

REFORM IN THE SOCIAL SECURITY SYSTEM

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STRUCTURAL DISPROPORTION IN THE PRESENT SOCIAL SECURITY SYSTEM

The services offered by National Social Security Institute (NSSI)

According to the Labor Legislation in Bulgaria the Social Security System obligatory includes all workers in state, public, corporate and private enterprises and organizations or joint ventures. The type of the work, its continuation and the way it is paid for does not reject the obligation for insurance.

The social security services are provided through Social Security Fund which is run by NSSI.

The main incomes in the Social security Fund are collected through:

- contributions to the fund which vary between the category of the labor and the risks covered.
- subsidy from the State Budget if needed
- transfers from the State Budget for special kind of pensions

The main expenditures of the fund consist of:

- benefits, monthly aids for child, pensions
- aids according Labor Legislation, Ch. III, (illness benefits, professional decease, labor hazard, pregnancy, child-birth, etc.)
- pension indexation

Structure of incomes

According to the National Statistical Institute (NSI), the employees for the 1995 have totaled about 3 310 884. 58,13% of them were employed in the public sector and 40,71% - in the private sector. Social security contributions into the National Social Security Institute (NSSI) budget for 1996 are given below:

| CONTRIBUTIONS | PERCENT AGE |
|-----------------------|--------------------|
| PUBLIC SECTOR | 94.02 |
| <i>ENTERPRISES</i> | 76.73 |
| <i>BUDGET SPHERE</i> | 17.29 |
| PRIVATE SECTOR | 5.8 |

The discrepancy between the percent of employees in each sector and the related contributions could have been even bigger since the state sector enterprises are still in arrears to the social security budget with more than 27% of the total contributions they had to make. This disproportion can be attributed to the following reasons:

- the low base of the income on which the contributions are calculated by the private sector. The Bulgarian legislation limits the income on which the contributions are determined from one to eight minimum wages and the most frequently used is the lowest limit. A more detailed research over the data for 1996 shows that only about 41% of self-ensured people pay installments of 32% of the minimum wage to cover all risks, while the rest 59% make pension contributions (equaled to 22% of the

minimum wage). Such a behavior is reasonable since a higher social insurance contributions do not guarantee higher pension in the future. In the same fashion if one person works at more than one job she usually prefers to select the lowest income for insurance. The so established pension system directs much less money to the pensioners compared to the income received by workers.

- The second reason stems from the Labor Code (chapter III, article 149) according to which even if the enterprise does not pay the obligatory contributions, eligible workers receive their benefits. This encourages employers to register the employees in the social security system since the due benefits are paid automatically by the fund. This explains why only 2,5% of the private employers pay contributions to the Social Security Fund based on the minimum wage.

Structure of expenses

According to the Bulgarian legislation the insurance contributions are proportional to the received income, although the percent varies among the different labor categories due to the different retirement age. However, such installments covered not only pensions but illness benefits, labor hazards, child-birth, motherhood and so on. In the most common category of labor, the contribution consists of:

- 22% of the base insurance income for pension (56% of the total contribution¹)
- 10% of the base insurance income for motherhood, illness benefits etc. (26% of the total contribution)
- 5% of the base insurance income for labor hazards and accidents (13% of the total contribution)

Structure of the National Social Security Institute (NSSI) expenses for social security activities is given below:

| | PERCENTAGE OF: | |
|------------------------------------|-----------------------|--------------------|
| | OWN INCOMES | ALL INCOMES |
| A\ PENSIONS | 87.23 | 83.28 |
| B\ AIDS ON LC, Ch.III | 8.48 | 8.09 |
| including:: | | |
| <i>ILLNESS BENEFITS</i> | 4.49 | 4.28 |
| <i>RISING A CHILD</i> | 1.62 | 1.55 |
| C\ AIDS ON BRED² | 7.26 | 6.93 |
| including: | | |
| <i>MOTHERHOOD</i> | 7.26 | 6.93 |

The above data reveals that the pension expenditures consume almost the entire accumulated fund. Hence the contribution rate for pensions is 34% to income instead of the normative 22%. It means that the public sector is the main contributor to the Social Security Fund.

The so described mismatch explains the significant deficit in the Social Security Fund.

