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Why is there no money for pensions? The causes of the social insurance budget deficit and alternative solutions

Abstract

This article reviews the implementation of the Pillar II pensions system in Romania. The approach is to be critical, as the title suggests, as a result of the deficit in the social insurance budget that has largely resulted from implementation of this policy, as well as from other aspects of the government's pro-cyclical policies on pensions including the cuts in wages to Romanian public sector workers. At the same time, Romania already spends a substantially smaller proportion of its GDP on pensions than the EU average, despite more than one-half of Romanian households receiving a pension of one description or another and nearly one-quarter of total consumption being accounted for by retirement pensions. The article reviews the draft law on the payment of Pillar II pensions, concluding that not only is the pensions legislation deficient, but that the new draft law does not improve what is already a complex and burdensome system, while a combination of job creation and wage increases are necessary to boost the economy.

Keywords: *public pensions system, social insurance budget deficit, cost cutting, consumption, 'Pillar II' private pensions, annuities, indexation, balanced budgets, job creation, wage increases*

Introduction

The public pensions system has become a widely debated issue both in Romania and in the European Union, mainly due in the latter case to the deficits recorded in most EU states. In states where there are no recorded deficits, the decrease in the number of taxpayers – associated with lower birth rates and the ageing of the population – is creating concerns for the future.

Pensions systems are very different in the EU member states, due both to traditions and to reform processes (which are in different phases of progress in every country). Pensions systems in all 27 member states provide at base a state pension but most states have introduced, in addition to the state pension, a number of occupational pension schemes and/or mandatory or voluntary private pensions. Meanwhile, in most states, the public pensions system also provides a guaranteed minimum pension to those who do not meet the requirements to access an age-limited retirement pension or who have only a very small pension.

Table 1 shows that, among developed countries, Luxemburg has the highest minimum pension, amounting to more than €1 500 per month. Austria has a very attractive system, too. In addition to the minimum pension, which varies between €772 and €1 125

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per month, depending on marital status, Austrians also receive a supplement of €80 for children until they graduate; if the child has a disability, this supplement is granted for an indefinite period. In Belgium, the minimum pension amounts to €1 250.

Minimum pensions amounting to several hundred Euros a month are paid in Ireland (€460), Greece (€500), France (€677) and Spain (around €600).

Lower minimum pensions are found in the former Communist bloc countries, where the guaranteed minimum pension does not reach €200 per month. Bulgaria pays the lowest minimum pension in the EU (€70 per month), while Romania pays €81 per month. Pensions of similar values are found in the Czech Republic – €84 per month; Hungary – €105; Estonia – €128; and Latvia, where the minimum pension varies between €70 and €109, depending on the number of years of contribution. Slovenia pays the highest minimum pension (€191 per month) within this group of countries.

Table 1 – Guaranteed minimum pension in the EU

Country	Amount (€/month)	Country	Amount (€/month)
Belgium	1 250	Cyprus	341
Bulgaria	70	Latvia	70-108
Czech Republic	89	Luxembourg	1 567
Denmark	896	Hungary	102
Estonia	128	Malta	507
Ireland	461	Austria	772 – 1 125
Greece	496	Poland	178
Spain	601	Portugal	420
France	677	Romania	81
Italy	510	Slovenia	191

Source: adaptation after MISPROSS data

There are also countries such as Germany, the Netherlands, Lithuania and Slovakia in which the minimum pension is not regulated by law.

A guaranteed minimum pension is established in most EU countries, but there tends to be no limitations regarding the highest threshold of pensions, as the individual pension amount is determined based on years of service, years of contribution or working conditions and field.

In the context of population ageing, all countries are worried that they will no longer be able to support a public pensions systems based on a single pillar, where current pensions are paid from the contributions of those who are now in employment – the so-called 'principle of solidarity'. This is due to an increase in pensions expenditure in the 2000-2008 period which was recorded across the European Union (see Table 2).

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Not just Romania but all former communist countries had much higher increases of expenditure on pensions per capita during 2000-2008; this is explained by the low level of pensions they had compared to other EU member states compared to purchasing power parity. This can be seen from Table 3, which shows the pensions expenditure ratio in terms of GDP across EU member states.

Table 2 – Pensions expenditure per capita, real terms, 2000-2008

	2000	2005	2006	2007	2008	% growth
EU-27	2 332	2 519	2 549	2 500	2 551	9.40
EU-25	2 482	2 671	2 700	2 644	2 693	8.49
EuroZone (16 countries)	2 814	3 078	3 116	3 163	3 201	13.74
EuroZone (15 countries)	2 750	2 922	2 941	2 967	2 989	8.67
Romania	111	99	113	147	178	60.31
Bulgaria	140	185	199	202	223	59.50

Source: Eurostat

Table 3 – Pensions expenditure as a percentage of GDP

	2000	2005	2006	2007	2008
EU-27	12.24	12.14	11.95	11.41	11.67
EU-25	12.27	12.19	12.01	11.48	11.73
EU-15	12.35	12.29	12.12	11.59	11.86
EuroZone (16 countries)	12.51	12.63	12.44	12.27	12.44
EuroZone (15 countries)	12.53	12.66	12.46	12.30	12.48
Romania	6.11	6.07	5.90	6.32	7.46
Bulgaria	8.14	7.57	7.25	6.85	7.02

Source: Eurostat

From Table 3, we can see that in Romania, despite the 60.31 % real terms increase in pensions expenditure between 2000 and 2008, the share of pensions expenditure in GDP in 2008 was still below the EU average by 4.27 percentage points – 7.46 % of GDP in Romania compared to 11.73 % of that of the EU.

