, we do not consider this to be a major shortcoming because the formula is actually calibrated not to be too divergent with respect to an actuarial criterion. The planned reduction of the role of the PAYG component, however, in parallel with the diversion of funds toward the funded component, casts some shadows on its future.

4.12 Within this framework, it is possible to maintain that the first priority of FYR Macedonia was a comprehensive nation-building approach and that the pension and social assistance reform could be seen as a very important complementary condition. Given that we do not have the whole picture, the evaluation that we can provide assumes that the other elements in the approach were met. Our evaluation can thus be summarized by saying that the relevance was indeed substantial, but that a more tailored approach would have been advisable. Table 4.1 summarizes the evaluation of relevance.

Table 4.1: Evaluation of Relevance

Features	*Relevance*
Supporting economic development	Substantial
Sheltering the poor and reducing distribution gaps	Substantial
Striking a good balance between efficiency and redistribution	Substantial
Overall evaluation of relevance	Substantial

Efficacy

4.13 Under the topic of efficacy, two preliminary observations are warranted: (i) although the pension reform appears to have been effectively realized in terms of legislation, its practical implementation, as far as the funded pillar is concerned, will certainly be delayed, because of the still substantial uncertainty dominating the country; and (ii) the role of the Bank was crucial in shaping the new pension architecture, and in implementing the appropriate set of reforms.

4.14 Given the above, efficacy is assessed with reference to the same issues considered in the evaluation of the reform's relevance, that is, by adopting as guiding criteria, (i) support for economic development; (ii) shelter for the poor; and (iii) the trade-off between redistribution and efficiency.

[10] According to data provided by the pensioners' union (which we could not verify), the labor cost is very high with respect to the net salary, at about 1.68 times greater, including the 21 percent pension payroll tax but also a 14 percent health payroll tax and a progressive income tax, which averages to about 15 percent.

4.15 On the first point—support for development—the prerequisites would be for pension expenditures not to absorb too much of the public budget, financial equilibrium of the scheme, and a good incentive structure for savings and labor choices. Moreover, if a diversified pension portfolio is pursued, it should be realized without creating additional uncertainty, which could hamper positive feedback on savings and investments. Some of these conditions were certainly met in the case of the Macedonian reform: the first pillar will be brought to equilibrium and, even if no automatic stabilizer is introduced (in an NDC fashion), the system seems robust with respect to "normal" economic cycles.

4.16 Concerning the second pillar, we have already stated our view that the initial schedule for its reform was probably too fast and based on an overly optimistic outlook. Consequently, we do not see the present (as of early 2004) "reflection break" as a shortcoming, but as an opportunity to carefully reconsider the timing. On the political side, the government seems to have realized that simulation models, although they provide useful scenarios, cannot be a substitute for political choices. On the market side, the development of financial markets is hardly foreseeable.[11] True, the availability of funds would certainly improve their prospects, but the chance that markets conditions are simply too risky for savers suggests prudence.

4.17 On the second point about sheltering the poor, while the long-run impact of pension reforms on the financial balances of the system should be positive (indeed, the projections forecast a long-run surplus), the critical issue is whether the system, as it is now designed, will be able to deliver adequate pension benefits. True, simulations suggest that the replacement ratios will be maintained, although with a much different composition (that is, 30 percent from the PAYG component and 40 to 50 percent from the funded one). However, the conditions for this to be realized are very stringent, requiring not only that the political situation be normalized and the path of sustained economic growth be taken, but that financial markets also deliver good returns.

4.18 According to IEG documents, on social assistance, the reforms *qualitatively* achieved their results in terms of laws, targets, and administration. We cannot, however, establish the extent of the improvements owing to a lack of indicators.[12]

4.19 The third point—the balance between redistribution and efficiency—strongly relies on the separation between assistance and insurance. The law on social assistance appears to be well designed and, at present, adequate redistribution seems to suffer more from limited resources than from poor design of the scheme. As for pensions, even if the benefit formula is not based on

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[11] Not even at the level of an impression, because the officials from the Security Exchange Commission cancelled the scheduled meeting.

[12] The cancellation of the scheduled interview by the Ministry of Labor and Social Policy, as well as the limited information we could collect at the National Statistical Office, especially on social protection and pensions, somewhat reduced the scope of our evaluation. As for the Statistical Office we think that greater effort should be devoted to improving (i) the conceptual frameworks that inevitably support the collection of data and information, and (ii) coordination with other institutions, such as the Pension and Disability Fund.

actuarial equivalence, the system seems well balanced, to meet efficiency goals (in terms of both financial equilibrium and the provision of a correct set of incentives) as well as intergenerational solidarity.

