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The Challenge of Pension Reform in Kosovo

Republic of Kosovo

Boele Bonthuis and Selim Thaçi

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The Challenge of Pension Reform in Kosovo, Republic of Kosovo
Prepared by Boele Bonthuis and Selim Thaçi

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ABSTRACT: This paper examines the evolution and challenges of Kosovo's pension system. Since its inception, a basic pension and mandatory individual accounts have formed the key element of Kosovo's pension system. Over the years, the pension system has expanded to include a variety of merit pensions, occupational pensions, and a legacy pension. While spending on the basic pension remains relatively low compared to international standards, there should be a more restrictive approach to special pension benefits. To enhance the clarity and effectiveness of pension indexation, it is essential to clearly define the index used for adjustments of the basic pension.

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Author's E-Mail Address:	BBonthuis@imf.org, SThaci@imf.org

SELECTED ISSUES PAPERS

The Challenge of Pension Reform in Kosovo

Republic of Kosovo

Prepared by Boele Bonthuis and Selim Thaçi[1]

[1] “The author(s) would like to thank staff from the Economic Policy Department under the Ministry of Finance Labor and Transfers for their valuable data sharing and information. We also extend our gratitude to all participants in the presentation of this SIP on November 8, 2024.

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REPUBLIC OF KOSOVO

SELECTED ISSUES

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THE CHALLENGE OF PENSION REFORM IN KOSOVO[1]

1. Kosovo's independence demanded a fundamental rethinking of economic and social policies, including the objectives and structure of the pension system. Due to various financial, legal, and administrative constraints, the newly-independent country was not in a position to continue operating the same social protection system as before. New social protection programs—including both social assistance and social insurance schemes—were narrower in terms of risks covered and offered lower benefit levels than similar programs in other European emerging economies. At the outset, certain risks and benefits often covered by state social security—such as loss of breadwinner, childcare, unemployment, and work injury—were omitted from the safety net. In other ways, Kosovo followed the example of other countries of the former Yugoslavia: war-related, categorical benefits have filled the void left by a rudimentary social policy system.

A. The Pension System in Kosovo

2. Since its inception, a basic pension and mandatory individual accounts have formed the key element of Kosovo's pension system. Both were established in 2002, following policy and technical advice of international financial institutions, most importantly the World Bank. The original concept was devised in consideration of the serious macroeconomic, labor market, financial sector, and public administration constraints of a newly-independent Kosovo.

3. Over the years, the pension system has expanded to include a variety of merit pensions, occupational pensions, and a legacy pension. Apart from the typical disability and survivor benefits, there are special benefits for war veterans, war invalids, people who contributed to the pension system in former Yugoslavia, miners, teachers, and the army. All in all, more than a dozen pension schemes exist, with an additional ten different sub-schemes in the pension scheme for war invalids. Many of these schemes function as a form of social assistance or unemployment benefits, both of which would serve society well, but are difficult to implement given high informality and inadequate tax compliance.

The Core of the Pension System

4. A universal basic pension is available to all citizens of Kosovo who reach the retirement age, which is set at 65 years for both men and women. This pension is designed as a fixed, non-contributory payment, about 18 percent of the average wage in 2023, aimed at providing a minimum safety net for the elderly population. It is funded entirely through the state budget and is not contingent on any previous employment or contributions to the pension system. While the basic pension law allows for indexation to inflation, in practice the adjustments have only been made on an ad hoc basis, with the latest adjustment in October 2024 by 20 percent and the one before in early 2022.

[1] Prepared by Boele Bonthuis (FAD) and Selim Thaçi (local office).

5. **In addition to the basic pension, there is a defined-contribution provident fund managed by the Kosovo Pension Savings Trust (KPST).** Employees are required to contribute 5 percent of their gross salary to this fund, with an equal contribution of 5 percent from their employers. Contributions are pooled and invested in various financial instruments. Upon reaching retirement age, individuals can withdraw their accumulated savings either as a lump sum or as periodic payments. Early withdrawal is permitted under specific conditions, such as severe illness or permanent disability. Like Chile or Peru, extraordinary withdrawals were allowed from KPST pensions during the Covid-19 pandemic. Around 10 percent of savings were withdrawn.