However, even if the share of GDP spent on pensions remained low in Romania, in the context of the low number of employees, the importance of pensions to households is very high. According to the Household Labour Force Survey (HLFS) conducted by the National Institute of Statistics, 51.39 % of households receive income

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from pensions. According to the survey methodology, the types of pensions fall into one of six categories:

1. social insurance pension in line with length of service and the state pension age
2. social insurance pension for loss of work capacity
3. social insurance survivor's pension
4. welfare-type pension
5. social insurance pension for farmers
6. pensions for the disabled, orphans and widows of war, including survivors.

The category that includes most beneficiaries, and is the most important in terms of the budget, is the first of these: 33.51 % of households in Romania benefit from a social insurance pension in line with their length of service and the state pension age. Table 4 below shows the distribution by percentile of the pensions income for these households. The mean income, incidentally, was just over 1 000 lei.

Table 4 – Percentiles of income from social insurance pension in respect of length of service and the state pension age limit, 2009

10	20	30	40	50	60	70	80	90
480	590	675	750	839	950	1 178	1 450	1 800

Source: National Institute of Statistics

The social importance of pensions in Romania is reflected in the following conclusion that emerges from the same household survey: for 17.79 % of households, the income they receive from this category of pension represents more than 70 % of total revenue. This means that almost 20 % of the population is dependent, to a very high degree, on pensions income.

The low employment rate and the low number of employees means that incomes from retirement pensions have a particularly high impact on consumption. The household survey revealed that 23.36 % of total household income is actually income from pensions. Pension income goes mainly towards consumption, so we can appreciate that more than one-quarter of household consumption in Romania comes from retirement pensions. Under these conditions, a decrease in the pension level would generate not only social consequences but also economic ones that would be reflected in a loss of jobs and a reduction in GDP.

These issues broadly constitute the outlook of this article. Considering the chronic problems of the retirement pensions system in most EU countries, we have tried to identify the specific conditions in Romania that have led to the highest deficits in the state social insurance budget. The second part of the article analyses the draft law on the organisation and functioning of the payment of private pensions. This law would further complicate the already difficult situation facing the system.

Why is there no money for pensions?

2007 was the last year when the public social insurance budget was balanced, i.e. when the contributions from taxpayers and employers were equal to the system's ex-

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penditure. After 2008, the deficits have been increasingly higher, reaching this year an expected record deficit of 14.9 billion lei, which is about 2.75 % of 2011's forecast GDP (according to National Forecast Commission data).

It should be mentioned at the beginning that the 2007-2011 period does not contain major demographic events (such as, for example, the entry into retirement of large groups of people, such as resulted from the 1967 decree banning abortions). Over such a short period, of just four years, we can not take into consideration any change in the age structure of the population. In fact, the aging population, combined with increasing life expectancy at retirement, is not yet a concern for the Romanian pensions budget, given that we still have one of the lowest life expectancy levels in the EU (according to data provided by the Romanian Labour Ministry, in 2010 the life expectancy at retirement was 14.7 years for men and 22 years for women; whereas in the United Kingdom, for example, a man aged 63.9 years will live on average another 18.7 years, while a woman aged 58.9 years will live on average another 26.3 years). Therefore, the current causes of the public social insurance budget deficit should not be sought in the realm of demography but within the economic developments and political decisions that have marked the last years in Romania.

A superficial glance would address the issue of the Romanian pension deficit to the effects of the economic crisis. It is apparent that these deficits started 2008, at the same time as the outbreak of the international financial crisis. However, we shall not assess the impact of recession on the pensions system, because that approach can be misleading. Far too often, the economic crisis has been seen as an implacable force, something that hit Romania from the outside, allowing us to forget to measure our own errors.

We begin by reviewing the political and economic decisions that various governments have taken and which took their toll on the pensions budget.

Introduction of the second pension pillar

The second pillar of the pension scheme was defined and introduced in the Romanian pensions system by Law No. 411/2004 on privately-managed pension funds. Broadly speaking, the impact on the pension budget is to require the transfer of a percentage from the contributions of young workers (compulsory for those under 35 years and optional for those between 35 and 45 years) to privately-administered pension funds. This percentage was set at 2 % of the share of contributions to the pensions scheme at the outset (in January 2008); within eight years, it was meant to rise gradually to 6 %.

Therefore, in 2008, 2 % of the contributions of 4.53 million people went to privately-administered pension funds. In 2009, there were 4.91 million people, and in 2010, 5.19m. In 2011, we had 5.34m contributors. Both the rising contributions, and the higher amount of people encompassed within the system, represent an increase in the level of the transfer. Beyond any considerations of the usefulness, effectiveness, efficiency, etc. of the second pension pillar, its impact on the public social insurance budget is obvious: there is less money in the first pillar, i.e. a smaller amount (according to the principle of solidarity on which the first pillar relies) from which to ensure the payment of current pensions.

