PENSIONS SYSTEM AND REFORM IN ROMANIA

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Abstract: All transition countries inherited pension systems based on the principles of pay-as-you-go and definedbenefit (PAYG-DB). In the early years of operation, such systems had advantages over a fully-funded, defined-contribution (FF-DC) system. For, under a PAYG-DB arrangement, those who retire receive pension benefits immediately and contributions initially tend to exceed the payments. These advantages, however, disappear later on, when population (and employment) growth rates decline and when people live longer after retirement. Under such circumstances, an FF-DC programme has the advantages of greater flexibility and transparency, hence greater financial viability. The changeover from PAYG-DB systems to FF-DC systems is therefore a worldwide trend.

Although Romania has undertaken many necessary and difficult reforms to public pensions to contain the fiscal cost of ageing, much more remains to be done. Replacement rates are low and falling to a degree that undermines workers' willingness to participate in the state pension plan, particularly at contribution rates that are among the highest in the region.

Key words:pensions system, pay-as-you-go, reform, public pension.

After 16 years of economic and social transition, Romania is still struggling

*to develop a financially sustainable and reliable social protection system***.** In the years following 1989, the Romanian Government pursued a comprehensive structural reform that - combined with the difficulties inherent in any fundamental economic transformation - placed the country's social protection system under extreme financial stress. This emphasized the system's shortcomings, particularly in the area of pensions and other forms of contributory social insurance, and resulted in calls for change that successive governments have heeded to differing degrees.

Romania inherited a generous but fragmented and unsustainable mandatory, pay-as-you-go (PAYGO) pension regime from the socialist period. Replacement ratios were high and benefits were paid to a wide range of pensioners (including early and normal length of service, survivor and invalidity/disability benefits). The regime also financed several generous non-contributory benefits (such as sick leave, maternity/child upbringing leave, and farmers' pensions). The first years of the transition were marked by ad-hoc and hesitant reforms. As the transition advanced, the pension regime suffered from several fundamental shocks, including a rapid increase in beneficiaries as a result of population ageing and generous early retirement plans, a decline in economic growth, and a sharp fall in the number of contributors from the growth in unemployment and informal employment. These problems were aggravated by weak administrative capacity and policies that encouraged early retirement as well as the use of invalidity pensions to compensate increasing unemployment among older workers. Consequently, the pension plan's dependency ratio increased dramatically and remains one of the highest dependency ratios in the region today. With its population old-age dependency ratio expected to grow further (from 30.9 in 2003 to 59.5 in 2050), Romania's demographic profile creates another source of concern for sustainability. This aging process will create an additional burden on the working age population, as each worker will have to support an increasing number of retirees.

The Government has attempted to cope with these strains by raising contribution rates to levels that are high even by OECD standards. To make up the shortfall in revenues and the increase in system expenditures during the 1990s, the social security contribution rate was increased from 14 percent to 35 percent in 2001. Although the rate was then decreased to 29.75 percent in January 2006, it remains high by international standards. Moreover, aggregate social insurance charges (pensions, health, unemployment, work injury and disability) count for almost 50 percent of gross wages, making the Romanian workforce

one of the most heavily taxed in Central and Eastern Europe. Romania with a pay-roll tax of 46.25 percent, ranks the sixth (out 26 countries) in Europe on social security contributions in the neighborhood of Albania (49 percent) Poland (46.64 percent) and Hungary (45.50 percent), some of the highest in the Central and Eastern European Region. Even the Italian payroll tax rate, considered burdensome by OECD standards, is significantly below Romanian levels. High payroll taxes increase non-wage labor costs and can have adverse consequences for the generation of formal employment and, by extension, for coverage of the public pension plan.

