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ROMANIAN PENSION REFORM IN COMPARATIVE PERSPECTIVE

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PART I

The Reform of the Pension System in Romania
- Expectations and Reality

(by Valentina VASILE)

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Content

1.Introduction

The social protection of the elderly is provided by a system of social assistance and aid services, among which the insurance of the elderly by pensions is the main form.

The pension programs implemented so far define the social protection reform initiated after December 1989. Looking back at the past, we may reveal two pension systems:

a) The system used also before 1989 that underwent several adjustments, especially between 1997-2001 (March).
b) The system implemented on the 1-st of April, 2001, that principially meets the requirements of the Romanian society and is compatible with European practice.

At present, two years after the initiation of the system, the pension reform is still waiting for effective action. Actually, the initial reform program has been postponed for more or less objective reasons as the Government has taken several measures to “adjust and correct” the Pillar I, focused on meeting the popular expectations, which in turn have caused more inequity. The reform continuation, and the moment and content of the privately managed funded pension system still are controversial issues.

The reform continuation is accepted by all parties involved, while the controversial issue refers to the alternative “model” that fits best Romania’s economic and social condition.

While the former pension system was changed to prevent a deep social crisis, the new one, after two years of partial implementation and poor support from the economic environment, has caused a general (conceptual, functional and practical effectiveness) crisis. The pensioners’ poverty is deepening, the inequalities are worsening and the temporary “adjustment” measures are proving their practical efficiency only punctually and on very short term.

This part of the study presents retrospectively and prospectively the Romanian pension system, laying the stress on the strengths and weaknesses of the reform. The comparative approach is also considered to reveal the constructional and functional features in relation to similar systems of other countries but mainly to point out the system malfunctioning, “bottle-necks” and gaps.

2.The pension system in the period 1990-2001 (March)

2.1.General presentation

In the period **1989-2001 (March),** the Romanian pension system was based on the old principles applied also to the centrally planned economy, i.e. a **redistribution-oriented public pension system**.

The main components of the system were the following:

a) **The state social insurance pensions for employees**, consisting of the compulsory contribution of the employers that amounted to 13 percent of the gross wage fund.
b) **Compulsory additional pension** based on the employees' contribution, amounting to 3 percent of the net wage[1] (unfunded).
c) **Social insurance pensions for farmers, optionally introduced in 1992** were an extension of the insurance system for the co-operative farmers that disappeared once the land was reverted to the former owners, i.e. the dissolution of the co-operative farms.

During the transition, the system underwent many changes and adjustments in order to provide the resources for the fund supply and preserve the purchasing power of the pensions in payment:

- The **contribution rose from** 16 percent in 1989 to 28 percent in 2002 (Table 1).
- The **unification of the pension funds** (the above three components).
- The purchasing power was supported by the **periodical pension indexing** in various proportions to the wage, the stress being laid on the nominal increase in the small pensions.

Table 1

The contribution quota to the social insurance fund prior to the reform

% of the gross wage fund

	Period of application		
	1989- 1992 (March)	1992 (April)- 1999 (January)	1999 (February) – 2001 (March)
The employer's obligations	13	25	30
The insured persons' obligations	3	3	5
Total	**16**	**28**	**35**

Even undergoing many adjustments, **the insurance fund was in deficit every year**, the **real pension diminished,** and the pension **distribution scale shrank** and the pensions were grouped at the bottom of the scale.

[1] The additional pension system used in Romania in the period 1967-2001 (March) is comparable by purpose with the pensions of Pillar II in France. During that period, the contribution to the additional pension amounted to 16 percent of the calculation basis for the full contribution period and legal length of service. For financial reasons, the funds for the above component were included in the state pension.

2.2 Inequities caused by the policy for the "protection" of the pensions against the disturbances occurring in the economic environment.

The chaotic restructuring, the atomization of the production units, the inadequate privatization and the inflation were the factors that **disturbed the pension system that gradually changed from a social protection mechanism into a social assistance mechanism** accompanied by *major inequities* both between various categories of pensioners and within the homogeneous groups of pensioners.

The inequities were favored by the inconsistent and inadequate economic policy made by the 1990-2000 governments:

- In order to ensure the minimum subsistence conditions, they increased the pensions in different proportions and caused the *pension "leveling"*.
- In the late 1990's, especially in 1997-2001 (March) some measures caused *major inequalities between pensioners of the same category but retired in different years.*

The system based on the faster pension indexing as compared to the wages as well as several regulations concerning the pension calculation correction have caused major disturbances in the system. For example, the combination of the provisions for pension indexing after 1991 with the provisions of the GD 565/1997 regarding the pension calculation caused that a pension in payment after 1997 equal or even exceed the level of the last wage (!). It could happen if the period of five consecutive years considered for the pension calculation of the last 10 years was at the beginning of the interval. The average pension calculated as above was increased, according to the indexation threshold imposed by the Government by a higher rate than the wage rise. It happened that **persons having similar "history" and incomes received differentiated pensions depending upon the year when the pension was first paid (!).**

- The average pension for age limit and full length of service increased only by making the application for pension in 1999 and not in 1996 by one-fourth. In 2000 it increased by one-third and in 2001 (March) by almost one half.[2]

Another measure that caused inequities was the introduction of the **minimum limits within the pension categories**, updated periodically to ensure the social protection of the poorest pensioners. The differentiated indexing or mere increase in the minimum threshold caused the pension shrinking to the bottom, i.e. the diminution in or even elimination of the pension differences that were due to the kind of profession, training level, contribution period, etc.

Another factor was the **wage policy that was quite chaotic at the company level**. Especially in the early 1990's, high wages were negotiated at the company level in an inflationary context. Such wages were not economically supported, but obtained by strikes, mostly in state-owned enterprises (regies autonomes, national companies) that held the market monopoly and covered the vital fields of the economy: oil, gas, electric power, mining, transport, etc. In the private companies, the managers as well as the associates or shareholders set (rather arbitrarily than

[2] For further details, see Nicolae N.Popescu, "Eliminarea discrepanțelor dintre pensii", ***Tribuna Economică***, nr.16/2001.

on an economic basis) high wages so that at the retirement time they got a higher average of the incomes considered in the pension calculation.

If we associate such a behavior with the anticipated pension practice (to a greater extent than required to prevent the effects of the privatization and restructuring and relax the labour market – lower pressure upon unemployment) then we get the general picture of the problems of the pension system: deficit, inequities, etc. Therefore, it is necessary to reform deeply the pension system, that is to correlate it with the economic and social environment and make it function.

3.The necessity to reform the system

In the context of the European integration and social protection modernization, the pension system reform should be approached on three levels: the European level, the candidate countries' level and the national level.

a) The first level approaches **the action taken by the EU and the member countries to improve the pension system**, and the problems that may affect the social protection of and assistance to the elderly.
b) The **candidate countries** have to take up two challenges: on the one hand, the reform/adaptation of the pension systems so that they become functional under the new economic and social conditions and, on the other hand, the harmonization of the national systems with the Community acquis in the field.
c) The **national approach** should take into account the reform accommodation to the specific environment in the country: traditions, expectations, needs, possibilities.