Special Pension Regimes

6. **The pension system in Kosovo provides various "merit pensions" to participants and victims of the independence struggle, which are available to mostly able-bodied working-age individuals without age thresholds or work history requirements.** These pensions are not conditioned on income or assets and include a wide array of benefits such as war invalids' pensions, civilian invalids' pensions, and survivor pensions for widows, orphans, and caretakers. Eligibility for these pensions is more relaxed compared to other benefits, focusing on merits earned during the pre-independence struggle or disability linked to the war; this has led to a skewed age distribution towards working-age recipients.

7. **Merit pension levels are largely discretionary creating significant disparities across different benefit types.** War veterans' pensions, which are among the most important war-related benefits, have seen an increase in recipients, now numbering over 38 thousand, with eligibility based on affiliation with the Kosovo Liberation Army. These pensions, significantly higher than basic pension, are paid regardless of age but cease upon receiving other income or reaching retirement age, in the latter case they are replaced by a supplement to ensure total benefits remain consistent. Additionally, families of deceased or missing individuals during the war receive varying levels of benefits based on the deceased's status, and individuals with war-related disabilities have access to pensions that are more generous than standard disability pensions.

8. **Occupational pensions primarily cater to certain public sector employees, including those in the Kosovo Security Forces (KSF), the Kosovo Protection Corps (KPC) and teachers.**[2] Eligibility criteria for occupational pensions can include years of service and specific job descriptions. Benefits from these pensions generally exceed those of the basic pension and may include both a fixed amount and additional benefits based on criteria such as rank or years of service. This paper will not discuss pensions for the security forces of Kosovo.

9. **For teachers, a new pension scheme was established in 2019 to recognize the contributions of educators who worked in the alternative Albanian-language education system during the 1989–99 period, which was not officially recognized.** This scheme covers various educational staff and provides supplemental benefits to retirees, calculated as a percentage

[2] There are also special pensions for Trepca miners and the Shota folkdance group.

of elementary school teachers' current base pay. In 2023, approximately 14 thousand recipients benefited from these supplements.

10. The pension system recognizes past entitlements for individuals who contributed to the pension scheme in the former Yugoslavia, granting special ex-contributory benefits to those with at least 15 years of contributions before 1999. Initially a fixed benefit, the scheme was differentiated in 2016 based on educational attainment, resulting in varied benefit levels that exceed the basic pension.[3] By 2023, nearly 50 thousand received these benefits, with a notable disparity between male (40 thousand) and female (10 thousand) recipients reflecting historical labor participation trends. The increasing number of beneficiaries and benefit levels has led to a significant rise in government spending on legacy pensions, placing pressure on public finances.

11. The newest addition in special pension benefits was the result of a constitutional court ruling stating that non-teaching workers who served during the independence war are eligible for partial ex-contributory pensions. Workers with 5–14 years of contributions can now receive a partial pension, a significant shift from the prior requirement of 15 years. This has led to an additional number of beneficiaries of 7.5 thousand.

Disability and Survivor Pensions

12. Disability pensions are provided to individuals who have been assessed and certified as permanently disabled. The assessment process involves evaluations conducted by authorized medical bodies. The benefit amount for disability pensions is typically calculated based on the individual's previous earnings and the length of time they contributed to the pension system. Additionally, recipients of disability pensions may be subject to periodic reviews to confirm their ongoing eligibility.

13. Finally, survivor pensions are available to dependents, such as spouses or children, of deceased individuals who were active contributors to the pension system or who were receiving a pension at the time of their death. The benefit amount is usually a percentage of the deceased individual's pension or contributions, and specific rules govern how benefits are allocated among multiple dependents.

