ESPN Thematic Report:

Assessment of Pension Adequacy in Turkey

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Summary/Highlights

- Entering the millennium faced by a trade-off between improving the adequacy and financial sustainability of the pay-as-you-go (PAYG) based pension system, Turkish governments have taken a series of major steps towards parametric and institutional reform.
- With the rehabilitation of the compulsory pillar run by the state largely completed by 2008, recent interventions in the pension system have focused mostly on extending the (optional) coverage of the funded pillar.
- A notable recent step in this direction was the introduction of legislation requiring that all wage and salary earners younger than 45 be automatically enrolled in a funded plan, unless they request to opt out within 2 months.
- Under the new legislation, all workers on a fixed-term, albeit renewable, contract will be automatically assigned to an individual pension plan after January 2017 and start contributing 3% of their taxable earnings, unless they opt out.
- It remains to be seen whether this move will make funded retirement accounts popular enough to help make up for the decline in pension adequacy resulting from the reduced generosity of statutory PAYG scheme.

1 General description of the national pension system

The pension system in Turkey has two pillars. The main pillar is the statutory pension scheme run by the state on a PAYG basis. It provides compulsory old-age insurance coverage to all workers and the self-employed through the social security system. The retirement benefits provided to current retirees are financed from the social security contributions of current workers, and any resulting deficit is funded by the Treasury.

The supplementary pillar includes funded schemes that provide optional additional coverage through privately managed personal pension accounts. This option has been available since 2003, when a new law allowed private companies to offer everyone the option to purchase a complementary pension plan, regardless of their employment status. OECD calculations based on 2016 data indicate that the coverage rate is 16.4%.

Prior to 2006, the publicly managed pillar providing compulsory pension coverage (and a number other types of social security) was made up of three independent institutions: each offered retirement benefits to different groups within the working population, through PAYG schemes that operated with different parameters, rules and regulations. Of these, the SSK insurance fund covered all blue-collar workers and white-collar workers employed in the private sector; Emekli Sandigi covered white-collar workers employed by local and central government; and Bag-Kur covered farmers, artisans and other self-employed people.

The latest social security reform package, which took effect from 2006, required that these three institutions be restructured and merged into a new public agency called the Social Security Institution (SSI). The newly created SSI was put in charge of running both PAYG-based social insurance schemes and transfer payments made to the needy through non-contributory social assistance schemes. Differing rules and regulations (such as entitlement conditions or the calculation of pensions and other benefits) applying to different working groups previously covered by three separate institutions were also harmonized to a great extent. The coverage provided to workers previously covered by SSK, Bag-Kur and Emekli Sandigi is now regulated by Articles 4/a, 4/b and 4/c, respectively, of the current Social Security Law (Law No. 5510). In fact, the groups of workers whose pension coverage is subject to rules spelled out in those Articles became known as 4/a, 4/b and 4/c. Workers employed through a fixed-term, albeit renewable,

contract previously covered by SSK (that is, all blue-collar workers and white-collar workers employed in the private sector) are now called the "4/a group"; whereas white-collar workers employed by the public sector through an indefinite-term contract are now referred to as the "4/c group". Likewise, the self-employed are now called the "4/b" group. Pensioners and survivors who are currently collecting benefits, *plus* active contributors and their dependants who are getting ready to collect benefits in the future, make up about 86 per cent of the current population. In other words, only 14% of the population are without access to some sort of benefit from the SSI. (It must be noted that unregistered workers may continue to collect benefits as survivors or dependants of registered workers.)

In principle, participation in retirement plans is compulsory for all wage and salary earners as well as the self-employed, but actual coverage is less comprehensive due to serious compliance problems. Unregistered workers currently account for about one-third of the total workforce. Voluntary participation is possible for people who are active outside compulsory coverage categories.

Currently, the minimum number of contributory days for a worker to become eligible for retirement is 7,200 (20 years) for private sector employees covered under Article 4/a; and 9,000 days (25 years) for civil servants and self-employed workers covered under Articles 4/b and 4/c (Law Number 5510, Article 27). There is also a minimum entitlement age for people to start collecting their monthly pension. This age is 58/60 for women/men whose working lives first started after the 1999 reform. Those who were already working in 1999 will be subject to a scheme gradually increasing their retirement ages, depending on their seniority at the time. An additional scheme coming into effect after 2036 was introduced during the reform wave of 2006, which will gradually increase minimum entitlement ages for women and men so as to equalise them at 65 by 2048. There are early-retirement options and relaxed conditions for part-time workers, miners and other workers in hazardous jobs, and disabled people.