4.20 It has to be remembered, however, that even the best reform does not work if the economy lags behind. In the Macedonian case, the effectiveness of the Bank's operations can certainly be measured in terms of the laws approved by Parliament, but it does not seem that the minimum conditions for the efficient operation of the system have been met. Indeed, as the experience of other countries shows, an "excess" of legislative action can sometimes be interpreted as an easy substitute for real changes, not considering that the market economy works differently, owing at least as much to good incentives as good laws.

4.21 On the positive side, it should be recognized that the Bank's efforts succeeded in building a "shared view" of the pension reform by politicians of all parties so that, notwithstanding military crises and government changes, the reform principles were never disowned, and the implementation substantially proceeded along the established path, although with some delay. Table 4.2 summarizes the evaluation of efficacy.

Table 4.2: Evaluation of Efficacy

Features	***Efficacy***
Support to economic development	Modest
Sheltering of the poor and reducing distributive gaps	Modest
Striking the good balance between efficiency and redistribution	Substantial
Overall Evaluation of efficacy	Modest

Overall Outcome Evaluation

4.22 The overall evaluation takes into account both relevance and efficacy, and can be seen as the extent to which the major relevant objectives of the project were achieved or are expected to be achieved.[13] Table 4.3 summarizes the overall evaluation of outcome.

Table 4.3: Overall Evaluation of Outcome

Item	***Rating***
Relevance	Substantial
Efficacy	Modest
Overall Outcome Evaluation	Moderately Satisfactory

Institutional Development Impact

4.23 The institutional development impact is assessed in this section according to its relevance and efficacy, while the requirements that will make the reform sustainable in the long run (after international help is supposedly gone) are discussed below.

[13] References for this paragraph, in addition to the citations in the text, are: World Bank 1994b, p.2; World Bank 1995a, p. 36; World Bank 1998b, pp. 14, annex B1- p. 5; World Bank 2000, p. 15; and World Bank 2002, pp. 1, 3–5, 7–10.

4.24 Regarding the relevance of the Bank's action for institutional development, the difficult initial conditions must be remembered. The political instability, the administrative weaknesses, the need to replace old ideologies with new "philosophies," and the lack of information and specific expertise, all pointed to the necessity of a significant intervention to supply not only the much needed technical skills, but also an appropriate "cultural" framework.

4.25 It is to the Bank's credit that, even sometimes with reluctance by the government, funds were used for capacity building. The efficacy of the Bank's effort, however, presents somewhat mixed evidence, highlighting the fact that developing a common "cultural" framework possibly is even more difficult than reorganizing the administration and disseminating technical skills.

4.26 Our visit and interviews confirmed this mixed impression. A high level of technical preparation was clearly apparent by all the officials who took part in the Pension Reform Steering Committee or who closely collaborated with it. In this respect, the member-based macro-simulation model of the Pension and Disability Fund is a powerful policy instrument, and the staff working on it will certainly be able to continue developing it, as well as to strengthen an already good reporting ability. The Bank's documents, moreover, expressly recognized improvements in the organization and the targeting capacity of the social assistance framework.

4.27 However, the old style of approaching social and economic issues still seems prominent among politicians and in the bureaucracy, to some extent lacking the conceptual framework needed as the basis of a democratic system and a market economy. The relationship between the pension system and other aspects of the economy—within a general equilibrium construction—was not well understood.

4.28 It is true that assistance to the pension reform was purposely a very focused one, which could have contributed to its successful preparation and legislative implementation. However, this could also have been a drawback, in that a more comprehensive view of the workings of a market economy, including its welfare provision, could have complemented the acquisition of technical skills in the pension area, possibly representing a wider advancement.

Table 4.4: Overall Evaluation of Institutional Development Impact

Item	*Rating*
Relevance	Substantial
Efficacy	Modest
Overall Institutional Development Evaluation	Substantial

Sustainability

4.29 Generally speaking, sustainability can be defined as the capacity of the system to deliver adequate pensions, while substantially maintaining a financial equilibrium (if not in consecutive years, at least in the long run), under foreseeable negative shocks. "Adequate" pensions can be achieved by a sufficiently high contribution rate; a "good" diversification of pension wealth; relatively high returns to contributions (or at least uncorrelated returns, able to partially compensate for a shock in one of the portfolio components, either funded or

PAYG). A system that corresponds to this stylized picture is, in our view, sustainable. How does the Macedonian pension system fare in this respect?