All the above mentioned approaches shall consider the complex influence of the demographic factor in three ways:

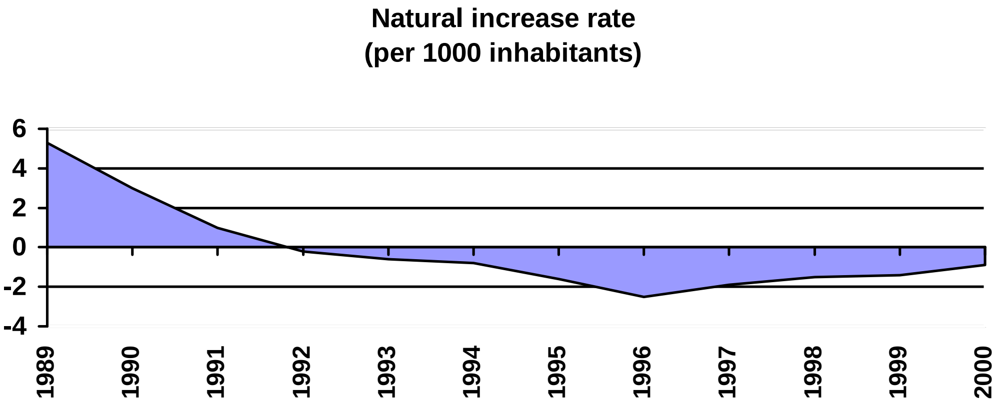
- population ageing;
- natural increase rate, which is under the limit of 2.1. that allows for the replacement of the generations;
- higher average life expectancy at birth.

It is not our purpose to describe the set of factors/constraints considered for modeling/building a proper and functional pension system in Romania. Therefore, we present the main reasons for changing the pension program.

3.1.Demographic factors and the long-term sustainability of the pension system

Romania has to face major demographic problems. Although existing in many European countries, the population ageing is associated in Romania with a negative natural increase rate and high mortality rate. The natural increase rate (per 100 inhabitants) decreased from about 5.3 in 1989 to 1.0 in 1999 and then it became negative: - 2.5 in 1996, 0.9 in 2000 (Chart 1).

Chart 1



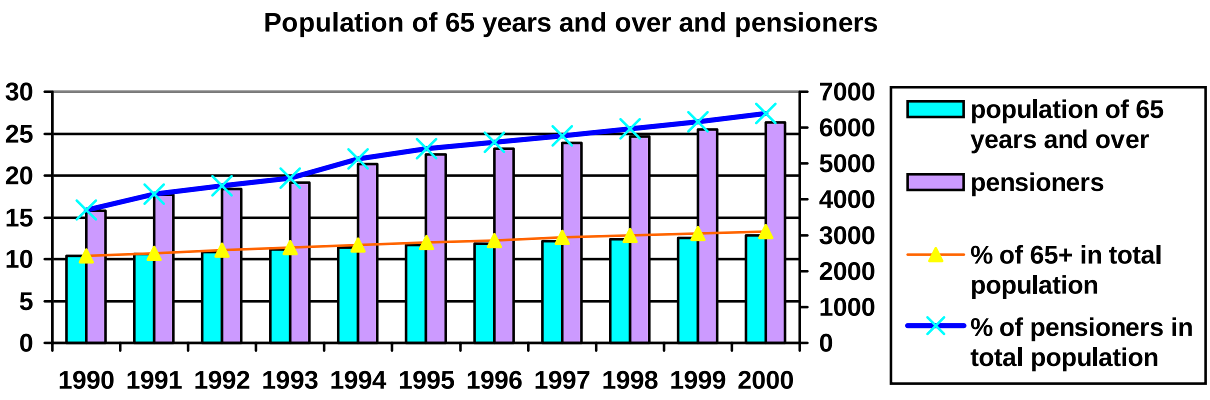
Source: Romanian Statistical Yearbook 2001, NIS, Bucharest.

The old population of 65 and over grew constantly, from about 2.4 mill. pensioners in 1990 to 2.7 mill. in 1995 and further to 3 mill. in 2000, i.e. from 10.4 percent of total population in 1990 to 13 percent in 2000. The trend is similar to the EU one, that is the proportion of the elderly will double in the next 50 years (Chart 2).

The dependence demographic ratio is worsening due to the unfavorable trend in:

- **Total population**[3]**, which is expected to diminish** in the next 50 years by **about 6 mill**. people (equivalent to one quarter of the present population of Romania), that is more than the total diminution in the EU 15 population over the same period[4].
- **Work age population, which will decrease by 5 mill**. people, while the absolute increase in the old population (65 and over) will be approx. 2 mill. people (!).
- **Dependence ratio**, i.e. the share of the population of 65 and over in total population of 20-64 **will increase** from 21.8 percent in 2000 to 58.4 percent in 2050, thus exceeding by 5 p.p. the level estimated for EU 15 (Chart 3).

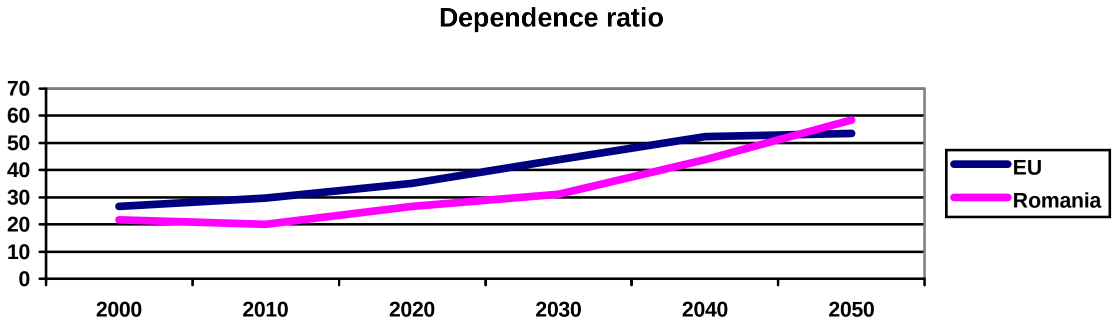
Chart 2



[3] UNO Projection 1988, average alternative.

Source: Romanian Statistical Yearbook 2001, NIS, Bucharest

Chart 3



Source: Romanian Statistical Yearbook 2001, NIS, Bucharest

Another demographic factor that influences the pension system is the **average life expectancy which will increase slightly**. In the period 1989-2000, the indicator increased from 69.76 years to 70.63. The pressure exerted by the demographic trend on the pension system is partially taken up by the older age of retirement which may lead to the diminution in the average retirement period (at present, about 14 years).

Owing to the above demographic trend, the pension system, especially the redistribution component, will become unbalanced. The completion or substitution with a private system seems to be the present directions in which the pension reform moves in other countries. ***In Romania, the implementation of an exclusively private pension system is not viable, firstly because the population is not used to invest in such a system, and secondly because the economic environment is not ready for that. The combined alternative seem to be the only solution at present but the question is how to reform and improve the public system.***

3.2. Economic and social factors

The economic system has not stimulated the adjustment of the social system reform, especially the policy for the pensioners' social protection. The real economy has no adequate resources and functional and efficient mechanisms to manage the imbalances and the medium– and long-term policies. As regards the economic environment, the state has taken uncorrelated measures, often determined by social pressure and has not quite firmly fulfilled its specific tasks: coordination, control and effective management (of its own property, as well).