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Deficits in the public social security budget are reflected in the subsidies received from the public budget – subsidies which are necessary to balance the social insurance budget, i.e. to make payments to beneficiaries, defray administration expenses and make transfers to the second pillar. Therefore, the transfers represent a substantial loss to the budget. These issues are explored in Table 5:

It is obvious that in 2008, when the collection of contributions for the second pillar started, transfers towards Pillar II represented a large percentage of the public social insurance budget deficit (59.58 %) – being, in fact, the main cause of the deficit. Deficits have widened in the coming years, while the share of these transfers has decreased but remain considerable – 15.07 % in 2011. Moreover, in the coming years the contribution to Pillar II will increase to 6 % of gross salary, and so the share of transfers to Pillar II will also increase as a percentage of the total public social security budget deficit.

The subsidies necessary to cover these transfers are practically shifting pressure on to the public budget, with the public budget being the one that is actually supporting the second pillar by covering the associated deficit in Pillar I.

Table 5 – Transfers to the Pillar II, subsidies and the budget deficit

	2008	2009	2010	2011
Amount transferred to Pillar II (lei)	821 977 642	1 324 924 385	1 564 017 375	2 254 029 000
Subsidy to social insurance budget (lei)	1 379 569 000	6 397 515 000	10 954 712 612	14 950 637 000
Transfers (% of subsidies)	59.58	20.71	14.27	15.07

Source: Budget execution for the public social insurance system

The introduction of a guaranteed social minimum pension

In 2009, when the state social insurance budget deficit was increasing substantially, the guaranteed minimum social pension was established by emergency order. The beneficiaries were intended to be public pensioners residing in Romania whose pensions were below the level of the guaranteed minimum social pension. The guaranteed minimum social pension was defined as the difference between the established amount (currently 350 lei) and the amount to which those pensioners would be normally be entitled under the previous laws.

In June 2011 there were 409 364 pensioners in the public system receiving the guaranteed minimum pension and 208 735 farmer pensioners. The average value supported by the public budget is 91 lei per person per month in the first case; and 85 lei per person per month for farmer pensions (according to data provided by the National Public Pensions Agency). Extrapolating the data to the whole year, we get a likely cost of 659 935 188 lei for the minimum guaranteed pension – an amount that has not changed substantially from 2010 and which stands against the budget.

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The share of the guaranteed minimum pension in the public social insurance budget deficit was, therefore, about 6 % in 2010, and is likely to have been around 4.4 % in 2011 (because of the likely increase in the deficit in 2011). Beyond any moral or political considerations, it appears that the introduction of the guaranteed minimum pension has had a significant impact on the pensions budget.

Entry into the public pensions system of beneficiaries coming from defence, public order and national security

A third, more recent event is the entry into force during 2011 of Government Emergency Order No.1/2011 concerning pensions granted to beneficiaries in the defence, public order and national security systems. The impact of this on the budgets of the main credit operators of the public social insurance budget led to another government Order which was intended to rectify the problems. Specifically, the entry into the public pensions system of these beneficiaries brought a deficit of approximately 809.5 million lei, i.e. the difference between this year's contributions of military staff, policemen, etc., and the amount to be paid out in the pensions of former soldiers and policemen.

A single pensions law is not a bad thing, in principle, and the elimination of various privileges has been a constant issue in the public discourse since 1989. However, the entry into the public system of more than 350 000 pensioners who have not contributed at all, or who have never contributed to the public system (as was the case with military and police staff) led to additional pressures on the social insurance budget – in fact, a transfer of pressure from the various ministries who were managing special pensions agencies. The amount of this 'pressure' – 809.5 million lei represents 5.4 % of the expected pensions deficit – is evidently significant.

Reduction of public sector wages

Specific attention in this context must be paid to the 25 % reduction in public sector wages in 2010. Obviously, reducing the wages decreased by the same percentage the related contributions to the social insurance system. This measure was implemented by Law No.118/2010, published in the Official Gazette No. 441 of 30 June 2010. According data made available by the Fiscal Council in its 2010 annual report, there were 1 266 550 employees in the public sector in December 2010. Before the wage cut, the average salary in the budget sector was 2 108 lei, decreased following the implementation of Law No.118/2010 to 1 701 lei.

The contribution to the social security budget is 31.3 % of gross salary: 10.5 % for the employee and 20.8 % for the employer. Thus, 407 lei drop in the gross average wage resulted in a decrease in contributions to the social insurance system, in the last six months of 2010, of approximately 161 347 071 lei per month – a total of 968 082 426 lei in the last year. This figure represents no less than 8.84 % of the total deficit for 2010, leading to the conclusion that the wage cuts had a major impact on the pensions system.

The consequences of the wage cuts in the budgetary sector were still being felt in 2011. At the end of 2010, a decision was taken to increase public sector wages by 15 %, but this decision brought only limited relief to the situation facing the public social insurance system. Thus, increasing the average gross salary in the public system

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by 15 % would take this to 1 956 lei in 2011, still 152 lei lower than the average gross public sector salary before the wage cuts. Making a comparison with the level of contributions to public social insurance in early 2010, the total average monthly contribution of public sector employees is still lower by 60 257 382 lei, i.e. about 723 088 594 lei for the whole of 2011 – some 4.8 % of the deficit.

Employment policies during the financial crisis

The introduction of the second pensions pillar, the guaranteed minimum pension or the transfer to the National Pensions Agency of beneficiaries from the army and police clearly had nothing to do with the economic crisis. The 25 % wage cut for public employees appears to be motivated solely by the recession (and here the discussion is more complex), but it was often argued – including by ourselves – that the public sector wage reduction would not lead to the projected budget savings. The deficit in the pensions budget created by the adoption of this measure shows that at least one of our arguments is true: in a time of crisis, such pro-cyclical measures merely emphasise the difficulties faced by the economy.

