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Pension update

Romania has entered the 1990s with a healthy situation of pension funding. However, the political unsustainability of the PAYG system and the demographic evolution have bankrupted the system. The newly implemented law on pension reform 19 / 2000, and the subsequent changes brought by the government ordinance OU 49 / 2001 have improved the incentive structure of the system, by encouraging higher contributions over a longer period. These improvements do not go far enough. The demographic trend and the motivational problem built-in in a PAYG system require the introduction of a funded scheme. The government should devise a replacement along the line of the annulled government ordinance OU 230 / 2000 of the previous administration.

The emergence of the crisis

Similar to all the other former socialist countries, Romanian pension system was a PAYG (Pay As You Go) system, where the pension of today pensioners is paid from the wage-related contributions of today employees, and the quantum of the pension is somehow income related (with minimum contribution periods), but not directly related to the overall contribution. The key variable for such a system is the dependency ratio: the number of pensioners over the number of employees (contributors).

Romania has started the transition in the 1990s with a healthy dependency rate of 3.42. This situation quickly changed (see table 1). The demographics worked against the pension system. The population registered a decrease, due to negative natural growth and emigration (see table 2). The main reason behind the spiralling dependency rate has been premature retirement. Taking advantage of the generous provisions of labour law that allowed for normal retirement as early as 50 for women and 55 for men, and the upgrade of a number of professional categories into the higher risk ones, allowing for full pension at early retirement, scores of Romanian older employees, facing the challenges of the transition economy, chose the relative security of early retirement.

Table 1.

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Dependency rate (contributors / pensionaires)	3.43	2.69	2.17	2.10	1.91	1.75	1.63	1.48	1.32	1.16	1.05

Source: INSES

Table 2. Ageing population

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Population 15-60	14,105,078	14,148,184	13,908,563	13,965,275	14,026,275	14,075,541	14,098,705	14.101.632	14.094.720	14.035.000	14.081.214
Population	3.632.966	3.708.780	3.778.153	3.842.518	3.901.357	3.960.969	4.009.166	4.068.500	4.130.225	4.148.128	4.199.272

over 60											
Population over 60 / population aged 15-60 (%)	25.76	26.21	27.16	27.51	27.81	28.14	28.44	28.85	29.30	29.55	29.82

Source: INSES

The number of pensioners has quickly risen (see table 3), and, if agriculture employees are also included, by 1999 has overtaken the number of pension contribution paying employees. The rise of pension liabilities has been coupled with a shrinking contribution base due to the transition output contraction. These two factors have pushed the social insurance budget (separated from the central government budget since 1992), from a strong positive cash flow, into the red by 1995 (see table 4).

Table 3. Increasing number of pensioners

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Average number of pensioners	2.380.038	2.816.628	2.996.419	3.174.128	3.358.925	3.518.932	3.651.728	3.782.304	3.923.721	4.074.200	4.246.250
Pensioners/ population aged 15 – 60 (%)	16.87	19.90	21.57	22.73	23.94	25.00	25.90	26.82	27.83	29.02	30.15

Source: INSES

Table 4. Financial situation of the Pension Fund

	Revenue (% of GNP)	Deficit (% GNP)	Revenue (mil. ROL 1990)	Expenditure (mil. ROL 1990)
1991	7.44	0.41	607.23	573.90
1992	7.77	1.06	558.50	482.05
1993	6.59	0.70	440.28	393.28
1994	5.65	0.10	397.62	390.37
1995	5.44	-0.23	419.67	437.32
1996	5.43	-0.17	455.21	469.59
1997	5.26	-0.02	397.99	399.73
1998	6.81	-1.01	438.16	503.42
1999	7.35	-0.25	492.56	508.75

The government has reacted by increasing the contribution rate. Since 1990, the old age pension contribution rate has more than doubled (from 17% to 35%). The Romanian main pension contribution rate is one of the highest among transition economies (see table 8). However, this has failed to alleviate the problem, because the increased taxation has pushed even more people out of the legal economy, mostly into the informal one (see table 5).

Table 5. Decreasing rate of contribution payers (fully employed)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Contribution payers	8.156.000	7.574.000	6.888.000	6.672.000	6.438.000	6.160.000	5.939.000	5.597.000	5.200.000	4.737.091	4.458.758
Contribution payers / population aged 15 – 60 (%)	57.82	53.53	49.52	47.77	45.90	43.76	42.12	39.69	36.90	33.75	31.66

Source: INSES

The only compensation strategy available to the government, faced with a growing number of pensioners, and lack of financial resources, has been the decline in the value of pensions. Tables 6 and 7 present the absolute impoverishment of pensioners (the decrease in the real value of average pension) and their relative impoverishment (the decline in value of the average pension as a proportion of the average wage).

