

7. Pension system reform - first difficult steps

Pension schemes are the most important component of the social security system aimed at insuring and maintaining living standards of non-employed people and social vulnerable groups at a decent level. They consist of a set of economic, legislative, social and organizational measures.

Effective in November 1998 the pension system in Moldova comprises 756.7 thousand pensioners or 21% of the total population. Old age pension receive 557.2 thousand people, (of whom 150.9 thousand are privileged pensions), 113 thou–disability pensions, 34.9 thou-survivor pension, 38.8 thou-social pensions, and 4.2 thou-long-service pension. According to household budget survey data pensions amount for 10.5% of the people's global disposable income.

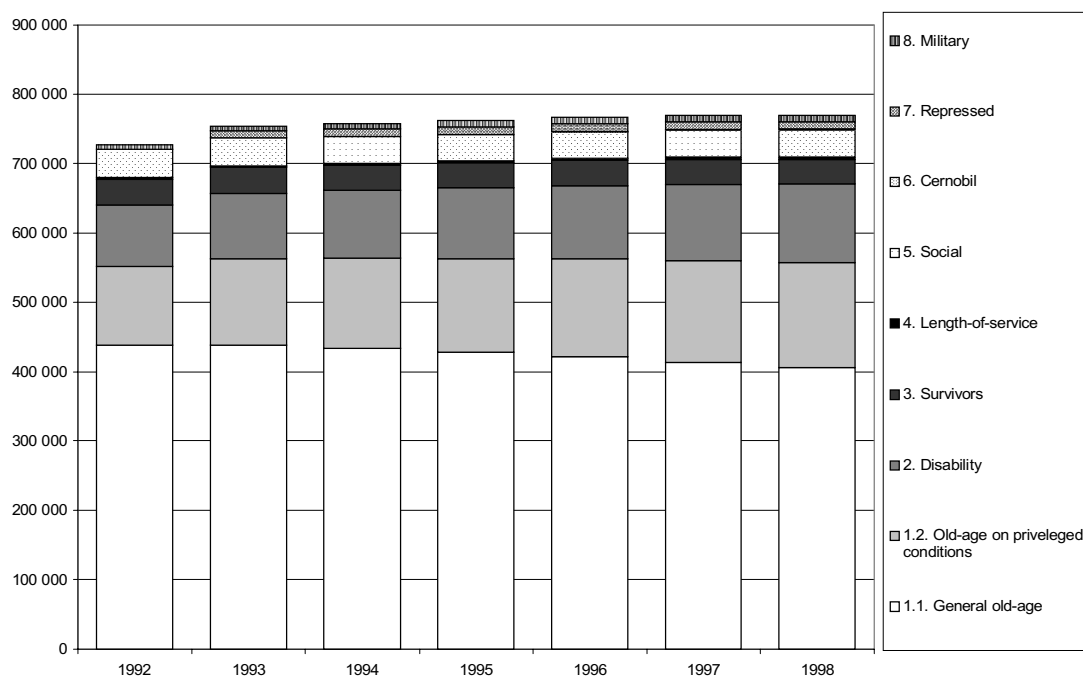
Analysis of the changes occurred in the structure of pension attests that over the last five years there was a significant decrease in the old age pension. Their share has fallen from 60.2% registered in 1993 to 54.6% in 1998. Meanwhile the share of privileged pension has increased substantially: from 15.6% to 19.5%. These shifts in favor of privileged pension have been pushing up the financial burden of the whole pension system.

Number of Pensioners in Moldova

Types of Pensions	1992	1993	1994	1995	1996	1997	1998
Total Beneficiaries	727 356	743 602	746 702	750 556	754 653	757 020	756 716
1. Old-age pension	551 443	562 298	563 982	562 954	562 688	560 439	557 237
1.1. Old-age pension for normal conditions	438 185	437 686	433 078	427 504	421 808	413 134	406 356
1.2. Old-age on privileged conditions pension	113 258	124 612	130 904	135 450	140 880	147 305	150 881
2. Total disability pension	88 561	94 983	97 602	102 255	105 623	109 219	113 012
3. Survivor pensions	37 791	37 552	36 388	36 223	36 351	36 334	34 918
4. Length of service pensions	1 970	1 939	1 847	2 286	2 892	3 799	4 181
5. Social pensions	40 535	40 282	38 819	38 003	38 267	38 430	38 827
6. Pension for participants to liquidation of consequences of explosion at Chernobyl APS		199	297	422	677	933	1 551
7. Pension for repressed people		10 000	10 730	11 220	11 442	11 448	11 365
8. Military pensions	7 066	6 548	8 064	8 835	8 832	8 799	8541