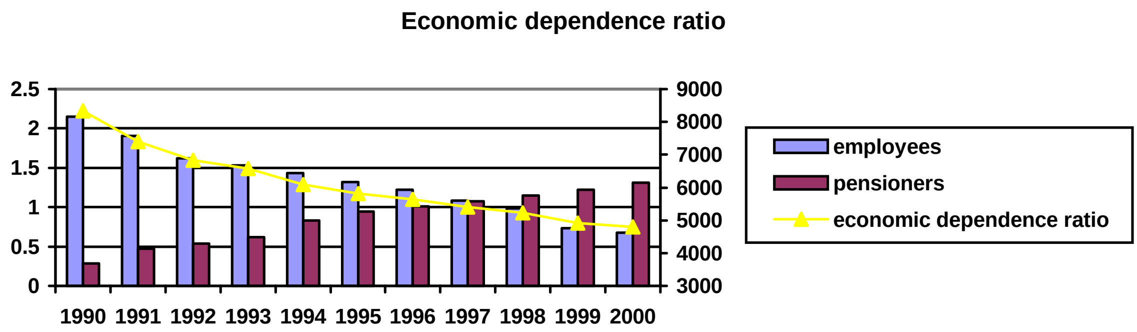
[4] EUROSTAT Projection, average alternative.

The poor economic performance has caused hazardous supply of the pension funds by the employers' and employees' contributions because of the following:

a) **Absolute diminution in the contributions** by:
   - Severe diminution in the number of employees as a result of the elimination of the over-employment specific to the former regime and the economic restructuring and privatization: as against 1989, the number of employees contributing to the social insurance has diminished to almost half. The economic dependence ratio[5] worsened, from 2.42:1 in 1990 to 1.13 in 1996 and further to 0.74 in 2000 (Chart 4).
   - More part-time jobs.
   - The diminishing number of people that enter the labour market (low birth rate associated with the significant migration of the youth) as compared with the number of people leaving the market by retirement before term or after full length of service.

b) **The deliberate non-participation in the pension system**. Due to the financial burden, very heavy if related to the economic bearability, the economic agents and the active persons do not participate or do not pay their contribution. They enjoy the payment postponement and rescheduling or even exemption from payment and do business on the black market.

Chart 4



Source: Romanian Statistical Yearbook 2001, NIS, Bucharest.

We may conclude that although the pension system of the 1990-2000 (March) period underwent more or less necessary changes/adjustments and followed a social protection policy (although it avoided some of the principles of equity and social justice), its performance was very poor: the purchasing power of the pension diminished, the budget deficit became chronic (for example, insurance budget deficit was in 1998 13.7 percent, in 1999 3.3 percent and in 2000 9 percent; as an average, it was less than 1% of GDP in each year). In 2000, the average pension amounted to only 44 percent of the net average wage as against 53 percent in 1990 (Chart 5).

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[5] Ratio of the number of employees to the number of pensioners.

Chart 5

Source: NIS data

4.The architecture of the restructured pension system – The early alternative

The purpose of the pension system introduced in 2001 (1st April) was:
- **The adaptation of the old age insurance programs** to the recent conditions specific to the market economy.
- **The elimination of the inequity** caused by the former system.
- **The implementation of a modern pension system compatible** with the systems of the EU countries.

The system consists of three pillars correlated by philosophy and general design with the EU practice, and with the present economic, social and demographic trends. The system construction is based on the general scheme suggested and financially supported by the World Bank and the International Monetary Fund in the transition countries.

Some of the **potential gains** through the above system are given below.
To the beneficiaries:
- The insured persons' freedom to build their own old age insurance scheme.
- The intrageneration and intergeneration equity and labour market relaxation.

To the State:
- By design, the system may finance itself, thus diminishing the pressure exerted on the state budget to cover the deficit.
- The system stimulates the economic revival and the internal demand for goods and services.

The system design is based on the ***general principle of complementarity*** as follows:
a) Pillars I and II are compulsory and Pillar III is optional.
b) Public management of Pillar I and private management of the other two pillars.
c) The redistribution method for Pillar I and the insurance system for Pillars II and III.

d) PAYG direct financing of the public pensions and funded system for the private pensions.
e) Defined contribution for Pillars I and II and defined benefits for Pillar III.

The above combination was supposed to ensure some balance of the system and gradual extension of the privately managed funded pensions. It is worth mentioning that the State sought from the very beginning to impose as obligatory both the state-managed pensions and part of the private pensions (Pillar III).

4.1. The pension scheme

The features defining the system are the following:

a) The **total pension has several sources**, i.e. the provision of a minimum basic pension based on the public pension system and a supplement based on the funded pension system.
b) **The compulsory contribution** to the public pension system and to some extent to the private funded pension system and optional contribution to the individual pension and life insurance system based on funded pensions and private management.
c) **Combined financing**: unfunded or PAYG for the public system and funded and from the investment incomes for the private system.
d) The combination of the **two ways of defining the pension right**: defined benefit formula and defined contribution formula (Table 2).

Table 2

The general pension scheme in Romania

Components	Organisation	Participation	Financing	Pension benefits
Pillar I	Public	Compulsory	PAYG	Defined contribution formula
Pillar II	Private	Compulsory and facultative	Funded financing	Defined contribution formula
Pillar III	Private	Facultative	Funded financing	Defined benefit pension formula

Pillar I had to take on the whole amount of social insurance existing at the time the new system was introduced in order to manage it on a PAYG basis. By the time the Pillar II was introduced it had been decided that almost one-third of the contribution should be transferred to Pillar II that was designed in the beginning to be compulsory only for the work force which had at least 20 years till the retirement, and facultative for the other people. Pillar II had to become compulsory gradually for all employees and the assimilated ones. Thus, the purpose was to provide a decent pension consisting of two compulsory parts, a public one and a private one, and a facultative part consisting of the participation in Pillar III.

The system built in this way was balanced, based on insurance prudence and allowed for control exerted by every beneficiary on the whole insured amount and the assuming of the risk specific to the selected type of portfolio. The facultative insurance and the supplementary one could be practically achieved in two ways:

a) Through the public pension system, if the option was for a basic income higher than the level set by the law, in which case the insured person was going to receive additional points.
b) Through the range of insurance provided by Pillar III, fully integrated and funded: life insurance or personal saving plans.

4.2. Gains/disadvantages resulting from the partial introduction of the system

The first implementation stage of the new system was Pillar I, i.e. the reform of the public pension system. Introduced on the 1st of April, 2001, and based on the principle of distribution it was designed from the very beginning to allow for compulsory and/or facultative private funded pension formula.

The new elements introduced by Pillar I in place of the state pension system:

- ✓ **Extended applicability**. It includes besides the employees, other categories of employed people, public servants, elected or appointed persons working in public institutions, people working in individual farms, independent workers, unemployed people, etc. Also, other categories of persons may participate in the system (employers, shareholders, associates, etc.), when an insurance contract should be concluded with the territorial pension house.
- ✓ **Support for the labour mobility** owing to the export of services.
- ✓ **The extension of the retirement age** to 65 years through a 13' years program.
- ✓ **The standard period of the contribution to the full pension formula extended from 30 to 35 years** for men and 25 to 30 years for women (covering also 13 years).
- ✓ **The social insurance contributions are set as percentage quotas** and **differentiated** by the working conditions: normal, unusual, special.
- ✓ **A ceiling of the calculation basis at which the contribution is compulsory**: three gross average wages at the economy level. The average wage is set every year by the National Institute for Statistics and is included in the social insurance budget (in 2003, the ceiling was raised to five average wages). The supplementary insurance is facultative at this ceiling.
- ✓ **The total quota of the contribution as well as the distribution between the employees and the employers are set by a Government regulation**. Initially, the participation quotas were 35 percent for normal conditions, 40 percent for unusual conditions and 45 percent for special conditions, while the employees' share amounted to one-third, that is 11.6 percent. The Government Emergency Ordinance 147/October 31, 2002 imposed the annual approval of the total quota of the contribution (in 2003, it is 34%[6], 39% and 44% percent) through the Law of the state insurance budget. At the same time, the employees' contribution was reduced to 9.5 percent, irrespective of the working conditions, while the balance was to cover by the employer (Table 3).

