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Collection of Pension Contributions: Trends, Issues, and Problems in Central and Eastern Europe

The Collection of Pension Contributions: Trends, Issues, and Problems in Central and Eastern Europe

EDITORS

ELAINE FULTZ

TINE STANOVNIK

International Labour Office

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About the Authors

PREDRAG BEJAKOVIĆ is a researcher at the Institute of Public Finance in Zagreb, where he has contributed to a number of projects, including “The Underground Economy in the Republic of Croatia,” “The Development of the Tax Administration in Croatia” and “Pensions Reform and a Sustainable Budget.” He is co-author of a number of books in the areas of economics, public finance and labour economics.

AGNIESZKA CHŁOŃ-DOMIŃCZAK is the director of the Department of Economic Analyses and Forecasts at the Polish Ministry of Social Policy. She holds her Ph.D. degree in Economics from the Warsaw School of Economics. She previously worked in the Office of the Government Plenipotentiary for Social Security Reform, at the Gdansk Institute for Market Economics, and as a consultant to the Ministry of Labour and Social Policy. She also worked as a consultant for the ILO, World Bank and the OECD. Her research focuses on pension systems, labour markets and social policy.

ELAINE FULTZ is the senior specialist on social security at the ILO Budapest and the manager of the project which produced this volume. Prior to joining the ILO, she worked at the Social Security Subcommittee of the Committee on Ways and Means of the U.S. House of Representatives. She has written on a wide range of social security issues. She holds a Ph.D. from the Wagner School of Public Service at New York University.

LEVENTE L. MÁTÉ is a senior consultant for the Central Administration of the National Pension Insurance Fund in Budapest and an adjunct professor at the Department of Labour Law and Social Security at the University of Szeged. He is the main designer and systems analyst of the computerised Hungarian pension claim resolution system. He is also a co-author of a major ILO study of the Hungarian pension reform of 1998.

TINE STANOVNIK is associate professor of economics at the Faculty of Economics and senior research fellow at the Institute for Economic Research in Ljubljana. He was a Fulbright scholar at the Institute for Social Research (University of Michigan) in the academic year 1989–90 and at Drury University in the academic year 1998–99. He has published widely on pension reform issues, income and income distribution, taxation and social protection.

CRISTIAN TOMA is General Manager of the Contributions Control Division in the Romanian Ministry of Labour. He graduated from the Law Faculty of the University of Bucharest and later obtained a postgraduate degree in International Law. He has participated in several specialised courses on social security and consults regularly with the ILO on social security issues.

KARMEN VEZJAK is undersecretary for economic and financial issues in the Government of the Republic of Slovenia, Office for Legislation, after working for a decade for an international trading company. She graduated from the Faculty of Law and later obtained a master's degree from the Faculty of Economics at the University of Ljubljana. Afterwards she joined the Ministry of Finance, Head Office of Tax Administration.

Foreword

This volume describes recent efforts to strengthen the collection of pension contributions in five countries of Central and Eastern Europe: Croatia, Hungary, Poland, Romania, and Slovenia. It is an output of the ILO project, *Strengthening Social Protection in Southeast Europe*, which is being carried out with financial support from the Government of France. The work was undertaken within the framework of the Social Cohesion Initiative (SCI) of the Stability Pact for South Eastern Europe, which provides international support, both technical and financial, for social reconstruction in the region following the turmoil of the 1990s.¹ The research component of the project, of which this analysis is part, examines the restructuring of national social security schemes. The studies examine both social policy formation and consequent experience with implementation of legislated reforms. Their broad objective is to provide countries considering reform with information on the recent experience and policy results of neighbours facing similar issues. Through these studies, in association with technical support, we also seek to empower the government's social partners as participants in the social policy process.

The collection of pension contributions is one of several topics examined in the project research component. Other volumes in this series will focus successively on: 1) strengthening the delivery of social services to persons in need; 2) strategies for enabling persons with disabilities to engage in rehabilitation and gainful employment; 3) overall social spending across the region, comparing national expenditure levels, financing, coverage, benefits,

¹ The countries of the Stability Pact for South Eastern Europe are Albania, Bosnia, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania, and Serbia and Montenegro.

and administrative costs, and assessing the effect of social spending in reducing inequality and poverty;² and 4) the role of social dialogue in shaping pension reforms. The first two of these will be published in the summer and fall of 2004, the remaining ones, in 2005.

