Development of the Pension System in Bulgaria in the Context of a Modern Market Economy

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Abstract - **The current article explains the nature and analyzes the status of the pension system in Bulgaria. It distinguishes between the positive and negative features arising as an aftermath of the reform conducted in 2000. It also outlines the prospects for the development of the system in the future.**

Index Terms—**three-pillar pension system, pension reform**

I. INTRODUCTION

In Bulgaria, the transition from a socialist, centrally-planned economy to one based on free market principles has created a number of financial problems with implications for the reproduction of the individual, the collective and society. From the very onset of the transition period apprehensions have been voiced that addressing the issue of the sustainability of the pension system will be protracted and challenging and that the price will ultimately be paid by the labour force, capital and society. The only questions that remained unanswered at the beginning of the transition period were how long the process was going to be and what price would society pay.

During the period in question the insurance system operated at a loss with a high relative number of pensioners who, objectively, are not a productive part of society. Problems in relation to their subsistence have occurred and still need to be addressed. The anticipated crises have imperatively called for creating buffers with a view to ignoring the sharp fluctuations in the amount of the funds paid into the insurance system. One such buffer was the Silver Fund.

The transition period put the entire insurance system under enormous pressure. The pension system had and continues to have a central place and the changes to it were rightly the subject of broad social, economic and political debates. In general terms, the goal of the system was to objectively raise the standard of living of pensioners who make up 26 percent of the entire Bulgarian population through a combination of mandatory – from the point of view of reproduction security – and voluntary pension insurance.

The appraisal of the changes undertaken during the twenty-year transition period shows that reforms fall short of the expectations of society and the requirements for a functioning market economy. Is this so because they were partial in nature; were not well thought out; or were not consistently applied? Or is the answer a combination of the two? Seeking to address these issues led to a large-scale reform, which was form of expanding the scope and altering the model of the pension system.

In parallel to mandatory state insurance a private insurance system was designed and set up, so that the current insurance system has three pillars (layers). The first one known as the public social insurance pillar has existed for a long time having been set up in the period of the centrally-managed (planned) economy. That pillar was called on to cover approximately two-thirds of pensions. It is essentially based on a pay-as-you-go principle. The second pillar, known as the additional mandatory pension insurance, was to be based on the principle of private accounts. Two funds were set up under the second pillar – a Universal Pension Fund (UPF) and a Professional Pension Fund (PPF) whose aim was to allow a significant amount of capital to accumulate, which would cover approximately half of the remaining one-third (approximately one-sixth) of pensions. The two funds were established in 2001 and 2002. The UPF was set up for the younger generation only, born after 31 December 1959 and the PPF – for those working in difficult and hazardous conditions (approximately 180 000 workers). The other half of the remaining one-third will be available only to those pensioners, who can afford saving for old age. For this group, the third pillar known as the additional voluntary pension insurance was set up as far back as 1994, i.e. prior to the 2000 reform of pension insurance. According to expectations at the time the goals of the reform would be achieved over a period of 20 to 25 years.

What were the main results achieved after the recent changes in the pension system?

The answer to these questions should be sought in the overall development of the pension system and its constituent pillars following the reform undertaken in the year 2000.

II. THE FIRST PILLAR OF THE PENSION SYSTEM

A. *Positive features of the public pension system*

Regardless of the relatively short period during which it has functioned, the following positive trends in the set up and management of the mandatory public pension insurance system can be highlighted:

1) Enabling the possibility to make long-term payments into a separate fund and defining the precise scope of the payments. The removal of the old system of making long -and-short-term payments into a Public Insurance Fund;

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2) Enabling the possibility to set aside reserves was a necessary step towards a transition from a pay-as-you go financial arrangement to a pension coverage system.

3) Adopting the principle of a self-financing fund was a necessary condition for viability and stability. As a result, achieving a higher substitute level of the average pension per retiree as a share of the average national insurance income measured through the income substitution index. In the period between 2002 and 2010 a stable trend towards an increase of the money paid into the fund has been observed. However, it should be taken into account that the fund does not fully cover the level of substitution because it does not take into account the contributions towards the additional mandatory and voluntary insurance, respectively.

4) Ensuring a gradual transition to the new retirement system; a relatively gradual increase of the length of service and the retirement age in order to mitigate social tension and allowing for a gradual adaptation of the workforce to the new retirement system.