4.30 In this section, sustainability will be assessed in two aspects—economic and political. Economic sustainability will be considered, not only in terms of internal consistency but also with respect to the reform's ability to withstand negative changes in both demographic and macroeconomic variables. Political sustainability will be assessed in terms of popular support for, and political willingness to proceed with the reforms, and in terms of continued capacity building.

4.31 As for economic sustainability, the capacity of the pension system to deliver adequate benefits will crucially depend on employment and growth. Although analyzing macroeconomic prospects is beyond the scope of this evaluation, we cannot avoid stressing the potential negative impact of the high degree of uncertainty that surrounds both the political and the economic scenarios.

4.32 In FYR Macedonia, the reform of the first pillar strongly improved its solvency. This came, however, at the cost of a sensible reduction in the pension promises.

4.33 The second-pillar reform has yet to occur, although the legislative framework has already been implemented. In our view, this delay is not a shortcoming, given the rather ill-equipped economic and financial environment, for example, privatization has failed to produce sensible results in terms of economic efficiency and growth; foreign investment is scarce; and the supervisory agency for pension funds still needs to complete its organization. Problems are also present in the regulatory framework, given that the law requires that 80 percent of pension fund assets be invested within the domestic market, which appears to be an undue restriction on portfolio management.

4.34 We cannot but agree with the following quote by Peter Diamond (2001):

> *I think we have to recognize that individual accounts are much harder to set up and run for a country with an inadequate capital market than a lot of people suggest. In some former communist countries, with no capital markets and no regulatory ability, setting up individual accounts seems to me to be pointless: they will hold government debt. Talk about political risk: some of these countries have enormous troubles collecting taxes, and what is the one thing you can surely collect taxes on? Pension accounts that the government is holding. So they may be more vulnerable to heavy taxation than any other asset. And there may be less political protection from inflation than with defined benefits.*

4.35 Regarding the issue of political sustainability, according to the documents we examined and, in particular, the interviews we conducted in the field, the support for the reform process has been relatively high among the full spectrum of political parties and in successive governments, which remained committed to the reform notwithstanding the urgent social issues that emerged from the Kosovo

crisis in 1998, as well as from the domestic crisis in 2001. As for the future, political stability would be enhanced by the attainment of membership in the European Union.

4.36 As for support by the civil society, it must be assessed with special reference to the perceived importance of savings for retirement, and the perception of gains from working in the formal rather than in the informal sector.

4.37 The reform process included a public information campaign to raise people's awareness of the functioning and the opportunities offered by the multi-pillar system. The picture that emerged from our interviews with representatives of the civil society, however, presents a somewhat mixed attitude with respect to pension reforms, in contrast to the determination shown by the government.

4.38 First, high unemployment and the difficult economic environment make pension issues of little interest to the young. Second, a very critical position is assumed by the most convinced advocates of the PAYG, with respect to the introduction of a mandatory funded pillar, on the basis not only of an "ideological" preference for the public system, but also of a lack of familiarity and confidence in financial principles and markets, and even more in the rationale of the multi-pillar system. A third position, finally, simply reflects a prudential attitude. Supporters of this view argue that the estimation of transitional costs might have been overly optimistic, the burden on the first pillar was underestimated, and the lack of prerequisites was ignored. It is also probably owing to this opposition that a break was taken before launching the pension funds.

4.39 The last important aspect of sustainability is maintaining acquired capacity in the long run. In the Macedonian case, even the "building phase" of the needed capacity has yet to be completed. Further attention should be devoted to promoting widespread sensitivity to economic incentives, to prudent budget management, and, particularly, to the complexity of economic relations and feedback in a modern market economy. Table 4.5 summarizes the evaluation of sustainability.

Table 4.5: Evaluation of Sustainability

Item	***Sustainability***
Economic sustainability	Modest
Political sustainability	Modest
Overall Evaluation of Sustainability	Unlikely

5. Results

5.1 Macedonian reforms were undertaken by the Bank, in cooperation with a broad support group, including the government of the Netherlands, the British Know How Fund, the IMF, the Organisation for Economic Co-operation and Development, the European Union, the European Bank for Reconstruction and Development, the European Investment Bank, and (especially for pension reform) USAID.