The impact of the economic crisis on the pensions budget can be identified only when we refer to the loss of jobs in Romania, but the situation is also nuanced. The loss of jobs in recent years in both the public and the private sectors has been extremely high – almost 600 000 jobs in 2010 compared to 2008. Jobs are not the focus of this article but we should look briefly at the employment policies the government implemented during the crisis. We note that keeping jobs was not a priority, but that the reduction in spending was. This is the same pro-cyclical attitude that deepened the imbalances and which resulted in a huge pensions budget deficit.

It is because we did not make efforts to preserve jobs that contributions to the state budget are lacking – in fact, this is the main cause of the current deficit in the pensions system. Table 8 identifies the changes in employers' and insured employees' contributions between 2007 and 2011, but a clearer demonstration is given by the changing nature of contributions updated in real terms. Therefore, we identify the amount of contributions in years prior to 2011, uprated in line with 2011 prices to the present value of money (Table 6):

Table 6 – Changes in contributions to the public social security budget (m lei, 2011 prices)

	2007	2008	2009	2010	2011
Employers' contributions	21 299	25 393	25 512	23 747	23 560
Insured employees' contributions	9 954	12 188	12 566	11 506	9 918

Source: Executions of the public social insurance budget

By viewing contributions in present value terms, we can see that employers' contributions have increased in real terms by only 9.6 %, while the contributions of insured people have witnessed even a slight decrease of 0.4 %.

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Considering changes in the total number of employees and in gross wages, the trends look like this:

Table 7 – Changes in the total number of employees (excluding military) and in gross wages

	2007	2008	2009	2010	2011*
Total employees	4 717 200	4 738 600	4 367 700	4 101 600	4 155 000
Average gross wage (lei)	1 396	1 761	1 845	1 937	2 008

*Source: Romanian Labour Ministry * Estimated*

Compared to 2007, an estimated 562 200 jobs had been lost by the end of 2011. Considering that the distribution of these jobs was uniform in terms of wage percentiles (as a modelling assumption), then the impact on the public social insurance budget would, at the average wage, be 4 240 139 385 lei in 2011. This represents about 28.4 % of the total budget deficit for this year.

Table 8 – Revenue and expenditure of the public social insurance budget (m lei)

	2007	2009	2009	2010	2011
Total revenues	**24 632**	**32 833**	**40 639**	**42 873**	**48 494**
Employers' contributions	16 626	21 126	22 561	21 996	23 560
Insured employees' contributions	7 771	10 140	11 112	10 658	9 918
Subsidies	12	1 380	6 398	10 955	14 951
Total expenditure	**23 073**	**33 705**	**40 391**	**42 640**	**48 324**
Staff costs	120	165	130	105	90
Expenditure on goods and services	274	348	396	401	507
Pensions and old age benefits	22 071	32 484	39 136	41 423	46 859
Insurance and social assistance for occupational accidents and diseases	20	27	30	28	91
Pillar II transfers	-	822	1 325	1 564	2 254

Source: Executions of the public social insurance budget

The data shows clearly that there is no doubt concerning that the expenditure budget was not unbalanced in any way by the administration costs of the system – it is obvious that staff costs have decreased not only in real terms but also in nominal values, from 120m lei in 2007 to 90m lei in 2011. There are increases in expenditure on goods and services, but the amount is not large in terms of the public pension system.

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The increased expenditure stems particularly from changes in pensions and old age benefits that recorded a jump of 32 % in nominal terms between 2007 and 2008, and another jump of 17 % between 2008 and 2009, before maintaining the upwards trend, although attenuated, during the next two years. Also, there was a considerable increase in terms of insurance and social assistance for work accidents and occupational diseases, although the amounts allocated to this category are small in relation to the total budget and such a development cannot be considered a major cause of the deficit.

The elements presented so far enable us to identify the main causes of the budget deficit in the public social security system, and calculate their share for 2011. These are summarised in Table 9.

Adding up the percentages by which these cases contribute to the social insurance budget deficit, it seems that 58.1 % of the deficit is due to certain political and economic decisions taken between 2007 and 2011 (introduction of the second pensions pillar; introduction of beneficiaries from the defence and police; public sector wage cuts; and guaranteed minimum pension); and – chief among all – to the inability of governments to take measures able to preserve jobs (job losses). The chronic deficit in the pension system stands at only 41.9 % of the total deficit, and is made up of the increases in pensions since 2007.

Table 9 – Summary of causes of public social security deficit

	Share of loss of public social insurance budget (2011, lei)	Percentage of 2011 deficit
Loss of 562 200 jobs on 2007 figure	4 240 139 385	28.4
Transfers to Pillar II	2 254 029 000	15.1
Introduction of beneficiaries from defence and police	809 500 000	5.4
Wage cuts for public employees	723 088 594	4.8
Introduction of guaranteed minimum pension	659 935 188	4.4

Source: data processed by author.

Private pensions: who will pay and how?

Many countries in central and eastern Europe have reformed their pension systems, reducing the first pillar, the one based on public contributions, and establishing a private pensions pillar, based on capitalisation. Private pensions systems have been introduced in one form or another in fifteen of the twenty one countries in the region, but recent years have brought some changes in their organisation, including nationalisation (in Hungary in 2010).