TABLE I
THE INCOME SUBSTITUTION INDEX, 2002-2010 [1]

Year	Pension paid vs. average net monthly insurance income	Pension paid vs. average gross monthly insurance income
2002	49.93	39.38
2003	49.63	39.41
2004	50.97	40.40
2005	51.63	40.60
2006	53.30	42.90
2007	54.00	43.10
2008	53.32	41.75
2009	56.28	44.06
2010	58.39	46.19

5) Adopting the tripartite principle in the management of the pension fund through stakeholder involvement in the insurance process thereby fostering greater trust in the mandatory pension insurance system;

6) Introducing pension contributions that are covered by the insured person

According to the adopted model contributions are split between the insurers (employers) and the insured (workers and employees) in a certain ratio – 75:25 in 2004 and increasing by 5 percentage points for the insured each subsequent year so that it reached 60:40 in 2009. The objective is to ensure the insurance weight is shared equally (50:50) between employers and workers in the future as an incentive aiming to boost employer investments.

7) Higher requirements for length of service during which insurance contributions are made prior to retirement.

This is expected to partially offset the negative demographic trends in Bulgaria and lower the insurance burden on economically active persons. Over the period 2001-2010 a trend towards a decrease of the support ratio, also known as the pensioner figure, has been observed.

8) Removing the upper limit of pensions in the long-term and tying in the minimum pension to the social pension amount.

9) The intended removal of the current ceiling capping the maximum insurance income to be replaced by the possibility for each worker to pay insurance on the basis of their actual income should be seen as a positive development.

B. Positive and negative results of the pension reform

What results did the pension reform achieve over this relatively short period? A summary is set out below.

1) Relatively low pensions: in comparison to most countries in Europe pensions in Bulgaria are low – in the first decade of the 21st century their share of GDP remains below 10 per cent. In most economically developed countries, following retirement the pension received is two-thirds up to three-fourths of their income in the last several years prior to retirement. In Bulgaria that ratio is about fifty per cent of the pre-retirement income. In the last decade a trend towards greater dynamics and growth in real terms of the average pension per retiree has been observed. However, the rate of increase has not been sufficient to raise the standard of living of pensions to that of their counterparts in developed countries.

Low pensions are primarily due to the low insurance contributions whose level was consistently decreased over the last ten years. In 2006 alone the contributions paid into the State Pensions Fund was decreased on several occasions.

Besides the decrease in the amount of pension contributions after 2000 the amount of pensions paid was increased and the coverage of the pension system was extended. This was coupled with higher subsidies for the insurance system from the State budget with most funds being paid directly into the pension system. In 2009, a part of the subsidy was "legalised" as a 12% State budget contribution to the sum total of insurance revenue, whist the remaining part remains a subsidy proper. These developments have had a destabilizing effect on the pension system.

Fig. 1 [2] shows the continually increasing deficit in the Pensions Fund.

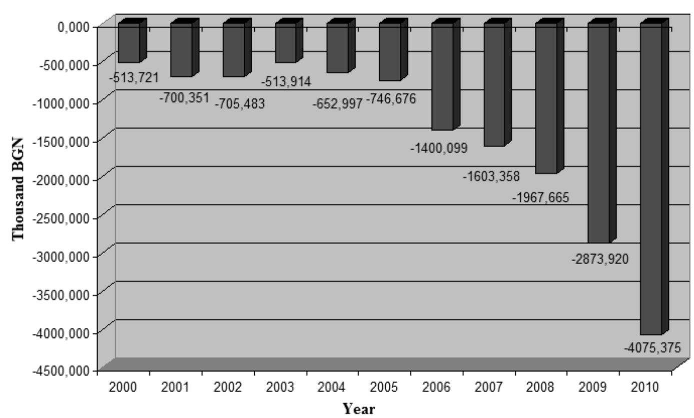

Fig. 1. Pension fund deficit in the period 2000-2010

A growing rift has occurred between the decrease in pension insurance contributions and the sharp increase of pensions by the previous governments in power over the period in question. It can be reasonably argued that at the moment Bulgaria is receiving loans that enable it to continue to pay pensions. In the last few years the State budget deficit is lower that the deficit in the NII budget. For example, in 2010 when State budget deficit stood at BGN 3.684 billion [3], the NII received a subsidy of BGN 4.336 billion [4]. Substantially the same happened in 2011 when the State budget deficit stood at BGN 2.160 [5] and the NII received a subsidy of BGN 3.871 billion [6]. Had the NII addressed the problems relating to early retirement, disability pensions and the low retirement age, respectively dealt with the deficit issue, Bulgaria would have had a surplus of BGN 652 million in 2010 and BGN 1.711 billion in 2011. It makes no economic sense to continue paying pensions through government loans. In countries like Germany, for example, by law debt may only be issued for investment purposes and not for the payment of pensions.