Table 6. Absolute impoverishment

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Average real pension (%)	100.0	77.5	63.7	56.5	55.3	61.2	62.8	49.7	48.5	50.44	46.90

Source: INSES

Table 7 Relative impoverishment

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Replacement rate (average pension / average wage (%)	44.69	45.05	43.64	45.20	43.27	40.78	38.60	40.33	39.13	35.0	38.93

Source: INSES

<u>Pension reform</u>

Discussions about pension reform go as far as 1992, when the first White Paper has been published. However the first major review of the system was the law 19 / 2000, that came into force on April 1st 2001. The law reforms the state pension – so called pillar one of the new pension system envisaged. This change was supposed to be supplemented by the pillar two – compulsory pension contribution managed by private pension funds and pillar three – optional private pension. However, the second and third pillar run into opposition, among others form the trade unions, who wanted a stronger say in the work of the funded scheme. This delayed the transit through parliament. Finally, the reform has been enacted through an emergency government ordinance OU 230 / 2000 in the latest days of the outgoing Isarescu government. The ordinance has been quickly annulled in the first meeting of the incoming Nastase government.

The pension law phased in an increase in the retirement age with five years (to 60 for women and 65 for men), and changed the method for calculating the pension from one based on the income in the latest years of activity, to one that takes into account the contribution over the whole working life – with an yearly ceiling of three times the contribution for the average wage. These changes should assure that people stay longer in the labour force. In addition, it becomes in the interest of employees to demand to their employers to fully report their wage, therefore bringing into open some of the informal economy. A last minute change (emergency ordinance OU 49 / 2001) is strengthening this feature of the law by penalising the employees whose employer has not paid the pension contribution.

Policy alternatives

Anyway, this last measure has inflamed the opposition of trade unions. A welcome move would be the transfer of the whole contribution to the employee (as opposed to only one third at present). This would increase the legal penalty of an employer that fails to discharge the pension contribution paid by the employees, while also improving the transparency of the system.

However, in any form the law does not guarantee a good return on the contribution. It only provides that somebody who had a higher contribution will have a proportionally higher pension, but not that it will be a good pension. This is where the private management of pension funds would prove useful. A funded scheme would allow for a higher return than the meagre one provided by the state pension fund. In addition, a funded scheme would alleviate the political dependence of the PAYG system (the value of a pension point is decided annually by the government, and is therefore completely unpredictable), its major motivational shortcoming. For a comparison with other CEE countries, see table 8.

Table 8. Reform laggard: comparison between Romanian pension reform and selected CEE countries

Country	**Reform**	**Date of introduction**	**Retirement age**	**Contribution level**
Croatia	Three pillar system	1999	65 (both men and women)	25.4%
Letonia	Virtual capitalisation	1995	60 (both men and women)	37%
Polonia	Three pillar system	1999	65 men / 60 women	19.52%*
Ungaria	Three pillar system	1997	62 (both men and women)	31%
Romania	Reformed PAYG	2001	65 men / 60 women	35%*

* Old age pension contribution only

Trends

The demographic trend will continue to work against the pension system, with the working age population continuing to shrink as the Romanian population grows older. The unknown quantity here is the number of contribution paying employees. On one hand, the economy is expecting to grow this year, even if the rate of growth varies widely from forecaster to forecaster. This would not necessary lead to more jobs, as an increased output could be accommodated by the under-utilised production facilities through increasing the productivity of existing employees. In addition, the economic restructuring process might lead to more unemployment. On the other hand, the crucial element will be whether tax evasion will be reduced: employees in the informal economy joining the formal one, and employers reporting the full earnings of their employees.

Conclusion

The pension law that has recently come into force provides the right incentives for helping the survival of the pension system. However, the system is going to face a mounting pressure from the ageing population, and faces the uncertainty over the evolution of the number of contribution paying employees – dependent on the overall evolution of the economy, but also on the industrial restructuring process, and especially on coming into light of the informal economy.

The increased efficiency, and the supplementary contributions brought by a privately managed funded system will prove helpful in mitigating these risks. The government should devise a replacement along the line of the withdrawn emergency ordinance of the previous administration.