Attention has been focused, however, mostly on the emerging regulatory framework for the accumulation phase, the stage of the actual implementation of payments being addressed only marginally. In countries where pensions reform began over a

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decade ago, the need for an appropriate organisational framework for payment becomes acute. The way in which other countries handle this problem may be an important example for Romania. Our country is not under the same pressures caused by a closer proximity of the payment period, but it is behind the original schedule established for the implementation of the legislation. A law on the arrangements for payment of private pensions should have been adopted by mid-2009, according to the requirements of the original legislation, but the draft of the law (*Law on the Organisation and Operation of the Private Pensions Payment System*) was launched for public consultation only in December 2010 (by the Romanian Labour Ministry).

Countries that have already implemented a Pillar II-style private pensions system in one form or another have problems concerning the payment stage, linked either to the entities that should make the payments or to the actual way of establishing them.

'Pension-provider' issues

In Romania, the draft law provides for the establishment of companies in charge of the 'provision of private pensions', i.e. for the management of a private pension-providing fund. Specifically, those who have reached retirement age must opt for a private pension-providing fund into which will be transferred the amounts accumulated in their private pension fund. The pension providers will have to ensure not only the payment of pensions but the management of the accumulated amounts, making investments – just like the pension funds – in various instruments.

This type of organisation has some major disadvantages. The first is related to the augmentation of an existing problem; namely, the increase in the number of players – which is already high – as stakeholders in private pensions. Thus, if up to now the management of private pensions has been fragmented between accumulation, management and deposit, with each of these activities performed by separate entities, two more players will now be added to the chain: namely, the administrators of payments; and fund deposit administrators. This will translate into an increase in costs related to the transfer of the amounts, the bureaucracy implied by this process, the need to choose a deposit organisation, etc.

The insertion of this new level brings into focus an issue often raised since the introduction of the mandatory private pension fund – that is, the responsibilities of the fund administrators. Currently, they are strictly concerned with the management of the amounts collected through Pillar II and are under restrictions regarding investment limits. In Romania, mandatory participation in a pension scheme was not associated with a guarantee of the proper administration of funds, current taxpayers having to sign a 'blank cheque' regarding their future pensions.

There is no relevant history of private pensions, or of private pension administrators, that could help an informed choice and, therefore, marketing campaigns have been based on attracting employees to one pension fund administrator rather than another, and not on their performance.

There was no choice of a wide range of funds and thus there was a homogenisation of taxpayers, regardless of their risk appetite. Now, in the absence of a guaranteed minimum return at least equal to inflation, and an inflation rate which is among the

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highest in the European Union (ranking 2nd in July 2011, after Estonia), this homogenisation implies a degree of risk which is higher than the average.

The existence of a minimum guaranteed return would have had beneficial effects both for taxpayers and the pension funds themselves. Taxpayers could receive a 'guarantee' in terms of their future pensions, ideal both for those with risk aversion and for those with a higher appetite for risk. The explanation is that, having the certainty of pensions correlated with their contributions (revalued), they would have stronger incentives to invest in facultative pensions, with higher risk levels and, therefore, higher yields. However, there is a reluctance to invest additional amounts in funds without having a guaranteed pension in return. As far as fund administrators are concerned, the existence of a minimum guaranteed return equal to inflation would require only a slightly increased caution regarding Pillar II, associated with additional participants and amounts for Pillar III.

The appropriateness of introducing a guaranteed minimum return equal to inflation is also supported by two quantitative arguments. The first refers to the degree of erosion of the amounts saved as a result of the impact of inflation; the second relates to combating the oft-mentioned claim in support of there being no need to guarantee the return at a level equal to inflation – namely, that such a measure would lead to excessive caution among fund administrators, thus depriving beneficiaries of potential higher returns. The investment structure in June 2011 (see Figure 1.) shows that pension fund managers have turned to easy gains, since 66.28 % of assets are invested in government securities (this percentage is very close to the 70 % limit imposed by the legislation). Thus, fund administrators have chosen the easy route – they are neither trying to diversify investments to obtain higher returns, nor are they assuming any responsibility for the outcome of their investments. Therefore, we would recommend a lower limit for investments in government securities as a means of limiting the possibility of increasing the public debt.

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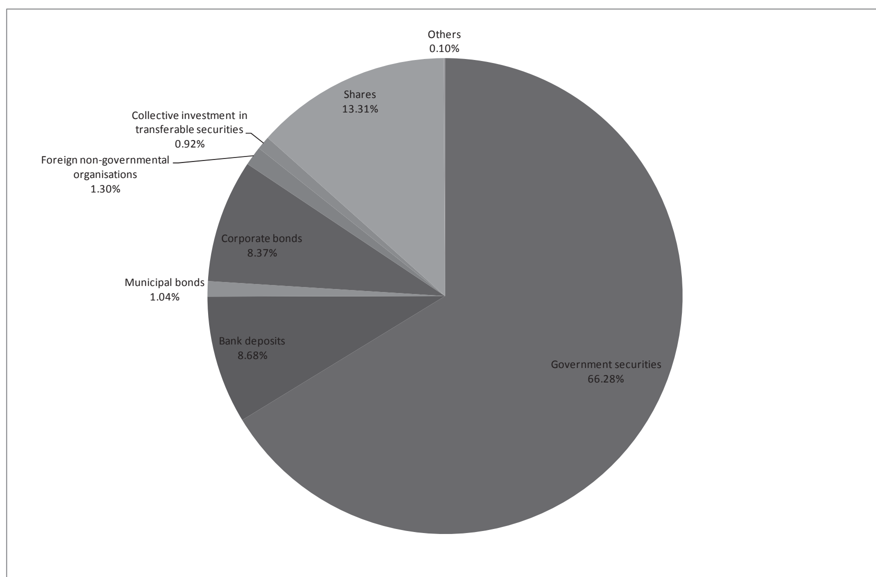
Figure 1 – Structure of holdings of pension funds (June 2011)