[6] The 1 percent diminution in the contribution quota is rather a political measure to point out the change in the Government's attitude, that is the orientation towards a gradual tax relaxation.

Table 3

The quotas of the contribution to the social insurance fund following the Pillar I introduction

	2001		2002	2003
	March	1st April		
Employer's obligation	30	23.33	23.33	24.5
Insured persons' obligation	5	11.67	11.67	9.5
Total	**35**	**35**	**35**	**34**

- ✓ **The contribution for the unemployed** is fully paid by the Unemployment Allowance Fund and the individually insured persons pay for the whole insurance quota.
- ✓ **Another form of pension calculation**, based on an annual average score resulted from the contribution amount (at present, maximum five a year) and on the value of a pension point set by the law every year. Such calculation is based on the incomes earned during the whole active life, changed into points (to avoid the income updating formulas).
- ✓ **The value of the pension point is set every year by the Law of the state insurance budget** and, in accordance with the latest regulations, it should range between 30 and 50 percent of the gross average wage at the economy level.
- ✓ **Some flexibility of the system**: the employees working under unusual and special conditions benefit by diminution in the standard pension age. Before-term pension (provided the contribution period is covered) or partial before-term pension, diminished accordingly, may be granted. It is possible to carry on the work after the standard retirement age, in which case a 3.6 percent score increase is granted for each additional work year.

4.3. Controversies and inconsistency of the enforcement of the Law 19/2000

As initially designed, the law - although incomplete – provided a strong support to the implementation of a more equitable modern system of social protection. It also paved the way for funded pensions. The amendment to the law was initiated soon after the law enforcement. ***While some modifications were necessary to allow for a better implementation or adaptation to the economic environment dynamics, other modifications affected the very substance of the system and caused deep inequities.***

The major amendments to the public pension system are the following:

a) **Access to services**. The taxes and charges paid by the employees for insurance and social assistance are levied at the source, and the employer is obligated to deduct them from the employees' gross income and transfer them to the funds. Their size is significant as they amounted in 2002 to about 58 percent of the gross wage (excluding tax on wages) of which 20 percent paid by the employee and 38 percent by the employer. The social insurance contributions (for pensions and sick leave, social benefits) amounted as a whole to more than half. Initially the law stipulated that *the employers' failure to pay in accordance with their obligations entails penalties against the employees, i.e.*

such amounts are not considered in the determination of the pension rights. The constraint was eliminated under the trade unions' pressure.

b) **Field of application.** The system was set up for all categories of pensioners, but later the army, the judges and the lawyers left the system and created their own systems. Thus, people having the same education and training and complying with the same retirement criteria receive different pension amounts due to the mere fact that they worked with the Ministry of Defence or as judges, etc.

c) The value of the pension point, i.e. **the rate of replacement of the wage with the pension**. It was a hot issue for the social partners, the Government and the civil society as a whole. Initially Parliament adopted a rate of "at least 45 percent" of the monthly gross average wage at the economy level as estimated by the NIS. The Isărescu Cabinet placed the limit "at the most 45 percent" which deeply disappointed the trade unions, especially because of the risk of "free falling" of the point to unacceptable values hardly bearable by the society (the risk of placing the pensioners in the extreme poverty group). The Năstase Cabinet initially raised the maximum ceiling to 50 percent and then, under the trade unions' pressure considered the possibility to place the annual point *value between 30 and 50 percent of the gross average wage* (in 2003, the pension point value accounts for 39 percent of the gross average wage). Even under such conditions, the ceiling is under the replacement rate of the former regime that had ranged from 54 to 85 percent (depending upon the work groups)[7].

d) **The pensions in payment** at the time of the enforcement of the public pension law **had to be recalculated by the new formula**. Thus, the pensions could be correctly and principially adjusted to ensure equitable conditions for all pensioners. It means that the individual score and new amount had to be set in only one year. That operation led to the elimination of the system inequities. Moreover, since in the former regime the difference in wages was minor and just under the average, the Law 19 provided also the correlation of the pensions to ensure equitable conditions for persons equal from the point of view of the retirement conditions but retired in different years.

Actually, ***the pension recalculation did not take place***.[8] The GEO 49/May 2001 abrogated the related law provisions (Art.180). The calculation of all pensions in payment according to the new methodology was given up, which meant the non-observance of the principle of equal treatment in setting the pension amount. The setting of the score for the pensions in payment was achieved by relating the existent amount to the value of one pension point, thus preserving the inequities caused by the previous practice in making the pension policy. To "correct" such inequities the pensions were *correlated* (!) later on. This action is detailed in the following chapter.

[7] To that amount one should also add the additional pension (whose size for a 25-year contribution period accounted for 16 percent of the pension calculation basis) and a 0.5-1 percent increase for each working year after the retirement age.

[8] The non-application of Article 180 was related by the Government to the technical problems of setting the point value for each pensioner. The specialists believe that the estimation of the "contribution history" could last several years.

5.Two years of application of the public pension system

The application of the public pension system for only two years cannot provide a full picture of the viability and compliance of the selected "model" with the conditions in our country. We should also point out that due to the short period of application, no major effects have occurred. In our opinion, the actual results will be less valuable than the expected ones and, what is worse, they cannot improve significantly the condition of most pensioners. Anyhow the first month of application of Pillar I yielded partial effects, good and bad alike.

The Pillar I policy was focused on the following main aspects:

- ***The system putting into operation***, that is the establishment and functioning of the specific institutions, mechanisms and instruments: National House of Pensions and Social Insurance, the compilation of the database[9], the reform of the social insurance budget, the creation and consolidation of the contribution collection network, etc.
- ***Rethinking the ways of solving the budget deficit*** both on short term by contingent measures and especially on medium and long-term. In this respect, the stress was laid on the creation/consolidation of the specific mechanisms: widening the range of possible contributors to/participants in the system; setting acceptable contribution quotas and increasing the fund collection rate from about 60 percent at present to over 90 percent in the next ten years; increasing the total amount of the contributions by means of a higher maximum ceiling of the calculation basis (of the compulsory contribution) associated with additional insurance for the incomes exceeding the ceiling.
- ***Re-establishment of the system equity*** by means of the pension re-correlation system and the related taxation system.
- ***The purchasing power of the nominal pensions to be maintained*** through the indexing system.

5.1.The pension re-correlation – A means to diminish inequities

The effects of the GD 565/1996 concerning the pension calculation formula, associated with the indexing policy (especially the early 1990's policy focused on the increase in the small and very small pensions) have caused and worsened intrageneration and intergeneration inequities that have further brought most of the pensions to the bottom of the distribution formula of the incomes. Moreover, the introduction of the new pension calculation formula (Law 19/2000) and the non-application of Art.180 concerning the pension recalculation have caused more imbalance this time between the pensions in payment before the 1st of April and those in payment after that time. The authorities' response to such developments has been the pension correlation.

The Government's Program for 2001-2004 provides for the elimination of the pension inequalities among different generations of pensioners through a program

[9] The creation of the computerized system for working out the database of the public pension system will be completed in 2004 with financial support from the World Bank.

for the pension recorrelation for three years up to 2004 (in six stages). It is assumed that the structure of the average pension of the persons retired in the same year reflects correctly the ratio between the individual pensions set by the same legislation. The pension correlation is achieved by increasing the score (Table 4).

The number of added points will be the same for all pensioners retired in the same year, but different for the pensioners retired in different years because the lower pensions increase faster during the early stages. The contribution of the Social Insurance State Budget will amount to ROL 29,000 billion, that is about 3.6 percent of Romania's GDP in 2000.

