



TURKISH INDUSTRIALISTS' AND BUSINESSMEN'S ASSOCIATION

## **REFORMING THE TURKISH PENSION SYSTEM: PRESENT SITUATION AND ALTERNATIVE STRATEGIES**

### **EXECUTIVE SUMMARY<sup>1</sup>**

#### **BACKGROUND INFORMATION**

Old-age insurance operations of the publicly managed social security system in Turkey were set up in the 1940s to offer universal coverage to workers employed by public and private sectors alike. The system is made up of three different and distinct branches, each providing pension benefits in return for compulsory participation in retirement plans run on a pay-as-you-go (PAYG) basis. Prior to 2003, additional coverage on a voluntary basis was only available through a number of private pension funds set up by some companies, banks etc. to provide optional coverage to their own employees. Following the completion of legal and regulatory framework to allow working individuals to voluntarily purchase optional retirement plans from private companies in 2002, most insurance companies began to sell optional coverage through money purchase schemes in 2003.

Of the publicly managed pension funds, SSK provides coverage to blue-collar workers employed in the public sector and blue- and white-collar workers in the private sector; BK covers farmers, artisans and other self-employed people, while the ES serves as the pension fund administration for white-collar workers employed by local and central governments. The developments in the number of people covered by each branch since the beginning of the 1990s are shown in Table 1.

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<sup>1</sup> This report is the executive summary of the original study entitled "Reforming The Turkish Pension System: Present Situation And Alternative Strategies" prepared by Prof. Dr. Yusuf Alper, Prof. Dr. Selahattin İmrohorođlu and Assoc. Prof. Serdar Sayan in Turkish and published by TÜSİAD in November 2004.

**TABLE 1. Social Security Coverage by Status and Institution: 1990-2002 ('000)**

	1990	2000	2002	% Change 1990-2002
<b>ES (T.C. EMEKLİ SANDIĞI) TOTAL</b>	<b>8,586</b>	<b>9,766</b>	<b>10,699</b>	<b>24</b>
1. Insured (Active Contributors)	1,560	2,164	2,373	52
2. Pension Recipients (Passive Users)	843	1,297	1,409	67
3. Dependents	6,182	6,305	6,917	11
4. Active /Passive Ratio [1/2]	1.85	1.67	1.68	↓
5. Dependency Ratio [(3+2)/1]	4.50	3.51	3.51	↓
<b>SSK (SOSYAL SİGORTA. KURUMU) TOTAL</b>	<b>18,977</b>	<b>34,139</b>	<b>35,261</b>	<b>86</b>
1. Insured (Active Contributors)	3,446	5,283	5,257	52
2. Voluntarily Covered Contributors	300	844	942	214
3. Active Contributors in Agriculture	74	185	149	101
4. Pension Recipients (Passive Users)	1,596	3,339	3,748	134
5. Dependents	13,560	24,488	25,166	85
6. Active /Passive Ratio [(1+2+3)/4]	2.39	1.89	1.69	-29
7. Dependency Ratio [(5+4)/(3+2+1)]	3.97	4.41	4.55	15
<b>BK (BAĞ-KUR) TOTAL</b>	<b>13,361</b>	<b>15,036</b>	<b>15,548</b>	<b>16</b>
1. Insured (Active Contributors)	1,967	2,182	2,193	12
2. Voluntarily Covered Contributors	106	255	238	124
3. Active Contributors in Agriculture	752	876	891	18
4. Pension Recipients (Passive Users)	595	1,277	1,394	134
5. Dependents	9,940	10,446	10,833	9
6. Active /Passive Ratio [(1+2+3)/4]	4.75	2.59	2.38	↓
7. Dependency Ratio [(5+4)/(3+2+1)]	3.73	3.54	3.68	↓
<b>PRIVATE PENSION FUNDS TOTAL</b>	<b>312</b>	<b>324</b>	<b>324</b>	<b>-10</b>
1. Insured (Active Contributors)	84	78	72	-14
2. Pension Recipients (Passive Users)	32	71	78	143
3. Dependents	195	174	175	-10
4. Active /Passive Ratio [1/2]	2.63	1.10	0.92	↓
5. Dependency Ratio [(3+2)/1]	2.70	3.12	3.53	↑
<b>OVERALL TOTAL</b>	<b>41,236</b>	<b>59,265</b>	<b>61,832</b>	<b>50</b>
1. Insured (Active Contributors)	7,058	9,707	9,894	40
2. Voluntarily Covered Contributors	406	1,099	1,180	190
3. Active Contributors in Agriculture	826	1,061	1,040	26
4. Pension Recipients (Passive Users)	3,068	5,985	6,628	116
5. Dependents	29,878	41,413	43,090	44
6. Active /Passive Ratio [(1+2+3)/4]	2.70	1.98	1.83	↓
7. Dependency Ratio [(5+4)/(3+2+1)]	3.97	3.99	4.10	↑
<b>TOTAL POPULATION</b>	<b>58,754</b>	<b>68,036</b>	<b>70,171</b>	<b>19</b>
<b>SHARE OF INSURED POPULATION (%)</b>	<b>72.7</b>	<b>87.1</b>	<b>88.1</b>	<b>21</b>
<b>ACTIVE INSURED/EMPLOYMENT (%)</b>	<b>39.1</b>	<b>46.3</b>	<b>46.3</b>	<b>18</b>

