The Economic Crisis and the Solidarity of Social Insurance Systems

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Abstract: In the first section we will briefly introduce the main impact of the global crisis on Romanian macroeconomics, financial markets with special focus on the pension systems, as well as the outlook of the international rating agencies and of the financial institutions regarding the reform solutions. The second section tackles the solidarity dimension of pension schemes, i.e. concepts like inter-generational, intra-generational, gender, and fiscal solidarity. The third section describes the pension reform measures tackled during the crisis providing also concise country profiles in CEE. These measures were mostly envisaged to mandate later retirement, reduce the deficit of Pillar I, change the pension indexation rules, eliminate privileged pension rights for special groups of workers, and improve benefits. The last section is to conclude with some policy implications.

Keywords: global crisis; Romanian macroeconomics; financial markets; pension systems

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1. Romania and the 2008 Global Crisis

Like all the CEE countries, Romania was hit dramatically by the global crisis. It was one of the hardest and longest in emerging Europe, with real GDP declining by 6.6 percent in 2009 and a further 1.1 percent in 2010. Gross fixed capital formation reached -27.8 in 2009 and -2.3 in 2010 (as compared to 16.1 in 2008), while household final consumption expenditure attained 71.9 in 2009 and 73.0 in 2010 (as compared to 74.0 in 2008). However, export sector was less striking than in other emerging economies in Europe and since 2010 export growth has constituted the main factor contributing to aggregate demand, triggering a mild economic recovery commenced in 2011.

The international rating agencies cut Romanian credit ratings significantly. Although the trade union movement accepted that some fiscal adjustment was required to stabilize the economy, it contested the scale of the contraction and the unequal distribution of the burden. The trade union organized a series of protests in 2010.

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The Romanian currency depreciated by around 20 percent against the euro between October 2008 and January 2009. The commercial banks in Romania experienced liquidity problems and interest rates increased sharply.

Given the large foreign currency loans in the years prior to the crisis, the Romanian authorities were concerned about a possible outburst of non-performing loans. Therefore, in early 2009 they negotiated and concluded another Stand-By Arrangement with the International Monetary Fund which involved additional financial support from the World Bank and European Commission. Access to support came with public-sector belt retrenchments.

In late 2008, the Government included in the 2009 budget a 3 percentage point reduction in the fiscal deficit by increases in social contributions, indirect taxes hikes and public wage bill cuts. The Stand-By Arrangement required further cut in public expenditure, yielding 1.1 percent of GDP in 2009. In 2010 a package of reforms was adopted and produced a fiscal contraction equal to 4.6 percent of GDP. The package included a 25 percent cut in public wages, the elimination of holiday bonuses and the 13th salary in the public sector, a 15 percent reduction in most social transfers and a 5 percentage point jump in VAT.

The crisis has affected differently the various types of pension schemes in Romania. The revenues of the public system of pensions – Pillar I declined as a result of lower employment and consequently of fewer contributors. By the end of 2009, the State Social Insurance Budget attained 1.5 billion RON (0.29% of GDP).

Due to volatility sensitivity of the financial markets during crisis, the pre-funded systems register smaller assets and rates of return. Notwithstanding, weighted average return of the Romanian private pension system – Pillar II was 8.56% during 2010-2011. Before entering the economic crisis, funds recorded significantly higher rates of return. However, because according to conservative investment rules much of pension fund assets were invested in bonds, the losses were relatively lower compared to systems whose investment portfolios were at risk because they were chiefly in shares. In August 2010, eight CEE reforming countries and Sweden requested that the EU allow their transition costs associated with the mandatory private pension systems to be deducted from their budget deficits. In December 2010, the Commission reached an agreement with Poland on allowing for temporary flexibility without changing the accounting rules of the EU. The Member States that do not overly exceed the EU's criteria (a Government deficit within 3 percent of GDP and a Government debt less than 60 percent of GDP) and are implementing pension reforms are permitted to deduct the transition costs from their deficits for up to five years.[1] 2010 marked the world economy out

[1] Pension reform in Central and Eastern Europe: in times of crisis, austerity and beyond, pg. 4.

of recession, but the other side of the crisis – financial, social, sovereign debt continued to show major frequencies different from one country to another.[1]

