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Reform of the Pension System in Romania - Privately Administered Pensions and Facultative Pensions

Stela Aurelia Toader

Romanian-American University Bucharest, str. Bulevardul Expoziţiei, nr.1B, Sector 1, Bucureşti
e-mail: stelatoader@yahoo.com

Abstract

The latest reform measures of the pension system in Romania have imposed the introduction of new categories of pensions (privately administered pensions and facultative pensions), by which the participants can obtain, after having fulfilled certain conditions, increased pensions, based on capitalization of the contributions paid by the participants as well as the profit obtained by investing these contributions.

Key words: *system of public pensions, privately administered pensions, facultative pensions, social security, budget of the state social security*

Reform Circumstances and Determinations

For Romania, the transition to the market economy, besides the undisputable economic and social advantages it brought, meant also the appearance of certain phenomena with social negative implications.

Practically, in the last 16 years, we witnessed the steep degradation of the degree of dependence of the retirees to employees, by the rapid increase of the number of retirees (the number of retirees increased by approximately 90 percent in the period between 1990 and 2006) and a reduction of the number of employees to almost half.

This evolution was favored mainly by:

- the measures taken by the decision factors in the 90s which allowed retirement in the case of certain categories of employees before the original legal term as a temporary solution of the increase of unemployment, caused by the restructuring of many companies;
- important demographic changes (aging of the population, migration of labor force).

This led to the current situation when a Romanian employee contributes monthly to the social security system for 1.23 retirees, as compared to 1990, when 3.34 tax payers supported one retiree (table 1).

This situation, to which in time it was added the fact that the state social security budget was deprived of funds by evasions from the payment of the social security contributions, widely practiced in Romania, placed a negative mark on the financial support capacity of the public pensions system, thus reaching its incapacity to provide an adequate level of income for the beneficiaries.

Table 1. Dynamics of the dependence ratio between the average number of retirees and the average number of employees (thousands of persons)

Year	Average number of retirees (*)	Average number of employees	Dependence ratio (%)
2001	6,192.4	4,502.3	1.37
2002	6,212.3	4,372.8	1.42
2003	6,141.5	4,384.8	1.40
2004	6,069.8	4,420.9	1.37
2005	6,532.3	4,536.5	1.44
2006	5,638.5	4,594.3	1.23

(*) – state social security retirees, including agricultural workers
Source: National Statistics Institute, www.insse.ro

Relevant for the existing unbalances at public pensions system level and the evolution in the last years of the ratio between the gross average salary and average social security pension, at present, the average social security pension represents almost the fourth part of the gross average earning, i.e. lei 311 per month, an amount which in no way can provide a decent living standard for the retirees (table 2).

Table 2. Dynamics of the ratio between gross average earnings at economy level and the average social security pension

Indicators/Year	2001	2002	2003	2004	2005	2006
1. Gross average salary at economy level (lei)	422	532	664	818	968	1150
2. Average social security pension (lei)	131	163	187	232	267	311
3. Ratio ½	3,22	3,26	3,55	3,53	3,62	3,70

Source: National House for Pensions and other Social Security Rights, www.cnpas.ro

The public pensions system has been in operation in Romania ever since the times of centralized management, undergoing in time a series of changes imposed by the need of adapting to the market economy requirements.

The system is based on the „Pay-as-you-Go” (PAYG) principle, i.e. the funds of the public pensions system made up of the social security contributions paid by employers, employees and other insured persons are distributed among the insured in the form of social services. In other words, the active generation supports, by its social contributions, the pensions for the inactive generation. In reality these funds proved insufficient for providing adequate pensions.

The chronic financial unbalance of the state social security budget between 1995 and 2003 influenced negatively the state budget, which had to grant subsidies in order to cover the deficits (figure 1).