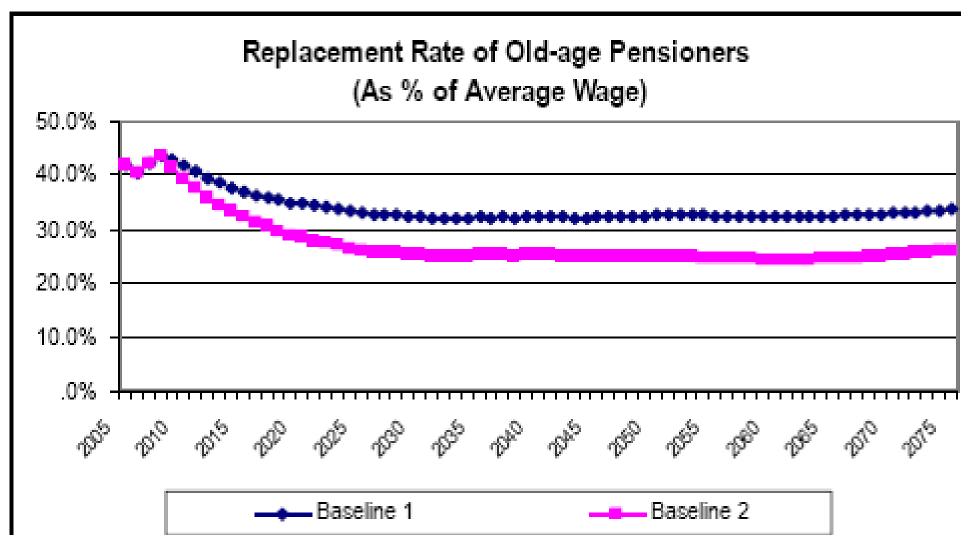
Table 1. Pension Contribution Rates and Total Social Security Contribution Rates in Europe

	Old Age, Disability, Survivors			All Social Security Programs		
	Insured Person	Employer	Total	Insured Person	Employer	Total
Netherlands	19.15	8.90	28.05	39.45	17.20	56.65
Czech Rep.	6.50	21.50	28.00	12.50	37.00	49.50
France	6.65	9.80	16.45	15.45	33.86	49.31
Albania	9.50	29.90	39.40	9.50	39.50	49.00
Poland	16.26	16.26	32.52	26.96	19.68	46.64
Romania	**9.50**	**19.75**	**29.25**[a)]	**17.00**	**29.25**	**46.25**[b)]
Hungary	8.50	18.00	26.50	13.50	32.00	45.50
Bulgaria	21.75	7.25	29.00	25.00	17.70	42.70
Austria	10.25	12.55	22.80	17.15	24.95	42.10
Germany	9.75	9.75	19.50	20.00	21.33	41.33
Italy	8.89	23.81	32.70	8.89	30.90	39.79
Average	9.53	16.44	25.98	14.11	25.05	38.57
Slovenia	15.50	8.85	24.35	22.10	15.90	38.00
Spain	4.70	23.60	28.30	6.25	31.58	37.83
Croatia	20.00	0.00	20.00	20.00	17.20	37.20
Greece	6.67	13.33	20.00	11.55	24.10	35.65
Slovakia	7.00	19.00	26.00	9.40	25.60	35.00
Estonia	2.00	33.00	35.00	2.00	33.00	35.00
Portugal	11.00	23.75	34.75	11.00	23.75	34.75
Sweden	7.00	11.91	18.91	7.00	25.87	32.87
Finland	4.60	22.75	27.35	6.10	25.36	31.46
Lithuania	2.50	23.40	25.90	3.00	28.00	31.00
Belgium	7.50	8.86	16.36	13.07	17.92	30.99
Latvia	2.00	18.00	20.00	..	..	24.32
United Kingdom	11.00	12.80	23.80	11.00	12.80	23.80
Ireland	8.00	10.75	18.75	8.00	10.75	18.75

Note: a) For normal working conditions. Contributions are higher for exceptional and special working conditions (Law 380/2005); b) Refers only to social insurance, health fund and unemployment fund contributions. Employers also contribute to the social solidarity fund for the handicapped, the fund for work accidents and occupational illnesses, etc., which adds another few percentage points to the burden.
Source: United States Social Security Administration.