2. The Solidarity Dimension of Pension Schemes

Since the World Bank publication averting the old age crisis: policies to protect the old and promote growth[2], the main division of pension schemes has been made on the basis of a three-pillar system. Therefore, the 1994 report called for a multi-pillar system: the first mandatory publically managed, the second mandatory privately managed, and the third voluntary. The first pillar was originally meant to serve to alleviate poverty in old age, but has since simply been classified as a general public pension pillar. (Pension Schemes Study, p. 17)

The importance and size of each pillar is different, responding more or less to the solidarity and contributory principles. Nevertheless, the trend is the multiplication of sources of retirement insurance. State, trust, solidarity, and equity are prerequisites to support Pillar I. Pillar I features intra and inter-generational solidarity, and gender solidarity [3]. In the PAYG system, active members contribute to the generation of older people today and receive benefits from the next younger generation. This is the inter-generational solidarity.

Some authors elaborated on closely related concepts such as the inter-generational and the intra-generational equities.[4] In this view, the inter-generational equity concerns:

- the protection system (of pensions - Pillar 1) should be sustainable for today's active generation and the level of protection should be recognized as reasonable by the generation protected (retirees);
- the pension system (Pillar 1 and Pillar 2 contributions) should not cause long-term indebtedness. Here two mentions should be made: first, contributions to Pillar 2 are somewhat forced savings, capitalized and will produce a protective effect only after 2032. Until then they represent costs for the PAYG system, which are compensated either by budget subsidies or through a current lower net average pension or by increasing contributions to the social insurance system - impossible for Romania, given their current level. For the next 20 years the present value of the additional costs attributable to Pillar 2 should be at least offset by the investment returns of assets collected by Pillar 2 and

[1] The circumstances of World Economy, 2011, p. 1.
[2] World Bank, 1994.
[3] Social solidarity in the context of pension reforms, pg.5.
[4] Alternative compromises Romanian pension system for the next 20 years, pg.18-19

managed by private pension funds. The figures to date of investment returns of Pillar 2 assets suggests that this really happens (even with a significant margin of 4% - 5%), but a change of trend as regards deficit increase, which would result in higher financing costs (interest) may adversely affect the process described. Second, unsustainable growth of the consolidated budget deficit and public debt and hence its share in GDP would lead to a growing financial burden on the shoulders of the next active generation which would thus be less able and less willing to respect the basic consensus of the PAYG system;

- the ratio between resources allocated to Pillars 1 and 2 also affects inter-generational equity: greater resources allocated to Pillar 1 favors the generation of current pensioners (because through this pillar the pensions of the current generation of retirees are covered based on PAYG principle) rather than the current active generation (because less resources will accumulate in Pillar 2 of which a part of pensions of the future generations of retirees will be paid depending strictly on funded individual contributions); and greater resources directed to Pillar 2 have a reverse effect;
- the rate between the employees and pensioners on the one hand and the net replacement rate on the other hand should be kept in a dynamic balance so that work incentives would not disappear and private and public investment would support a sufficient economic growth. For Romania, this means at least 2.5% per year, preferably more than 3%, in order to reduce the differences in development compared to the average EU 27 and EU 15.

Along with the inter-generational solidarity, there is also an *intra-generational solidarity* – solidarity within generations.

The Romanian Pension Law No. 263/2010 provides for the non-contributory periods (Art. 49 – Figure 1). By taking into account these non-contributory periods the society demonstrates solidarity and agrees to compensate the sacrifices of beneficiaries for the State.

Non-contributory credited periods in the Romanian Pillar I:

- short-term benefit payment from 1 January 2005 onwards: e.g. Temporary Working Incapacity Indemnity due to accidents at work and occupational diseases etc.;
- full-time university courses attendance under graduation condition;
- attendance of an educational institution in the field of defense, public order and national security;
- conscript service or periods served as drafted, mobilized or prisoner of war,
- other periods, stipulated by special legislation.