5.2 Although the presence of these other institutions can be traced back to 1994, all of them—with the possible exceptions of the IMF and USAID—seem to have had only a secondary role in the field of the pension reform, or none at all (both the documentation and our interviews indirectly support this).

5.3 Joint work by the Bank, the IMF, and the Macedonian government was required by the Social Reform and Technical Assistance Project to provide projections for the pension system, while the most relevant partnership specifically addressing pension reform was created by the Social Sector Adjustment Credit (1998). Although the credit itself was not a joint operation, the Bank acted in strict cooperation with USAID, which even took on a coordinating role in providing advice and support to the Macedonian government for pension reform.

5.4 We are not aware of any fundamental disagreement among the various institutions, particularly as far as the introduction of the funded component is concerned. It is possible that USAID first brought the issue to the agenda, but we could not detect any strong opposition to the project by other institutions. However, the somewhat competing philosophy of the International Labor Organization, much less inclined toward the funded pillars, was referred to by representatives of the trade unions, as "something that could have been given more consideration, and which could contribute—as of end 2003—to a more prudential attitude toward the establishment of the funded schemes." Following the previous evaluation of the various aspects of the Bank's involvement in the Macedonian pension reform, we consider the following summary evaluation to be appropriate.

Table 5.1: Evaluation of Bank Performance

Item	*Performance*
Quality-at-entry	Satisfactory
Supervision	Satisfactory
Overall Bank evaluation	Satisfactory

5.5 As for the country's performance, we registered a notable commitment within the government in introducing even radical changes in concert with the international institutions' advice. All individuals interviewed who had been involved in the reform, in fact, provided evidence of reasonable cooperation by local institutions, the Bank, and other donor representatives. Accordingly, the following summary evaluation of the borrower's performance is given.

Table 5.2: Evaluation of Borrower Performance

Item	*Performance*
Preparation	Satisfactory
Implementation	Satisfactory
Compliance	Satisfactory
Overall borrower evaluation	Satisfactory

5.6 Finally, we attempt to sketch a "what-if-not" scenario, which means speculating about what would have likely happened had the Bank not been involved in the Macedonian pension reform. Arriving at an answer is a difficult exercise because of the country's critical initial conditions. At the beginning of independence, FYR Macedonia was itself a morass of problems in a very problematic region. The country had neither a clear identity nor a strong economic role. Instead, it could be characterized as a largely undeveloped economy with inadequate infrastructure and strong religious and ethnic differences, which created questions about its future development. Even a decade after independence, it is clear that the country could not have managed without strong international leadership, in a peacekeeping as well as in a nation-building role, and without continuous external aid. In this respect, without diminishing the importance of the Bank's role, it should be recognized that other international players were crucial. They provided background condition not only for reforms toward democracy and a market economy, but also for national identity and everyday activity.

5.7 Taking the more limited perspective of pension reform, the impression is that the local authorities were eager to take up almost any suggestion to prove their commitment to change. In this respect, the content of the reform was perhaps less important to them than the symbolic or "face" value. The specific solution adopted for the pension problem then owes a great deal to the Bank's philosophy. Even so, some discontent was voiced. For example, the trade unions, as mentioned earlier, expressed to us their disappointment that the International Labor Organization's view had not been given the same consideration as the Bank's.

5.8 In our view, the outcome, at least as far as the public component is concerned, is not bad. Emphasis on launching the second pillar—the critical step of the reform—was perhaps less because of insistence by the Bank than the eagerness of local authorities to show their willingness to comply.

6. Lessons Learned and an Agenda for Future Action

6.1 In many respects, Macedonian history since independence suggests both optimism and pessimism, perhaps with the former more in evidence in recent years. In our opinion, the main objective of the reconstruction programs should have been, and probably was, to support nation-building. This is not within the direct domain of the Bank's interventions. However, economic development, where the Bank is more concerned, is usually an important determinant of the overall progress of society. In this respect, the involvement of the Bank in the country's pension reform cannot be underrated. It is certainly easy, after the event, to find mistakes and shortcomings in what was suggested and done. We inevitably forget the sense of urgency that existed, when decisions had to be made and a course of action adopted, without the wider consideration that is normally required and prevails under less dire conditions.