Table 4

Pension re-correlation

Pensioners' category	Number of pensioners	Percentage added in:		
		2002	2003	2004
Pensioners for full seniority and age limit, with a score up to 1 point				
-for up to 0.6 point	18807	50	30	20
- over 0.6 – 0.75 point	558372	25	38	37
- over 0.75 – 0.85 point	448345	24	40	36
- over 0.85 – 1 point	441336	22	40	38
Persons receiving successor allowance, with a score up to 1 point				
- for up to 0.3 point	132385	50	40	10
- over 0.3 – 0.6 point	496213	30	40	30
- over 0.6 – 1 point	14547	24	40	36
Pensioners with a score over 1 point				
- over 1 point – 2 points	482922	18	35	47
- over 2 points – 3 points	2473	10	38	52

Source: Legal provisions concerning the re-correlation

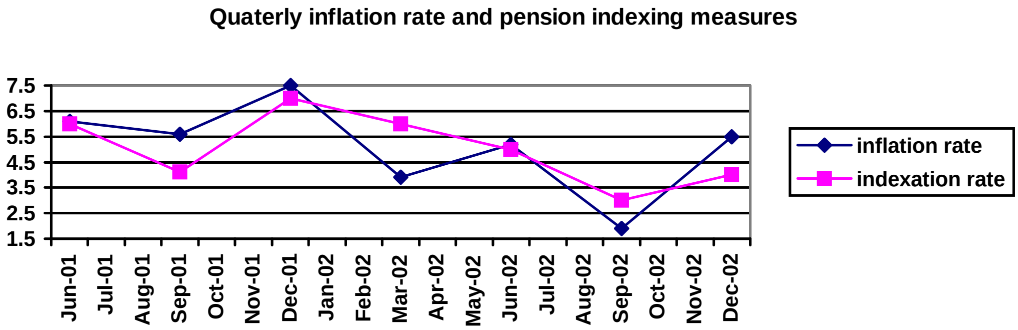
The beneficiaries of the correlation were persons whose right to pension for age limit and full length of service or successor's pension was valid until the 1st of January, 1999 and whose corrected annual average score was less than 3. So far, three correlation stages have taken place.

The above system diminishes but does not eliminate the unreasonable difference among pensions. Moreover, the pension leveling (downward "flattening") occurs due to a significant increase in the low pensions. Actually, the differences among pensions that are equal/comparable but in payment in different years become smaller, **but new inequities occur or the existing ones increase in relation to the individual pensions of the same year** (the amounts draw to each other until becoming even, thus canceling the differences justified by the professional and training status reached during the active life).

5.2.Pension indexing

The pensions have been indexed even after the enforcement of the Law 19/2000. Usually the action takes place every quarter and is meant, on the one hand, to cover the inflation and, on the other hand, to increase the pensions that are smaller than or equal to the ROL amount equivalent to three points. The indexing of the value of one pension point range, on the average, between 3 and 7 percent and was designed to fully cover the inflation (Chart 6).

Chart 6



Source: NIS data

The pensions have not been indexed uniformly, as the small ones have increased more than the other ones. Through the specific application procedures, the indexing brings about new inequities in the system. Although necessary to maintain the purchasing power, the differentiated indexing ***brings too closer the pension incomes of persons with different training levels and wrongs the people with a contribution period longer than the full term***. The indexing is based on the estimated average score by categories of pension, but making no difference in favor of the persons having a higher score based on the additional work years, and not on the artificially increased incomes.

The pensions now in payment do not comply with the consistent application of the principles on which the pension system is based. For example, the relation between pension and wage incomes, contributions respectively, is obvious in the pensions in payment after the 1st of April, 2001. But the retirement year is more important than the incomes and active life for the pensions set before that time. If the pensions are not recalculated such disturbances will go on and even worsen. Moreover, even if the pensions are recalculated, some of the employees in payment, i.e. those in payment over the validity period of the GD 565/1999 will be favored since they are protected by the laws in force that forbid the cancellation of a right already acquired according to a valid regulation, although their pension should be smaller according to the calculations.

The application of the system of taxes on pension, along with the enforcement of the Law concerning the tax on the global income (2000), has diminished to some extent the difference between the big and very big pensions and the other pensions that have been ranked low within the income distribution. Thus, the big and very big pensions are partially adjusted downwards, but the imbalances have been maintained.

Even for the above reasons only, the public pension system should be based on equity and the differences justified by the individual participation schemes (period, incomes, contributions, etc.) should be considered. ***The balanced recalculation and indexing, along with social insurance and assistance measures in support of the small pensions (special funds for assistance granted to the people in need, etc.) are the most efficient and equitable options regarding the public pension system, at present and on medium term. In its turn, the system should be completed with funded pension formulas to ensure decent incomes at an old age.***

6. Funded pensions

In building a balanced and flexible pension system, the funded pensions have been considered necessary from the very beginning as a means to increase the income earned as pensions from the redistribution public system. The practice in other countries has proved that Pillar I provided diminishing pensions, in fact a guaranteed minimum pension. The system was quite ineffective on long term and some countries gave it up or adapted it. A rise in the pensions provided by Pillar I is the present or future general concern of most countries. The share of the funded pension schemes in the general pension design varies from country to country. The general trend is to increase their share in the general pension portfolio.

6.1. Controversies over the funded pensions

The implementation of the funded pension systems in Romania was the normal step to be taken along with the public pension fund. In November 2000, our Prime Minister, Mr.Mugur Isărescu signed the Government's Emergency Ordinance 230 concerning the organization and operation of the universal pension funds. Since the legal and institutional framework for the operation of the funds did not practically exist and there were many problems in the capital market, the ordinance stipulated a period of two years (from December 2000) when the Commission for Regulation and Supervision of the Pension organisations had to work out the necessary regulations, while the Government promised "to take necessary action to clarify the problems confronting the Romanian capital market."

Given the economic and, especially, social importance of the Ordinance it was felt that it had to be discussed in the Parliament but in an amended form. The regulation was withdrawn for completion and improvement soon after the publication by the Năstase Government, a few months being provided for revision (by October 2001).

The **matters in dispute** were:

a) **The sources for financing** the expected deficit in the public pension budget following the transfer of one-third of the contributions to the compulsory universal funds.

b) **The market operators** of the universal funds: the selection and licensing procedure, their capacity to achieve the required performance to reduce the risk.
c) **The role of the state in supervising the activity of the private funds**: on the one hand, the potential market operators (mostly, insurance companies) rejected any strict control of the funds, while the trade unions favored, at least in the beginning (until the operators proved their good intent and management effectiveness – it was even intended to set some hard performance criteria), a rigorous control by the state or the Government's responsibility for that.
d) **The attitude of the possible contributors and beneficiaries towards the system credibility and operation.** The "experience" acquired with the SAFI and FNI investment funds shook the people's confidence in such market instruments.

The procedure of amending the Ordinance was debated for a long time within the Economic and Social Council, the specialized commissions of the Parliament during roundtables attended by all institutions that could be possibly involved (representatives of the MLSS, National Pension and Social Insurance House, trade unions, organizations of the pensioners, etc.). Several alternatives were worked out, but they did not end in a coherent project to be accepted by the civil society and further submitted to the Parliament.

