

DON'T COUNT YOUR NEST EGGS BEFORE THEY VEST: A LACK OF REFORM COULD LEAVE A GENERATION OF RETIRING ISRAELIS WITHOUT A FUTURE

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Abstract: Israel's pension system has changed drastically since the mid-1990s, when it faced an underfunding crisis. The transition to defined contribution plans permitted a wider range of investments and shifted the burden of income-replacement from the government to the individual pension plan participant. This shift required increased protections for pension plans, which led to the creation of the Capital Market Insurance and Savings Division (CMISD) to oversee and regulate pension management entities. In comparison to post-Soviet nations that experienced similar transitions from socialist to market economies, Israel's pension system is significantly healthier and more regulated. However, the CMISD must enact measures to oversee the transition of funds from "old" to "new" pensions, reduce or eliminate the mandatory 30% investment in government bonds, and increase the accountability requirements for pension management entities and the organization itself.

I. INTRODUCTION

In unprecedented fashion, the Israeli government has pursued a sweeping overhaul of its pension system while simultaneously shifting its socialist economy to a free market system. Pension reform came just before the nation faced an impending funding crisis, which threatened the financial security of an entire generation of Israelis. By releasing its grip on the pension system, the Israeli government increased the ability of Israelis to achieve income-replacement on retirement by permitting outbound investments, offering from a greater range of plan options, and introducing strict pension protections overseen by the Capital Market, Insurance and Savings Division (CMISD). Like other nations with well-regulated private pension systems, CMISD officials continuously consider potential revisions to enhance the profitability, stability, and protection of Israel's pension system.

This comment will review the history of Israeli pension reform, compare Israel's progress to several post-Soviet nations that experienced

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similar economic transformations, review areas in need of further consideration, and suggest modifications to the current system. Part II will provide a primer on pension systems in order to highlight the prevailing pension plans that dominated the pre and post-reform era in Israel. Part III will describe the early history of Israel's pension system, including the struggles that led to its reform, while Part IV will explain how the Israeli government reformed the pension system. Section V will introduce some of the more recent additions to Israeli pension programming. Part VI compares Israeli pension developments to similar efforts in post-Soviet nations that also transitioned from a socialist to a free-market economy and the lessons Israel can learn from these nations. Part VII will identify five key areas where further refinement to Israeli law is needed. Finally, in Part VIII, this comment will briefly conclude.

II. PRIMER ON PENSION SYSTEMS

While pension systems vary greatly in form from one nation to another, they share some overarching similarities. These similarities led to the development of the "three-legged stool" metaphor for describing retirement systems en masse. Each leg represents a different source of retirement benefits, and different nations emphasize certain legs depending on the economic climate and government system in place. The first leg is "government-provided pension and welfare programs for the aged; the second is employer or labor union-provided pensions, and the third is direct individual saving."¹ The first leg serves as a form of "safety net" by providing cash and medical insurance, while the second and third legs are influenced by tax policies that incentivize specific forms of retirement savings.² Any meaningful pension reform plan will address how wide a safety net the government will provide and how it chooses to protect employee pensions through employer plans and individual investments.

Pension plans fall into one of two forms: defined benefit or defined contribution plans. The plan's form determines who contributes to the plan, when contributions and distributions occur, and how much is contributed and eventually distributed. Historically, the defined benefit plan was the

¹ ZVI BODIE & ROBERT C. MERTON, PENSION REFORM AND PRIVATIZATION IN INTERNATIONAL PERSPECTIVE: THE CASE OF ISRAEL 2 (1992) (English version on file with the author; Hebrew version published in 152 ECON. Q. (Aug. 1992) (Isr.)).

² *Id.*

dominant pension plan form used in countries around the world.³ As the name implies, a defined benefit plan specifies an amount the employee will receive on retirement, termination, or separation from the employer, often based on the employee's salary and years of service.⁴ The obligation to fund this eventual benefit lies with the employer, who absorbs all investment risk.⁵ Employers distribute benefits from a collective "pension fund," which contains an aggregation of pensions held by all employees, providing employers with a more substantial fund for larger and more diverse investments.⁶ Since the defined benefit plan dictates only the eventual payout due to the employee, employers are able to efficiently integrate government-funded benefits (for example, social security) and accurately predict the amount of investment capital needed annually for distributions.⁷

Despite the increased predictability afforded by defined benefit plans, many nations and employers have moved away from this form of pension plan. The promise to provide a pre-determined benefit is manageable when the employer is financially secure (as it can always cover investment losses from other reserves). One of the major issues with defined benefit plans, however, is the instability of the employee's pension when the employer is no longer financially viable. This issue was highlighted in the United States in 1963 with the Studebaker Incident, which led to the passage of the most comprehensive pension protection reform legislation ever passed: the Employee Retirement Income Security Act (ERISA).⁸ When the Studebaker-Packard Corporation closed its doors, it found that it did not have sufficient capital in the collective fund to provide the promised benefits to all of its employees.⁹ The company decided to distribute the full defined-benefits to employees who were age sixty and above (the retirement age), a fraction of the entitled benefit amount to some younger employees, and nothing at all to a large portion of employees under age sixty.¹⁰ This incident highlighted a flaw that impacts many defined benefit plan sponsors:

³ *Id.* at 4.

⁴ JOHN LANGBEIN, DAVID PRATT & SUSAN STABILE, *PENSION AND EMPLOYEE BENEFIT LAW* 45 (5th ed. 2010).

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 48.

⁸ James A. Wooten, "The Most Glorious Story of Failure in the Business": *The Studebaker-Packard Corporation and the Origins of ERISA*, 49 *BUFF. L. REV.* 683, 684 (2001).

⁹ *Id.*

¹⁰ *Id.*

underfunding.¹¹ To avoid situations like the Studebaker Incident, many governments incentivized a shift from defined benefit to defined contribution plans.

Unlike the defined benefit plan, a defined contribution plan specifies only the periodic contributions made to an employee's individual pension fund.¹² These contributions usually take the form of a fixed percentage of employee compensation, which is tax-deferred until eventual distribution.¹³ The collective pension fund consists of a set of individual employee investment accounts.¹⁴ On retirement, the employee receives the total value of contributions and earnings on investments made to this account.¹⁵ Payments take the form of structured annuities, which pay out in regular and consistent distributions rather than a lump sum.¹⁶ The legal obligation of the employer is limited to making the pre-determined periodic contributions to the employee's individual fund.¹⁷ All investment risk (necessary in order to accomplish "income replacement" on retirement) is borne by the employee.¹⁸ Since the value of benefits in a defined contribution plan is equal to the value of the assets in the fund, the plan is always fully funded.¹⁹

Understanding the life cycle of a nation's pension reform process requires considering the influence of reigning economic philosophies on the use of defined benefit plans, "focusing events"—such as the underfunding crisis in the Studebaker Incident—that encourage a shift to defined contribution plans, and modern statutory provisions that demonstrate the extent to which a complete pension system transformation has occurred. The likelihood of a nation undertaking comprehensive reform is heavily influenced by its own experience with focusing events, which demonstrate the need to engage in strict regulation and protection of pension funds.²⁰ The desire to avoid similar crises in the future encourages governments to adopt regulatory procedures, which may result in additional costs to government agencies and management fees paid by pensioners.

¹¹ *Id.* at 685.

¹² LANGBEIN, PRATT & STABILE, *supra* note 4, at 48.

¹³ *Id.*

¹⁴ BODIE & MERTON, *supra* note 1, at 4.

¹⁵ *Id.*

¹⁶ LANGBEIN, PRATT & STABILE, *supra* note 4, at 48.

¹⁷ BODIE & MERTON, *supra* note 1, at 4.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *See* Wooten, *supra* note 8, at 726–36.

III. EARLY HISTORY OF ISRAEL'S PENSION SYSTEM

As with former Soviet Bloc nations in the 1990s, Israel underwent a transition from a centrally planned, nationalized economic system to a capitalist system of free markets and private ownership.²¹ Though Israel's political history varied significantly from these post-Soviet nations, its government had exercised near total control over banking and pension systems, restricted outbound capital transactions, and overseen almost all household savings.²² Much like the gradual pace of its economic transformation, Israel implemented reforms to its government-run pension system and privatized many of its state-owned enterprises incrementally.²³

For much of Israel's pension system history, the vast majority of pension plans were defined benefit plans.²⁴ While these plans still promised to provide a set benefit upon retirement, they were either partially funded or completely unfunded government plans.²⁵ This meant there was no reserve fund set aside exclusively for the purpose of distributing retirement benefits. While this freed up significant amounts of capital, it also led to payment in full of Israeli employees who retired early.²⁶ These distributions were made without concern about the level of funding remaining for younger workers still decades away from retirement, creating a risk of future plan insolvency.²⁷ The lack of a "focusing event" until the late 1990s meant there was little incentive for Israel to move away from this risky pension strategy and little concern that the government would ever need to trim benefits.²⁸

Israel's overarching labor union association, Histadrut, managed roughly half of the nation's defined benefit plans through several funds for different types of workers.²⁹ Almost 95% of employee and employer contributions were invested in special "index-linked" bonds issued by the Israeli government that guaranteed a real interest rate higher than rates provided by bonds on the free market.³⁰ The Israeli government limited

²¹ BODIE & MERTON, *supra* note 1, at 1.