The current government subsidy that makes up the total revenue of the pension system exceeds 50 percent. The government's share is primarily funded from tax revenues, which form approximately 90% of the State budget – more than two-thirds (73.13%) [7] represents the share of indirect taxes (VAT, excise and customs duties). The draft 2013 State Budget Act retains a very similar share of indirect tax revenues – 73.45 percent [8]. In other words, the first pillar is currently funded mainly from taxes and insurance contributions. This means that pensioners too contribute to the pension fund from which their pensions are paid.

2) The NII no longer enjoys a measure of relative independence and is being prepared for privatisation by the State. This will render it even more vulnerable to political influence and make pensioners dependent on decisions underlined by political expedience. This demonstrates that one of the major requirements for the pension system – its independence as the basis for predictability of the system over a relatively long period – has essentially been undermined.

3) Pension system failures: the adopted points-based retirement system has been roundly criticised. Its greatest failing is its inadequacy in terms of the choice of a retirement date. This can be overcome by abandoning the current system according to which the date of retirement is a sum total of absolute numbers (length of service in years and length of the period during which insurance contributions have been paid) and introducing an alternative, which relies on one of two criteria – reaching a certain age or actual length of the period during which insurance contributions have been paid, which will allow a retiree to receive a pension in a rate calculated on the basis of the points-based system.

4) The unnecessarily complex pension calculation system, which fails to take into account the income received by the insured, respectively insurance contributions paid and therefore contribution to the funding of the pension system, during their entire working life. This means that in all likelihood the calculated pension is not fully realistic;

4) Low rate of collection of insurance contributions. The introduced insurance thresholds partially boosted collection but failed to produce a major improvement. In 2010, the collection rate stood at 93.97% (or almost 94%) against 86.4% in 2009. Collected insurance revenue in 2010 was 6.03% lower (a shortfall of BGN 213,719.9 thousand) as compared to planned annual revenue [9]. The financial stability of the fund remains in jeopardy because the decisive factor for stability remains the accumulation and maintenance of a considerable reserve. There are still many companies, which hire workers and employees without an employment contract, i.e. don't pay any or pay social insurance at reduced rates.

5) In 2002 a possibility was created to receive a social pension for disability in addition to another pension. This prompted many retirees, particularly those of a more advanced age, to request medical certification and hence entitlement to that pension. The average number of social pensions for disability in 2010 was 492,243 and in 2009 it stood at 488,334, which represents an increase by 3,909 pensions. The average number of social pensions for disability in 2010 stood at e 958,947 or slightly less than all pensions paid in Bulgaria (The total includes the pensions for disability due to general illness or occupational disease, social pensions for disability, civil and military pensions).

III. THE SECOND PILLAR OF THE PENSION SYSTEM

In the second pillar of the pension system the following organisational and managerial arrangements for mandatory pension insurance merit a positive appraisal

A. Positive features of the second pillar

1) The underlying capital principle, which allows funds to accumulate into the individual accounts of future retirees but also increase the amount of the funds through investment. This will lower the burden for future generations for pensioners living at the same time. According to expectations the second pillar is to provide approximately 15-20% of income from work.

2) The principle of legal and hence financial independence of pension companies and the additional mandatory pension funds (occupational and universal). By separating the activities of the companies and the funds the interests of the insured persons are safeguarded and guaranteed as a matter of priority;

3) The sole object of the company's activity is pension insurance and a prohibition for the company to act as a lender. This is also a requirement for obtaining a permit (license) for the company and obtaining a court registration for the funds. Government regulation is ensured through the Financial Supervision Commission (FSC) and representation of the interests of the insured through a Board of Trustees.

4) A direct link between the amounts of revenue received from additional mandatory pension insurance and insurance income paid and the income from their investment. This link and functional dependence between contributions and pensions is a personal incentive for the insured to proactively provide for their future.

5) The insured person can choose whether to pay pension insurance into an occupation and/or a universal pension funds and the receipt of a pension in case of earlier retirement. Retirees are guaranteed the minimum profitability from the investments made by pension funds.

6) The regulation of activities includes a set of rules on investing in certain instruments that are allowed to pension funds. The underlying objective is guaranteeing the savings of the insured and making a profit within the limits of a certain diversification of the investment portfolios of pension funds.

7) The payment of the funds of insured persons into individual accounts, which are inviolable, and the possibility to receive in case of earlier retirement and the prohibition on the use of accumulated funds for any other purposes should be appraised as highly positive.

8) The relatively well diversified insurance portfolios of the two funds.

B. Negative features of the second pillar

At the same time certain failings in the system for additional mandatory pension insurance have stood out, which are summarised below.