A controversial problem was the re-orientation of the reform to either the Pillar II (compulsory) or Pillar III (optional):
On the one hand, the population, in general, and the younger work-force, in particular, were not properly informed and ready to accept a high-risk compulsory insurance system, providing uncertain benefits on long term, i.e. retirement. The low wages and high and lasting inflation were of no support for such investments. The category of the earners of incomes high enough to enable their involvement in the optional system was too small.
On the other hand, the retirement waves that had taken place before the implementation of the new system caused a higher financial pressure, as the deficit in the redistribution system was high due to the deteriorating dependence ratio and the wage earners' low bearability. The impact of the Pillar I reform on the budget deficit was more significant than expected. The financial balancing of the Pillar I and the need for preserving the employees' purchasing power make the optional funded pension system more attractive. Still there are controversies as either alternative is quite risky.

The proposals to amend the GEO 230 did not essentially change the system, but they aimed at increasing the contributors' and beneficiaries' safety (confidence) in relation to the fund management: e.g., the increase in the minimum capital of a pension organization in order to ensure the financial power required to operate efficiently in the capital market. The separation of the providers of annuities from the pension organization; assistance from an adviser having international experience in the pension fund supervision.

At present one may notice a different orientation of the Government in building funded pension system. The present idea is based on *two coordinates*:

- on the one hand, **to carry on the Pillar I reform**, the balancing of the fund budget, the clarification of the functional problems of the system, the diminution in/elimination of inequities, etc;
- on the other hand, **the additional insurance of the interested persons through optional funded pension schemes**, based on private management. Also, the above alternative was discussed and **the trade unions accepted a complementary system based on optional system of occupational pensions**.

A draft law regarding the occupational schemes is expected to be discussed in the Parliament early this year. Although there are controversies regarding the market operators, the support given by the social partners to the system, the acceptance of and participation in the system by the population, one may notice the consensus regarding the reform continuation. The cost of any delay are too high to be ignored. Moreover, the pension reform is one of the targets of the Community acquis in the social insurance and assistance field.

6.2. The complementary pension systems. Comparative advantages.

The improvement of the funded pension scheme should be based on the international practice and experience, present trends in the field, but also on solutions suitable for Romania. The Swedish, Chili or German models, efficient as they are, cannot be taken up by Romania due to the very specific economic and social conditions, but they are benchmarks and sources of experience for building the pension system in our country. In this context, it is worth mentioning that *Romania is reforming the pension system while solutions complementary and/or alternative to the applied models both in Europe and the world are being searched for,* just because of the precarization, low efficiency, and incompatibility with the demographic and economic developments.

Careful selection and firm implementation should be the pillars of the private funded pension system.

In comparison with the GEO 230, the **present proposals for the optional occupational pension schemes (OOPS) are different in the following main aspects**:

a) ***Elimination of the compulsory provisions***:
- The contributors to the Universal Pension Funds (UPF) were natural persons [10] having at least 20 years to reach the legal retirement age provided by the Law 19/2000. The persons having at least 10 years to reach the legal retirement age could opt for the system, without being obligated to do that.
- The participation in the OOPS is optional and the access to the occupational pensions depends on contributions for at least five years. The capacity of participant in a OOPS proposed by an employer or a trade union is restricted to his/its employees/members, former

[10] Who were entitled and obligated to contribute to the public pension fund.

employees/members or their husbands/wives and those entitled to optional pensions following the death of a member. The participation in the OOPS may be achieved by the participation in setting up a pension organization or by the conclusion of contracts with OOPS suppliers.

b) **Increasing involvement of the social partners**:
- In the case of the Universal Pension Funds (UPF), the social partners had representatives appointed by the Consultative Committee under the Commission for the Regulation and Supervision of the Pension Organizations (having a consultative role in the organization and operation of the UPF) and took part in the management of the National Pension Guarantee Fund.
- The employers and trade unions involve themselves directly in the OOPS and may suggest OOPS's[11] to their employees and/or members in accordance with the provisions of the collective agreements concluded at the level of company, group of companies (multi-employer) or branch (sectoral agreements).

c) **The private management may be also carried out by insurance companies**, not only by the pension organizations, as in the case of the UPF.

In both cases a commission is set up as an autonomous public institution for the fund management. During the first five years, the National Commission for the Pension Fund co-operates with a consultant having international experience in the pension fund supervision.

d) **The President of the National Commission for the Pension Fund**[12] is not appointed by the President of Romania, as in the UPF case, but by the Prime Minister and voted by the Parliament.

e) The provision concerning the **minimum number of members** for setting up a pension fund and the limitation of the contribution calculation basis was removed.

f) The contributions are no longer the same for all the participants and there is no central system of collections through the National Pension House. **The contributions are individualized through the OOPS.** The minimum contribution is set by the collective agreement.

g) **The decision concerning the additional contribution (above the compulsory level set by Pillar I) is made by the social partners and is stipulated in collective agreement at company level.** The application of the Pillar II to the initial system is not financially possible: on the one hand, the already underfunded public system would collapse by giving up one-third of the contributions; on the other hand, the tax increase to balance the budget is not acceptable in practice. It is well known that the present tax burden is too heavy in comparison with the supporting capability and bearability of the economic system. The alternative

[11] OOPS is a system of terms, conditions and rules according to which the supplier of occupational pensions pays such pensions to the participants. Each OOPS should be authorized by the CRSPO.

[12] The National Commission for the pension fund (autonomous public institution): protects the interests of the pension fund members; ensures the prudential supervision of the pension organisations, pension funds, annuity suppliers and custodians; informs the public on the pension fund market; ensures the functioning of the pension fund system; works out regulations concerning the activity of the entities that offer services to the funds.

based on occupational pensions allows for optional insurance, that is accepting a heavier tax burden. The highest risk affects the range of the system expansion. We may expect a positive attitude of the social partners. But there also is a complementary, associated risk in relation to the capability to ensure the system operation.

h) **The pensions are also to be paid after the retirement but on the additional condition that the person should be aged between 50 and 70**.

It is worth mentioning that, in both cases (UFP and OOPS), the purpose is that **the funded system should provide the minimum pension**. If the amount to be received as pension in accordance with the individual contribution is smaller than the amount set by the Commission, then a fixed amount will be granted. But if the account amount is larger than required for a minimum pension, the balance is to be paid as fixed amounts or installments (max.10 years). That means a fund increase but in a restrictive way: a minimum amount is paid to which a contribution-based amount is added for maximum 10 years. But there is a general trend towards the life expectancy rise, which implies that the pensioner status is longer. In our case, it might be profitable to supplement the incomes by the Pillar III in the form of life insurance, etc.

6.3. The potential impact of the funded pension system. Limits.

The pension funds, irrespective of their form, **might cause the increase in savings, development (and even revival) of the capital markets and diversification of the incomes of the retired persons**. Such objectives may be achieved only if they are supported by a functional and efficient market economy and a rigorous, transparent but flexible supervision and control system.

Traditionally, the Romanians are very cautious, take reasonable risks and that is why they have relied on property and savings. The optional participation in the private pension systems rather causes a ***defensive and prospective attitude*** than a participative one until the first results occur. Generally, the Romanians base their idea of saving on the principle “white money for black days” and less on the orientation by objectives (pension, health care, children’s financial support, etc.). The historical analysis of the share of the savings in all incomes of each person/household reveals that the low-income earners (that cannot bear the impact of the financial risks) and the elderly make major efforts to save. They save to support their family (parents save for children), for health care, possible accidents (as the present system cannot even provide the minimum decent services), etc. Their savings are based on sure, time-proven instruments (incomes from real estate, hard currency, gold or cultural values such as paintings, amounts managed and guaranteed by the Savings Bank, etc.). The bank savings, investment funds, portfolio securities are rarely used instruments due to the market instability and the painful experience in the last thirteen years (the bankruptcy of the Bank of Religions, of Transylvania Bank, of the FNI and SAFI Investment Funds). Actually the saving rate reveals all such problems affecting the market. That is why it is small (under 8 percent) and fluctuating: - 3.4 percent in 1992, 7.6 percent in 1995, and 1.2 percent in 1997.