²² *Id.*

²³ *Id.*

²⁴ Avia Spivak & Rita Troitsky, *Pension Reform in Israel*, 2 PUB. & MUN. FIN. 26, 27 (2013).

²⁵ BODIE & MERTON, *supra* note 1, at 9.

²⁶ *Id.* at 9–10.

²⁷ *Id.*

²⁸ *Id.*

²⁹ Spivak & Troitsky, *supra* note 24, at 30.

³⁰ BODIE & MERTON, *supra* note 1, at 12.

investment in these special bonds to defined benefit plans, making it harder for defined contribution plans to overcome the gap between promised benefits and existing funds, known in Israel as an actuarial deficit.³¹ This did little to address underfunding concerns for defined benefit plans, but did hinder defined contribution plan participants from achieving income replacement. Fears of an impending crisis were made worse by a series of government statements that bonds issued to defined benefit plans would no longer provide special interest rates.³²

In their seminal analysis of Israel's impending pension crisis, economists Zvi Bodie and Robert C. Merton identified three issues that prevented reform to Israel's pension system in the early 1990s.³³ Each of these issues represented a fundamental conflict between what reforms would most directly benefit the health of the pension system, and what values were desired by the still largely socialist nature of Israel's government and economic system.

The first issue was that Israeli pension plans could not achieve income replacement or necessary diversification because the Israeli government limited plan investment to securities issued by Israeli firms.³⁴ By preventing Israelis from investing their retirement funds globally, the Israeli government denied employees and employers the chance to reduce the actuarial deficit by investing in more profitable securities while hedging the increased risk involved by creating a diversified portfolio, including more stable government bonds.³⁵ Few Israeli legislators supported diversification through outbound investment because it flew in the face of two aspects of Israel's economic philosophy: limiting capital outflows and continued government oversight of the pension system.³⁶ Permitting pension funds to invest internationally caused concerns because it meant the Israeli government was tacitly approving the outbound flight of capital, rather than investing in the still-young Israeli state, and placing such outbound capital investments beyond the reach of government regulation.³⁷

³¹ Spivak & Troitsky, *supra* note 24, at 30.

³² BODIE & MERTON, *supra* note 1, at 11.

³³ *Id.* at 10–12.

³⁴ *Id.* at 10–11.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

Second, the Israeli government mandated participation in the pension system, specifically through defined benefit plans.³⁸ The justification for requiring all workers to divert some of their compensation toward their pension was based on the idea that by doing so the government would not need to compensate “free-riders” who reach retirement age without any savings.³⁹ Most nations require employees to contribute at a minimum annual level, but up through the 1990s the mandatory participation requirements in Israel were used more as a means to restrict the level of investment risk undertaken by plan sponsors than as a “safety net.”⁴⁰ Concerned that Israeli investors would lose outbound investments and then rely on government-provided benefits, the Israeli government created these mandatory minimum participation requirements and restricted defined contribution investments to Israeli securities.⁴¹ These limitations seemed reasonable given Israel’s paternalistic approach to economic regulation, but became a point of concern upon realizing that the government pension system was entirely unfunded. As a result, these mandatory minimum participation amounts could only guarantee the minimum level of benefits at times when employee retirement and national economic stability coincided.

Finally, by limiting investment to government-sponsored bonds, which were indexed to cost-of-living, Israelis were unable to invest in a way that reflected “standard of living” values.⁴² These bonds were adjusted to approximate cost of living changes in a manner that ensured all retirees could afford basic necessities following retirement.⁴³ By restricting diversification and investment for pension plans, the Israeli government made it impossible to retire at the same standard of living that citizens experienced throughout their years of employment. This fit the Israeli socialist ideal that influenced pension policy for much of the nation’s history, but left countless Israelis reliant on the government’s “safety net,” which, again, was unfunded. By not opening investment to securities that could match the standard of living, the Israeli government passed on the opportunity to ensure that only those who truly needed it would turn to the safety net.

³⁸ BODIE & MERTON, *supra* note 1, at 11.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* at 12.

⁴³ *Id.*

IV. REFORMS TO ISRAEL'S PENSION SYSTEM

Growing actuarial deficits through the early 1990s finally forced Israeli government officials to recognize that the existing system was unsustainable. Government Resolution 5156, passed in March of 1995, outlined how the government would address actuarial deficits on existing defined benefit plans and transition newly-created plans to a more sustainable model.⁴⁴ Part C of the resolution closed off access to these “old pensions” and restricted newly created plans to defined contribution plans.⁴⁵ As part of this resolution, the Israeli government promised to insure all benefits promised to existing old pensions, but the Israeli High Court of Justice ruled in five separate constitutional challenges to the resolution that this promise was little more than a goal, without any binding guarantee.⁴⁶ These rulings permitted years of inactivity, and it was not until 2002 that the Knesset (Israel's primary legislative body) took binding steps to protect the old pension funds.⁴⁷ By this time the total actuarial deficit had reached NIS 109 billion, approximately USD 27.5 billion based on the current exchange rate between New Israeli Shekel and American Dollars.⁴⁸ The realization that the deficit had reached this astonishing level would serve as Israel's “focusing event” that prompted reform.⁴⁹ Interestingly, Israel was able to act early enough to avoid a crisis like the Studebaker Incident.

The 2002 measures to implement the policies of the 1995 Resolution addressed the growing deficits by shifting plan responsibility to participants, thereby limiting the government's liability. The government committed to funding NIS 80 billion over a period of thirty-five years, with the remaining deficit shifted to plan participants.⁵⁰ The retirement age was raised from sixty-five to sixty-seven for men and from sixty to sixty-four for women, and at the same time the required contribution rate was 20.5% annually of participants' salaries.⁵¹ Further, the financial responsibility for the funds was

⁴⁴ ORG. FOR ECON. CO-OPERATION AND DEV., ISRAEL: REVIEW OF THE PRIVATE PENSIONS SYSTEM, 18 (Oct. 2011) [hereinafter OECD REVIEW].

⁴⁵ Knesset Res. 5156, Part C (Mar. 29, 1995).

⁴⁶ ISRAELI MINISTRY OF FIN., PENSION SYSTEM: ANNUAL REPORT 2000, 31–32 (2000) [hereinafter ANNUAL REPORT 2000]. See, e.g., *Prof. Shmuel Kaniel et al v. Government of Israel*, HCJ 3975/99 (1999) (“The Government resolution does not have the effect of creating a guarantee, tantamount to a binding legal undertaking by the state, to meet the liabilities of pension funds to their members . . .”).

⁴⁷ OECD REVIEW, *supra* note 44, at 18.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

shifted to the plan members, while fund management was delegated to professional managers who collected pension management fees.⁵² The resolution also permitted an increase or decrease of promised pension benefits should the cumulative actuarial gain or loss exceed 5% of the pre-determined benefit.⁵³ The resolution simultaneously placed the burden of diminished benefits on plan members, while authorizing the creation of defined contribution plans for transitioning old plan members and new members.

Government Resolution 5156 laid the foundation for a more sustainable pension system by creating “new pension plans,” which functioned exclusively as defined contribution plans.⁵⁴ Beginning in January of 1995, workers were able to establish these new pensions through either collective-bargaining agreements or, unlike with old pensions, on an individual basis.⁵⁵ Resolution 5156’s cap on government contributions did not limit the benefits provided by these plans and the 5% adjustment benchmark ensured that each new pension plan was fully funded.⁵⁶ These plans pay out in an amount based on total contributions and investment return, reduced only by fees paid to the management company.⁵⁷ A minimum level (typically defined as a percentage) of benefits (as determined by the management company) must be paid in the form of a structured annuity, with the remainder paid either periodically or in a lump sum.⁵⁸

While this resolution paved the way to effectuating many of the reforms Bodie and Merton outlined in 1995,⁵⁹ it also gave rise to the need for strict regulation of defined contribution plan management akin to the United States’ aforementioned ERISA statute. After years of legislative gridlock, the Knesset passed these much needed regulations with the Control of Financial Services (Insurance) Law (CFSIL), 5741-1981, which included the creation of the CMISD within the Israeli Ministry of Finance.⁶⁰ CFSIL empowered the Commissioner of the CMISD to “give, modify and withdraw

⁵² *Id.*

⁵³ OECD REVIEW, *supra* note 44, at 19.