Breakup of Pension Beneficiaries

Types of pensions	1992	1993	1994	1995	1996	1997	1998
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Total beneficiaries	75.8%	75.6%	75.5%	75.0%	74.6%	74.0%	73.6%
1. Old-age pension	60.2%	58.9%	58.0%	57.0%	55.9%	54.6%	53.7%
1.1. Old-age pension for normal conditions	15.6%	16.8%	17.5%	18.0%	18.7%	19.5%	19.9%
1.2. Old-age on privileged conditions pension	12.2%	12.8%	13.1%	13.6%	14.0%	14.4%	14.9%
2. Total disability pension	5.2%	5.1%	4.9%	4.8%	4.8%	4.8%	4.6%
3. Survivor pensions	0.3%	0.3%	0.2%	0.3%	0.4%	0.5%	0.6%
4. Length of service pensions	5.6%	5.4%	5.2%	5.1%	5.1%	5.1%	5.1%
5. Social pensions	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.2%
6. Pension for participants to liquidation of consequences of explosion at Chernobyl APS	0.0%	1.3%	1.4%	1.5%	1.5%	1.5%	1.5%
7. Pension for repressed people	1.0%	0.9%	1.1%	1.2%	1.2%	1.2%	1.1%
8. Military pensions.							

Changes in Number and Structure of Pensioners

The baseline of old age pension is set up at 55% of the average wage plus 1% of wage for each year in excess of 25 years of work for men and 20 years for women. Besides that, there are some compensations and supplemental payments envisaged by the law. Over 1994-1997 the size of pension has been risen several times due to the inflation. Main changes took place as follows:

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1994 – increment by 10.80 lei as a result of price liberalization on basic goods and services; there were established differentiated nominative cash compensations of 8, 10, 13 lei with regards to the size of pension;

1995 – increase by 7.20 lei; pension indexation due to inflation;

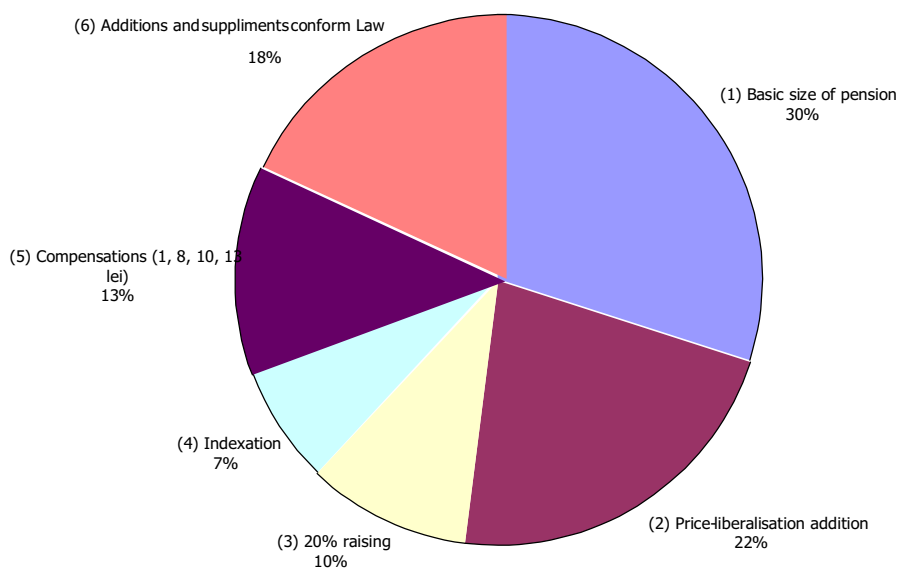
1996 – increment of total number of pensions by 20%.

As a result, all these changes have led to a situation when the basic size of pension constitutes only 30% of the total value of pension. This phenomenon has weakened the link between contributions and benefits. Using wages instead of contributions as a basis for calculating the size of pension undermines compliance to pay these contributions and pushes up pension arrears.

Even with these additional payments, average replacement rate has shrunk from 59.7% in 1992 to 37.7% in 1997. In October 1998 this coefficient constituted 32.2%. Consequently, the share of minimal consumer basket covered by the average pension has dropped significantly: from 18.8% in October 1997 to 16.6% in October 1998. The ratios of pensions increasing are much smaller than the ratios of salaries or minimal consumer basket. Thus, during 1993-1997 the minimal consumer basket grew up by 9.1 times, average salary-by 7 times, and average pension only by 4.4 times.