1) Relatively low pensions are largely due to the low pension contributions, which over the greater part of the period was 3% of the insurance income. The rate has now been raised to 5%, which is still insufficient. From 1 January 2017 pension contributions paid into universal funds is set to increase by 2 percentage points, i.e. from 5% to 7%.

The average amount of the funds accumulated in an individual account with universal pension fund at the end of 2011 stood at BGN 1,123.41 and is highly insufficient to cover the percentage it will form of the future pension. Occupational pension funds are in a situation that is essentially the same. At the end of 2011, 247,333 persons were paying contributions to them and the net assets of the funds stood at BGN 471,129,000 [10]. The average amount per insured accumulated with occupational pension funds stood at BGN 2,085.52. This coupled with the reasonable assumption that future retirees will be receiving pensions over longer periods of time, means that the sums in question are highly insufficient to cover the intended percentage of the future pension.

At present there are nine licensed pension insurance companies in Bulgaria. A breakdown of the average amount accumulated per individual in the different funds per gender and age is shown on Fig. 2 and Fig. 3.

It is easy to notice that the funds accumulated into the accounts of women who typically live longer are less than those accumulated into the accounts of men.

2) Insured persons were attracted without a comprehensive awareness and information campaign at a very high cost for the private companies.

3) On average, the insurance culture of the population is relatively low. This is due to the ineffective campaign aimed to attract them as clients of the pension insurance funds.

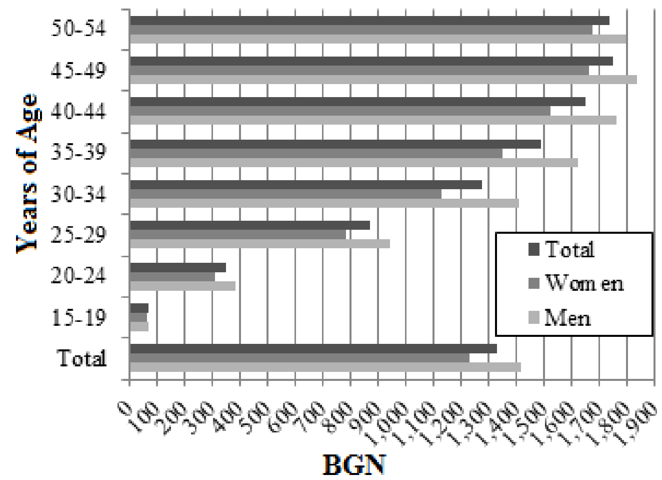

Fig 2. The average amount of funds accumulated per insured person in the universal pension fund at 30.09.2012

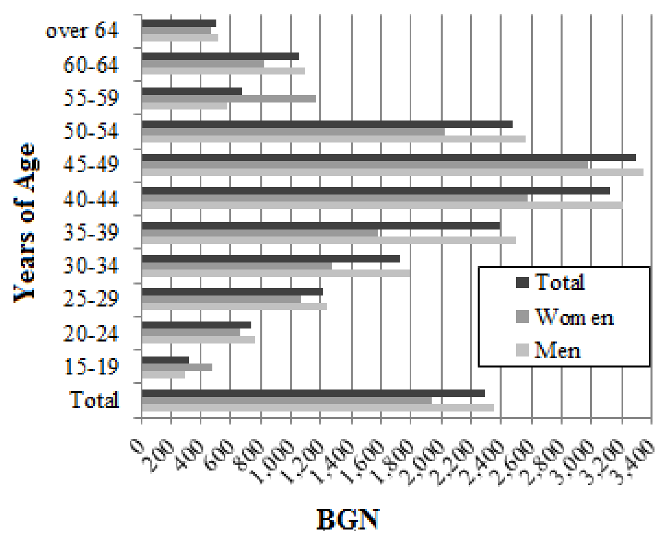

Fig 3. The average amount of funds accumulated per insured person in the occupational pension fund at 30.09.2012

4) The underlying principles of the methodology for distribution of insured persons who had failed to choose a pension fund following the campaign was incorrect and not in line with free market principles. It would have made economic sense to deprive large companies of the possibility to insure persons on an ex officio basis for a certain period so allow smaller ones to reach parity. A similar arrangement was introduced in Poland.

5) The highly complex requirements for licensing pension funds remain a problem.

6) The State should provide support to the persons not covered by those subject to mandatory insurance. This group covers all individuals born before 31 December 1959 who do not pay contributions into a universal fund. This may be achieved through a subsidy from the State budget or another source.

IV. The Third Pillar of the Pension System

The third pillar of the pension system comprises the voluntary pension insurance schemes.