⁵⁴ ANNUAL REPORT 2000, *supra* note 46, at 4.

⁵⁵ OECD REVIEW, *supra* note 44, at 19.

⁵⁶ Knesset Res. 5156 (Mar. 29, 1995).

⁵⁷ OECD REVIEW, *supra* note 44, at 19.

⁵⁸ *Id.*

⁵⁹ BODIE & MERTON, *supra* note 1, at 11–13.

⁶⁰ Control of Financial Services (Insurance) Law, 5741-1961, § 2(a), 5.

an insurer's license,"⁶¹ as well as "issue instructions about the way insurers and insurance agents, their officers and their employees shall operate and be managed, all in order to assure their orderly operation and the protection of the interests of insured persons or of clients, and in order to prevent any detraction from an insurer's ability to meet his obligations."⁶² Should the plan management insurance entity disagree with the Commissioner's decision to deny or revoke a license, CFSIL grants the right to an appeal reviewed by both the Commissioner and the CMISD's Consulting Committee.⁶³

Regulation of plan management insurance entities was furthered by passage of the Insurance Control Law (ICL), which sought to increase accountability of the governing boards of these entities.⁶⁴ This amendment to the original pension system reform required external membership of the governing boards.⁶⁵ At least one-third of the board members must be external directors, and at least half of these external directors need "experience or specialization in the area of pension activity or at similar financial bodies."⁶⁶ These requirements serve to ensure that management entities will promote the interests of plan beneficiaries rather than the interests of shareholders to whom these private entities are ultimately accountable.

In addition to granting regulatory power to CMISD, CFSIL also defines the fiduciary responsibilities of insurance entities, investment limitations, contribution rates, financial reporting requirements, tax treatment of deferred income, and adjustment of benefits based on actuarial deficits and surpluses.⁶⁷ It also authorizes the Commissioner to issue circulars that have binding legislative effect.⁶⁸ The law further requires public notice in *Reshumot*—the Israeli government's publication of official records and laws—that a new circular has been issued and the date it enters into effect.⁶⁹ The Commissioner is also held accountable for his or her management of the CMISD, as CFSIL establishes provisions to authorize his

⁶¹ OECD REVIEW, *supra* note 44, at 11.

⁶² Control of Financial Services (Insurance) Law, 5741-1961, § 2(b), 5.

⁶³ *Id.* § 102(a)–(c), 58.

⁶⁴ Control of Financial Services (Insurance) Law, 5741-1961 (as amended).

⁶⁵ *Id.*

⁶⁶ OECD REVIEW, *supra* note 44, at 13.

⁶⁷ *Id.* at 11.

⁶⁸ Control of Financial Services (Insurance) Law, 5741-1961, § 111A(a)–(b), 63.

⁶⁹ *Id.*

or her removal from office (as well as that of any commission or council member).⁷⁰

Government Resolution 5156 and the CFSIL comprehensively overhauled an underfunded system that seemed headed toward disaster (especially in light of the sharp increase in the number of Israelis retiring and claiming benefits in the late 1990s and early 2000s). In mimicking many of the protections afforded by ERISA, CFSIL has transformed Israel's pension system from a decaying monument to socialist economic policies, to one that is better equipped to meet the demands of Israel's rapid economic privatization.

V. MODERN PENSION SYSTEM DEVELOPMENTS

More recently, several amendments to CFSIL have adapted Israeli pension law to reflect changes in market demands and acknowledge regulatory necessities.⁷¹ In particular, three forms of new pension funds were developed to offer a better range of investment options for defined contribution plan participants.⁷² New "General Pension Funds" were authorized by the Commissioner of the CMISD through instructions issued on July 8, 1997, allowing participants to acquire only old-age pensions.⁷³ This permitted investors to pass on disability insurance and survivors' pensions, thereby choosing to receive pension benefits only on retirement rather than on the occurrence of these contingencies.⁷⁴ The general pension funds are the only funds that permit one-time deposits to be made, and as a result, they tend to be attractive to highly compensated savers.⁷⁵

Second, the Control of Financial Services (Provident Funds) Law (CFSPFL), 5765-2005, authorized the use of "Provident Funds," which serve as a hybrid of new pensions and general pension funds.⁷⁶ Like general pension funds, these provident funds function as savings instruments without any insurance coverage.⁷⁷ They do not, however, permit "one-time" contributions, so they are not as attractive to highly compensated workers.

⁷⁰ *Id.* at § 9, 7.

⁷¹ ISRAELI MINISTRY OF FIN., PENSION SYSTEM: ANNUAL REPORT 2003, 15 (2003) [hereinafter ANNUAL REPORT 2003].

⁷² *Id.*

⁷³ *Id.*

⁷⁴ OECD REVIEW, *supra* note 44, at 20.

⁷⁵ *Id.*

⁷⁶ Control of Financial Services (Provident Funds) Law, 5765-2005, § 16(a), 14.

⁷⁷ *Id.*

Similar to new pension plans, provident fund benefits can only be withdrawn when the member reaches the age of sixty (the age is subject to modification by the CMISD Commissioner or the Knesset), and the minimum payment must be made in the form of a periodic annuity in the amount of NIS 3,850.⁷⁸ As with the new pension plans, any benefits beyond the designated annuity amount can be withdrawn in the form of a lump sum.⁷⁹ Unlike the new pension plans, participants in provident funds may not invest in government bonds that produce “relatively high and stable rates of investment return,” thus limiting the popularity of this type of fund.⁸⁰

Finally, Israelis can also invest in traditional life insurance policies that may or may not be covered by the regulations of CFSIL. If the saver chooses to invest in a pure life insurance program, then the disbursement of savings is limited to either death or loss of earning capacity. These plans are covered by legislation that addresses life insurance plans, not pension laws.⁸¹ However, if the saver chooses to invest in a life insurance plan that splits contributions between insurance coverage and a savings component, the savings component is covered by CFSIL’s strict coverage regulations.⁸²

While these new plan options expanded how workers could invest for their retirement, employers were explicitly precluded from denying pension coverage to employees beginning in 2008.⁸³ The Minister of Industry, Trade, and Labor signed an order that codified an agreement between the Histadrut and Coordination Office of the Economic Organizations, requiring that every salaried worker receive a pension.⁸⁴ This mandatory pension agreement covered those workers who were not already protected by the pensions provided for by collective bargaining agreements. The order authorizing these plans stipulated a contribution rate that exceeded new pensions (approximately 7% contribution by employee and 7.5% by employer as opposed to 5% and 6% respectively for new pensions), and permitted investment in a new pension, provident fund, or a life insurance policy.⁸⁵

⁷⁸ OECD REVIEW, *supra* note 44, at 21.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.* at 21–22.

⁸² *Id.*

⁸³ *Id.* at 22.

⁸⁴ OECD REVIEW, *supra* note 44, at 22.

⁸⁵ *Id.*

Lastly, in addition to this expansive reform of the nation's private pension system, Israel established its public pension system to serve as a safety net under the National Insurance Law.⁸⁶ This law (passed in 1953) authorized the creation of the National Insurance Institute, which provides benefits on attainment of the qualifying age (as amended, currently sixty-seven for men and sixty-four for women).⁸⁷ The National Insurance Institute requires all workers to "pay-as-you-go," where each employee contributes to the system regardless of whether or not they will eventually come to rely on it.⁸⁸ In order to obtain benefits through the public pension system, recipients must be an Israeli resident, have paid insurance fees as required, and pay the fixed-rate contribution.⁸⁹ This includes an annual payment of NIS 141 for non-working individuals until the retirement age.⁹⁰ Every retired Israeli is entitled to an annual payment of approximately 30% of the average wage in the economy, including those who are sufficiently insured through private pension plans.⁹¹

These modern amendments to earlier pension system reforms have successfully afforded more options to pension plan participants, while also improving the stability of a previously overburdened system. The mandatory pension requirements ensure that all workers are provided for on retirement, regardless of their field of employment. Meanwhile, the "safety net" provided by the public pension system serves as a meaningful fallback provision for those who experience investment losses through defined contribution plans, or simply do not work at all. Still, some lingering provisions, as well as an absence of certain provisions, recall Israel's former socialist ideologies, inhibiting the effectiveness of CFSIL.⁹²

VI. COMPARING ISRAEL'S REFORMS TO SIMILAR EFFORTS IN POST-SOVIET NATIONS

While Israel's economic privatization occurred at a slower, more evolutionary pace, the post-Soviet republics had a market economy thrust upon them in the early 1990s. Undoubtedly, this is one reason why post-Soviet nations could not adopt the incremental approach to pension system

⁸⁶ See generally Amendment to the National Insurance Law, 5755-1995, 208 (5773-2013).