Source: Romanian Private Pension Supervisory Commission

This investment structure covers a perverse process – the state is borrowing money from the pension funds to cover a deficit created in part precisely by the transfer of these same amounts (as we have seen, the amounts transferred to Pillar II are a major cause of the deficit in the social security budget). In other words, the state is paying interest to borrow its own money! Moreover, this has created a moral hazard as the state has incentives to increase contributions to Pillar II and thus to supplement the amounts it can borrow.

Returning to the issue of the creation of new structures for the payment of pensions, and remaining within the area of perverse effects, the likely result of such an organisation of the payment stage will be the establishment by the pension funds of companies to handle the payments. This would entail additional costs due both to the bureaucracy and the habitual marketing campaigns intended to 'help' taxpayers in their decision. These costs will be transferred, naturally, to the recipients of the payments. Given that most of them will choose, most likely, the corresponding company that managed their pension, there will be unnecessary additional costs. It would, therefore, be better if the pension fund administrators were the ones who also managed the private pension payments. At the level of the pension plan, this new level hinders the process by requiring again the choice of a supplier, as well as a random distribution for those who did not choose.

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The only arguments in favour of such a system are that, once accumulation is complete, contributions must have a different administration than during the period of accumulation. During accumulation, higher risks can be assumed because, in the case of loss or lower returns, they can be recovered in a wider timeframe. Once this period is over and payment is in progress, their management requires taking very few risks since the timeframe is uncertain and thus it is unlikely that any potential losses could be recovered. Even if the payments were managed by the pension fund administrators, the amounts should be transferred into low-risk funds.

The administration of payments would also imply some costs (such as those related to the actual payment of the pension). However, these would be considerably lower than the solution proposed by the draft law.

Another argument for payments to be made by the pension fund administrators is that most of the activities that have to be made by a pensions provider overlap the activities of a pension fund administrator, i.e. cash management. Indeed, pension funds do not have the know-how to manage payments, but a pension fund is entitled to manage pensions which means the whole chain, from accumulation to administration and payment. In addition, as shown in Table 10 below, fund administration is not substantially different in the pre-payment and payment periods: specifically, the instruments in which they may invest during the period of accumulation tend to include those in which they may invest in the payment period.

Payment operation by pension fund administrators could act as an incentive for the increased responsibility of the other parties concerned, in which case the participants could choose, without commission or with only very low ones, their provider of the pension payment. With a historic knowledge of the performance of the pension funds and the administrators' relationship with their clients, participants reaching the point of retirement are in a position to make an informed choice on the provider of their pension payment. Thus, they can 'punish' the administrators if they are dissatisfied by choosing another administrator as the provider of their pension payment.

Chile, the country that was the model for the World Bank's Pillar II system, seems to have noticed the advantages of this type of organisation, allowing the provision of retirement products only by those institutions which are specialised in life insurance and pension fund administration (i.e. experienced entities in investment management).

Another overlap of activities occurs for the holder of the pension payment funds. According to the draft law under debate, the profile of the holder of the pension payment funds is identical to the pension fund holder (Articles 76-90 of the Law on the Organisation and Operation of the Private Pensions Payment System are identical in substance and almost entirely in form with Articles 119-133 of Law No. 411/2004). Under these circumstances, it is most likely that the same holders of pension funds will become holders of the pension payment funds. If a pension fund administrator sets up a company for pension payments, it will keep the same holder; this will involve a transfer of funds only on paper, but several related fees will be added.

By introducing this new level of player – namely, the holders of pension payment funds, who will perform the same type of activities as those they have already made as holders of the pension funds, and largely for the same cash amounts – costs will be increased again which, ultimately, will have to be borne by future pensioners.

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Table 10 – Investment tools for pension funds and pension payment funds

	Private pension funds		Private pension payment funds	
	Allowed	Limit	Allowed	Limit
Monetary market tools	Y	20 %	Y	20 %
Government securities issues by EEA member states	Y	70 %	Y	70 %
Bonds and other securities issued by local public administration authorities in EEA member states	Y	30 %	Y	20 %
Securities transacted on EEA markets	Y	50 %	-	-
Bonds and other securities issued by third states	Y	15 %	Y	15 %
Bonds and other securities issued by local public administration authorities from third states	Y	10 %	-	-
Bonds and other securities issued by foreign non-governmental organisations	Y	5 %	Y	10 %
Participation bonds issued by collective investment funds in transferable securities from Romania or foreign countries	Y	5 %	-	-
Other types of investment stipulated by the Commission's rules	Y	n/a	Y	n/a

** European Economic Area. Source: Law No. 411/2004 on Privately-Managed Pension Funds; Law on the Organisation and Operation of the Private Pensions Payment System*

Arrangements for the payment of pensions

The existence of a pensions system based on capitalisation, such as the one in Romania, raises problems concerning the effective arrangements for pension payments – whether there should or should not be limits on the amounts withdrawn; whether life annuity payments should be imposed; whether it would be good to impose restrictions on the number and type of possible payment methods, etc.