A. Main features of the third pillar of the pension system

A summary of the consequent results of the reform is set out below:

1) In the last 17 years 595,287 persons have been paying voluntary pension contributions. The net assets in these funds stand at BGN 564,724,000 and the average amount of funds accumulated per insured is BGN 948.66 [11]. 5,078 persons pay voluntary pension contributions under occupational schemes with net assets of BGN 3,984,000 and an average amount of funds accumulated per person of BGN 784.56 [12]. Only one pension scheme operates under this fund.

A breakdown of the average amount accumulated per individual in the different funds per gender and age is shown on Fig. 4 and Fig. 5 [13].

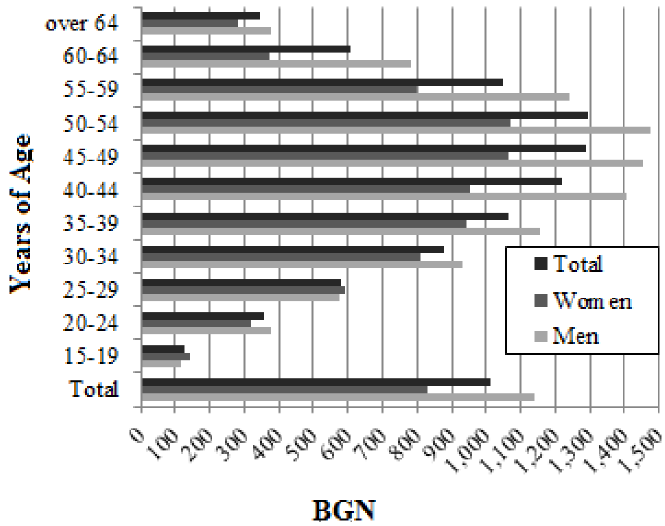

Fig 4. The average amount of funds accumulated per insured person in the voluntary pension fund at 30.09.2012

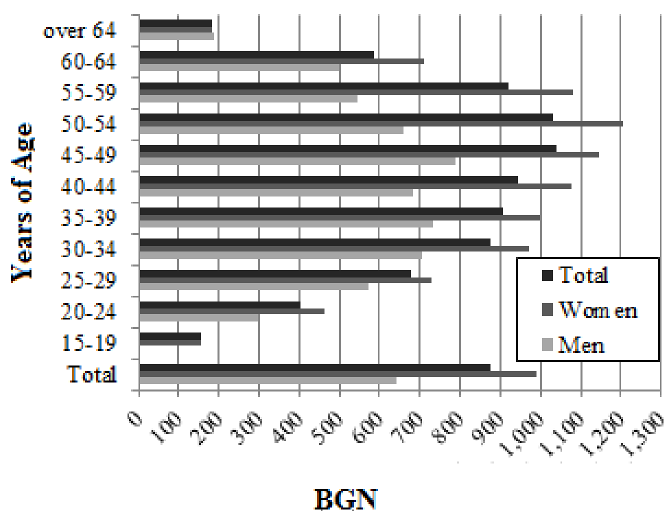

Fig 5. The average amount of funds accumulated per insured person of the voluntary pensions contributions under occupational schemes at 30.09.2012

The higher amount of funds accumulated in occupational schemes under the voluntary pension insurance fund is due to women being the majority of the workforce insured under the sole occupational scheme operating in the country (that of DSK Bank).

The results achieved are primarily due to existing tax incentives for the insurer and insured individuals. These incentives have been modified several times since the setup of additional voluntary pension insurance. Despite the incentives, however, the number of insured individuals shows a negligible growth rate;

2) The money accumulated in the individual accounts of future retirees in the different funds differ substantially. Under occupational schemes with voluntary pension insurance funds their total amount is BGN 4,975,000 as at 30 September 2012 or 0.83% of the net assets of the two funds. This significant difference in the amount of net assets can be explained by the fact that only one such pension scheme currently operates under one of the pension insurance companies – POK "DSK Rodina" AD;

3) Similar to additional mandatory pension insurance diversified investment portfolios have been set up for voluntary pension insurance under occupational schemes as well.

4) One of the shortcomings of the existing system for additional voluntary pension insurance is the limitation by the employer of the right of the employee to use the funds accumulated in their individual account prior to the date of retirement.

V. Conclusion

The conducted analysis demonstrates the failure to follow a systematic approach in the organization and management of the pension system. Reforms remain partial and inconsistent at best and serve to distort the entire course of its development. With regard to the specific insurance model, it should retain its present overall structure. The capital (private account) element as a component of the income of pensioners should be strengthened. The calls for full privatization of the pension system are untenable. In the case of Chile, the outcome was rather controversial.

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