⁸⁷ *Id.*

⁸⁸ OECD REVIEW, *supra* note 44, at 15.

⁸⁹ *Id.*

⁹⁰ Amendment to the National Insurance Law, 5755-1995, קרפ ה (Section 5), 208 (5773-2013).

⁹¹ OECD REVIEW, *supra* note 44, at 16.

⁹² See *infra* Part VI.

reform that Israel used. For example, while Israel maintained a “fully funded” defined benefit pension system for years after economic privatization, post-Soviet nations quickly adopted pay-as-you-go systems (where current workers subsidized the pensions of retirees).⁹³ Another divergence is that many post-Soviet nations are still plagued by low participation rates,⁹⁴ while Israeli participation rates are high by comparison. Despite these differences, both Israeli and post-Soviet pension systems continue to face three key issues that impede their development years after economic privatization: lack of programming to address rapidly aging populations, low pension levels, and a reluctance to fully adapt pension systems to the demands of a market-economy.

This section will conduct a historical analysis of pension system reform in post-Soviet nations, focusing on Ukraine, Georgia, the regions of the South Caucasus and Central Asia, and Russia. By comparing Israel’s pension system to systems in post-Soviet nations, the Knesset can gain insight into potential changes it could adopt that have already been successfully implemented in post-Soviet nations. More importantly, however, the struggles faced by post-Soviet nations serve to highlight changes that should be avoided by Israeli legislators. Most pressingly, some of these struggles must serve as a warning to advocates regarding the status quo for Israel’s pension system and the need for further modifications.

A. *Post-Soviet Pension Reform: Ukraine*

Ukraine’s pension system initially developed as a publicly run pay-as-you-go system, and officials in Ukraine, like policymakers in Israel for decades after declaring political independence, were extremely reluctant to adapt their system to suit the demands of a market economy.⁹⁵ Under a pay-as-you-go system, the health of the pension system, as it pertains to distributions to current retirees, is based almost entirely on contributions made into the system by current workers through payroll taxes.⁹⁶ Not surprisingly, such a system’s functionality depends entirely on the economic

⁹³ See generally ANTON DOBRONOGOV & LES MAYHEW, INT’L INST. FOR APPLIED SYSTEMS ANALYSIS, INTERIM REPORT: PENSION REFORM IN A HIGHLY INFORMALIZED POST-SOVIET ECONOMY (1990).

⁹⁴ *Id.*

⁹⁵ *Id.* at 6.

⁹⁶ Mitchell A. Orenstein, *The New Pension Reforms: Lessons from Post-Soviet Republics*, in FIGHTING POVERTY & REFORMING SOCIAL SECURITY: WHAT CAN POST-SOVIET STATES LEARN FROM THE NEW DEMOCRACIES IN CENTRAL Europe 87, 88 (Michael Cain, Nida Gelaziz & Tomasz Inglot eds., 2005).

health of the nation, and during periods of economic upheaval both Ukrainian workers (who faced layoffs and delayed wages) and pensioners were unable to maintain an adequate daily income.⁹⁷ On average, economic downturns in the 1990s resulted in payment delays that in turn caused non-payments in the amount of 1.31 million Hryvnias, or 1.3% of the total pension fund.⁹⁸ The cumulative impact of these non-payments on the livelihood of individual pensioners was stunning.

A survey conducted ten years following Ukrainian independence found that the average monthly pension was only 70 Hryvnias, approximately USD 13 dollars a month, which fell well below the poverty line of 90.7 Hryvnias and just above the monthly cost of food at 69.6 Hryvnias.⁹⁹ These limited pensions became more meager as Ukraine's economic struggles continued unabated throughout the 1990s.¹⁰⁰ In 1981, the percentage of Ukrainians earning and contributing less than USD 4.30 per day to the pension system was among the highest in the Soviet Union at 86%. By 1993, only 14% of Ukrainians earned below this minimal amount, which was the lowest rate among post-Soviet nations.¹⁰¹ However, economic instability derailed these improvements and by 1996 the rate of Ukrainians earning less than USD 4.30 per day was 46%, and by 1999 that number was 66%.¹⁰² Smaller earnings meant lower pay-as-you-go contributions.

Compounding the negative effect of declining wages on the public pension system, private employers further gutted this system by re-classifying their workers as "informal" workers to avoid paying payroll taxes.¹⁰³ Also, workers who saw older Ukrainians receiving extremely small pensions saw little benefit in contributing to the pay-as-you-go-system.¹⁰⁴ In response to this reality, many working-age Ukrainians found ways to evade the social security tax in order to keep their wages.¹⁰⁵ For decades, Ukrainian politicians held onto the collective pension system even though the system lacked any kind of savings or investment mechanisms.¹⁰⁶ The

⁹⁷ DOBRONOGOV & MAYHEW, *supra* note 93, at 6.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ BEN SLAY, U.N. DEV. PROGRAM, POVERTY, INEQUALITY, AND SOCIAL POLICY REFORM IN THE FORMER SOVIET UNION 4 (2009).

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ DOBRONOGOV & MAYHEW, *supra* note 93, at 6.

¹⁰⁴ *Id.* at 8.

¹⁰⁵ *Id.*

¹⁰⁶ *Economic Reforms in Ukraine: Pension Reform*, UKRAINIAN ECON. REFORM FUND, <http://uerf.org/>

limited reforms that did take place established different distribution rates for different types of employment, effectively granting greater pensions to certain classes of workers at the expense of roughly 80% of the working population who derived their pensions from the same limited fund.¹⁰⁷

By 2011, the Ukrainian government was forced to choose between implementing dramatic pension reforms and facing catastrophic consequences.¹⁰⁸ Pensioners faced a declining standard of living, employers increasingly informalized the workforce to avoid payroll taxes, and intergenerational tensions increased as pensioners felt that working age Ukrainians abandoned them entirely.¹⁰⁹ Finally, on September 9, 2011, Ukrainian President Viktor Yanukovich codified the Law of Ukraine “On the Measures of Legislative Enactment of Pension System Reform,” which replaced the state-run pay-as-you-go system with a three-tier hybrid.¹¹⁰ The three-tiered system that became effective in late 2011 represents a combination of the existing system, a state-funded insurance system, and a privatized defined contribution system.¹¹¹

The first-tier, a newly minted pay-as-you-go system, was not one pension fits all; instead, the pension size was tied to the size of the retiree’s working salary and duration of insured service.¹¹² The second-tier consisted of mandatory state-funded pension insurance, which protected pensioners against economic swings by shifting the payment burden away from working Ukrainians to the Ukrainian government itself.¹¹³ Finally, the third-tier was completely privatized and optional, a pension fund in which higher-earning Ukrainians could invest their funds in private securities in order to achieve income replacement on retirement.¹¹⁴ Ukraine’s new pension system law provides limited guidance regarding oversight or regulation of

economic-reforms-in-ukraine/pension-reform/ (last visited Feb. 28, 3016) [hereinafter *Economic Reforms in Ukraine*].

¹⁰⁷ Int’l Org. of Pension Supervisors, *Ukraine: Pension System’s Key Characteristics*, at 3 (2009) [hereinafter IOPS, *Review of Ukraine*].

¹⁰⁸ DUBRONOGOV & MAYHEW, *supra* note 93, at 9.

¹⁰⁹ *Id.*

¹¹⁰ Chadbourne & Park LLP, *Client Alert: New Pension System in Ukraine Becomes Effective from October 1, 2011*, [http://www.chadbourne.com/files/Publication/4ff89303-dd5b-43d8-8a5b-a6cd7eb6069b/Presentation/PublicationAttachment/dfdf14c4-37a1-48b1-b1a0-b431200f8581/Kyiv-PensionReformInUkraine_ca\(Johnson\).pdf](http://www.chadbourne.com/files/Publication/4ff89303-dd5b-43d8-8a5b-a6cd7eb6069b/Presentation/PublicationAttachment/dfdf14c4-37a1-48b1-b1a0-b431200f8581/Kyiv-PensionReformInUkraine_ca(Johnson).pdf).

¹¹¹ *Id.*

¹¹² See *Economic Reforms in Ukraine*, *supra* note 106.