6.2 This is why, even if we consider that the help of the Bank was perhaps less linear than in other countries, possibly biased toward overly optimistic scenarios, and less prudent than should have been warranted, we are not in the position to say how much of these ex-post deficiencies would have been detectable ex-ante, or whether it shows a lack of adaptation of already prepared steps given the specific circumstances of the country. Consequently, the only lesson that we think can be drawn from the experience of FYR Macedonia is that economic solutions (in this case, applied to the pension problem) cannot work if they are not supported by a more general conceptual framework and a consistent cultural approach. Such elements may have been partly overlooked by the Bank.

Appendix A: Bank Assistance Instruments for Macedonian Pension Reform

LENDING INSTRUMENTS		NONLENDING INSTRUMENTS	
Instrument	**Aim**	**Instrument**	**Aim**
Economic Recovery Loan / Credit **(P008408)**	1. To enhance fiscal restructuring. 2. To adjust the social safety net (supporting measures to foster cost efficiency and sustainability).		
Credit for a Social Reform and Technical Assistance Project **(P038092)**	1. To develop a more financially sustainable social benefits program. 2. To develop objective poverty criteria. 3. To develop actuarially–based pension planning. 4. To improve payroll tax collection.		
Financial and Enterprise Sector Adjustment Credit **(P008409)**	1. To support the privatization process. 2. To help 25 politically sensitive enterprises that were running losses. 3. To cushion the adverse social impact of those firms. 4. To help the banking system.	**FYR Macedonia: An Introductory Economic Report**	1. To support Bank work through a focus on the Macedonian economy.

Continued....

LENDING INSTRUMENTS		NONLENDING INSTRUMENTS	
Instrument	**Aim**	**Instrument**	**Aim**
Social Sector Adjustment Loan **(P038392)**	1. To sustain a systemic reform of the pension system. 2. To support the reorganization of the health insurance system. 3. To reform the unemployment insurance system. 4. To strengthen the social assistance system.	**Country Economic Memorandum**	1. To go into the Macedonian economic situation in more depth. 2. To focus on growth.
Credit for a Pension Reform Technical Assistance Project **(P058056)**	1. To design the pension reform (technical assistance, training, designing the information campaign). 2. To facilitate the legislative frame creation (development of public and private pension legislation, implementing the information campaign). 3. To coordinate the project.	**Poverty Report**	1. To understand the main determinants of poverty. 2. To highlight the composition of the poorest social classes.

Continued....

LENDING INSTRUMENTS		NONLENDING INSTRUMENTS	
Instrument	**Aim**	**Instrument**	**Aim**
Public Sector Management Adjustment Credit **(P0066154)**	1. To strengthen fiscal discipline. 2. To establish a transparent accountancy framework. 3. To improve allocation efficiency of the fiscal system. 4. Further reforms in the social protection sector.		
Exceptional access to IDA resources. **Emergency Recovery Assistance Credit (programmed) (P076192)**	1. To face the emergency situation following the war between Yugoslavia and the NATO.		