The overall contribution rate for old-age insurance is 20%. Contributions are collected out of the (gross) earnings base of each worker at the rate of 11% from employers and 9% from workers themselves. Pensioners who take new jobs after retirement are subject to so-called social security support premiums, collected at the rate of 30% (22.5% from employers and 7.5% from the pensioners).

The monthly pension is calculated by multiplying the present value of average monthly earnings throughout a worker's career by the replacement rate. The replacement rate is 2 percentage points for every 360 days of contributions, with a cap at 90%.

Article 40 of the Social Security Law (#5510) treats workers in arduous and hazardous jobs (WAHJ) differently, giving them a special status regarding their eligibility in the general retirement scheme. Called the Active Service Term Increment, the treatment has two components: a reduction in the pension entitlement age, and higher premium rates paid by employers throughout the working lives of WAHJ. For every 10 years of active work by a WAHJ, 20 months' worth of contributions are added to the period of service in retirement calculations. As such, it is easier for a WAHJ to complete the minimum number of active work days required for retirement. Furthermore, the minimum age of retirement is also reduced from 60 to 57.5 for men, and from 58 to 55.5 for women. The increment also translates into higher retirement benefits, thanks in part to an extra 1% of monthly earnings added to the employers' share of contributions.

2 Reform trends

The pension system in Turkey today was shaped by three major pieces of legislation gradually introduced after 1999. Since a primary purpose of these reforms was to curb pension deficits, which had already reached unsustainable proportions by the end of the 1990s, the initial stages of reform involved parametric adjustments, leading to higher statutory entitlement ages and lower replacement rates - and hence reduced pension benefits. As a result, the second stage of reform aimed to lay the legislative groundwork to allow working individuals to voluntarily purchase additional coverage from private companies that are authorised to sell individual retirement plans. This essentially transformed the single-pillar pension system in Turkey into a two-pillar system. Since the reform process targeting the compulsory pillar run by the state had largely been completed by the end of the 2000s, recent steps taken to further reform the pension system focus mostly on extending the (optional) coverage of the funded pillar.

The most notable step taken to address this need was Law No. 6740, which was enacted in August 2016 and came into effect in January 2017. Under the new law, all publicly and privately employed wage and salary earners (covered under Articles 4/a and 4/c of Law No. 5510) who are less than 45 years of age will be automatically assigned to an individual pension plan and start contributing at the minimum rate of 3% of their taxable earnings, unless they request to opt out within 2 months of their automatic enrolment in the plan. In 2015, informal employees (18% of all waged workers - or, put differently, 14% of all those in paid employment) and the self-employed (24% of those in paid employment) are not required to enroll, leaving 62% of those in paid employment within the scope of the new law. The major change brought about by the new law is that all wage and salary earners younger than 45 will have to opt out of an individual (funded) pension plan, rather than opt in, as in the case of workplace pension plans in the UK.

This automatic inclusion in an individual (funded) pension system for wage and salary earners is likely to significantly increase the number of participants. It is estimated that there are more than 10 million working individuals who are younger than 45, making up the target audience to be covered automatically by individual pension plans (Sayan, 2017). This compares favourably with the number of currently enrolled participants, which stood at about 6.9 million as of the end of 2017. Together, these have created a total fund value of about 67.7 billion Turkish Liras (TRY) through their contributions over the past 14 years - i.e. around €15 billion at the average exchange rate at the end of 2017. With the addition of 10.1 billion TRY (€2.2 billion) coming from state contributions, the total fund size of 77.8 billion TRY (€17.1 billion) corresponded to about 2.2% of Turkish GDP in 2016.

If these individuals stay in the system, rather than use their right to opt out, it would substantially boost the coverage of optional (funded) provision in Turkey. This would also contribute to a further "deepening" of financial markets (i.e. an expansion of financial markets combined with a change in the structure of the funds, with increased longer-term investment portfolios) and to the narrowing of the savings gap in the country. While the government hopes a large enough majority will stay in, the early signs indicate a larger-than-expected withdrawal rate. Nonetheless, industry analysts expect 10 million or more new contributors and more than 90 billion TRY (€20 billion) to be collected in pension contributions and returns over the next decade, due to this automatic inclusion. Given the total fund value so far created from the existing 6.6 million contributors, this represents a major boost to the privately managed pension system. It is, however, still too early to assess the impact of the new legislation. While there is recent news concerning thousands of people (including employees in the financial services sector) requesting to drop out of the automatic coverage provided, it is impossible to judge whether these exits will continue in bulk numbers or not. A systematic and robust evaluation requires the accumulation of data over a longer period.