¹¹³ *Id.*

¹¹⁴ *Id.*

these private pensions,¹¹⁵ but does provide a government-guaranteed fallback option that provides pensions for old age, disability, and surviving spouses.¹¹⁶

B. Post-Soviet Pension Reform: Georgia

Georgia's pension system faced many of the same struggles as Ukraine in the 1990s that eventually resulted in pension reform.¹¹⁷ The system faced a shrinking contribution base due to the rise in informal employment, political upheaval that led to economic uncertainty, and, as a result, extremely low benefits payments that forced many Georgians into extreme poverty.¹¹⁸ The percentage of Georgians who earned a daily working wage of USD 4.30 rose dramatically from 32% in 1981 to 71% in 2005.¹¹⁹ These improvements in daily wages meant greater pay-as-you-go contributions, but wages hardly rose to the levels needed for a healthy pension system. As early as 1999, the Georgian legislature began to consider adopting the exact same three-tier system that was established in Ukraine over a decade later.¹²⁰ For a variety of reasons, however, this proposal languished and failed to pass through the Georgian legislature.¹²¹

From 2004 to 2008, the Georgian government adopted a number of reforms addressing the failings of the public pension system.¹²² Through the 2005 Act on State Pensions, all Georgians were given the right to old age pensions, which would be subsidized by a 25% tax on all gross-profits for individual workers.¹²³ These flat pension payments reached as high as 70 Georgian Lari (GEL) per month, or USD 31.25, by 2008.¹²⁴ Government officials were still reluctant, however, to consider adding a privatized pension system.¹²⁵ These officials feared that by incentivizing retirement saving, individuals would have less money to spend on Georgian consumer

¹¹⁵ See Chadbourne & Park LLP, *supra* note 110, at 2.

¹¹⁶ See IOPS, *Review of Ukraine*, *supra* note 107, at 4.

¹¹⁷ ALEXI GUGUSHVILI, THE (NON) REFORM OF THE GEORGIAN PENSION SYSTEM, 1991–2011: A BRIEF HISTORY AND UPDATE 2 (2012).

¹¹⁸ *Id.*

¹¹⁹ SLAY, *supra* note 100, at 4.

¹²⁰ GUGUSHVILI, *supra* note 117, at 3.

¹²¹ *Id.* at 3–4 (noting the corruption in the pension system, concerns over growing budget deficits, and political discord prevented any one reform proposal from obtaining the necessary majority to be enacted).

¹²² *Id.*

¹²³ *Id.* at 5.

¹²⁴ *Id.*

¹²⁵ *Id.* at 6.

goods.¹²⁶ Georgian politicians only seriously considered pension reform when the 2008 global financial crisis depleted its reserves, and it could no longer fund its state-run pension system.¹²⁷

In the face of economic collapse, Georgia became reliant on international lending and investment by both foreign nations and international organizations. These lenders began to heavily influence pension policy, using their investments as leverage to goad Georgian leaders into supporting greater privatization of the pension system.¹²⁸ One such group, the Pension Review Group, directly proposed amendments to the Law on Non-State Pension Insurance and Provision that would allow private pension funds to diversify their investments beyond the scope of Georgian borders.¹²⁹ Despite these significant shifts, much of the current conversation surrounds two key issues: 1) whether Georgia's state-run pension system provides the 100 GEL monthly payment that politicians have promised since 2011; and 2) whether a mandatory pension system is in the best interests of Georgian citizens.¹³⁰

C. *Post-Soviet Pension Reform: South Caucasus Region and Central Asia*

Post-Soviet nations in the South Caucasus Region and Central Asia represent the most economically troubled nations following the collapse of the Soviet Union.¹³¹ The people of the South Caucasus nations of Armenia and Azerbaijan consistently earned daily wages of USD 4.30 at rates of approximately 73% and 85% respectively throughout the 1990s.¹³² The Central Asian nations of Kazakhstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan faced rates ranging from 24% to 99% at various points in the 1990s.¹³³ These low daily wages made the task of funding the generous Soviet pension system impossible. This underfunding crisis was the focusing event that led these nations to become the first to completely overhaul their pension systems in the post-Soviet era.

¹²⁶ GUGUSHVILI, *supra* note 117, at 6.

¹²⁷ *Id.*

¹²⁸ *Id.* at 9.

¹²⁹ *Id.*

¹³⁰ *Id.* at 8–10.

¹³¹ SLAY, *supra* note 100, at 4.

¹³² *Id.*

¹³³ *Id.*

Governing officials throughout these regions began to propose reforms that would ease the government's burden of funding defined benefit plans by authorizing defined contribution plans instead, moving from a pay-as-you-go government-run pension to a funded fallback system and shifting investment risk to individuals by permitting privatized retirement investment.¹³⁴ In many ways, these nations were the most likely among post-Soviet nations to seriously consider privatizing their pension systems because adjustment to revenue collection mechanisms could not reasonably meet pensioners' needs.¹³⁵ These nations were also quick adopters of pension reform because they faced factors that made pension reform extremely necessary: an aging population that would need income replacement in short order, rising poverty that reduced fund contributions and increased incentives to evade contribution requirements, a growing inequality gap between private industry leaders and the vast majority of workers, and growing unemployment due to disruptive economic swings during the 1990s and early 2000s.¹³⁶

With the stage set for reform, nations in these regions approached the reform process in unique ways. Two nations in particular demonstrate the wide range reforms can take: Kazakhstan and Tajikistan. Kazakhstan was forced into a position of reform when its state-run system began benefiting an unsustainable 83 pensioners for every 100 contributors.¹³⁷ The Law on Pension Provision in the Republic of Kazakhstan was passed in 1997, and had the effect of transforming the pay-as-you-go system into a series of fully funded, individual, defined contribution accounts.¹³⁸ The Kazakh government enacted a transitional period for retirees leaving the workforce in the years following the new legislation, and eventually adopted a universal minimum pension system that provided 3,000 Tenge a month, approximately USD 16.15, to support those who did not have private pension savings.¹³⁹

¹³⁴ JANE FALKINGHAM & ATHINA VLACHANTONI, UNIVERSITY OF SOUTHAMPTON CENTER FOR RESEARCH ON AGEING, PENSIONS AND SOCIAL PROTECTION IN CENTRAL ASIA AND SOUTH CAUCASUS: DEVELOPMENTS IN THE POST-SOVIET ERA 6 (2010).

¹³⁵ MAREK DABROWSKI, CHALLENGES TO ECONOMIES IN TRANSITION: STABILIZATION, GROWTH, AND GOVERNANCE 4 (1998).

¹³⁶ FALKINGHAM & VLACHANTONI, *supra* note 134, at 14–20.

¹³⁷ *Id.* at 29.

¹³⁸ *Id.*

¹³⁹ *Id.* at 31.

In contrast to Kazakhstan's denouncement of most state-run elements of its pension system, Tajikistan in many ways reinforced state-run elements of its system.¹⁴⁰ The Tajik government has maintained a social insurance old-age pension, with benefit amounts based on average earnings and years of service.¹⁴¹ Nearly 85% of elderly Tajik citizens receive a benefit in the amount of 56 Somoni a month, or USD 30, but nearly 20% of those recipients are also dependent on support of family members living in Tajikistan and abroad.¹⁴² The need to support a rapidly aging Tajik population has led nearly 26% of younger Tajik citizens to leave their children in the hands of their own parents and seek work beyond Tajik borders.¹⁴³ While the lack of reform in Tajikistan has allowed the Tajik government to avoid enacting complex regulatory regimes, a large portion of Tajik citizens have had to shoulder the financial burden of providing for older family members because the Tajik government has failed to enact pension reform.

D. Post-Soviet Pension Reform: Russia

Despite experiencing greater economic growth relative to many other post-Soviet nations, Russia experienced many of the same problems that stimulated pension reform across the region. In 1950, there were ten workers for every pensioner, but by 1995, that number declined to six and was projected to decline even further under the existing system.¹⁴⁴ Though the percentage of Russians earning less than USD 4.30 daily had declined to 19% by 2005 (third only behind Ukraine and Belarus),¹⁴⁵ the emigration of Russian citizens reduced the revenue required to maintain a state-run pension system at promised benefit levels.¹⁴⁶ The most pertinent period in Russia's pension transformation coincided with Vladimir Putin's first term as President of the Russian Federation. Beginning in 2000, Putin and his ministers sought to transform the lingering state-run aspects of Russia's

¹⁴⁰ *Id.* at 36–37.

¹⁴¹ *Id.*

¹⁴² FALKINGHAM & VLACHANTONI, *supra* note 134, at 38.

¹⁴³ *Id.*

¹⁴⁴ Timothy Heleniak, *Migration and Restructuring in Post-Soviet Russia*, 9 DEMOKRATIZATSIYA 531, 546–47 (2001).

¹⁴⁵ SLAY, *supra* note 100, at 4.

¹⁴⁶ Heleniak, *supra* note 144, at 547.

economy into a free market system, modernize Russia's economy, and reduce poverty.¹⁴⁷

The most impactful Russian pension reform law was enacted in 2001, and adopted a three-tiered system similar to Ukraine's.¹⁴⁸ The first tier consisted of the country's mandatory pension system, in which a 28% of wages fee was imposed on all earnings and half of this amount was paid to pensioners out of a state-run fund.¹⁴⁹ The second tier consisted of the other half of the collected fees, which were allocated to each worker's individual fund.¹⁵⁰ Finally, the third tier was merely a subset of the second tier, as workers could take their individual fund allocations and invest their fund amounts in government bonds or private securities.¹⁵¹ The model was essentially the same system that has been adopted by nations around the world, but the faults of the Russian system were exposed far more swiftly than in other systems.