¹ The total contribution is made by two part: the first part is paid by the employer and equals either 37%, 47% or 52 % of the base insurance income according to the different labor categories. The second part is always 2% and is paid by the employee. All contributions are subtracted from taxable income.

² Birth Rate Encouragement Decree

AGE STRUCTURE DEVELOPMENT AND MOVEMENTS IN THE DEPENDENCE RATIO (DR)³ AND REPLACEMENT RATIO (RR)

The big variety of risks covered by the Social Security Fund must be separated. Due to the big part of pensions in the social payments the stress of this paper is put on the establishment of separate Pension Fund. The analysis of the two main ratios for the pension insurance - *dependence ratio* and *replacement ratio* is made below.

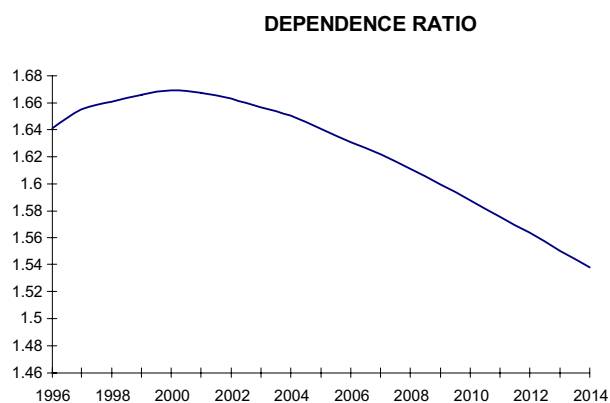
For the year 1996 the DR has been calculated to be 1,641 and the ratio between the average wage in the public sector and the average pension - 0,32. The last number is close to the so called **replacement ratio** (RR) but it is overvalued assuming that the average wage in the private sector is higher than in the public one.

The data from NSI (for the age structure of the population) and from NSSI (for the age structure of the pensioners) have been used to make an age structure forecast of the population until the year 2014. This forecast assumes:

- all people above 18 are either pensioners, unemployed, mothers or workers.
- all working people pay their contributions to the Social Security Fund
- the average wage equals 100%
- there is only one labor category
- 12% of the population is unemployed
- the annual percent of mothers totals 4,18% of the women between 18 and 40
- the annual percent of students totals 11,44% of the peoples between 18 and 35
- 2/3 of students are employed
- a single pension contribution equals 22% of the month income
- there is only personal pensions

With the above *made assumptions* the DR for 1996 is 1,64 while for 2014 it has been predicted to be 1,54. These figures indicate the increase in the pensioners and not proportional increase in the workers. If the percent of the contribution remains fixed for the period 1996-2014 RR will decrease from 0.361 for 1996 to 0.338 for 2014. The comparison between predicted value of the replacement ratio (0.361) for 1996 and the real one (0.32) shows that according to the assumptions, pensioners should receive higher income than actual one. The reason is that not all contributions in practice are based on the average wage. As a matter of fact, the pensioners would receive even lower income if pensions are not funded from other social security sources in addition to the pension payments contributions. The sources are state Budget and the Unemployment Fund .

The movement of the DR over the years shows how the number of workers 'paying' for the single pensioners changes. The lower it is the higher the percentage of the pension installment should be.



³ DR - the ratio between working people and pensioners.

THE INFLUENCE OF THE ARREARS IN SOCIAL SECURITY FUND

A more realistic forecast should reflect the existing discrepancies between the incomes and the expenditures of the Social Security Fund resources.

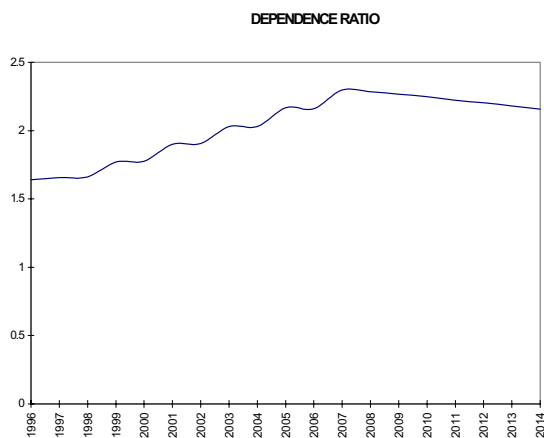
First, the considerably small contributions⁴ coming from the private sector will significantly influence the forecast. Some figures shows that the ratio between the average wage in the public sector and the minimum wage for the country is 3:1 for the year 1996. The number of the ensured employees (by their employers or self-ensured) in the private sector are 36% of the total number of people in the private sector. And most of them calculate their contribution on the lowest income limit.