**SOURCE:** State Planning Organization, *The Eighth Five Year Development Plan: 2001-2005*, and *Annual Program Documents 2003 and 2004* (all in Turkish).

The state-run part of the Turkish social security system began to experience serious financial difficulties in the 1990s. The prime contributor of these difficulties was losses from old-age insurance operations due to the imbalance between contributions collected and pension benefits paid which became a persistent problem after the 1980s. Like other PAYG schemes, the pension leg of the Turkish system has been financing retirement (old-age) benefits to current retirees out of contributions collected from currently active workers. The system as a whole generated significant losses in the 1990s, since the generosity of benefits relative to contributions was retained even after the ratio of active workers to retirees started to decline at an increasing rate following the 1980s. Since the losses generated by these three institutions together add to public sector deficits funded directly by the Treasury, the rapidly growing social security deficits caused an alarming increase in the public sector's borrowing requirements, proving to be unsustainable by the end of the 1990s and necessitating a major pension reform and a rehabilitation of social security system at large.

When the government prepared a proposal for a major pension reform in 1999, the losses had already reached at magnitudes putting the future solvency of the system at risk (Table 2). In the absence of interventions, total deficit of the whole system was projected to increase to 16.8% of GNP by the year 2050. Even considering pension losses alone, the projections indicated that the GNP share of deficits was likely to exceed 5% by 2010, if the pre-1999 values of pension parameters were to be retained (Ayaş, 1998).

**TABLE 2. Growth of Social Security Deficit in Turkey**

Years	Share of Soc. Sec. Deficit in Tot. Budget Deficit ( %)	Share of Total Transfers to Soc. Sec. Institutions in GNP ( %)
1993	17	1.20
1994	20	1.13
1995	36	1.44
1996	26	2.16
1997	34	2.55
1998	35	2.85

**SOURCE:** Ayaş, E. (1998). "Türkiye'de sosyal güvenlik sisteminin sorunları ve çözüm önerileri," *İşletme ve Finans*, 150, 41-50.

The crisis of Turkish pension system came at a time when PAYG pension systems in several other countries were encountering financial difficulties of their own, due mainly to the decreasing worker-to-retiree (or active-passive) ratios. Differently than these countries where decreasing worker-to-retiree ratios resulted from population aging, the fall in this ratio in Turkey was due primarily to exceptionally low entitlement ages for

pension benefits (minimum retirement age). In fact, pension regulations allowed female/male workers to begin collecting retirement benefits as early as 38/43 years of age.<sup>2</sup> The mismanagement of pension funds resulting from actuarially unsound entitlement ages and other populist practices introduced by policy makers gave rise to the pension crisis of the 1990s, although Turkey still had a predominantly young population.<sup>3</sup>

Another notable factor contributing to the pension deficits in Turkey has been low compliance with pension laws. There is a large number of unregistered workers, partly due to the high rates of taxes collected from workers and employees as contributions towards pension coverage. Even for registered workers, enforcement problems lower actual contribution receipts significantly below potential levels. These include the tendency among employers to underreport payments to workers or to withhold contributions collected rather than transferring them to pension fund administrations, as there usually are economic incentives for such violations of pension laws (such as low late transfer penalties relative to market interest rates).

The evident need to extend the average contribution period (and shorten the benefit collection period) made the entitlement age the most critical parameter for pension reform in 1999. In the early drafts of the pension reform bill, the entitlement age was set at 63/65 for female/male workers, representing a substantial increase over the existing levels. Under intensive pressure from trade unions and other interest groups, however, the government modified the proposal to lower the entitlement ages to 58 and 60 for female and male workers, respectively, and allowed for a transition period for making these effective.