First, minimal attention was given to how individuals, private entities, and government actors would transition from the Soviet-style pay-as-you-go system to the three-tiered system.¹⁵² Second, it was unclear who was charged with regulating the privatized portion of the system, and in turn, to whom this regulatory agency was accountable.¹⁵³ Third, the Russian government entirely failed to educate its citizens about the new pension system.¹⁵⁴ By 2002, nearly 93.2% of all workers kept their pension savings in the state-run system (which invested entirely in government bonds) rather than transitioning their funds into private investments.¹⁵⁵

As the Russian government attempted to address some of these shortcomings, other problems emerged in their place. State agencies charged with administrating the pension system were frequently found to be corrupt and ineffective.¹⁵⁶ Beginning in 2004, however, a series of

¹⁴⁷ Elena Maltseva, *Welfare Reforms in Post-Soviet States: A Comparison of Social Benefits Reform in Russia and Kazakhstan*, 283-284 (2012) (unpublished Ph.D. thesis, University of Toronto) (on file with author).

¹⁴⁸ See *Economic Reforms in Ukraine*, *supra* note 106.

¹⁴⁹ Maltseva, *supra* note 147, at 291.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.* at 291-92.

¹⁵³ *Id.* at 292.

¹⁵⁴ *Id.*

¹⁵⁵ Maltseva, *supra* note 147, at 292.

¹⁵⁶ *Id.* at 296.

amendments passed in the Russian Duma that helped solve the early struggles of the Russian pension system.¹⁵⁷ A 2004 resolution created the Pension Fund and regional Department of Social Protection offices in order to monitor the health and legitimacy of the pension system.¹⁵⁸ A transition program was also proposed to oversee the change from a purely state-run system to a largely privatized system, though the Russian populace rejected this program.¹⁵⁹

The results of Russia's reforms have demonstrated some of the struggles that many post-Soviet nations have faced in transitioning from a state-run model to a private pension system. The proportion of voluntary pension funds to mandatory pension savings has declined steadily from 2005 to 2012.¹⁶⁰ This can be explained in two ways: 1) a continued lack of education on private pension savings inhibits Russian workers from moving their pensions to higher-yield individual defined contribution funds; and 2) Russian law caps investment in most private securities but does not cap investment in government bonds.¹⁶¹ Some private pensions are so restricted that absolutely no foreign investment is permitted.¹⁶² Russia, like other post-Soviet nations, has dramatically overhauled its pay-as-you-go system, but has failed in many ways to refine its pension system enough to make it fully functional for the entirety of Russian citizenry.

E. Pension Reform Trends Across Post-Soviet Nations and Lessons for Israel's Knesset

Like many nations around the world, post-Soviet nations have struggled to modernize and privatize their pension systems in tandem with economic shifts from socialist to free-market systems. While the successes for these post-Soviet pension systems are few, there are relevant positive and negative lessons that Israel can learn from these post-Soviet pension systems. There are three trends worthy of observation: 1) the process of privatizing pensions is slow, arduous, and requires a commitment to refining the very specific flaws of larger reforms; 2) pension reforms require consideration of communal and social impacts that might not be considered

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 317–18.

¹⁶⁰ ORG. FOR ECON. CO-OPERATION AND DEV., DEVELOPING A FUNDED PENSION SYSTEM IN RUSSIA: INTERNATIONAL EVIDENCE IN RUSSIA, 108 (2013).

¹⁶¹ *Id.* at 109.

¹⁶² *Id.*

in a purely economic analysis; and 3) a successful reform requires commitment either to state-oversight or individual accountability and assumption of risk, while the inability to commit does a disservice to pensioners.

As evidenced by the experiences of post-Soviet nations, even comprehensive legislative reform does not guarantee that the transition from a state-run to a privatized pension system will come to fruition in practice. As was the case in Ukraine and Russia, the adoption of a three-tiered system fits the mold created by many nations with long histories of free-market economies, but a one-size-fits-all pension system approach cannot work without accounting for the economic history of post-Soviet nations.¹⁶³ For example, employers have few incentives to maintain a formal workforce when the pension system continues to rely on payroll taxes as a source of revenue without a regulatory watchdog, thus leading to massive informalization of workforces throughout post-Soviet nations to circumvent employer payroll taxes.¹⁶⁴ In addition, blanket promises to increase the guaranteed minimum stipend, as is the case in Georgia, often cannot be realized without modifying the revenue collection mechanism.¹⁶⁵ To fully see through the promised reforms in these nations, politicians need to dedicate significant political capital to adopt the programs necessary to transition to a free-market system and resist caving into political pressures to return to state-run roots.

While politicians need to consider the finer reforms that address the minute details that make a pension system work, they also need to consider the human cost of pension reform. By continuing to rely on a state-run system through a modified pay-as-you-go mechanism, nations such as Tajikistan force their citizens to make up for the deficit between cost of living and pension benefits.¹⁶⁶ Alternatively, nations such as Kazakhstan provide a state-run system in the context of minimum guaranteed benefits, but the lack of reasonable alternatives results in many citizens struggling to survive off of this bare minimum.¹⁶⁷ Politicians in these post-Soviet nations have failed to recognize that part of meaningful pension reform includes recognizing when private pension opportunities are inaccessible to the vast

¹⁶³ See Maltseva, *supra* note 147, at 291–92.

¹⁶⁴ See DOBRONOGOV & MAYHEW, *supra* note 93.

¹⁶⁵ See GUGUSHVILI, *supra* note 117.

¹⁶⁶ See generally FALKINGHAM & VLACHANTONI, *supra* note 134.

¹⁶⁷ See *id.* at 29, 31.

number of citizens living in extreme poverty. A nation that crafts its pension system in a manner that just barely covers the majority, while enhancing opportunity for a slim minority, cannot possibly have sustainable success.

Yet there is also an inherent problem in attempting to split the difference and settle on policies that fall somewhere between state-run and privatized pensions. One of Russia's major early failures occurred because citizens became comfortable with the government guaranteed pension and did not see the need or were not educated on how to access private pensions and why investing in such pensions would be advantageous.¹⁶⁸ Further, by continuing to cap investment in all securities except for government bonds, or by barring foreign investment, the Russian government has effectively rendered mandatory and voluntary pension funds equivalent. Finally, continued pay-as-you-go programs may serve an expedient political purpose, but these programs are incredibly out of place in a free-market context, where working individuals have tremendous incentive to evade paying into the system and funding their own retirements individually.

In many ways, Israel is years ahead of all the post-Soviet nations, both economically and the with respect to development of privatized pensions. Still, Israel can learn critical lessons from the experiences of these post-Soviet nations. Israel unquestionably set itself down the path of pension privatization with the enactment of the CFSIL that authorized and mandated the use of defined contribution plans. The Knesset has failed, however, to consider what steps are still necessary to assist older Israelis in the process of transitioning from defined benefit plans (that were capped in 1995) to defined contribution plans. As Russia learned, when citizens are given opportunities to achieve income replacement through private investment, but do not know how to do so, there is a substantial likelihood that those programs will not be accessed. The result of this knowledge gap will result in a generation of Israelis who enter retirement age under the impression that their defined benefits will be waiting for them in full.

As with the previously mentioned trend in post-Soviet nations, Israel's government has attempted to function partially in state-run territory and partially in private territory. Israel must learn from the mistakes of these post-Soviet nations in not providing mechanisms for transferring all pension funds from older systems to newer systems. Regardless of whether the

¹⁶⁸ See Maltseva, *supra* note 147, at 305–10.

initial program is a pay-as-you-go system or a defined benefit system, once expectations are settled, it is hard for pensioners to see the need to adapt their savings methods to new reforms. Israel has done little to foster the transition for older Israelis to private defined contribution investment, and the consequences will be dire. Failure to enact this reform will result in an entire generation of Israelis unable to meet minimum costs of living, as has already occurred in many post-Soviet nations such as Uzbekistan and Kazakhstan.

Next, Israel must learn from Russia's example and eliminate, or at least reduce, the 30% required investment in non-tradable government bonds. The imposition of these caps is a relic of state-run systems past and has no place in a modern privatized pension system. If the purpose of defined contribution systems is to shift investment risk to individuals, then governments should permit the free exercise of investment desires to permit accomplishment of income replacement on retirement. Capping private investment or requiring minimum investment in government bonds is problematic in two ways. First, it prevents private investors from accessing higher-risk, higher-yield securities, and second, it leaves pensioners dependent on the economic viability of the nation in their efforts to achieve income replacement. Fortunately for Israel, it has not experienced the same economic volatility of many post-Soviet nations. Given the political instability of the region, however, economic stability is by no means a guarantee. While eliminating the 30% requirement may expose some investors to greater risks, a well-regulated private pension system can address any issues caused by this exposure.