Appendix B: FYR Macedonia Statistical Summary

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Macroeconomic data													
GDP current prices (LCU)	506,212,000	920,171,008	11,793,903,616	59,164,524,544	146,408,996,864	169,521,201,152	176,444,178,432	186,018,545,664	194,978,873,344	209,009,672,192	236,389,007,360	233,841,000,448	238,889,992,192
GDP current prices (US$)	4,471,837,696	4,694,749,696	2,316,618,240	2,550,194,944	3,381,270,272	4,449,375,744	4,422,159,872	3,735,312,128	3,571,041,536	3,673,280,768	3,586,868,736	3,436,968,192	3,712,123,648
GDP real rate of growth		1.56	-6.57	-7.47	-1.76	-1.12	1.19	1.40	3.40	4.32	4.55	-4.53	0.26
GDP per capita (constant 1995 US$)	2,741	2,764.90	2,571.31	2,369.40	2,311.00	2,263.16	2,270.34	2,285.99	2,350.77	2,441.33	2,541.06	2,415.34	2,418.12
Nominal Monthly Wage			637.00	3,815.00	7,754.00		221.00	181.00	173.00	170.00	155.00	155.00	176.00
Number of employed (thousands)	567	537	524	514	508			512	540	545	550	599	561
Rate of inflation		78.99	1,271.76	442.15	151.89	17.09	2.87	3.97	1.37	2.76	8.18	3.61	1.89
Demographic statistics													
Total population	1,903,000	1,916,000	1,925,000	1,933,000	1,947,000	1,966,000	1,983,000	1,997,000	2,008,000	2,017,000	2,026,000	2,035,000	2,038,000
Population 0 - 14	497,540	494,731	491,938	489,161	486,400	483,654	478,619	473,636	468,706	463,828	459,000	453,678	448,417
Population 15 - 64	1,263,833	1,273,107	1,282,448	1,291,858	1,301,337	1,310,886	1,322,307	1,333,828	1,345,449	1,357,173	1,369,000	1,378,856	1,388,784
Population 65 and above	141,627	147,143	152,876	158,834	165,026	171,460	177,520	183,796	190,295	197,027	204,000	208,950	214,022
Life expectancy at birth M	73.6	74.37	74.00		74.00	74.20	74.50	74.54		74.68	75.09	75.49	75.90
Life expectancy at birth F	69.8	70.09	70.10		69.60	69.80	70.10	70.29		70.37	70.61	70.86	71.10
Life expectancy at birth	71.6	72.18	72.00		71.75	71.95	72.25	72.36		72.47	72.80	73.12	73.44
Fertility rate	2.06	2.30	2.18	2.16	2.08	1.97	1.90	1.90	1.90	1.76	1.76	1.75	1.75
Pension statistics													
Contributors									379,130		387,729		
Total numeber of pensioners	166,224	180,749	193,294	210,537	216,834	219,307	222,726	227,099	232,216	235,839	241,221	247,200	249,421
Contributor/Pensioner ratio*	3.4	3.00	2.70	2.40	2.20	2.00	1.80	1.70	1.60	1.60	1.50	1.40	1.30
Contribution base													
Contributions (million LCU)		85.07	1,027.27	5,949.64	13,576.00	14,287.00	14,959.00		14,264.00		15,054.00		
Revenues of the pension system (millions LCU)	58	96	1,116	6,960	17,494	18,011	18,327	20,674	20,521	21,031	22,896	24,289	25,809
Expenditures of the pension system (millions LCU)	61	103	1,337	9,412	18,445	18,296	18,925	20,054	20,533	20,681	22,941	24,696	25,880
Average nominal pension (LCU)		63	1,014	4,571	5,358	5,609	5,691						
Average pension (US$)						148.51	142.00						
Pensions payments (current prices - million LCU)		86.11	1,115.86	7,860.58	15,405.00	15,683.00	16,223.00						
Ratio average pension / average wage		1.07	1.60	1.21	0.69	0.65	0.65						

Source: Macedonia State Statistical Office, Ministry of Labour and Social Policy, Pension and Disability Insurance Fund of Macedonia and the World Bank

Appendix C: Interviews

Mr. Goran ANCESKI	Head of International Finance Dept., Ministry of Finance
Ms. Anita ANGELOVSKA BEZOSKA	State Secretary, Ministry of Finance
Ms. Zorica APOSTOLSKA	Director, Agency for Supervision of Fully Funded Pension Insurance
Ms. Sandra BLOEMENKAMP	Country Manager, World Bank
Ms. Ajrie CAUSOVSKA	Head of Social Statistics, Statistical Office of FYR Macedonia
Mr. Donco GERASIMOVSKI	Director, Statistical Office of FYR Macedonia
Mr. Zoran JOVANOVSKI	Former Head of the Research Dept., National Bank; and a member of the Steering Committee for Pension Reform
Ms. Ljubica JOVCEVSKA	Budget Dept., Fiscal Implications of Pension Systems, Ministry of Finance
Mr. Bosko KITANOVSKI	Director, Pension and Disability Insurance Fund
Mr. Atanas MANCEV	Pension and Disability Insurance Fund
Mr. Andon MARKOVSKI	Vice President of the Executive Board, Pensioners' Union
Ms. Biljana PETROVSKA	Pension Fund, Actuarial Unit
Ms. Snjezana PLEVKO	Senior Economist, Human Development, Sector Unit, Europe and Central Asia Region, World Bank
Ms. Liljana POPOVSKA	Finance Director, Pension and Disability Insurance Fund
Mr. Ilija RAJCANOVSKI	Head of Sector for Economic and Social Issues, Trade Unions

Mr. Boro VAROSLIJA	Assistant Director, Pension and Disability Insurance Fund
Mr. Naser ZIBERI	Former Minister of Labor and Social Policy

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