Legislated in September 1999 following heated debates between the government and the opposition groups inside and outside the Parliament, the bill no. 4447 required gradually increasing entitlement age to 58/60 over an 8 year period, while largely maintaining the values of average contribution and replacement rates. Besides the age increase, the major modifications introduced included the extension of the indexation period for calculation of pension benefits to the entire duration of employment and the linking of increases in pension payments to consumer inflation.

The parametric reform bill was an imperative step to control the rapid growth in pension (and hence, social security) deficits. Since the complete elimination of deficits would have required more radical measures (which were not necessarily feasible politically), the act had been intended to be just the first stage of a larger reform to overhaul the system. The additional steps towards the completion of reform process

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<sup>2</sup> Even though relatively few people actually retired before 40 years, about one third of people who took retirement during 1996-1999 period were younger than 45 years of age –see Table 44 at <http://www.ssk.gov.tr/wps/sskroot/istatistik/2000/t43-60.htm>) Despite some variation across pension institutions, the median retirement age has been significantly lower than OECD averages.

<sup>3</sup> As of 1990, the weighted age average of Turkish population was 26.43 whereas the median age was 22.21 ([http://www.frekans.com.tr/html/4tr\\_istatistikler.asp](http://www.frekans.com.tr/html/4tr_istatistikler.asp)). Despite its tendency to age, Turkish population is still young with 29% of the population between 0-14 years of age, 64% between 15-64 and only 7% older than 64 (HÜNEE, *Nüfus ve Sağlık Araştırması 2003*).

included the introduction of money purchase pension schemes managed by the private sector as an optional second pillar; improvement of information infrastructure and records to lower red tape, increase compliance and efficiency of operations, and attempts to merge different rules and regulations of coverage under each of the three pension institutions into a unified framework.

## **WHY THE NEED FOR REFORM NOW?**

While the most notable provision of bill no. 4447 was the gradual increase in minimum retirement age, a ruling of the Turkish Constitutional Court (or the Supreme Court) required that this provision be reconsidered. In February 2001, the Constitutional Court ruled, following its examination of an appeal by the deputies from the main opposition party in the Parliament that the bill's scheme for gradual increases in the entitlement age during the transition period violated equality principle and hence constitutional rights of workers in certain age groups. The Constitutional Court gave the government six months to make legal arrangements to make sure that the transition to new entitlement ages will be smoother. As a result, the transition period was extended until 2020 to increase entitlement age roughly by one every year, seriously reducing the effectiveness of the initially planned age increase scheme (Table 3).

In the aftermath of 1999, the governments continued to fail in curbing the tendencies to employ unregistered workers or to underreport wages and salaries, and in controlling the growth in transfer payments not tied to contributions during the severe economic crises between 1999 and 2002. Coupled with the extension of the transition period for age increases, the bill no. 4447 turned out to be largely ineffective in lowering the social security deficits. The GNP share of deficits overshooted its pre-reform values following a temporary improvement in 2000 (Table 4), clearly indicating that more had to be done.

**TABLE 3. Minimum Entitlement Ages for Female Workers**

Yillar	Prior to 1999	Bill No. 4447 (1999-2002)*	Revision of Bill No. 4447 (After 2002)
2000	38	38	38
2001	38	41	38
2002	38	43	38
2003	38	45	39
2004	38	47	40
2005	38	48	41
2006	38	49	42
2007	38	50	43
2008	38	51	44
2009	38	58	45
2010	38	58	46
2011	38	58	47
2012	38	58	48
2013	38	58	49
2014	38	58	50
2015	38	58	51
2016	38	58	52
2017	38	58	53
2018	38	58	54
2019	38	58	55
2020	38	58	56
2021-2060	38	58	58

\* Minimum entitlement ages that could not be put into effect during the evaluation of the appeal by the Constitutional Court first, and due to the Court's revoking.

**TABLE 4. Transfers to Publicly Managed Social Security Institutions  
Funded by the Treasury (as percentage of GNP)**

	1999	2000	2001	2002	2003	2004 (Est.)
SSK	1.41%	0.32%	0.69%	0.87%	1.35%	1.39%
BK	1.02%	0.84%	0.99%	0.96%	1.38%	1.27%
ES	1.32%	1.41%	1.49%	1.71%	1.72%	1.86%
<b>Total</b>	<b>3.75%</b>	<b>2.57%</b>	<b>3.17%</b>	<b>3.54%</b>	<b>4.45%</b>	<b>4.52%</b>

**SOURCE:** Teksöz, T., *Sosyal Güvenlik Reformu*, Ankara: ÇSGB, 2004.

Additional reasons underlying the need for a more radical reform included the following:

- Setting in of population aging in Turkey: Turkey is projected to get out of the demographic window of opportunity characterized by the increasing share of working age people in total population within the next 20 years. This by itself is reason to take additional measures to avoid even larger deficits.
- Obvious failure of the publicly managed system in allocating large amounts of resources made available to it fairly and efficiently and in such a way to improve living standards of masses: High payroll taxes reduce disposable incomes of workers and competitiveness of employers who comply; create compliance problems and collection difficulties; hinder the potential growth in employment by causing distortions in the labor market and negatively affect competitiveness of Turkish products in international markets, while the low level of pensions paid to retirees of SSK and BK fail to provide decent standards of living and the political process leading to the adjustments made to pension benefits over time create uncertainties for all retirees.