At the same time changes in the economy (entrepreneurial development, private sector growing, widespread of informal economy, building up of arrears) led to lessening of wages in the total disposable income of people.. The magnitude of this process is too wide: from 71.6% in 1992 to 36.8% in late 1998.

Breakdown of average pension and supplements



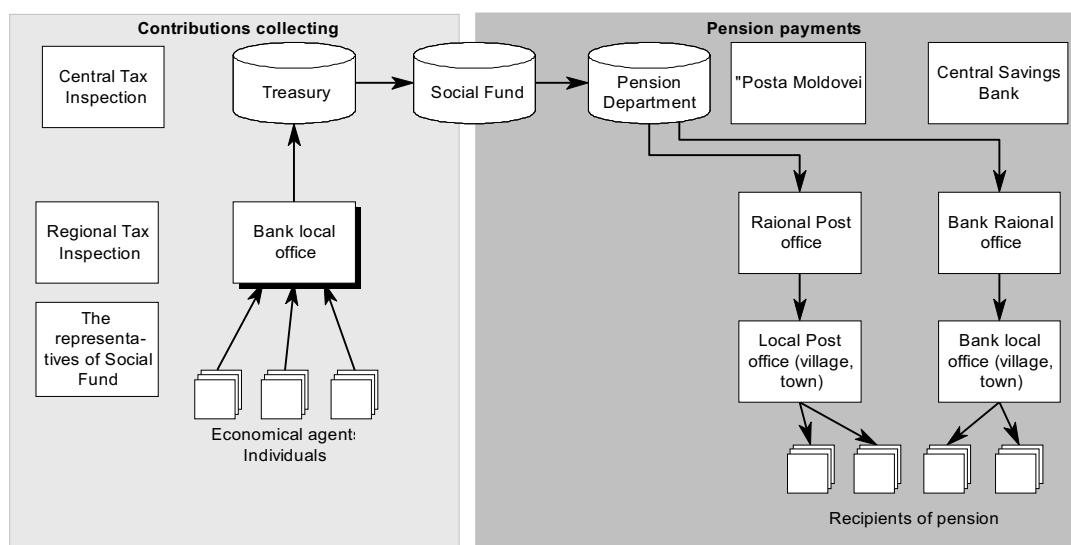
At present the *management of social security system in Moldova is too complicated* being run by a series of institutions: Ministry of Labor, Social Protection and Family; Administrative Board and Executive Division of Social Fund; Pension Department; Local Divisions of Social Protection. In the managing processes are implicitly involved Ministry of Economy and Reforms; Ministry of Finance; Ministry of Defense; Local Public Administration; Trade Unions, and economic agents.

Pensions and other social contributions are financed from the budget of Social Fund, which is formed from the contributions paid by the employers, employees, as well as transfers from the state budget. Although Social Fund does not keep an individual account of

contributions, nonetheless it keeps records on total sum of contributions collected to the Fund, and registers economic agents as contributors.

In managing activities many functions overlap, there is a lack of strict delimitation of authority and responsibility among the institutions/organizations dealing with social programs. Due to broad diffusion among institutions involved in managing of pension system, and also because there is a lack of legal regulations in their relations, it is hardly feasible to do an efficient control of collection and distribution of the social contributions.

The scheme of collection of the social contributions and their distribution is shown on the following figure.



Nowadays organizing the work on computing and paying the pensions is based on a high degree of centralization. Though in the past this system used to be sustainable and easy to manage (taking into account technical opportunities offered by PCs and financing from the state budget), at present it lost its advantages in many aspects and cannot assure an efficient solution for the issues related to the pension system management. Disadvantages of current system are as follows: long terms of processing the information database; big time lag (the process from the application presentation till pension provision lasts 2 months); this job requires large volumes of labor efforts and material expenditures; lack of an operative control at all levels; reduction of responsibility for performing well the work duties.

In the light of above mentioned the *main reasons for reforming pension system* are: failing in collection contributions to the Social Fund; building up of pension and other social arrears; decrease in the level of pension and social insurance; increase of the burden on active population of due to aging of population (calculations show that in the future the situation will worsen because of the high demographic dependency ratio), and also because of high share of privileged pensions; ratio of social contributions are high and split inequitable between employers and employees; high level of overhead expenditures; misallocation of available resources which does not allow to address them towards more needed people; losing of linkage between contributions and benefits and lack of targeting in providing social assistance; interference of functions between social insurance and social assistance; non-adequate legal framework; low efficiency in managing social insurance system.