Replacement rates from the public pension plan which were already low have begun to fall, and without further adjustment, they will continue to decline for another 10 years**.** Figure 1 compares replacement rates of old-age pensioners under two sets of assumptions about indexing: Baseline 1 and Baseline 2. The initial replacement rates are in the order of 42 percent rising to 44 percent in 2008 with the impact of 12 percent planned real increase in benefits in 2007 and 2008. Replacement rates in both Baseline 1 and Baseline 2 decrease gradually over the long term. The estimated long term replacement rates under Baseline 1, where the benefit is 150 percent inflation indexed, is 33.6 percent. The long term replacement rate under Baseline 2, where the benefit is inflation indexed, playing only the poverty alleviation role of pensions, is 26 percent.

Figure 1. Average Replacement Rate of Old-Age Pensioners-Baseline Scenarios



Source: World Bank PROST simulations 2006

Note: ***Baseline 1,*** the more realistic scenario, which assumes a long-term indexation of benefits of 150% of the inflation rate starting 2009 in line with the recent experience where indexation has been above the level of inflation. ***Baseline 2*** and assumes a long-term indexation of benefits to inflation only starting in 2009.

The authorities are very conscious of the problem of low and falling replacement rates and have indicated publicly that they intend to increase pensions by 30 percent in real terms over the period 2005-2008. In spite of the increases granted in 2005 and 2006 (almost half of the envisaged increase) and the recalculation of pensions, completed in 2005, replacement rates continue to remain at very low levels (36.1 percent in August 2006, compared with 51.1 percent in 1990). Encouraged by the current fragile financial surplus of the public pension fund, the Government will continue its policy of increasing public pensions. However, any other future increases of pensions will have to be accompanied by additional reforms in order to make the process sustainable on medium and long term.

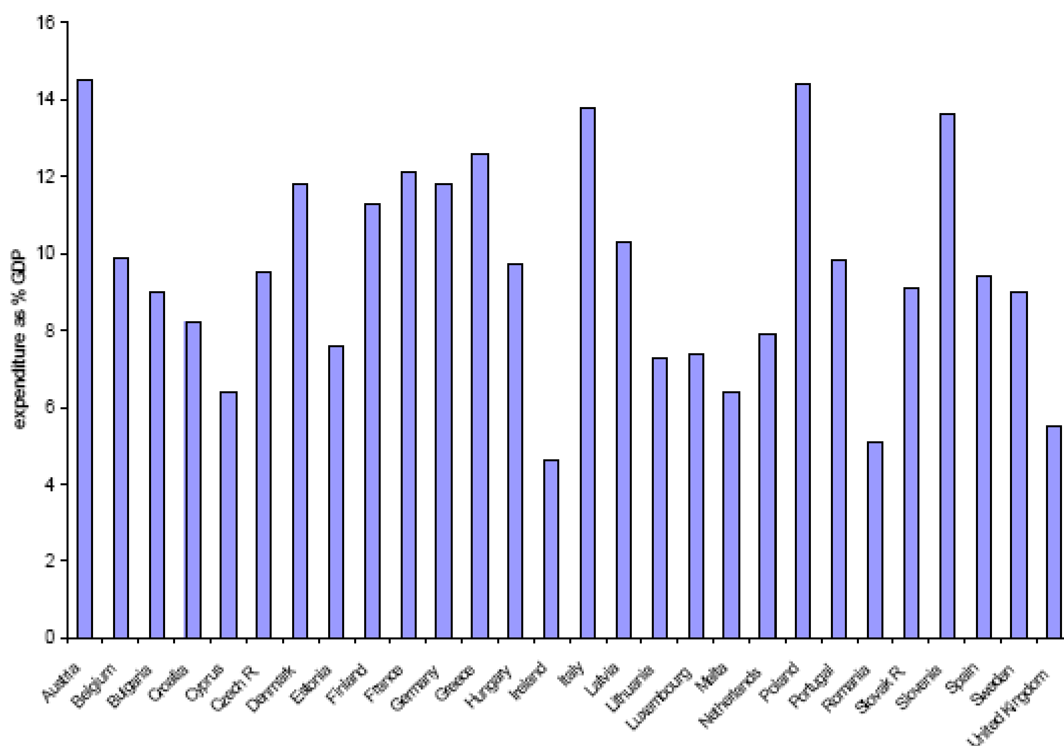
As noted earlier - so far, during transition, pension expenditures in Romania have been kept low in relation to GDP. However, simulations indicate that the contribution rate must increase from 25.5% in 1996 (and 32.5% in 1999) to 41.5% in 2040 in order to maintain the 1998 ratio of pensions to wages (De Menil *et al*, 1999). In 1998, this ratio, at 36.2%, was much lower than in Hungary and Poland. Romania is therefore expected to experience social pressure to increase that ratio in the future. This pressure and the expected increase of the coverage of the population by pension insurance are two major factors which prompted the Romanian government, in 1999, to propose a reform of the state pension system along the Hungarian-Polish model (G. De Menil, *et al*, 1999).