## **WHAT KIND OF A REFORM NOW?**

Having observed the developments summarized in the preceding sections and being mindful of the problems caused by the current structure and operations of the publicly managed pension system, the authors of TUSIAD report have come to share the view that reducing the degree of state involvement in the Turkish pension system was necessary. **Towards that end, the report proposes the creation of a new pension system (“Yeni Emeklilik Sistemi” or YES in Turkish) which will diminish the involvement of state but attribute a new role to it as an actor based on the following principles:**

- The new system must be impervious to the effects of exogenous changes in the demography, or economic and political business cycles.
- It must aim intergenerational as well as intragenerational fairness (must be fair in treating workers in public and private sectors, regardless of under whose retirement plan they are covered, and avoid favoritist practices concerning contribution/benefit packages applicable to the members of ES versus SSK or BK).
- The new system must give individuals more responsibility and power in deciding what type of a retirement income they desire, and provide a wider spectrum of choice and greater flexibility in the process of planning their retirement.
- It must reduce direct and indirect tax burden on individuals in such a way to make additional resources available for creation of new employment, while reducing unrecorded activities in the labor market and increasing the share of population with pension coverage, and must avoid practices that reduce competitiveness of businesses that comply with pension laws.

- It must prevent crowding out of private investment by public deficits and debt, while helping promote economic growth and improve international competitiveness.

Within this framework, the YES is proposed to be a 3-pillar system with compulsory participation to the first two pillars. The first pillar to be run by the state is meant to complement the individual retirement plans to be purchased from private companies providing funded retirement benefits to each worker through the second pillar. In other words, the first pillar is intended to provide minimum coverage to every worker who contributed to the system at pre-determined rates so as to make sure that even those who get the lowest returns on their second pillar-retirement plans will have some subsistence level of income. The third pillar will essentially preserve currently available alternatives for the voluntary purchase of individual retirement plans from private companies under the current set up.

The contribution rates proposed for the first pillar are much lower than the current rates that registered workers and their employers are required to pay. Part of the savings from current contributions will be transferred to the second pillar to finance compulsory purchase of retirement plans from private companies, while the rest is going to be available for consumption or saving –either through optional participation to the third pillar or through purchases of any other assets– at the individual’s discretion.

While the participation to the second pillar through individual accounts to be opened will be required for everyone, the asset composition of each account will be decided by individual workers who contribute, within the limits of minimum shares for bonds and equities, domestic and international assets etc.

The YES is proposed to require participation of everyone who is just beginning to work as well as those workers who have been contributing to the current system for less than 5 years at the time of its initiation. Those who have been contributing to the current system for more than 5 years as of the time YES becomes operational will be given a choice to stay in the current system subject to the same parameters or join YES under the applicable parameters as given in Table 5.

**TABLE 5. Proposed Pension Parameters for First and Second Pillars**

	First Pillar Contribution Rate (%) <sup>*</sup>			Second Pillar Contribution Rate (%)			Total Contribution Rate (%)			Replacement Rate (RR) & Entitlement Age (A)	
	Wrk	Emp	Tot	Wrk	Emp	Tot	Wrk	Emp	Tot	RR (%)	A
Current System	9,0	11,0	<b>20,0</b>	-	-	-	9,0	11,0	<b>20,0</b>	65	**
Individuals Given a Choice between Staying in the Current System and Joining YES											
Individuals who contributed to the cur.sys. for >15 yrs	4.0	7.5	<b>11.5</b>	5.0	3.5	<b>8.5</b>	9.0	11.0	<b>20.0</b>	60	56 under YES, ** Othw.
Individuals who contributed to the current sys. for >10 yrs	4.5	6.5	<b>11.0</b>	4.0	4.0	<b>8.0</b>	8.5	10.5	<b>19.0</b>	54	56 under YES, ** Othw.
Individuals who contributed to the current sys. For > 5 yrs	5.0	5.5	<b>10.5</b>	3.0	4.5	<b>7.5</b>	8.0	10.0	<b>18.0</b>	46	56 under YES, ** Othw.
Individuals Required to Join YES											
Individuals who contributed to the cur. sys. for < 5 yrs	3.5	3.5	<b>7.0</b>	4.0	4.0	<b>8.0</b>	7.5	7.5	<b>15.0</b>	25	56

\* Taken out of the base monthly salary defined as the part of salary below an upper bound set by the government every year.