This in turn leads to the next lesson: private pension entities must be held accountable to pensioners, and not merely their shareholders. For this issue, it is important to return to the growing income inequality experienced in the South Caucasus Region and post-Soviet nations in Central Asia. As previously noted, these regions contain populations with a growing divide between the working class poor and the newly wealthy leaders of private industry. These private business owners are often able to eschew tax and regulatory provisions and are held to little account at the hands of the very parties they represent. The same is the case with private pension entities in Israel. At their core, these entities are profit-making ventures responsible primarily to shareholders and not pensioners. While pension regulatory agencies should not arbitrarily set caps on particular forms of investment, private entities should have some internal mechanism for ensuring that their

investment choices do not overly expose pensioners to unnecessary risk. The simplest solution is to require these entities to include pensioners on their management boards, and in turn, give those pensioners the opportunity to promote diversification of investment from within the entity.

Lastly, the Israeli government must learn from the lessons of post-Soviet governments that failed to properly oversee the activities of their own pension administration agencies. In each of the previously discussed nations, the continued use of pay-as-you-go systems stemmed at least partially from the fact that the pension divisions of national governments continued to believe that these systems were economically feasible. By not requiring the CMISD to regularly report its activities to the Knesset, Israel's pension policy will be subjected to the potentially erroneous assessments of the appointed agency heads. While some level of insulation can be beneficial so as to avoid stagnation at the hands of a public that has come to rely on a particular system, it also permits the kind of corruption and ignorance that plagues Russia's system to this day. This is not to say that the Knesset ought to oversee all of the CMISD's affairs. Rather, the agency should be compelled to regularly articulate its rationale for the way it enforces and regulates pension policy in Israel.

Some Israeli pension analysts may scoff at the notion that there is much to be learned from post-Soviet nations that have fallen behind other nations that transitioned to a free-market economy in the past century. Still, there are areas of weakness in Israel's pension system that must be refined or Israeli citizens will face many of the consequences already experienced by post-Soviet nations. Israel's Knesset should adopt refinements to existing pension laws to address failings that leave many elderly Israelis without true income replacement and also retain too many ties to the ghosts of Israel's state-run pension system. The economic realities of Israelis are vastly different from citizens of Kazakhstan, Tajikistan, or even Russia, but the relative results appear similar. Israel must learn these lessons from other formerly centralized economies or it will be doomed to repeat their mistakes.

VII. RECOMMENDED ISRAELI PENSION SYSTEM REFORMS

In the larger scheme of pension reform, Israel has taken many of the necessary steps to ensure long-term systemic viability and protection of individual pensioners. In certain areas, however, the policy decisions to retain elements of Israel's socialist roots have potential to result in instability and insecurity for retiring Israelis. Five areas remain where greater reforms

are needed to fully accomplish the Knesset's goals in enacting the CFSIL. The sequence in which the Knesset should address these reforms tracks the lifecycle of Israel's history of pension reform.

The first step involves reexamining treatment of the remaining old pensions so as to ensure that Israelis who established defined benefit plans prior to the 1995 bar are adequately covered. Though the 2002 provisions that entered Government Resolution 5156 into force capped the government's total contributions, it reduced neither the 4% interest accrued through government bonds, nor the guaranteed accrual of 2% of each member's determinant earnings for the old pension plan.¹⁶⁹ The determinant earnings are set as the average of the last three years of work or as an average of wages in the economy.¹⁷⁰ As a result of combining a guaranteed accrual rate with a cap on government payments, pensioners who maintain defined benefit plans are at risk of realizing a benefit far less than what was promised by the determinant earnings formula.¹⁷¹

This concern has led many Israelis who held defined benefit plans to transfer their existing fund to privatized defined contribution plans. The problems involved with this transition are two-fold. First, the CMISD has not issued any guidance or regulations to standardize the process of moving funds from an old pension to a new pension fund.¹⁷² As a result, the reinvestment of these converted funds are made entirely at the discretion of the management entity.¹⁷³ Workers held old pension funds for many years, which required fewer management decisions by the participant. As a result, these workers are less likely to have the requisite knowledge about their investment options. Consequently, transitioning old pensions to new pension funds without a standardized process might actually harm rather than help old-pension holders. Moreover, this transition exposes employees to greater risks because they will be forced to try and accrue investment gains in a shortened period of time (given their pension funds will likely be less substantial than those who invested in defined contribution plans from the start of their savings).

¹⁶⁹ OECD REVIEW, *supra* note 44, at 18.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *Id.* at 12.

¹⁷³ *Id.*

Equally essential, steps must be taken to address employees who entered into defined benefit plans later in life, but shortly before the enactment of the 1995 bar on old pensions. Given the existence of many professions that were not covered by any pension plans in the early years of Israel's statehood (for example, working on a kibbutz), it is not uncommon for an employee who is approaching the retirement age to have started saving for retirement just before the enactment of the 1995 bar.¹⁷⁴ Even worse, when these workers are employed in the public sector, not all of their salary is insured for pension purposes.¹⁷⁵ As a result, the 2% determinant accrual rate may only apply to a portion of the worker's salary, with as much as half of their salaries discounted for calculation purposes.¹⁷⁶ In turn, elderly Israelis feel the need to work at higher rates than ever before, with work force participation for those between ages sixty-five and seventy-four increasing from 20% to 30% for men and 5% to 12% for women.¹⁷⁷

The cumulative result of these issues is that the percentage of elderly Israelis living under the poverty line in terms of available post-retirement disposable income is among the highest of OECD nations at 20.7%.¹⁷⁸ In comparison to other OECD nations that provide public pension wage-replacement rates roughly equal to half of lifetime wages, Israel's public system provides a rate of only 22%.¹⁷⁹ Israeli citizens are stuck with little more than the initial promise of a defined benefit that was later capped by the government and lacks the flexibility to invest in high-yield (albeit riskier) investments. Still, during the period between 1997 and 2011, there was a moderate decline in elderly reliance on post-retirement age wage income, from 37% to 33%.¹⁸⁰ This indicates that CSFIL reforms are, to an extent, accomplishing the Knesset's stated goals. This figure also emphasizes the need for "catch-up" provisions that allow those who entered the workforce later in life to retire with replacement rates similar to those who were lifelong wage earners.¹⁸¹

¹⁷⁴ Merav Arlozorov, *The Matter At Hand: Pension That Leads to Poverty At Old Age*, THE MARKER, <http://www.themarker.com/markets/1.1642036>.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ TAUB CTR. FOR SOC. POL'Y STUD. IN ISRAEL, STATE OF THE NATION REPORT 2014 402 (Dan Ben-David ed., 2014) [hereinafter STATE OF THE NATION REPORT 2014].

¹⁷⁸ LIORA BOWERS, TAUB CENTER FOR SOCIAL POLICY STUDIES IN ISRAEL, PENSIONS, POVERTY, AND THE ELDERLY IN ISRAEL 2 (2014).

¹⁷⁹ *Id.* at 3.

¹⁸⁰ STATE OF THE NATION REPORT 2014, *supra* note 177, at 403.

¹⁸¹ BOWERS, *supra* note 178, at 4.

Second, the continued requirement that old and new pension funds invest a minimum of 30% of assets in non-tradable government bonds inhibits achievement of income replacement goals while distorting the pension market in favor of new pensions. This investment restriction prevents retirement portfolio diversification by sacrificing actual pension fund growth in favor of the ephemeral mirage of stability. By limiting investment choice, Israeli pensioners are still largely prevented from investing in worldwide securities that could bring in significantly greater profits than the guaranteed 4% interest rate provided by government bonds. A greater return on more diversified investments could mean more tax revenue for the Israeli government, but this benefit is sacrificed in favor of pension plan investment in government bonds.

Further, by indexing the interest rate provided by these bonds to cost of living (rather than standard of living), many retiring Israelis find that their stable benefit is far below what is needed for true income replacement.¹⁸² Paradoxically, it is this same promise of 4% interest rates that overly incentivizes investment in new pensions rather than provident funds and life insurance policies.¹⁸³ This in turn reduces system-wide diversification and places an undue burden on the Israeli government to eventually pay off the amount it borrowed from Israeli citizens in the form of these bonds. Should the Israeli economy face a prolonged period of stagnation at the same time a heightened number of Israelis are “cashing out” their bonds, the government may face the perfect storm of underfunding that it sought to avoid through passage of the CFSIL.

