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Muddling throughthe pension reform

The government is thoroughly reforming the public pension system, but the positive results are still being awaited. On the contrary, the plans for the introduction of the additional private system are sketchy and tentative. Key issues still need to be solved, and more important, the modest scale reserved for private pension schemes in the government's plans will limit any positive effect these might have in the near future.

Fig. 1. Pension funds contribution payers versus working age population

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
(*)	8,156	7,574	6,888	6,672	6,438	6,160	5,939	5,597	5,200	4,737	4,459
(**)	57.82	53.53	49.52	47.77	45.90	43.76	42.12	39.69	36.90	33.75	31.66

(*) Contribution payers (thousands)

(**) Contribution payers / population aged 15 – 60 (%)

Challenges of the public system of pensions

We have previously argued in this publication that the public pension system is marred by a high dependency rate (i.e. high number of retired people per number of workers), due to early retirement and shrinking of the number of workers paying contributions. In addition, this situation will get worse due to demographic trends. The new figures are shown below in the following tables.

Fig. 2. Dependency rate dynamic

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Contributors/ pensioners	3.43	2.69	2.17	2.10	1.91	1.75	1.63	1.48	1.32	1.16	1.05

Fig. 3. Pensioners versus working age population

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
(*)	2,380	2,817	2,996	3,174	3,359	3,519	3,652	3,782	3,924	4,074	4,246
(**)	16.87	19.90	21.57	22.73	23.94	25.00	25.90	26.82	27.83	29.02	30.15

(*) Average number of pensioners (thousands)

(**) Pensioners/ population aged 15 – 60 (%)

Reform of the public pension system

A new pension law (19/200) has come into force, after being amended twice by the government. The law gradually increases the retirement age, eliminates the option of early retirement, and connects the value of the pension with the level and length of the contribution, thus encouraging the real reporting of earnings and staying in the labor force. However, the new law still has to make its effects felt. Against government predictions, the deficit of the social insurance budget continued to grow. The best explanation for this trend is the high number of individuals who quickly applied for retirement under the provisions of the old law, before the new legislation came into force. This effect can be expected to gradually fade away, but the real results of the new legislation are still in doubt.

Public hostility

A challenge faced by the new pension legislation is the ignorance and skepticism of public opinion. Opinion polls (SAR's own survey presented in the previous issue of this publication included) have consistently shown that a majority of the population do not have enough information about the new pensions system, but expect to be negatively influenced by it.

New labor contracts?

The Government's intention to abolish the difference between full-time working contracts and freelance contracts is consistent with its overall approach to the reform of the pension system, but it also raises some concerns. In this context, it should be highlighted that, over the last two years, the difference in the tax regime of these two types of labor contracts has diminished. A pension contribution is now paid on both. Freelance contracts represent about one quarter of wage employees[1]. If as a result of abolishing freelance contracts, these jobs move to the underground economy, the loss of revenue for the pension fund would be significant.

Introduction of the second pillar

Law 19/2001 reforms the state pension – the first pillar of the new pension system which is envisaged. This change is supposed to be supplemented by the second pillar – compulsory pension contribution managed by private pension funds and the third pillar – optional private pension. The World Bank supports the three-pillar structure of the pension system and the other CEE countries also aim to introduce it. They hope the advantages will result in better management of pension funds, with increased returns, that in turn would encourage people to contribute and to stay longer in the labor force. In addition, the large sums available would stimulate the capital market, specially by increasing the liquidity, and thus improving the efficiency of the economy.

The reform was debated in the previous Parliament. However, the second and third pillar run into opposition, amongst others form the trade unions, who wanted a stronger say in the work of the funded scheme. Finally, the reform was passed by an emergency government ordinance

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[1] There are currently approximately 1.5 million freelance contracts and 4.5 million full time contracts.

(OU 230/2000) in the last days of the outgoing Isarescu government, but the ordinance was quickly taken down in the first meeting of the incoming Nastase government.

Financing the transition period

The new government has let it be known that the new draft of the second pillar law would become public this fall. There is one major problem for the introduction of the funded system, this concerns the transition period between the introduction of the new system, when the working population starts to contribute for their pension account, and the maturity of the system, when these people start receiving their pensions. During this transition period, the contribution will be capitalized, and can no longer be used for paying the outstanding pensions to the current generation of pensioners.

There are two solutions envisaged for this problem. First of all the size of the funded scheme will be low, and will grow only gradually. It is planned that it will initially represent only 2% of the wage, and it will later increase to 8%. In addition, the funded scheme will be introduced only when the budget of the pension fund is balanced. The government estimates that this should happen by 2004-2005, based on the expectation of improved economic activity and increased number of employees, coupled with improved collection of the contributions, increased retiring age, and only a modest increase in the real value of pensions.