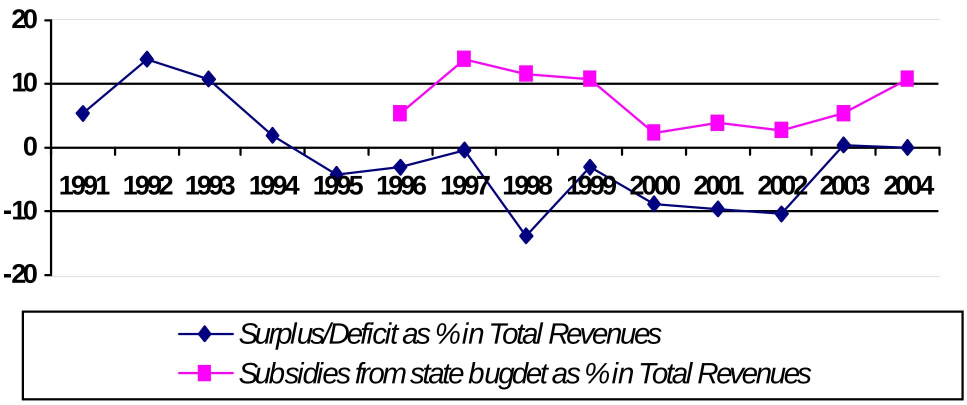

Figure 1. Execution of the state security budget (1991-2004)

Source: National Statistics Institute – Statistical Yearbook 2005

The New Components of the Pensions System in Romania

Requirements such as the creation of a modern social security system, able to provide reasonable pensions, as well as the removal of fiscal barriers and obstacles generated by the different pension systems, which influence free circulation of the labor force, have imposed, once Romania was integrated in the European Union, alignment of the Romanian pensions system to the European one.

As compared to our country, there is a more or less integrated system in the European Union countries based on three pillars:

- Pillar I: The public pensions system, which includes all employees, based on the mandatory contributions of the employees and employers, according to the PAYG principle;
- Pillar II: The private pensions system, financed by employers and employees. In this system, until the retirement event of the employees takes place, the funds are used for investments, observing the rules and tendency which operate in the capital market;
- Pillar III: The individual (additional) pensions system, based on bilateral contracts, concluded by employees with private life insurance companies.

In Sweden, for instance, there are two mandatory public regimes: one by distribution and another by capitalization based on a percentage monthly contribution.

In Germany, the reform of the social security system, started in 2001, diminished the contribution paid to the public pensions system and introduced a complementary facultative and individual system by capitalization.

The United Kingdom implemented as far as 20 years ago, the basic pensions regime which was completed by a mandatory system which allows the employee to opt between a pension fund and a public complementary regime, guaranteeing a complementary pension set at a certain percentage of the average salary.

The countries in the region, their majority members of the European Union, have also passed almost several years ago to the privatization of the pensions system. Thus, the Czech Republic started the pensions reform in 1996, when the first pillar was introduced in 1996, at the time of introduction of pillar II, two years later Hungary, Poland and Slovakia in 1999, Bulgaria in 2000 and Croatia (as a E.U. member country) in 2002.

Taking over the reform model based on three pillars, supported by the World Bank, starting in 2008, in Romania there will simultaneously be under operation:

- the public pensions system (Pillar I), and
- the private pensions system, with its two components, the mandatory pensions (Pylon II) and the facultative pensions (Pillar III).

As far as the private pensions system is concerned, two models operate at European level:

- the “defined benefit” model, applied in the Western European countries, in which the level of benefits is known but the level of contributions is not known, this being normally very high, and
- the “defined contribution” model, applied in the countries in the region, in which the level of contributions is known but the level of the benefits (pension) cannot be known in advance. The last system was also adopted in Romania.

Mandatory Private Pensions

The first component of the private pensions system fulfills the obligatory condition existing in the public system, but administration of the funds being achieved privately.

Participation to the constitution of the privately administered pension funds is mandatory for the insured persons according to Law no. 19/2000, on the public pensions system and other social security rights, and which contribute to the pubic pensions system and are aged over 35 (on January 17, 2008), and facultative for insured persons who contribute to the public pensions system, aged between 35 and 45.

The participant is entitled to a private pension the moment he fulfills the retirement conditions for limit of age in the public system, i.e. from 2013, women at 60 and men at 65 years of age. Therefore, the minimum contribution period for the mandatory private pension is 15 years for women and 20 years for men, that is between maximum 45 years not turned on the date of joining the fund and the legal age of retirement in pillar II.

It is worth mentioning that participation to the constitution of privately administered pension funds does not require an additional financial effort of the employee since the contribution to the privately administered pension fund is part of the individual contribution for social security owed to the public pensions system, being deduced from the gross income earned by the employee, similar with the mandatory social security contribution owed in the public pensions system.

At the time of starting the collection activity (year 2008), the contribution quantum will be 2% from the calculation basis, which will increase to 6% in the following 8 years with 0.5 percentage points per year, starting from January 1st of each year.