Second, the arrears of the public sector totaled to 27% of all contributions it should pay. With the above consideration the RR should be 0,172 which is much lower than the RR with the assumption that all working people make installments proportional to their income. In the last case RR should be 0.361. The difference in the above figures shows that if the person is motivated to make regular contributions the pension resources would be much higher with the same installment level.

Aging stricture worsens the pension system. In order to keep the level of the average pension the part of the contribution in the income should increase from 22% to 23,5% .

INVESTIGATION OF THE EFFECT OF POSSIBLE RETIREMENT AGE INCREASE

One of the possible solutions to the negative effects of the aging structure of the population is the raise of the retirement age from 55 to 60 for women and from 60 to 65 for men. If the increase is evenly distributed over the years (retirement age increases by one year every year) the transition period will be from 1998 to 2008. The DR would improve considerably in this case.



If we keep the assumption that all workers pay all due contributions of 22% of the average wage, the pension level when the reform completes (in 2008) would be 0.503 of the average wage and 0.475 in 2014. If the level at 0.361 of the average pension should be kept, the part of the contribution in the income should change from 22% in 1996 to 15,8% in 2008 and to 16.7% in 2014.

When the forecast reflects the distorted flow of fund in the Social Security Fund, the change in the part of the average pension would be from 0.172 of the average wage in 1996 to 0.239 in 2008 and 0.226 in 2014.

The increase of the pension age will have medium-term effect if the aging structure continue. Another possible solution to compensate the negative impact of the aging

⁴ Due to the use of the minimum wage contribution calculation and the big arrears

structure is a constant increase in the taxes. It is important to stress that it will not increase neither the motivation of the worker nor the motivation of employer to change their behavior.

THE PROBLEMS OF SOCIAL SECURITY SYSTEM

In the light of structural reforms the reform in the social sector plays important role.

A global social security reform is under way not only in countries in transition but also in developed countries. The main reason for reforms is the collapse of the state pension systems.

The reform in the social security is a whole set of structural reforms on labor market, financial markets and public sector.

At the moment the pension reform is a central part of discussions in many countries. The main issues of the discussions are : what kind of pension system to be adopted: pay as you go(PAYG) or fully funded (FF). Should this system be run by the government or should be private?

Bulgarian Pension System

There is a PAYG system in Bulgaria. That system has many negative sides which in combination with the expected aging of population will be a real problem in the near future.

3 473 526 people have been insured at Social Security Fund in 1996. Only 359 271 persons insured themselves at their own expenses (23% or 32%).

The Social Security Fund's deficit amounts to 5206. 8 mln. BGL and is covered by the Ministry of Finance. The nature of an old PAYG system is such that it could not be financially balanced.

Spending on pensions increases exponentially as population ages. In some countries pensions are above 15% of GDP. In Bulgaria - 6.7 % of GDP.

Problems

There are two general problems, closely related.

The first problem is the decrease of the dependency ratio (number of people, which make contributions to pensioners). That problem is related from one side with the aging of population and from the other side with peoples' unwillingness to contribute to the fund. The deterioration of the dependency ratio, which is expected in many Western Countries, leads to extension of losses of PAYG system, when contributions and pensions remain the same.

The second problem is aging of pension scheme, which is caused by deteriorated demographic structure. These are the main reasons for State Fund's deficits. Such deficits create press for growing subsidies from the budget.

The need of reforms is determined by the huge and growing deficit.

Solutions

There are two approaches:

Reconstructing the existing system

a) increase of contribution rate

The increase of contribution rate is a measure which will not face public support. According to the data in Bulgaria the contributions are very high. Therefore such variant is inapplicable.

b) restructuring of payments

Restructuring of payments could be made by creating a separate Pension Fund, Health Insurance Fund and expenses for rising a child, motherhood and etc. should be undertaken by the State Budget. Such a dividing will lead to transparency and will motivate people to make their contributions. At the moment the amount of pensions is lower than people's expectations.

The question how that Pension Fund should operate remains questionable.