Third, while mandatory participation requirements help promote retirement savings for all Israelis,¹⁸⁴ they may not be appropriate for low-income citizens. At a general level, one of the largest benefits of retirement saving is that contributions to retirement plans enjoy tax-deferred status.¹⁸⁵ This benefit, however, is not nearly as substantial for low-income earners as it is for higher-income pensioners.¹⁸⁶ On retirement, these higher-income earners enjoy a drop in their marginal tax brackets because their retirement distributions tend to be lower than their working wages. This is not the case

¹⁸² Arlozorov, *supra* note 174.

¹⁸³ *Id.*

¹⁸⁴ ADI BRENDER, BANK OF ISR. RES. DEP'T., DISTRIBUTIVE EFFECTS OF ISRAEL'S PENSION SYSTEM 7 (2009).

¹⁸⁵ *Id.* at 15.

¹⁸⁶ *Id.*

for low-income earners who consistently pay the lowest marginal rate throughout their working and post-retirement lives, leading to a diminished tax-deferral benefit for these low-income earners.¹⁸⁷ From a tax-benefit standpoint, Israel may need to reconsider whether mandatory retirement savings are justified for all Israelis.

These mandatory savings provisions are further called into question for low-income earners in terms of their need to balance lifetime consumption expenses with retirement savings. On the one hand, when combined with government entitlement programs, these mandatory savings requirements can result in post-retirement income replacement levels ranging from 140% to 150% for low-income earners.¹⁸⁸ On the other hand, for low-income earners, this capital may be desperately needed to cover lifetime consumptive costs.¹⁸⁹ Many low-income families around the world enjoy tax-benefits for two costs that are specifically problematic for Israelis: mortgage interest payments and childcare costs.¹⁹⁰ Israelis cannot deduct mortgage interest in calculating their individual income taxes, while only women are able to take advantage of childcare credits.¹⁹¹ The lack of these tax-benefits makes it that much more essential for low-income Israelis to have access to disposable income during their lifetimes, rather than necessarily saving for retirement.¹⁹²

Surely the arguments behind mandatory saving reflect the desire to ensure that all Israelis have post-retirement income, but such paternalistic savings requirements simultaneously inhibit the ability of low-income Israelis to cover pre-retirement lifetime expenses. As an alternative, tax-incentives for retirement savings should be applied only to contributions made above this minimum required rate.¹⁹³ In turn, these tax savings could be shifted to cover consumptive costs, including childcare expenses and mortgage interest payments that most heavily impact low-income Israelis.¹⁹⁴ Alternatively, Israel could allow for low-income Israelis to postpone mandatory retirement contributions until years in which they are considered

¹⁸⁷ *Id.* at 22.

¹⁸⁸ *Id.* at 15.

¹⁸⁹ *Id.* at 18.

¹⁹⁰ BRENDER, *supra* note 184, at 18.

¹⁹¹ *Id.*

¹⁹² *Id.* at 22.

¹⁹³ BOWERS, *supra* note 178, at 5.

¹⁹⁴ BRENDER, *supra* note 184, at 17–18.

higher-income earners.¹⁹⁵ For those families who consistently fall into the category of low-income earners, the requirements could be modified to allow each wage earner in a family to contribute towards satisfaction of one minimum retirement pool, rather than imposing the same minimum on each family member independently.¹⁹⁶ Underlying any changes to minimum participation requirements would be a reinforcement of government support, like social security, that continues to provide roughly one-third of Israeli post-retirement income.¹⁹⁷

Fourth, despite the meaningful protections enacted by the 2001 Insurance Control Law,¹⁹⁸ Israeli pension management entities are private entities with a direct responsibility only to their shareholders. Their ability to generate profit for their shareholders depends on successful investment strategies, which may incentivize overly risky investments instead of slower, but more consistent, securities. As long as these private entities continue to exist without plan member representation on the governing boards, there is little reason to assume that riskier investment strategies will not be prioritized. Employers who serve as plan sponsors exert little sway over the decision-making of insurance entities, because the choice of entity is made entirely by the employee. The need for greater internal regulation of management decisions is underscored by the mixed results of Israeli courts in interpreting pension-related claims.¹⁹⁹ Certainly a return to paternalistic government-sponsored management entities would be problematic, but the lack of participant representation on entity boards permits assumption of unnecessary investment risk, mismanagement, and leaving pension funds susceptible to fraudulent activities.

Finally, just as there is a lack of accountability for management entities, so too is the CMISD hardly held to account for its own decisions. Outside of the previously mentioned removal provisions for individual officers,²⁰⁰ the CMISD is not required to present any external reports on its

¹⁹⁵ BOWERS, *supra* note 178, at 5.

¹⁹⁶ *Id.*

¹⁹⁷ STATE OF THE NATION REPORT 2014, *supra* note 177, at 404.

¹⁹⁸ See Control of Financial Services (Insurance) Law, 5741-1961.

¹⁹⁹ Jill Sinigaglia, *The Israel Perry Case: Justice Must Prevail*, JERUSALEM POST (Feb. 21, 2013), <http://www.jpost.com/Opinion/Op-Ed-Contributors/The-Israel-Perry-case-Justice-must-prevail> (editor noting that Israeli district courts struggle to interpret pension policies, define what constitutes a pension protected by Israeli law, and how civil and criminal laws interact on this issue).

²⁰⁰ See Control of Financial Services (Insurance) Law, 5741-1961.

own performance to the Knesset.²⁰¹ Though the CMISD is required to apply the Ministry of Finance's internal controls, it is not required to develop its own plan for checking its performance prior to publication of legally binding circulars.²⁰² To this point the CMISD has to a considerable degree worked to minimize the risks faced by pensioners, but the agency is imbued with great authority that carries great potential for mismanagement if external controls are not brought to bear by the Knesset. For example, legislation in 2005 gave the CMISD the authority to impose substantial fines and sanctions on management entities.²⁰³ Further, the CMISD is authorized to collaborate with the Israeli National Police and the Justice Department to pursue criminal investigations and sanctions for gross abuses by management entities.²⁰⁴ Though the CMISD regularly releases surveys of its activities,²⁰⁵ review of the agency's civil-enforcement activities are left largely up to its own commissioner, not the Knesset.²⁰⁶ This leaves the commission vulnerable to political influences, industry pressure, and ill-advised decision-making without consequence.

Considering the nearly insurmountable number of issues the pension system faced prior to enactment of several key reforms, these few items may seem to be of relatively little importance. Failure to address these items, however, could lead to disastrous results greater than the "focusing event" that prompted earlier reforms in the first place. As a result, steps must be taken to clarify existing rules, cut ties to outdated socialist ideals, and increase the accountability of both private and government entities involved in the pension management process.

VIII. CONCLUSION

The comprehensive reforms implemented by the Control of Financial Services (Insurance) Law and subsequent regulations have resolved the majority of issues faced by Israel's pension system. Four lingering issues remain that must be addressed to see through this reform and ensure the protection of all Israeli pension plan participants. First, the CMISD must issue legally binding regulations to oversee the transfer of pension funds

²⁰¹ OECD REVIEW, *supra* note 44, at 14.

²⁰² *Id.*

²⁰³ ISRAELI MINISTRY OF FINANCE, ACTIVITY OF THE CAPITAL MARKET, INSURANCE AND SAVINGS DIVISION 234 (2009).

²⁰⁴ *Id.* at 235.

²⁰⁵ *Id.* at 209.

²⁰⁶ *Id.* at 234.

from old pensions to new pensions, and must create exceptions to the monetary cap on government contributions imposed by Government Resolution 5156 for workers who began saving in defined benefit plans late in life. Second, the CMISD must either eliminate or reduce the 30% requirement for investing in government bonds and permit a greater diversification of investment in both Israeli and worldwide securities. Third, pension insurance management entities must be required to include plan member representation on their governing boards, either through direct representation or incorporation of plan sponsors in the decision making process of these entities. Fourth, the CMISD must be held accountable through a requirement to regularly prepare external reports for review by the Knesset (and not only in times when an officer faces removal).

These changes may seem like minor refinements to the vast body of Israeli pension reforms, but as is often the case with protecting the post-retirement incomes of employees, the devil is in the details. By enacting these reforms, the Israeli government can promote stability and protection, as well as profit in its oversight of both its public and private pension systems. Many of these lessons can be learned directly from post-Soviet nations that illustrate the problems wrought by leaving one foot in a socialist system and placing the other in a privatized system. Israel should instead pursue a course where government involvement serves to protect the retirement investments of Israeli citizens, not one in which paternalistic policies restrict the ability of citizens to attain income replacement on retirement. A booming generation of Israelis is poised to retire in the coming decade, but many are counting their anticipated pensions based on outdated and unrealistic promises. The Knesset must promptly make these revisions to the existing pension system, or risk facing another underfunding crisis that threatens these pensioners' futures.