The participant is entitled to a private pension when the retirement age limit condition provided for in the public system is fulfilled.

According to the law, the amount due as pension cannot be less than the value of the paid contribution, adjusted by the consumption index of the prices which took place between the date o payment of the said contribution and the retirement date, of the transfer of availabilities and accessories thereof, diminished by the transfer penalties and legal commissions.

The Mandatory Private Pension Companies which received authorizations as administrators of a privately administered pension fund are shown in table 3.

Table 3. Mandatory Private Pension Companies and authorized pension funds up to the date of starting the joining process to a privately administered pension fund (September 17, 2007)

Administrator	**Pension fund authorized on Pylon II**
ING Pension Fund	ING Privately Administered Pension Fund
Aviva, Administration Company of a private pension fund	Viva Pension
Allianz-Țiriac Private Pensions	AZT Your future
Generali Pensions Fund	Wings
BT AEGON Pensions Fund	Vital
First Pension Pensions Fund	First Pension
AIG Pensions Fund	AIG Privately Administered Pension Fund
Interamerican, Administration Company of a private pension fund	Interamerican Privately Administered Pension Fund

Table 3. (cont.)

OTP Pensions Fund	OTP Privately Administered Pension Fund
BRD Pensions Fund	BRD Privately Administered Pension Fund
Omniasig Pensions	OMNIFORTE
BCR Administration Pensions Fund	BCR Privately Administered Pension Fund
Bancpost Pensions Fund	BANCPOST Privately Administered Pension Fund
KD Pensions Fund SA	KD Privately Administered Pension Fund
AG2R Pensions Fund SA	ALFA Pensions Fund
Marfin Pensions Fund SA	Marfin Privately Administered Pension Fund
MKB Romexterra Pensions Fund SA	Fiducia

Facultative Private Pensions

In the case of the second component of the private pensions system, facultative pensions, joining such a pensions fund is an individual option.

A facultative pensions fund can be joined by employees, public servants, persons authorized to carry out independent activities as per the law, persons who carry out activities in elective positions or who were appointed within an executive, legislative or judging authority, for the duration of the appointment, members of cooperative companies and other persons who earn income from professional or agricultural activities.

For the facultative pension (pylon III), the minimum contribution period is seven and a half years (90 months of contributions), and the legal retirement age is 60. In other words, only persons aged maximum 52.5 can contribute to pylon III.

Effective participation to a facultative pension fund consists of payment of a contribution by the person in question or by another person (employer) on his/her behalf, which contribution can be of up to 15% of the gross monthly income or the income assimilated to it of the person who joins a private pensions fund. It should be mentioned that this contribution can be shared between employee and employer.

The facultative pension schemes address mainly to persons with a greater saving capacity, since the contribution quotas are not deducted from the already existing contributions, as in case of the privately administered pensions, but are established in addition.

As opposed to the mandatory privately administered pensions, where a person can participate to only one fund, in the case of facultative privately administered pensions a person can participate to several funds provided the contribution percentage is not exceeded.

The contribution of a participant to a facultative pensions fund is transformed in fund units, into an account of the participant, and the administrator invests the collected amounts in financial instruments according to its investment policy.

According to the law, facultative pension funds can be administered by pension companies, investment administration companies and insurance companies, authorized by the Private Pensions System Supervisory, as well as any entity authorized for this activity from another member country of the European Union.

To encourage contributions to the facultative pension funds the legislator grants a series of fiscal advantages, such as:

- deductibility of the amounts representing contributions paid by the participant to the facultative pension funds from the gross monthly salary or the income assimilated to it, limited at an amount representing the equivalent in lei of euro 200, in a fiscal year;
- deductibility of the amounts representing contributions paid by the employee to the facultative pension funds from his/her taxable profit, limited at an amount representing for each participant the equivalent in lei of euro 200, in a fiscal year;
- the investments of the privately administered pension funds and the facultative ones as well as the investment results are tax exempt up to the moment of payment of the right due to the participants, moment after which the private pension becomes subject to the regulations regarding pension tax[1].

The right to a facultative pension is opened upon request of the participant when three cumulative conditions are fulfilled:

- the participant turned 60 years of age;
- a minimum of 90 monthly contributions have been paid;
- the personal asset[2] is at least equal to the amount required to obtain the minimum facultative pension, established by the norms of the Supervision Commission.