Positive and negative sides of private and public insurance will be further discussed.

c) Increase of the age of retirement by 5 years step by step

The burden on the working population of PAYG system depends to a considerable extent on the dependency ratio. An alternative strategy to cutting down the level of pensions promised to be paid, is to rise the age of retirement. According to the information the idea of increased age of retirement is well accepted in many Western countries. Such kind of programs should be implemented in connection with changes in the labor market and other programs like the unemployment insurance. The application of this program may give rise to unemployment, hence, many people will not be able to contribute and to receive pension in the future.

The results from increase of the age of retirement in Bulgaria were described above.

d) Mixed variant

According to the mixed variant, the State should provide a minimal pension on the base of the period of contributions or the length of service and to leave a possibility for employees to contribute to a private funds.

Such a mixed system exists in England. State pension is only 50% of pensioner's income, and around 23% are from private pension funds.

At the moment in two-tier system is under the discussion in Hungary. All employees will be obliged to contribute 1/3 of their installments to private pension funds. The newcomers in the labor force should adopt the new system immediately. Currently working people should also contribute to private funds.

It is clear that private pension funds are able to operate successfully if there is economic and financial stability. Financial and capital markets are not very well developed in Bulgaria, which creates many obstacles for private pension funds. Therefore the need of radical pension reform is obvious.

Privatization of Social Security

There is an alternative to the PAYG system - Fully Funded (FF) system.

Positive and negative sides FF and PAYG systems

a) A PAYG is a mandatory social contract of transfers from workers to pensioners. A FF system provides a close link between workers contributions and benefits, which implies that the FF system is a fair one. It leads to changes in the labor market and creates a motivation for old age saving.

Under the FF system the average return on old-age saving is determined by the market interest rate, while a PAYG system provides a real return on contributions equal to the real rate of growth of the wage bill, which is lower than real return on capital. Therefore PAYG provides lower rate of return in comparison with the FF system.

b) Under the PAYG system it is possible for powerful groups to secure generous pensions from the political establishment. (Professional Trade Unions)

c) Due to the expectations for small pension under the PAYG system, a great number of people are shifting into informal labor markets, where payments for social security, as well as taxes could be easily avoided.

Here are some of the main features of a private pension system :

- individual accounts
- decentralized private management
- rivalry, individual choice
- strict supervision
- annuity or possibility for withdrawing of accrued sum

A transition from PAYG to FF pension system.

There are some opinions that the change of PAYG with FF will increase savings, will eliminate distortions on labor market and will sustain growth in a long run.

The transition from PAYG to FF is a long process of reforms.

a) structural changes

Privatization of social security has three elements

- workers contribute to a personal retirement's accounts, rather than to a common pension fund
- the government should create a plan to finance the transition
- the government specifies portfolio allocation, tax, bequest and withdrawal rules, which regulate the individual accounts.

WE have to take into account that there are two kinds of pensions, which should be paid:

1) pensions to the current pensioners

2) pensions, which should be paid in the future to those, who have been contributed to the PAYG.

A problem arises in family couples, with one working member. In such cases the accrued sum should be divided between them. A similar approach should be implemented in a case of divorce. Therefore the necessary laws should be created.

Financing of the transition

The main question is how to finance the transition.

a) debt financing

A straightforward way to finance the transition deficit is by issuing new government debt. According to Corsetti and Schmidt-Hebbel (1995) a debt financing implies that national saving and capital stock are only marginally affected.

b) tax financing

The second possibility to finance the transition deficit is by rising taxes which is equivalent to the combination of pension reform and contractionary fiscal policy.

A tax financed transition hurts transition generations and benefits future generations and in the same time encourages higher saving and capital formation, which leads to the increase of growth in the long run.

As it was pointed out FF system eliminates labor market distortions, but creates tax distortions. Tax distortions are permanent if the transition period is debt-financed. (we are considering only general taxation, not payroll one). In the same talking Kotlikoff, Smerts and Williser (1996) asserts that the most appropriate tax is tax on consumption. (when one's wealth is spent on consumption, a tax should be paid).

It should be mentioned, that the pension reform is a part of our efforts to liberalize the economy.

As it was described the Bulgarian pension system is in crisis. It is better to undertake a radical reform, than to reconstruct the PAYG system, which will deteriorate the problems, having in mind the aging of population.

Literature

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