\*\* The minimum entitlement age that is applicable depends on the first year of employment and the year considered for retirement during the transition period as given in Table 4.

**PENSION BENEFITS UNDER YES VS THE EXISTING SYSTEM**

Table 6 presents a comparison of average net pension income per month under the existing system and YES. The numbers in the table are calculated for an individual who works for 25 years with second pillar contributions amounting to 8% of average annual income under the assumption that funds accumulated in the individual's retirement account will have a 6% (Scenario 1) or 8% (Scenario 2) yearly return during the working period, and 4% a year during the retirement period that lasts 10 years.

		First Pillar		Second Pillar		Total	
		Millions of TL	US Dollars	Millions of TL	US Dollars	Millions of TL	US Dollars
<b>Current System</b>	<b>Pre-1999</b>	325	217	0	0	325	217
	<b>Post-1999</b>	160	107	0	0	160	107
<b>YES</b>	<b>Scenario 1</b>	125	83	276	184	401	267
	<b>Scenario 2</b>	125	83	375	250	500	333

## A GENERAL ASSESSMENT OF YES

### Strengths:

- Visible reductions in contributions paid by the workers and their employers alike are likely to boost growth in employment and increase real wages while reducing the volume of unrecorded labor market activity.
- Increase in savings through second pillar contributions is expected to
  - accelerate economic growth through faster capital accumulation
  - deepen financial markets in the country
  - help reduce the cost of borrowing for the public as well as the private sector and extend the time horizon for servicing public or corporate debt.
- The decline in budget deficit resulting from reductions in the losses of publicly managed pension system is anticipated to improve macroeconomic stability and facilitate attracting foreign investment.
- Increases in disposable income resulting from cuts in payroll taxes and increases in real wages are expected to lead to visible improvements in workers' standards of living.

### Weaknesses:

The biggest obstacle to the creation of YES seems to be the additional funds required to finance the publicly managed system following the decline in contribution revenues until the initial participants retire, bringing some relief from reduced benefits. This transition cost would be at its highest if only the entrants to YES turn out to be the younger workers who have been contributing to the existing system for less than five years (including those who are just taking employment) at the time of the initiation of YES. It could be argued that the higher the share of more senior workers (i.e., those who have been making contributions to the existing system for five or more years) that choose to switch to YES, the easier it would become to handle transition costs, since for most of these workers, voluntary participation in YES would mean postponing retirement until 56 years of age. Given that this age would not become the minimum entitlement age until 2020 (Table 3), the switch to YES of the most senior workers would buy the publicly managed leg of YES the longest time. A 41 year-old female worker who has been working for the past 15 years, for example, would be able to retire and start collecting her benefits in five years under the current system. If this worker decides to switch to YES next year, on the other hand, she'd lower her contributions to 7% of her base salary for the next five years but would postpone collection of benefits (to be paid at a replacement rate of 60%) until she's 56, giving the publicly-run leg of YES 10 more years until beginning to worry about payment of her benefits. It is obvious that financing the transition to YES would still create additional costs for the state which is already running huge pension deficits. Since it is legally impossible and politically infeasible to lower benefits of current retirees or anyone who in the near future chooses to retire under the current regulations, the

additional funding sources must be sought for. Likely sources of additional financing can be summarized as follows:

- Expected improvement in fiscal balances because of
  - increasing revenues as a result of the rise in contributions collected due to the anticipated reductions in unrecorded labor market activities, and the higher tax take likely to result from accelerated economic growth,
  - declining spending due to the reduced cost of public borrowing and debt servicing,
  - likely improvements in the term-structure of public debt to result from the sale of longer-term bonds issued by the government to newly emerging pension companies to serve in the second pillar.
- Revenue from long-delayed privatization of major assets in the portfolio of Privatization Administration such as Turkish Telecom, Turkish Airlines just to name a few.
- Additional taxes (though this would admittedly be a source that is hard to tap, since way too many additional taxes have been imposed over the past few years after the earthquake of 1999, during recent economic crises etc.)
- Adjustment loans from IMF and the World Bank that have always been supportive of major restructuring in the Turkish social security system.

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