3 Assessment of adequacy

3.1 Current adequacy

3.1.1 General assessment of current adequacy

According to Turkstat figures, the at-risk-of-poverty or social exclusion rate (AROPE) for people older than 65 was 37.8% in 2015. The figure was mostly due to high material deprivation rates, as the at-risk-of-poverty rate (AROP) was 18.7%. While both the AROP and AROPE rates are lower than those for the general population (41.3 and 24.2% respectively), this was largely due to the high prevalence of poverty among children (48.2 and 35% for those younger than 15). Poverty is more prevalent among those older than 75, with AROPE and AROP rates of 39.6% and 21.9%, respectively, in 2015. It should also be noted that the relative poverty gap was rather high, at 31.3% in 2015 after increasing by 0.9 percentage points since 2008.

Looking at the gender dimension, the AROPE rate for males aged 65+ (36%) was slightly lower than the corresponding rate for elderly females in 2015 (39.2%). The gap has been about the same in 2008 as in 2015.

Regarding changes over time, the AROPE indicator has little value because a change in methodology relating to material deprivation questions in 2012 and 2013 resulted in a sharp drop in the rate (from 57.9% in 2011 to 43.8% in 2013). The AROP rate, on the other hand, was almost the same in 2008 and 2015 (18.9% and 18.7% respectively), indicating that the poverty situation had not changed over time.

The median relative income of the 65+ population was 1.04 in 2015, or 0.04 lower than its value in 2008. The income quintile ratio was 7.2, slightly lower than the ratio in the overall population (8.6) and 0.7 lower than its value in 2008. Both figures show that elderly people are similar to general population when it comes to income inequality – in both cases it is rather high.

The aggregate replacement ratio was 1.05 in 2015. That is mostly reflective of two facts. First, wages are low, especially in the informal jobs that constituted 33.5% of employment in 2016. Second, the early-retirement regime was relatively generous, resulting in relatively high pension payments.

As to the pension payment duration, due to rather early entitlement to retirement under the 1990s retirement system, the average retirement age is rather low at 51 years.[1] The average life expectancy at the age of 51 is 29.6. While it is common for retired individuals to continue working after retirement, the employment rate among those aged 55-64 is low, at 33.4% in 2016. It is even lower among women, at 18.1%. Unregistered employment among senior workers taking second jobs after retirement is somewhat common, as not registering these post-retirement jobs benefits both the worker and the employer financially by enabling them to avoid additional payroll taxes. Indeed, partially because of that, social security premiums for retired individuals who are self-employed have been initially set at 15% but was reduced to 10% in 2015 and was eliminated in 2016, enabling all retirees to continue earning additional income without sacrificing any fraction of their pension in case they take up self-employed work after retirement.

Perhaps a bigger challenge is to increase the coverage of (non-contributory) social assistance to the needy elderly, especially to those who do not receive any pension or survivors' benefit income. Given how widespread unregistered employment has been in Turkey, many people spend their working life without getting registered with the social security system, losing nearly all their income in old age. Currently, those who are not covered by social security are entitled to a monthly payment of around €50. This is clearly low and far from lifting individuals above the poverty thresholds.

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[1] http://aa.com.tr/tr/ekonomi/turkiyenin-ortalama-emeklilik-yasi-51-52/794947

3.1.2 Redistributive elements of public pension schemes

Pension benefits depend on contributions. Replacement rates (RR) for pension benefits are 2% for every year (360 days) of the contribution period (3% for civil servants for their first 25 years and 1% afterwards) with an upper limit of 90%. Monthly pensions are calculated as the RR multiplied by average monthly earnings (AME), which is obtained by multiplying the uprated present value of average daily earnings reported to social security during the contribution period by 30.

In uprating the AME of earlier years to the year of retirement, consumer prices and 30% of GDP growth are taken into account. For civil servants the AME figure is based on the last year of earnings. Pensions are adjusted according to the change in consumer prices twice a year.