The laws setting up these components of the new private pension system offer a series of guarantees to the participants, among which are:

- setting up of a guaranteeing fund;
- constitution of technical provisions;
- setting up of the Private Pensions System Supervision Commission;
- precise rules regarding the qualities of the administrators;
- control provided by the trustee (legal entity separate from the administrator);
- auditing of the annual activity of the administrator by an independent auditor approved by the Commission.

In spite of all these the participants to these funds cannot know at the moment of joining a certain pensions fund the quantum of the private pension her/she will benefit of, this depending on the efficiency obtained by the administrator from the investment of the respective assets.

Conclusions

By the two new components of the private pensions system in Romania, which come to partially substitute (the privately administered pensions) or supplement (the facultative pensions) the public pensions system, introduction of new alternatives of financing and administration of the capitalized pensions system type administration, privately administered, was achieved.

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[1] art. 146 of Methodological Norms of application of the Fiscal Code „as of January 1, 2007, the monthly tax related to pension incomes is calculated by applying a quota of 16% on the monthly taxable income from pensions determined by deduction from the pension income of the following:

- the mandatory contributions calculated, retained and paid by the physical entity, and
- a tax exempt amount of lei 900.

[2] the personal asset is equal to the amount accumulated into the account of a participant, equal to the number of fund units held by him/her, multiplied by the value to date of one fund unit

With reference to the financial implications of the pensions reform on the payment capacity of pensions by the state social security budget and the income of the beneficiaries:

- within the next 15-20 years (period in which the private pension administrating companies will only collect contributions, without paying pensions), the income of the stare social security budget will record an ever larger reduction (in inverse ratio with the increase of the contribution percentage to social security which will be transferred into a private pensions fund), thus limiting the pension payment capacity from the public system for those entitled today and those who will be entitled in the years to come without having at present the possibility to be insured in private system (persons over 45). These will probably be the generations who will support the transition to the private system;
- after this period of transition the situation is possible to become balanced, so the persons with facultative insurance in Pillar II (who will retire after 15 years – women and 20 years – men) and those mandatorily insured in Pillar II (who will retire after 25 years – women and 30 years – men) will be able to receive two pensions, one from the public system, which will be much reduced, receiving probably the character of a social aid, and another from the private system, Pillar II, which, at least for the time being, depends on a series of uncertain factors at this time, such as: the investments policy of the company which administers the private pensions fund, its efficiency, commissions imposed, experience of the administrator, contribution period (different between men and women), the amount of money paid monthly, inflation etc.

With regard to facultative private pensions, these address mainly to those persons with a greater saving capacity, since the contribution quotas are not deducted from the already existing contributions, as established in the case of privately administered pensions, but are set in addition (almost equaling the income tax quota of 16%), thus, it is supposed that a reduced number of persons will benefit from facultative private pensions.

As such the new system presents a series o less advantageous aspects, the most important among which being:

- *uncertainty with regard to the level of pension*, given by the adopted model itself, it depending on the efficiency obtained by the pensions fund and the commissions it collects;
- *inequity introduced among the participants to various pension funds*, practically at the same level of pension contribution they will differ according to the efficiency obtained by the pensions fund;
- *conflict of interests* with regard to the institution appointed with the regulation and control of the private pension funds, under the conditions in which it is financed from the taxes collected from the fund administrators;
- *lack of equality between men and women*, induced by the fact that at equal contributions, women will benefit from a smaller pension than the men, since the pension will be calculated, at least according to the regulations now in force, based on some biometric tables which take into consideration a greater life expectation for women than for men, but also a shorter period of contribution.

On the other hand it can be said that by the reform of the public pensions system and the introduction of the private pensions system there are created new premises for the development of the capital market, in particular, and the stimulation of economic growth, in general.

At the same time for the participants to these pension funds the obvious advantage is that of the possibility to benefit, on fulfillment of certain prior conditions, by an additional income to the one obtained from the private system, capable of offering them a plus of financial security.

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Reforma sistemului de pensii în România – pensiile administrate privat şi pensiile facultative

Rezumat

Cele mai recente măsuri de reformă a sistemului de pensii din România au presupus introducerea unor noi categorii de pensii (pensiile administrate privat şi pensiile facultative) prin care participanţii pot obţine, la îndeplinirea unor condiţii prealabile, pensii mărite, bazate pe capitalizarea contribuţiilor plătite de participanţi precum şi a profitului obţinut din investirea acestor contribuţii.