After the first step of the pension reform – the introduction old Law no.19/ 2000 for the public pension schemes - Romania postponed for too long the next steps. Compared with Hungary and Poland Romania is well behind. Even Bulgarian authorities were more decided in implementing funding pension schemes. Finally – in 2004, forced by the Romania's perspective to become an European Union member state, the politicians gave up their fears that the launch of funded pension scheme would be an unpopular decision. The laws concerning private and occupational pension schemes were issued and only the specialists and those interested to become pension fund managers reacted. The major part of Romanian working population still ignores this continuation of pension reform and how it would affect them. Funded pension schemes are at the beginning of their long road on Romanian pension reform. And the road could become even longer and more difficult without a proper campaign for public information. The potential contributors would not understand their rights and their options, wrong decision could be made and – as we shown previously – potential crisis could arise. After the last elections, the new Romanian government

made no declaration regarding the laws concerning the second and third pillar of pension reform. We hope that no radical decisions would be taken.

`As the contribution base of the PAYGO plan erodes and claims increase the financial sustainability of the plan is put at risk and a persistent systemic deficit has emerged. The state social insurance budget suffered a continuous decrease - from a surplus of 1.1 percent of GDP in 1991 to a deficit of 0.85 percent of GDP in 2003. Given that public spending on social security programs has historically been high, reaching 6.7 percent in 2003, this further increased the fiscal burden the pension plan placed on the general budget. Since 2003, spending on pensions has fallen to 5.3 percent of GDP in 2005, mainly as a result of shifting the financing of the non-contributory farmers' pension plan to general revenues. Long term projections prepared by the World Bank in 2006 show spending rising and stabilizing at around 6 percent of GDP. Furthermore, by conventional measures of implicit pension debt (IPD), the contingent liabilities of Romania's public pension regime outstrip those of most of its neighbors and even of several OECD countries. Although recent comparative data are scarce, and estimates of IPD will vary greatly (with the methodology and discount rates applied), Romania's international relative ranking by contingent pension liabilities is a cause of concern.

Figure 2. Spending on Public Pensions as a Percentage of GDP, Selected European Countries



Source: World Bank

Although the financial viability of the PAYGO plan improved following recent reforms the system still falls short of achieving fiscal sustainability. Too much room is left for discretionary interventions by politicians that make medium- and longterm actuarial forecasting uncertain. In addition to low average retirement ages, a recurring threat to the sustainability of the pension system is the practice of recorrelation. Having experienced erosion in the real value of pensions, pensioners demand a readjustment of pensions to a similar level to what new retirees receive, essentially an ad-hoc wage indexation of benefits. Although re-correlation should have applied only to those who retired with a full length of service prior to 1999 and to their survivors, it was expanded to new categories of retirees. This occurred as a series of discretionary measures resulting from political lobbying, rather than any formal policy or predictable benefit adjustment rule.

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