The Romanian draft law currently provides that private pensions can be granted as a life annuity, limited pension or 'other type of pension stipulated by the Commission's rules.'

In turn, a life annuity can be:

(a) an annuity for one person, representing a fixed monthly payment, owed and paid until the death of the member
(b) an annuity for one person plus a determined period of payment, representing the monthly payment of a fixed amount owed and paid until the member's death or, in case of the member's death, until the expiration of the period stipulated in the pension payment contact

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(c) a survivor's annuity pension, representing a fixed monthly payment owed and paid to the member until death and, after the death of the member, owed and paid to the surviving spouse during his/her lifetime and to minor children until they reach the age of majority.

A limited pension is a fixed monthly payment owed and paid over a period between five and ten years.

The draft law stipulates that fixed pensions are allowed; in contrast, it prohibits variable pensions.

The problems raised in this section of the draft law are numerous; we begin here with the simplest ones, which refer to the form. Thus, we may note the ambiguity of the wording set out in paragraph (b) above: this paragraph probably refers to the possibility to choose a payment until death but for a minimum period of time and, where death occurs before the expiry of that period, that a person appointed in the contract might be entitled to receive the monthly amounts for the remaining period.

Among the most important matters of substance, the life annuity, regardless of its form, appears in the draft law as a fixed monthly amount. There is no indication whether this amount may or may not be indexed by inflation; much less, a fact on which we insist once more, is there a requirement for mandatory indexing in line with the rate of inflation, bearing in mind the unfavourable conditions put in place by this country's history for this indicator. Moreover, the wording of the draft law shows that pensions might not be indexed by inflation; it stipulates that pensions may be increased by a fixed annual default rate 'in accordance with Article 126 paragraphs (2) and (3)', which read respectively as follows:

(2) Starting from a funding rate higher than 110 %, the excess of assets can be redistributed, by actuarial calculation, to the members of the private pension payment fund, after full recovery of the amounts which the private pensions provider funded from the provisions of the private pension payment fund.

(3) Redistribution is done by pension increases in the same percentage for all members of the private pension payment fund.

Therefore, the fixed amount determined at the time of retirement may be increased only if the financing rate exceeds 110 %, i.e. assuming that a certain level of return is obtained by that particular fund. The sole pressure exerted on the providers of private pensions is to refrain from reducing the fixed amount and in terms of the commission they may take – which is set at 2 % per annum of the net assets of the private pension payment fund. It remains to be seen whether the latter factor will be able to stimulate private pensions providers to a level of management achievement that would ensure an increase in the fixed amounts to at least an updated level in view of inflation. If they fail to do so, taking into consideration a life expectancy at retirement of twenty years, and an inflation level of 3 % per year (very optimistic for Romania), the fixed amount set at the beginning of the retirement period will be smaller by 45 % in real terms at the end.

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Further clarification is needed as regards what concerns the choice of pension:

The Member is required to purchase a life annuity, if the personal assets are sufficient for the purchase of a life annuity,

and:

The Member is required to purchase a limited pension, where his/her personal assets are not sufficient to purchase a life annuity.

The level of 'sufficient assets' is not defined. How is this limit established and by whom? It is possible that limited pensions are intended only for those who have contributed largely to state pensions (i.e. those who were in the age category of 35-45 years when Pillar II was launched), in which case this pension will complement the state pension. However, if it applies additionally to those who have a full record of contributions to private pensions, it is necessary to discuss the need to establish a social protection mechanism.

Another article from the draft law that requires further clarification is that stating

If the participant's personal assets are sufficient to choose any life annuity, he/she may choose the type of life annuity deemed most appropriate.

Again, there is a deficiency as regards the definition of the limit and how or which entity sets the limit for which the asset is considered 'sufficient' for the choice of any life annuity.

The draft law is very restrictive in terms of the conditions and arrangements for the payment of pensions, which is surprising given their 'private' nature. Private pension payments can begin, under the existing laws, as soon as the conditions for retirement are met. Nevertheless, a private pension should provide a certain flexibility regarding the payment starting date, as well as in terms of any possible restrictions relating to the contribution period. One advantage of a private pension, in its basic sense, is precisely that it gives the opportunity to retire before the age stipulated by the law – especially as this is expected to rise to 65 years, while population aging is likely to increase even this new limit. Once a certain level of contributions has been completed (either in terms of a predetermined period or as a total amount), the beneficiaries should be able to receive their private pension.

For those in old age – and especially given the increase in the retirement age – a more flexible form of employment may be appropriate (for example, part-time employment), in which context a private pension could supplement the salary.

The reasons for the conditioning of private pensions by the state pension, as provided in the draft law, are related to the limitation of the types of pensions from which a participant may choose. Thus:

The member is required to purchase a life annuity, if the personal assets of the member are sufficient to purchase a life annuity.

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Disregarding the ambiguity concerning the extent to which the asset is considered 'sufficient', to which we have just referred, we may see that participants are limited to choose life annuities, requiring the a fixed amount payment and providing the possibility to choose a beneficiary after death. Participants are not entitled to choose payment for limited periods of time, which could favourable those with a history of ill-health, nor for withdrawal, either partial or total.