The government's plan treats the funded scheme as a luxury: it will be implemented when it is not needed (i.e. when the budget is already balanced), and it will be small anyway. The danger with this approach is that the new scheme may have little impact. Moreover, the economic expectations upon which the timing of reforms depends look shaky. If anything, the budget of the pension fund is going to be under serious pressure over the next few years: the government has promised the indexation of pensions according to the rate of inflation, and in December this year is supposed to start the three year process of 're-correlation', by the end of which all pensioners with comparable professional record will receive the same pension.2 The moral case for this is rock-solid, but consecutive Romanian governments have failed to find the means to achieve the 're-correlation'. Cabinet Isarescu even had to backtrack on its promise in an electoral year.

Beyond the fundamental questions concerning the size of the private scheme and the timing of its introduction, there are a series of technical matters that have to be solved.

Size of pension funds

The size of the funds is a matter of contention. Here the government faces a trade-off. Large pension funds (in terms of capital requirements and minimum number of registered people) would be more credible with the population, whose confidence is pretty low after the series of debacles, of which FNI is still fresh in memory. However, establishing high barriers for market entry would deter competition, thus reducing returns. Moreover, it means that the industry would be dominated by foreign players, thus antagonizing the domestic allies of the government who are interested in entering this lucrative business, as is especially the case with the trade unions. Their opposition on similar grounds helped derail the adoption of the legislation by the previous administration.

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[2] Until the implementation of the new pension law (19/2000), the quantum of the pension used to be determined according to the nominal wage. Due to the high inflation of the last 11 years, this algorithm led to paradoxical situations where people with the same profession received very different pensions, according to the year when they retired. This system was very detrimental to those who retired before 1989, or soon afterwards.

Regulation

Supervision will be crucial for the credibility of the scheme. After successive fiascos in the financial sector, entrusting one's savings (even if compulsory) to a private fund for 20 or 30 years, with the expectation that eventually one will receive a pension, requires a leap of faith. The stakes are very high, and any mistakes by the regulator could have dire consequences for the state budget, which will be the ultimate guarantor. From the institutional point of view, there are three possible options. One possibility is for the insurance watchdog to also take over the supervision of the pension funds. Another option would be to establish a new specific regulator. Finally, one could also take into account the creation of a super-watchdog that would cover the whole financial sector (banking included).

From the three alternatives, the first one is probably the most feasible. Since most pension funds will be connected to insurance (specially life insurance) companies, the Commission for Insurance Supervision is well placed to also supervise pension funds. The Commission has the advantage that it acquired experience in dealing with the insurance companies. Setting up a new institution would be cumbersome, even more so if it has to cover the whole financial sector, wresting control of the banking sector from the Central Bank.

Investment policy

The draft bill is expected to limit the share of funds that can be invested abroad by pension funds, to 10%. The desire of the government to have pension funds help in reviving Romania's capital markets, rather than worsen the balance of payments is understandable. There are good reasons to be cautious however. The domestic capital market is very limited, and it does not have the capacity to absorb large funds. This is less of a problem over the short term, when the volume of the private pension contributions is capped to 2% of the wage. More significant is the argument that investing abroad is essential for risk mitigation. Actually, this is also the only way to dealing with the demographic trend – the ageing population. Finally, a ceiling of 10% for investments abroad may be incompatible with the accession to the European Union. Such a ceiling infringes the free movement of capital, one of the cornerstones of the internal market. Sooner or later, depending upon the negotiations with the EU, this limit will have to be relaxed or removed altogether. It is worth paying attention to the pressure being now put on Poland on the same issue.

The National Pensions House

The introduction of the funded scheme will put additional pressure on the National Pension House, the government agency that manages the current public pension system. The National Pension House will continue to collect all the pension contributions. It will be its task to allocate individual contributions to the pension fund of choice. This requires a sophisticated infrastructure. The difficulties already encountered in the public pension system suggest that the current infrastructure is not that sophisticated yet, and its development will require years of preparations.

Conclusion

The Romanian public pension system ("pay-as-you-go") is undergoing a thorough rationalization. There are however built-in limits in a PAYG system, and the financial situation of the Romanian one is critical and it is going to remain so. The introduction in parallel of a privately funded system is therefore essential. This reform has the backing of the World Bank, had been under consideration in Romania since 1993, and a bill was passed in the final days of the previous administration. The Nastase cabinet, however, is not fully engaged in implementing this reform. Its plans are still sketchy, the envisaged size of funded sector is small, and the conditions set for its implementation are doubtful at best.