But such attitude towards savings does not lead to a clear association of the public pensions with the funded pensions. The private pensions will be easily accepted by the people having financial resources and being aware of the importance of the insurance during the active life for safe incomes at an old age. For this category, the private pensions may exceed the public pensions. **The public pension will prevail or will be the only income at the old age for the small income earners.**

7. Prospects for the evolution of the pension system in Romania

A matter that concerns the civil society and, especially, the people directly involved in the funded pension domain is what importance is to be attached to the development of the pension system in Romania in the future. Now it is not very clear whether we want a model similar to the Dutch or British models according to which the occupational pensions cover 90 percent and 50 percent, respectively, of the employees or a minimal one that covers about 10 percent.

According to the latest alternative to the system design, the private pensions are optional and the contribution rates are fiscally deductible. But, as the labour incomes are too low for most employees to live decently (even if every individual is aware of the necessity to participate in a complementary insurance system), the amounts employed in the occupational schemes will be very small and, consequently, the annuities cannot cover the additional income for the old age. In this context, it **should be pointed out that the conversion rate will diminish from 39 percent at present to less than 30 percent.**

The persons who, by status and age, could be favored if they participated in an occupational pension system are about 3.5 million in number. ***Their involvement in an occupational pension scheme would bring about individual advantages and, at the same time, would produce economic benefits, investments, etc. that may stimulate the economic growth and domestic demand, provided that the system operation takes place mainly in the Romanian capital market.***

It is to mention that **Pillar III is now functioning in Romania in the form of life insurance and individual pension plans offered by the insurance companies**[13]. Therefore, the people who have financial resources and understand what advantages the complementary insurance could bring about have life insurance with the present market operators, i.e. the Romanian and (especially) foreign insurance companies. According to the latest estimates, the number of the people who afford such insurance is relatively small, less than 500 thousand, of which only a fraction participates effectively in the system. Their contribution, irrespective of how important it is for the individual, is not significant for the society, since it cannot make major economic gains.

[13] The pension plans launched by the insurance companies in Romania combines three components in a complex insurance system: insurance against unexpected events, benefits in the form of monthly annuities over a set period, etc. and the possibility to develop investment plans. The most important and complex systems operating at present are the insurance for private additional funded or re-evaluated pension (for example of the ASIROM PROSPERA type) and the life insurance plans with a saving and investment account that allow for the transformation of the annuity account at the retirement age (e.g., MERIT and MENTOR products based on the Unit Linked concept).

Therefore, by content, components and designed structure, the Romanian reformed pension system fulfils the general and specific requirements for a modern construction fit for the present and future, economic and social environment:

- It *guarantees the living standard* by means of the public pension system (but not sufficiently).
- It *provides many opportunities for the complementary insurance* to the extent desired by every participant in the system and stimulates personal initiative and the responsibility for saving for retirement.
- It *allows for establishing the necessary and effective balance* between the public component and the private one.
- It sustain (by means of the designed institutions, mechanisms and instruments) for the *creation of a stable and stimulating capital market for private funded pensions* and the social partners' involvement in the occupational pension system could be guarantee and argument for the people's confidence in that system.

To produce the expected effects, ***some problems should be clarified***:

a) **Revision/correction of the public pension system, fine adjustments to improve effectiveness**; recovering of the required balance to ensure the intrageneration and intergeneration equity. They all form the grounds for the system credibility.
b) **Support for the reform by means of a flexible and efficient information structure** able to collect and disseminate data, to provide access to important information, but also the secrecy of the personal accounts, assets, etc.
c) Support for **developing an insurance culture and philosophy**, publicity, staff training.
d) The **system equilibrium**, especially the financial one.
e) **Mature behaviour of the pension companies and annuity providers**, associated with transparency, efficiency and elimination of any FNI or Elron-type crisis.

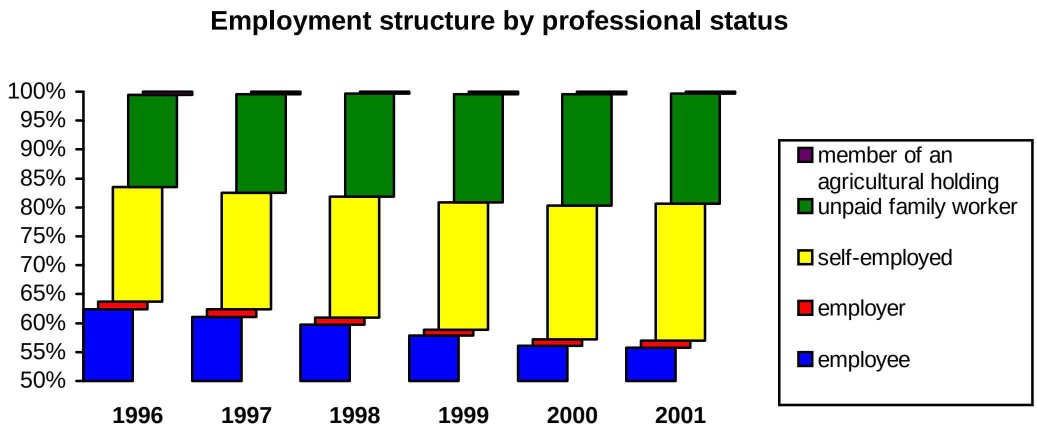
All these general requests may be scheduled according to a **scale of priorities** (and of practical possibilities) as follows:

i) On short term

- **Increasing coverage of the public system** by involving the persons who could be insured on a contract basis: persons authorized to carry out independent activities, associations and shareholders, farmers and persons who work in individual farms, tenants, etc. According to the governmental estimates, the provision for the compulsory insurance of the self-employed persons could lead to the increase in the number of insured persons by about 2.5 million people (Chart 7).

- **The elimination of the pension system risks brought about in the labour market** by: adequate functioning of the market, policies for the stimulation of the performance, active (re) employment policies, diminution in the parallel market (estimated at about one-third of the employed population).

Chart 7



Source: AMIGO Survey, 2001

- **Gradual diminution in the pressure exerted by the new-comers in the system** (new pensioners), that is descouraging the retirement before term and stimulating the extension of the active life beyond the standard retirement age (Chart 8).