The on going administrative-territorial reform in Moldova represents also one of the reasons, which urged the necessity of transforming the management of pension system.

The purpose of new reformed pension system is to provide right benefits to the right

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people, in the right form, and at the right time according to the principles of social justice, equity, individual rights, and responsibility in a transparent and sustainable way. Taking into account all these goals, the *main objectives of pension reform* are: to insure elder people with an adequate level of income; to improve financial sustainability of the system; to insure respect of social justice, equity and solidarity principles; to insure a greater recovery of the social costs by the social system.

Main directions of pension reform are as follows:

- Improvement of life standards of current pensioners;
- A new program for the future pensioners;
- A continuous functioning of the system during transition from the old to the new pension system.

There has been elaborated some legislative acts aimed at facilitating the pension reform. Among them: Strategy for Reforming Pension System (approved on September 23, 1998); drafts of Laws On State Pension Insurance; On Non-State (Private) Pension Funds; On Compulsory Social Insurance; On Social Fund. On October 14, 1998 the Parliament has adopted the Law On State Pension Insurance which will come into effect beginning with January 1999.

What is the reality of the pension insurance in Moldova? Failure in collection of social contributions has led to a build up of pension arrears. At January 1, 1995 pension arrears accounted for 128 m lei, in 1996-there were 315m lei, in 1997-23 m lei. Effective on April 1, 1998 pension arrears amounted to 212.6 m lei, from which 21.4 m lei for 1996 year; 48.2 m lei for 1997, and 142 m lei for January-March 1998 year. During January-July 1998 historical pension arrears have been reduced significantly: for 1996 –to 4m lei, for 1997- to 22 m lei. But the overall stock of arrears still remains big-290 m lei as of July 28, 1998.

In order to improve financial sustainability of pension system (and as a result to make better provision of benefits) the new Law On State Pension Insurance envisages:

- piecemeal reduction of early retirement (lists number 1, 2, and 3; mothers with many dependent children);
- increasing the statutory retirement age by 65 years for men and
- 60 years for women;
- ceiling pensions for elderly who combine pension with work activities.

Besides that, in order to achieve a sustainable financial basis it is necessary to put into effect a series of measures on preparing a more realistic and feasible budget of Social Fund; rationalizing the structure of expenditures and excluding from this system the items which are not related to the nature of pension insurance.

The international practice offers several types of pension insurance- PAYGO (based on solidarity principles) which is called *Defined Benefits (DB)* system; accumulation (or capitalization) pension which is known as a *Defined Contribution (DC)* pension system, and *voluntary savings and annuities*.

PAYGO system is publicly managed and based on intergenerational redistribution. Such system works well in countries with young population, but for countries with aging population (like Moldova) it would be inefficient due to an increasing burden on the social protection system.

Accumulation system (DC) is fully funded and is based on personal risk of contributors.

State is involved at a less degree in managing this system. Such system can operate well if there are developed and settled up the institutions of financial market, i.e. investment fund, stocks exchange and others.

Voluntary saving schemes constitute an intermediate chain in a pension system. They offer supplemental retirement income with the means and inclination to save more. It is based on supporting saving versus consumption and envisages creation of so-called quasi saving accounts.

The situation in Moldova shows that the most convenient approach is the multipillar system, which comprises public compulsory pension insurance and private voluntary tier. That is why in conformity with the Strategy for Reforming Pension System and Law On State Pension Insurance the current PAYGO system will be replaced by a system with three pillars which consists of minimal guaranteed pension, old age pension, and individual (private) pensions.

On the basis of the art. 12 of the Law On State Pension Insurance *minimal pension* constitutes the minimal sum which is guaranteed by the state to people who are entitled to receive the pension, but the effective size is less than the minimal level envisaged by the Law. In this case the minimal pension is set at 25% of the average wage in the national economy registered in the previous year from promulgation of the present law. Further the size of minimal pension will be indexed in accordance with the rate of inflation.

Old age pensions are based on insurance principles and are provided to those people who have accumulated the statutory years of contributions and the minimal income required by the Law. In this sense Law envisages that the size of pension is computed on the basis of the average insured income determined in compliance with the total sum of contributions made. The Law also envisages provisions about incentives for a late retirement, and extra work years added to the statutory number.

It is worth to mention that the new pension formula simplifies the process of its calculation, assures a tighter link between contributions and pension benefits, and increases incentives to late retirement. Besides that there were reduced non-insured periods of time, limiting to the following: a) compulsory military service within institutions of Ministry of Defense, Ministry of Internal Affairs, and Ministry of National Security; Department of Civil Protection and Emergency Situations; b) child care till age of 1.5 year.