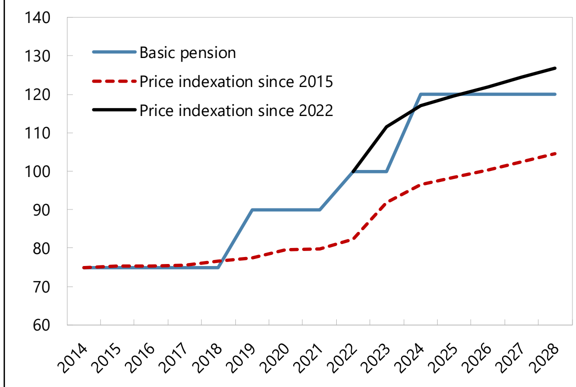
B. Issues

14. The pension system in Kosovo has undergone significant changes since its inception nearly two decades ago, yet it remains affected by a lack of a clear vision and overarching policy objectives. Attempts to introduce earnings-related pension schemes have surfaced amidst growing discontent with the current system.

[3] Individuals with eligibility to receive pensions under different schemes will not receive basic pension unless the latter is higher than the benefit under alternative scheme.

15. Adjustments to pension benefits are often ad hoc without clear policy rationale. Even though the law, adopted in June 2014, allows for adjustments of pension benefits to the cost of living, the basic pension has been updated three times since 2014 (in 2019, 2022 and 2024). In 2022 double basic pension benefits were awarded in April and October, again with unclear policy rationale. If the full price indexation would have been followed since 2022—the last time the benefit was updated prior to 2024 update—this would have largely resulted in similar benefit levels, protecting pensioners better against drops in real income without the risk of the perception of politically-motivated adjustments.

Basic Pension in Kosovo—Actual and Counterfactual



Sources: Kosovo Authorities and IMF staff estimates.

16. A significant gap exists in the social protection framework, particularly the absence of unemployment benefits. This gap drives demand for various pension benefits that often do not serve their intended purpose, such as protecting people from the loss of employment income. Since some of these benefits prohibit employment, their design is exacerbating the self-reinforcing cycle of low labor force participation and low KPST pensions.

Fiscal Considerations

17. Fiscal considerations appear to play a limited role in shaping pension system legislation. The introduction of various occupational and merit pension schemes has occurred without comprehensive medium- or long-term fiscal impact analyses. This lack of long-term projections undermines policymakers' ability to evaluate the potential effects of demographic changes, labor market dynamics, and macroeconomic conditions. As a result, this oversight may lead to decisions with adverse fiscal and welfare implications.

18. High expenditures on merit pensions significantly constrain the fiscal space available for enhancing anti-poverty income replacement programs. The social protection system is disproportionately focused on benefits related to wartime service, while traditional social assistance programs, such as cash transfers, fall short in eligibility and benefit levels. Currently, less than 40 percent of public pension spending is allocated to the basic pension, while significant amount is spent on benefits to working age people (Table 1). This inadequacy hampers the system's effectiveness in addressing poverty.

Table 1. Kosovo: Overview of Spending, Number of Beneficiaries and Average Benefit by Scheme

	Number of beneficiaries (thousand)	Spending (EUR million)	Average monthly benefit (EUR)
Basic pensions	145.9	185.4	106
Ex-contributory pensions	48.1	122.3	212
Veterans	36.8	73.7	167
Pensions of families of war martyrs and invalids	13.0	39.0	251
Pensions of disabled persons	19.2	26.8	117
Teacher's pensions	13.3	13.9	87*
Paraplegic and Tetraplegic Pensions	2.8	11.5	346
Families with children with disabilities	3.1	10.5	277
Partial ex-contributory pension	6.4	10.3	135
Scheme for the blind	1.8	5.1	236
Pensions of the Kosovo Security Forces	0.7	4.0	452
Family Pensions	3.1	3.8	102
Pensions of the Defense Forces of Kosovo	1.3	3.4	215
Pensions of Trepca	1.5	2.3	127
Pensions of disabled workers	0.1	0.1	101

Source: Kosovo authorities.

Note: *in addition to basic pension.