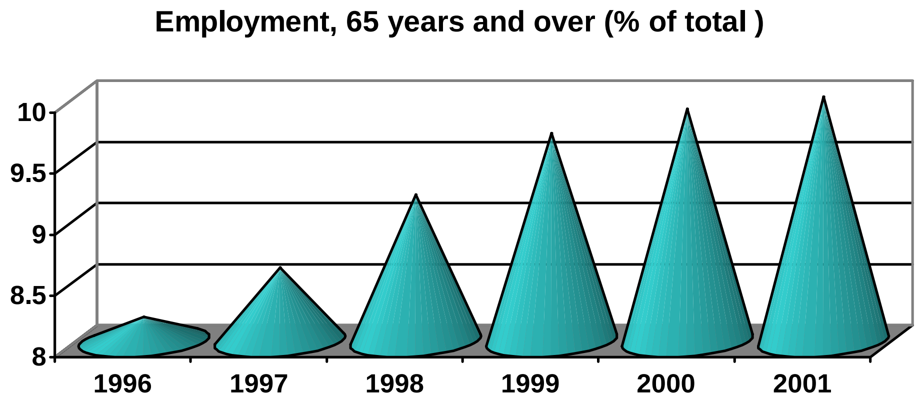


Chart 8
Source: AMIGO Survey, 2001

- **More sources and increasing effectiveness of collection of the contributions to Pillar I as well as improving control and elimination of any re-scheduling, delay, exemption,** etc. A matter of principles still unclarified so far is the equity of the present ratio of the contribution amount to the level of the services offered. In Romania, the contribution rate is 1.7 times that of Germany, and 2.3 times that of France (34 percent as against 19.5 percent and 14.7 percent, respectively), but the efficiency of the redistribution system is much lower (Chart 9). On the other hand, the pension point value of 39 percent of the gross average wage and the average score of about 1.5 points provides some system equilibrium, but when such proportions come to be turned into money, the purchasing power and level are not fit at all for an emerging economy whose purpose is sustainable development and fulfilment of the requirements for the accession to the EU.

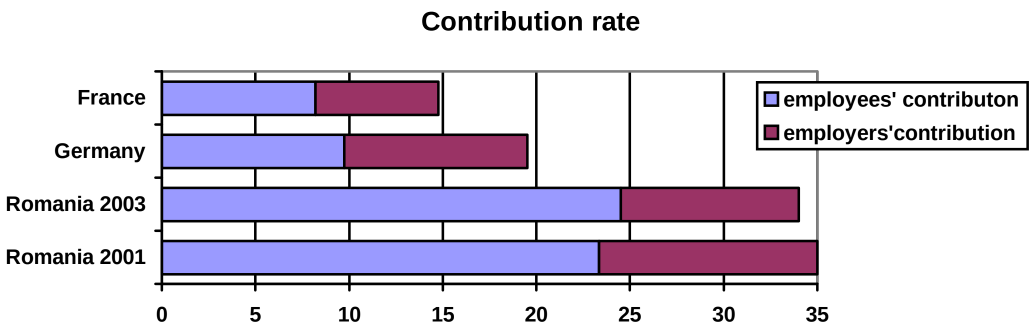
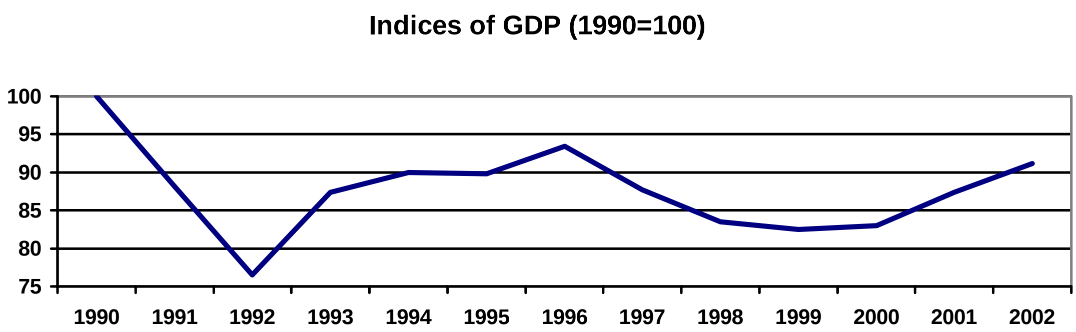


Chart 8

- The stimulation of the production of goods and services, the employment and the productivity in order to sustain/to make the public pension system functional and efficient. In Lisbon, the European Council set, as EU objectives, the increase in the general employment rate by 10 percent and an annual average growth rate of the GDP by 3 percent in order to stimulate the active policy of social protection and assistance able to withstand the demographic and social pressure. But Romania's task is much more difficult. The economic programme for the pre-accession provides for the GDP growth by 4.5 - 5.5 percent in the period 2001-2005, while Romania's GDP in 2000 amounted to only 27 percent of the EU average GDP. So far, the economic growth target has been achieved as the annual pace in the last two years has been around 5 percent. The question is whether the economic revival is sustainable (the economic growth peak was also reached in the mid 1990's but then the GDP fell again (Chart 9). If the last two years' dynamics goes on, a slow relaxation of the financial system of Pillar I is expected.



Source: NIS data

ii) **Medium and long-term**

- The stimulation of the **expansion of the funded pension system** by means of the media coverage of the system and its performance, and the education of possible beneficiaries. It is estimated that the funded financing will be fully profitable and beneficial in about 10-15 years.

- Complementary to that, **less risky financial and capital markets**.
- The **prudential supervision** of the private pension companies functioning. The funds are privately managed, but the beneficiaries' status is a problem of national interest and common responsibility.
- The fulfillment of the Community acquis in the field and the application of the principle "sure and viable pensions" (according to the final COM (2000) 622), as follows:
  - *Keeping the pension within reasonable limits* in order to enable the elderly to be financially independent and to maintain a reasonable living standard during the active life.
  - *Ensuring the intergeneration equity* that requires the elimination of the effects of the population ageing and the balanced distribution of the risks between employees and economic agents, on the one hand, and between the present generations and the future ones, on the other hand.
  - *Strengthening the solidarity* within the pension system, by the limitation/elimination of the exclusion from the system ("justified" by lacking/insufficient incomes). The elimination of the differentiated protection against the inflation effects that "flattens" downwards the distribution scale of the incomes from the public pensions and the introduction of minimum pensions for social assistance, financed from outside the redistributive system (ecological taxes, like in Germany, or a special old age solidarity fund, like in France, etc.).

- **Financial recovery of the system**, prevention of future imbalances, proper operation of the mechanisms for the system self-supporting.
- **Re-establishment of the equity by applying Pillar I to all pensioners in payment**, i.e. the database completion and pension recalculation on the basis of the same principles.
- **Gradual reform of Pillar I in accordance with the present international trend and/or resizing of the system parameters** (contribution level, pension point value, income ceiling for compulsory participation, etc.).

8. Brief remarks

a) ***Romania opted for an updated and balanced system*** able to ensure equitable intrageneration and intergeneration transfers, export of services, opportunities for assuming individual responsibility for the old age well-being and quality of life.

b) At present, ***Romania is undergoing a full reform*** of the pension system.

Pillar I, introduced 2 years ago, **has begun to function**. The early effects have become obvious. General implementation adjustments have been made. Although the parameters of the public pension system are more restrictive than before, there still are shortcomings of the fund.

The implementation of Pillar II is delayed. Unlike the universal fund system with a compulsory funded component the present option is for free, facultative participation and the social partners' involvement. Now there are many – economic, social and especially financial and credibility-oriented – arguments in support of a change in the reform orientation towards complementary systems like the *facultative occupational pensions*. If the occupational schemes are set by the collective contract, they become compulsory for the trade union members.

c) ***The private pensions do not replace Pillar I, but complete it***. Now endeavours are made to establish a *public-private partnership* similar to the British one. According to the present scheme, the basic pension of the public system may be supplemented by a secondary state pension (due to the additional insurance through Pillar I) to which the pensions from the occupational systems (Pillar II) may be added and by the individual pension and life insurance plans (Pillar III).

x
x x

The question of the private funded pensions is now a real challenge to the Romanian society. Their implementation should not be delayed, at least because Romania cannot afford only a public pension system without causing a long general social crisis. If the Government carries out the promises and the social consensus is achieved, then we get the law of the funded pensions this year. Therefore, we must overcome the disputes among the social partners, the Government, political parties, civil organizations of the pensioners, etc. and have the bill passed by Parliament.

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