Individual pensions are a type of voluntary supplemented to old age pension, and managed through private pension funds. Such kind of insurance runs nowadays the insurance company "Asito" but it covers only 3-4% of the total number of pensioners..

The main reasons which hinder the development of individual pension insurance are: lack of suitable legal framework; underdevelopment of financial market institutions; low level of income of the population; lack of credibility expressed by the potential clients towards various private funds.

Calculations made by the Ministry of Labor, Social Protection, and Family shows that in reforming pension system the equilibrium in the budget of Social Fund would be achieved in 2006 and would be positive till 2020. Calculations made by the WB experts shown the same findings and according to them the total sum of contributions could reach 50% of GDP in 2020 (in case of improvement in the administrative capability of the system).

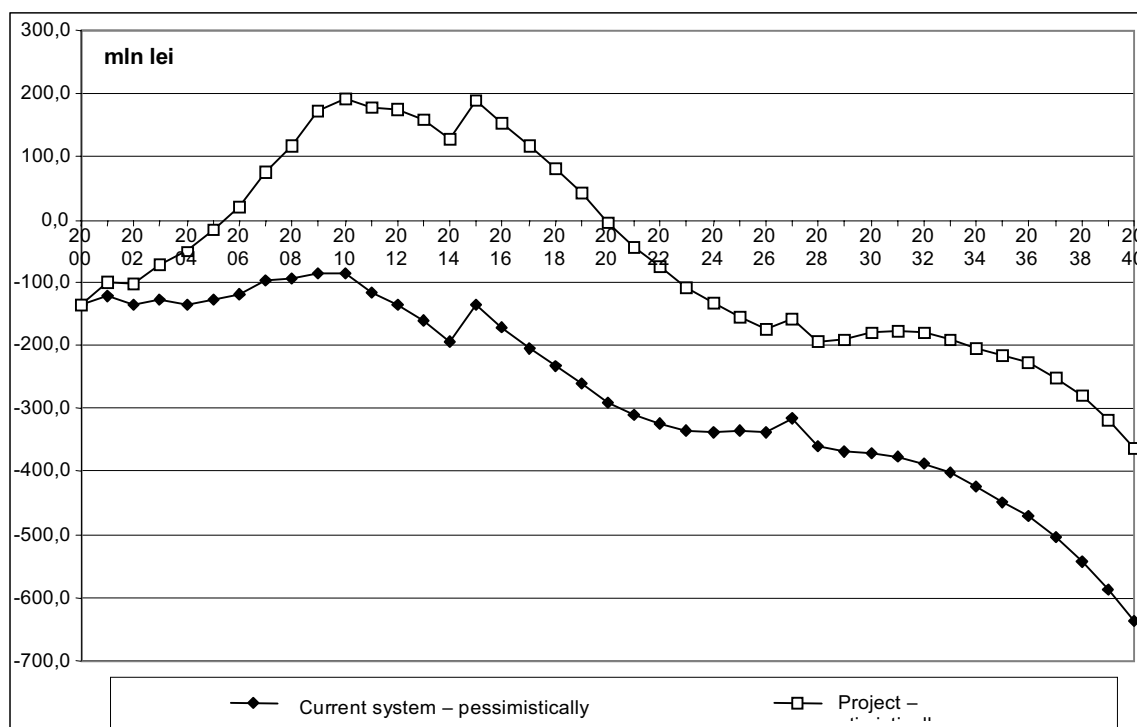
In promoting pension system reform it is critically important to introduce individual accounts in order to keep records on paid contributions. This would improve the ratio of

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contribution collection, and at the same time would intensify the control and monitoring of expenditure distribution.

The program of reforming pension system envisages transition to new principles of social insurance while keeping rights received in the old system. Shifting to a new pension system should be a difficult process and some programs could last from 5 to 40 years. Thus increasing the retirement age will be implemented in 12 years, current pension payments will be eligible more 40 years, supplementing current PAYGO system with a three pillar – during 4 years.

Social Fund Budget (with and without reforms)



Shifting to a new pension system in Moldova encompasses several stages. At each stage the main strategic direction should be adjusted to the new economic and social environment. In this regard it is important to develop and improve a monitoring and forecasting system of pension development.

Besides that it must be taken into account that pension system is not a closed system, it represents a part of the economy texture. In this sense pension reform might not affect all macroeconomic indicators, although there could be some relations between them. First steps are always the most difficult in each enterprise but at the end they lead to a solution of so important issue as pension system is.