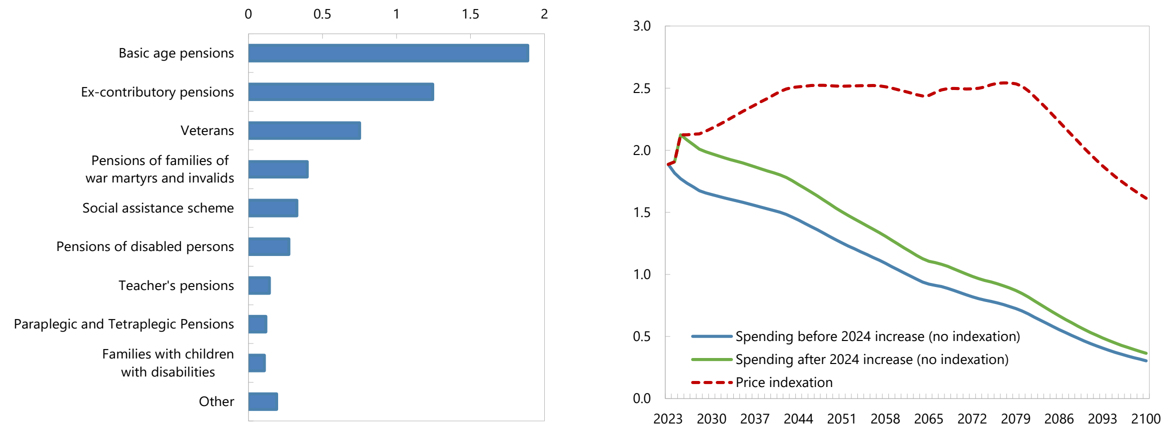
19. Demographic factors introduce additional complexity to the pension system. High fertility rates, combined with relatively low life expectancy, contribute to an old-age dependency ratio that is significantly below the European average. Although Kosovo has a youthful population, it is undergoing a rapid aging process. This swift demographic shift, along with high spending on special schemes and the emergence of additional pension schemes, puts upward pressure on total pension spending. Despite being one of the youngest countries in Europe, projections suggest that the old-age dependency ratio will nearly triple over the next three decades, sharply contrasting with trends in other European nations.

20. The projected increase in the old-age dependency ratio will exert upward pressure on pension spending. Assuming the basic pension remains unindexed from 2023 onwards, spending on this benefit could decline from just under 2 percent of GDP to below 0.5 percent of GDP by 2100. However, this scenario has already been overtaken by recent events (the 20 percent increase in pensions implemented in October 2024). This shows how much these ad hoc adjustments influence the spending path. It also shows that no indexation going forward appears unlikely. A more realistic assumption is that pensions will generally follow price trends. In this case, pension spending is expected to rise to 2.5 percent by 2040, stabilize for an extended period, and then decrease to below 2 percent of GDP after the 2080s, when the old-age dependency ratio stabilizes.

Figure 1. Kosovo: Current Spending and Spending Projections for the Basic Pension

A) Spending
(Percent of GDP)

B) Projections of Spending on the Basic Pension
(Percent of GDP)



Sources: Authorities and IMF staff calculations.

Source: IMF staff calculations.

Equity and Fairness

21. The significant discrepancies between merit pensions and other pension benefits raise questions about equity and fairness within the system. Individuals qualifying for merit pensions can receive lifelong support without the necessity of employment, while others may receive relatively small pensions despite a lifetime of work. This disparity is particularly notable among individuals with disabilities, where the distinction between war-related and other disabilities lacks a basis in medical assessment. Furthermore, the absence of partial disability benefits for those not in the war disability system creates additional inequities.

22. Inconsistencies in the tax treatment of pension benefits raise further concerns about equity. While KPST pensions are subject to personal income tax, pension benefits paid by the government, including war-related ones, are exempt. However, after amendments to personal income tax law introduced in August 2024, which raised zero-rated threshold to €250 (from €80), taxing government paid pension benefits would not generate significant tax liability as most benefits are below the new zero-rated threshold. Nonetheless, subjecting these benefits to income tax could enhance equity within Kosovo's tax system and reduce the net fiscal burden of these benefits in the future, especially after the benefit levels rise above the zero-rated threshold. Additionally, requiring KPST contributions could improve the fairness of the overall pension system, making it easier to phase out post-retirement supplements.

Impact on Labor Supply

23. The provision of lifelong cash benefits to able-bodied individuals and those with minor disabilities negatively affects labor supply and perpetuates informality within the labor market. Many recipients of such benefits do not require ongoing financial support for their pre-independence activities, yet they receive state financial aid that serves as a disincentive to seek formal employment. The structure of these benefits discourages labor market engagement, as future pension entitlements are independent of the recipients' employment behavior.