Partial and total withdrawals can be explained in the circumstances in which private pensions can be considered to be savings instruments that offer a good relationship between the degree of risk and the returns. They are allowed without restriction up to a maximum ceiling in various states that have implemented private pensions, such as Australia, Hong Kong, Canada and the US, and with certain restrictions in some European countries (Switzerland, Sweden, Estonia and Lithuania).

The obligation to purchase a life annuity means lower monthly pensions due to the increased risks to which the pension provider is exposed (arising from uncertainty related to the period over which payment will be made). We have indicated already that life annuities entail further exposure to inflation and the lack of a guarantee of a return to cover inflation during the periods of accumulation and payment. Allowing total withdrawal of the amounts from private pensions may be considered primarily as a first step in protecting savings against inflation.

Summary

To summarise, the pensions legislation is deficient and the new draft law does not improve this already complex and burdensome system. The problems concern both the payment mechanism, namely the introduction of new players, and the actual means for the payment of pensions which do not provide, in any of the existing forms, the opportunity or obligation to index the amounts due according to the rate of inflation. The legislation is about to become more restrictive, but not in the interests of the participants in Pillar II, who are lacking real choices between different pensions products and who have virtually no opportunity to protect their pensions against inflation.

Conclusions and recommendations

A budget can be balanced by increasing revenue or cutting expenditure, but there intermediate solutions are also available. However, in the past years, and confronted with economic crisis, Romanian governments have seen cost cutting as the only viable solution. We are witnessing today, at least as far as the public social insurance budget is concerned, the failure of this policy: in times of recession, the cuts in expenditure are translated into low revenues. It is a vicious circle, called in economic terminology the 'paradox of thrift' or Keynes's Paradox.

Our analysis highlights the chronic deficit in the pensions budget, generated by the pensions increase in 2008 and 2009, but the data show that this component is not as large as has often been claimed in the political sphere: it is only 41.93 % of the total deficit in the social insurance budget in 2011. In contrast, 58.07 % of the deficit is represented by various political decisions that have marked recent years: the introduction of the second pensions pillar; the guaranteed minimum pension; inclusion in the

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public pensions system of former military and police personnel; and the 25 % wage cuts in 2010. Even the job cuts, apparently a consequence of the economic crisis, have the specific traits of the pro-cyclical policies adopted both by the government and the private sector. It is worth mentioning that there is no significant demographic component of the deficit, either now or likely in the near future.

Before blaming the current level of pensions for the budget deficit, at least two things should be understood properly. The first concerns the social and economic importance of the money which comes from pensions. Surveys conducted by the National Statistics Institute show that, in almost 20 % of households, 70 % of total revenues come from pensions alone. Furthermore, one-quarter of total household income is from pensions, and these revenues tend to go directly into consumption. Domestic demand is based on pensions, and modelling reveals that a decrease in pensions even by a few percentage points would lead directly to the loss of tens of thousands of jobs.

Secondly, any responsible government should assume and fix the mistakes made previously. Our recommendations regard precisely this situation. Thus:

- we believe a public debate is necessary in order to discuss the mandatory character of the Pillar II pensions system. The long-range, and illusory, advantages that it could bring are fully offset by the big hole it makes in the budget. The problems generated by this system are obvious and any analysis of the draft law on the Pillar II pension payment system reveals alarming conclusions
- the guaranteed minimum pension may be an option to provide social assistance, but it is not an issue for the state social insurance budget. This pension should be transferred to the general budget, and classified as social assistance
- the introduction of former soldiers and police officers into the public pensions system is a policy idea, although it will mean the elimination of privileges. Nevertheless, the difference between the amount received by military and police pensioners and the current year contributions of those in service should be borne by the state budget (not by transfer, but directly)
- wage cuts also contribute to a decrease in contributions to the pensions budget. Therefore, it is essential to develop policies to support wage increases in the medium-term, as consumption is already affected
- finally, increasing the number of jobs should be a national priority as it is the only way to secure a balanced budget, and not only as regards the pensions budget.

We currently have 4.4 million employees. Modelling that the Observatory has conducted, but not examined directly in this article shows us that we require some 6.1 million employees, at current average wage levels, in order to secure equality between revenues and expenditure in the pensions system.

To balance the public social insurance budget, there are two extreme options:

- the creation of around 1.7 million jobs paid at the current average wage, all other variables remaining unchanged
- for the same number of employees, the average wage should be increased by about 750 lei, all other variables remaining unchanged.

In the absence of Pillar II, the number of employees would need to increase to some 5.7 million at the current average wage level. If the number of employees is maintained,

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also in the hypothetical absence of Pillar II, then it would take an average salary of 2 585 lei to balance the budget (compared with 2 773 lei were Pillar II not to exist).

Calculations have been made on the basis of the deficit for 2011. We should not forget, however, that these directions can be combined: the extremes are not realistic, but middle solutions, comprising both job creation and an increase in the minimum and average wage, provide some viable possibilities. Naturally, the effort required may be reduced via the elimination of some other factors of an administrative nature which affect the pensions budget, which are listed above. The chronic component of the deficit is little more than 40 % of the current total deficit, and the only meaningful solution to balance the budget is to shift the whole orientation of economic policy towards an increase in jobs.

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