Figure 1

Moreover, certain categories of workers (e.g., military etc.) contribute a shorter period of time, because their work can not be accomplished by people of a certain age, below the statutory retirement age. Additionally, the intra-generational equity concerns:

- a protective system (of pensions - Pillar 1) transparent, stable and predictable, where the level of protection (of pension) is directly proportional to the level and contribution period - in the broad sense;
- a pension system (Pillar 1) as unitary as possible and with as few “special cases” (or special retirement scheme);
- the difference between the minimum and maximum protection should be socially acceptable – here the authors discuss about pillar 1 (PAYG) and not about pillars 2 (in bulk) or 3 (total) where the benefit is directly proportional to the level of contribution, period and investment return. Pillar 1 is based on a social consensus for intra-generational protection and not on individual investment decisions.[1]

On the other hand, there are proposals for enlarging the scope of solidarity. Therefore, it is stated that the PAYG system may be (re)balanced by instituting an articulated and transparent system of contributions-benefits by solidarity participation of those with high and very high incomes. To this end, the authors propose the additional taxation and taxation in installments of wages over the average level at quotas exceeding 16%, and directing this tax for diminishing the deficit and gradually balancing Pillar I[2].

Gender solidarity is based on life expectancy differences between men and women. Consequently, according to Pension Law No. 263/2010, retirement ages are different. But even if it will achieve equalization of retirement age of women with men, women will continue to enjoy further for a longer period of retirement because of their higher life expectancy. In the period 2000-2010, life expectancy at 65 years and over increased by 1.3 years for women and 0.7 years for men.[3]

Pillars II and III are pre-funded and operate through individual accounts and individual contributions. Pensions will depend on the individual contributions and returns on investment of the pension funds; therefore there is no redistributive feature to these pillars. However, another type of solidarity could be found in the

[1] See also Alternative compromises Romanian pension system for the next 20 years, pg.18.
[2] Strategy and Policy Studies - SPOS 2011 study no. 4, pp. 322.
[3] EHLEIS National Report. In the period 1995-2001 the life expectancy of men and women was below the EU15 average European countries and by 2010 the life expectancy at 65 years and above for both men and women (21.3 years for women and 17.8 years for men) recorded values below the EU25 average European countries.

tax deductions for contributions to the private pillars. In this case, there is a kind of solidarity between society at large and members of the private pillars. This is described as fiscal solidarity[1].

3. The Pension System Reform Measures During The Crisis

In order to improve their fiscal position, many states have imposed fiscal austerity measures. Pension systems were particularly vulnerable to the State spending cuts due to their great dependence on State budgets to cover their deficits. CEE countries have implemented, or have begun to plan, pension reforms since 2009. The following description is a summary of the main features of these reform measures in Romania and the other CEE countries during the crisis (the other CEE countries reforms are delivered in Figures 2-6).

3.1. Measures Increasing Retirement Ages

Romania legislated the normal retirement age for women at 63 years by 2030 and tightened the reduction rates for early retirement pensions.

- Croatia and Hungary will increase the normal retirement age for women to 65 years and Bulgaria to 63 years by 2030. Poland did not change the normal pensionable age for women, leaving it at 60 years.
- The Czech Republic has adopted a new schedule for increasing the normal pensionable age. This schedule accelerates the increase in the normal pensionable age for women as set out in the previous schedule. Moreover, the increase in the normal pensionable age for both sexes will further continue beyond 65 years without any maximum.
- In the Slovak Republic, the normal pensionable age for both sexes is 62 years, but it had been proposed that the normal pensionable age be increased in line with the life expectancy.
- The qualifying conditions for early retirement pensions were further tightened in Bulgaria (for women), Croatia (for women), Poland and the Slovak Republic.
- Croatia and Hungary modified the reduction rates for early retirement pensions.

Figure 2

[1] Social solidarity in the context of pension reforms, pg.6.

3.2. Measures to Reduce the Deficit of Pillar I by Increasing Contribution Rates or by Adjusting the Contributions of Pillar II

Romania increased its pension contribution rate by 3.8 percentage-points in 2009. The scheduled phased increase in Pillar II contribution rate was temporarily frozen in 2009, but resumed in 2010.

- Bulgaria decreased its pension contribution rate by 4 percentage-points in 2009 and by an additional 2 percentage-points in 2010. Since 2009, the State has become a "third insurer" that pays statutory contributions of 12 percent of the total contributory base. In 2011, the combined contribution rate of employers and employees was increased by 1.8 percentage-points. Starting in 2017, the contribution rate for the second-pillar system will be increased by 2 percentage-points.
- Poland has decreased the contribution rate of the second pillar from 7.3 percent to 2.3 percent. Since 2012, is gradually increasing to 3.5 percent by 2017. The difference in the contributions has been retained by the state pension system to finance its deficit.
- The re-nationalization of the second-pillar pensions in Hungary may represent an extreme case. It was first decided that, from November 2010 until December 2011, the 8 percent contribution rate paid into the second-pillar pension will cease and be used to finance the state pension system. The Government next proposed to restore full state pension rights for members of private pension funds in exchange for the balances that had accrued in their individual accounts. By the end of January 2011, only 3 percent of the members had declared their intention to voluntarily remain in the private pension funds. The process of switching back to the state pension system, including the transfer of assets from the private pension funds (worth HUF 2.8 trillion or 10 percent of GDP) was taking place in 2011.
- In contrast, the Czech Republic decided to introduce a new voluntary funded pillar financed by a 2 percent contribution rate paid by employees and supplemented by a 3 percent contribution rate redirected from employees' contributions to the state pension system.