24. The absence of temporary survivor pensions further complicates the labor market landscape, particularly for working-age widows. While regulations around young survivors' pensions align with international norms, spousal benefits create disincentives for labor supply. This is especially pertinent for women, whose labor participation rates are already low. Most advanced economies provide temporary pensions to survivors younger than the retirement age, allowing them time to adjust their financial and employment situations. Such measures are absent in the Kosovo context.

C. Policy Options

25. The basic objectives, structures, and constraints of pension policy should be defined in a framework law that serves as a benchmark for both current and proposed pension schemes. The existing, fragmented regulatory framework should be simplified and aligned with a pension policy framework established by an act of parliament.

26. While spending on the basic pension remains relatively low compared to international standards, there should be a more restrictive approach to special pension benefits. The creation of new pension benefits should be limited by law. This would create fiscal space to consistently index the basic pension with prices and make it a more effective pension to keep elderly out of poverty.

27. To enhance the clarity and effectiveness of pension indexation, it is essential to clearly define the index used for adjustments. The current law mentions both Cost of Living Adjustment (COLA) and inflation, leading to confusion and inconsistency. It is recommended to adopt a single, clearly defined index to ensure that pension adjustments are based on transparent and objective criteria. The choice between COLA and CPI depends on whether one believes that the elderly consume a significantly different basket of goods and services. Over longer periods, the two measures typically do not differ greatly. CPI is preferred due to its clearer definition and objective nature. Indexation should be backward-looking, as this method relies on statistical data, while forward-looking indicators tend to be influenced by political considerations. However, this backward-looking method can result in delayed adjustment in benefits, which can become problematic during periods of sudden high inflation. It is therefore crucial to have additional social safety net tools available, which are currently crowded out by merit-based pensions.

28. The calculation of the index should be delegated to an independent statistical agency rather than the Ministry of Finance. This change would support the objectivity and credibility of the index, ensuring that it does not become a political issue. Such a move would improve public trust in the pension adjustment process and align with best practices observed in other countries.

29. Lastly, to address the potential for excessive discretion regarding pension adjustments due to fiscal constraints, it is important to establish clear rules governing the budgetary

process and pension contributions. Rather than wide authority based on budgetary space, specific guidelines should be developed to ensure that pension increases are protected from arbitrary cuts or increases during financial downturns and upturns (or elections).

30. If fiscal pressure of the basic pension becomes problematic, it would be prudent to link the retirement age to life expectancy at 65. The law on pensions financed by the state mandates a review of the retirement age at least every five years. However, until now this has not been done. Once reliable statistics on life expectancy at retirement become available, this long overdue review should be conducted and ideally the retirement age should be linked to life expectancy. One option is to increase the retirement age with two-third of life expectancy gains at 65, keeping the ratio of working life to retirement roughly constant.

31. Teachers' complementary pensions should ideally be replaced with a lump sum payment. Benefits should be indexed to prices rather than administratively set wages, allowing for separate wage and benefit-setting mechanisms. This would reduce the overall cost of public sector wage increases and provide more stability in benefit values during periods without public wage adjustments. The government might also consider offering a lump sum that is significantly lower than the total expected discounted benefit stream.

32. Expenditures on merit pensions and the net present value of these schemes' liabilities should be reduced, reallocating savings to better-targeted social cash transfers. Since discontinuing various merit pensions, especially for war veterans, is politically unfeasible, alternative methods could be employed to limit expenditures (and allow for additional support for poverty-alleviation measures), improve labor supply, reduce informality, and create fiscal space. Options include:

- Make war veterans' pensions and other merit pensions for able-bodied working-age individuals subject to income tax and KPST contributions.
- Make pension supplements for war veterans above retirement age subject to income tax.
- Offer a one-time lump sum payment to working-age war veterans and war disability pensioners instead of monthly payments, reducing the present value of their expected benefit. Make the lump sum income tax-exempt if transferred to a KPST account, per the beneficiary's choice.
- For surviving spouses more than five years younger than retirement age, replace lifelong survivor pensions with temporary benefits payable for one year.