There exists a minimum threshold for monthly earnings subject to social security dues; and also a cap set at 6.5 times the minimum wage. As the pension system has been subject to various changes, the last one dating from 2008, there are currently retirees subject to different rules, and occasional adjustments are made to make the pension payments made to different retirees comparable.

Survivors' benefits are extended to spouses and children, as well as parents who qualify as dependants. A spouse is entitled to 50% of the pension calculated for the deceased (75% if there is no other person receiving survivor benefit and the spouse has no other income). Female children are entitled to payment as long as they are not married.

3.2 Retirement conditions for the self-employed and for people in non-standard employment

Participation in retirement plans is compulsory in principle for all wage and salary earners as well as self-employed individuals and most non-standard workers, but actual coverage is less comprehensive due to serious compliance problems. Voluntary participation is also possible for people who are active outside compulsory coverage categories.

The minimum number of contributory days for self-employed workers to become eligible for retirement (9,000) is higher than that for waged employees in the private sector (7,000) but is the same as that for government employees. Social security contributions and monthly pensions, as well as survivors' benefits, are calculated on a similar basis to those for waged employees. The retirement age varies with the year of starting work, but is set to gradually increase after 2036, reaching 65 in 2048 for both men and women.

It is quite common for the self-employed not to pay their social security contributions. The latest available data (from January 2011) on self-employed people in non-agricultural activities (previously covered by Law No. 1479) indicate that only 44% were fully up to date with their contribution payments, whereas 33% were in arrears with their contributions. Furthermore, the remaining 23% had never paid any contributions after registering themselves. The same percentages were 52%, 30% and 18%, respectively, for people working on their own account in agriculture, i.e. those previously covered by Law No. 2926 (Alper, 2011). Non-compliance results in low or no pension payments in old age, and consequently in poverty.

3.3 Future adequacy and challenges

The Turkish pension system began to generate huge deficits following the government's (extremely populist) move in the early 1990s of getting rid of the statutory entitlement age, and leaving contributory days as the only criterion for starting to collect pensions. These deficits are still a major obstacle to addressing pension adequacy issues. With hundreds of thousands of workers taking early retirement in their 40s or even 30s, worker-to-retiree ratios (or active-passive ratios) in the Turkish pension system fell to alarmingly low levels (below 2, as recently as the early 2000s). The absence of an entitlement age often meant a period of retirement significantly longer than the period of active contributions for many beneficiaries (Sayan, 2006). Measures brought in under the

pension reform acts of 1999 and 2006-2008 to combat unsustainable pension deficits included increases to entitlement ages (as discussed above) and reductions to replacement rates. As a result, pensions will from now on correspond to a lower share of earnings from work unless individuals complement their pension income with receipts from individual plans they opt to purchase. Admittedly, it is difficult for most workers to make monthly contributions that purchase funded plans large enough to generate significant additions to pension income from compulsory PAYG schemes run by the state. The introduction of direct state contributions at the rate of 25% to complement individuals' contributions seems like an effective step in the right direction.

4 Main opportunities for addressing pension-related challenges

A major challenge in Turkey is to balance adequacy with financial sustainability in the compulsory pillar of the pension system run by the state. High dependency ratios remain a big obstacle to making significant improvements to adequacy. There are, however, two channels through which the number of contributors to the system could be increased relatively quickly to curb the increase in dependency ratios.

1. Currently, about one-third of all workers in Turkey work without registering with the social security system. Reducing unregistered employment rates would mean increased contribution revenue and improved active/passive ratios. Unregistered employment should be fought not only through better and more effective inspection, but also by tackling the underlying causes of unregistered employment, such as the low education and skill levels of the workforce.

A relatively quick drop in unregistered employment could follow if (non-contributory) social assistance benefits ceased to be tied to unemployment status. The existing system encourages individuals who would like to remain eligible for social assistance benefits to prefer unregistered jobs, deliberately choosing not to register with the social security system. Better and more innovative channels must be created to provide social assistance to the needy elderly of today, and without causing more workers to turn themselves into the needy elderly of the future.

2. Labour force participation rates among Turkish women are rather low. About two-thirds of working-age women stay out of the labour market. To the extent that they were effective, measures to increase participation rates among women would mean increased contribution revenue for the social security system and might hence help improve pension adequacy.

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