Figure 3

3.3. Measures Eliminating Privileged Pension Rights For Special Groups Of Workers

In Romania, the special pension schemes for military, police, and national security officials and some other smaller schemes (except for the special pension scheme

for magistrates) have been integrated into the public pension system. These pensions were recalculated based on the individual's average salary during their whole career and were paid by Pillar 1.

- Croatia decreased the amount of pension benefits obtained under special conditions by 10 percent. However, it postponed the gradual suspension of privileged pensions, including the pensions for parliamentary deputies, military and police officers, and war veterans.
- The Slovak Republic and Hungary were considering reforming their army pension systems.

Figure 4

3.4. Measures Changing the Pension Indexation Rules

In Romania, pension indexation was frozen for 2011. From 2012 to 2020, pensions will be indexed according to full price increases plus 50 percent of real wage growth. Starting in 2021, the partial wage indexation will gradually taper off until pensions are indexed according to prices only from 2030 onwards.

- Hungary abolished the 13th pension and introduced indexation rules linked to GDP growth. Price indexation shall be applied if GDP growth is less than 3 percent, while the Swiss formula i.e. the weighted average of prices and wages shall be applied if GDP growth is more than 5 percent.
- The Czech Republic strictly adhered to the statutory minimum rate of indexation (full price increases plus one-third of real wage growth) and ceased making discretionary increments to the statutory rates of indexation.
- According to its draft Law on pension reform, the Slovak Republic proposed to change its indexation rules to reflect changes in the ratio of contributors to pensioners.
- As an emergency measure, Slovenia indexed pensions only by 50 percent of the average nominal wage growth in 2010, and by 25 percent of the average nominal wage growth in 2011. The Government proposed a freeze on pension indexation for 2012.
- As an emergency measure, Bulgaria suspended pension indexation from 2000 until the end of 2012.
- Croatia also suspended its pension indexation in 2010 and 2011.

Figure 5

3.5. Measures Improving Benefits

Romania introduced a tax-financed minimum pension. The amount of the minimum pension was RON 300 in March 2009 and increased to RON 350 in September 2009.[1]

- Bulgaria was to increase the accrual rate used in the pension formula from 1.1 percent to 1.2 percent in 2017, abolish the maximum pension for pensions granted after 2014, and increase pension supplements for surviving spouses from 20 percent to 26.5 percent of the deceased spouse's pension starting in September 2011.

Figure 6

4. Conclusions

The global financial crisis has affected everyone. No country or pension system is immune. Yet, there is no panacea or one-size-fits-all solution to a crisis challenge. Reforms cannot prevent another crisis. Crises are cyclical in nature and may recur.

The challenge is to make pension systems financially sustainable and trustworthy for future generations in the long term. A well-functioning pension system is an important social system that today's generations have an ethical obligation to preserve and hand it over to the next generations in good shape.

To effectively lead and manage the reform process, the Romanian Government and the resort ministry must strengthen their policymaking capacity. The central focus of the social debate should be on how to strike a balance between solidarity and contributory principles, in order to be more resilient to crisis, on policies that create opportunities for working longer, whilst also ensuring solidarity with those who are unable to do so. Social dialogue plays a vital role in this process, as the different social partners seek solutions that are broadly appealing to all parties concerned. Member States, European institutions and all stakeholders need to respond together and within their respective roles, to the challenges that population ageing represents. Indeed, pension systems must contribute to growth in Europe by promoting active ageing, while remaining an adequate and sustainable instrument at the core of the European social model to sustain the living standards of elderly Europeans.[2]

[1] For figures 1-5 see Pension reform in Central and Eastern Europe: in times of crisis, austerity and beyond, pg. 8-11.
[2] White Paper, p. 15.

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