This book is the work of many authors, all of whom are recognised on the About the Authors page. On behalf of the ILO, I thank them for their important contributions. In addition, Urszula Lonc, the regional project coordinator, facilitated the work of the team throughout the research period, providing close liaison among all participants, making the group meetings smooth and efficient events, and overseeing the many steps in this publication. Ágnes Fazekas, project assistant, provided efficient support throughout the process. Eileen Brown provided final editing of the reports.

Finally, I thank the French Ministry of Social Affairs, Labour, and Solidarity for its financial support for this project. The ILO deeply appreciates the commitment of the French Government to supporting the recovery of South Eastern Europe and values its understanding of the significance of social security for social cohesion.

We at ILO Budapest hope that these materials will further regional efforts to strengthen the collection of pension contributions and, through these efforts, to extend and improve the social protection of CEE workers.

Petra Ulshoefer
Director

² The third study will be based on Social Protection Expenditure and Performance Reviews now being undertaken by a network of national experts with support from ILO Budapest and the Financial, Actuarial, and Statistical branch of the Social Protection Sector, ILO Geneva.

Chapter 1

Introduction

Elaine Fultz and Tine Stanovnik

One rarely reads or hears a discussion of pension reform in Central and Eastern Europe that fails to mention the problem of lost contribution revenues. The root of this problem lies in the early years of transition, when most countries lost a large number of formal sector jobs, in the range of 20–30 percent.¹ Some of these workers left employment entirely, but many found work in the informal sector, beyond the reach of pension collection institutions. In addition, the 1990s witnessed a decline in compliance with the contribution requirement among registered firms and individuals in the formal sector. In many countries, concealment of workers and underreporting of wages became widespread practices, as did government tolerance of contribution arrears by large firms with weak financing and close associations to the state. The resulting losses of revenues have fueled pressures for cuts in pension benefits (i.e. reduced pension adjustments, increased retirement ages, and lower replacement rates) and required annual state subsidies of pension systems.

Yet despite frequent allusions to this problem in public discourse and its serious consequences for scheme financing, efforts to find solutions have so far been limited. In most countries, pension policy deliberations have been dominated by the public-private debate, and basic issues of scheme governance such as collection of contributions have remained on the sidelines of action.

¹ *Economic Survey of Europe*, 2004/1, UNECE, Table 5.

Tripartite social dialogue rarely touches on compliance problems, nor is there much in the way of public education on the hardships that non-complying workers face when they retire, become disabled, or die and leave survivors at an early age. There has also been little investigation into the characteristics of the non-complying firms and workers – i.e., what portion is in the grey or black economy or in family businesses, what is their capacity to pay contributions, and what might induce them to enter or return to the pension system.

This volume seeks to fill part of this gap. It examines collection issues and problems in Central and Eastern Europe, focusing primarily on five countries: Croatia, Hungary, Poland, Romania and Slovenia. They were selected to exemplify different arrangements for collecting contributions and different pension reforms that have a bearing on collections. The country studies are organised along similar lines to facilitate comparisons: they first describe the collection process as it occurs in each country, including its component functions of control, inspection, and enforcement. Then they chart recent national trends using several measures of compliance.² They seek to explain the observed trends, to identify the main sectors and firms that are failing to make contributions, and to assess the legal consequences of non-compliance for workers.

A comparative review of the studies (Chapter 2) analyses patterns and trends across the countries. Four broad patterns stand out in this comparison. First, it indicates the continuing seriousness of weak compliance as a regional problem. The covered wage bills³ computed for the countries fall well below the minimum level for developed economies, and none of the five has yet

² These are: 1) the covered wage bill; 2) the effective contribution rate; 3) the contribution gap; 4) contribution debt (arrears); and/or 5) the ratio of the covered wage bill to the actual wage bill. Stanovnik and Fultz, Section 4.3.1., this volume.

³ The covered wage bill is the hypothetical amount of wages that would generate the contributions actually collected at current contribution rates. This measure normally exceeds 50 percent of GDP in developed economies, but in these five countries the 2002 calculation ranged from a low of 16.4 percent (Romania) to a high of 40.8 percent (Croatia). The Croatian measure may be overstated due to underestimated GDP. Stanovnik and Fultz, Section 4.3.1., this volume.

turned the corner decisively to recoup losses of contributors and revenues incurred early in the transition. Chronic problems are found in industries such as construction, health care, tourism and catering, and retail trade. Fictitious self-employment is widely reported.⁴ The largest portion of contribution arrears is still attributable to large firms with close ties to the state.

Second, national efforts to combat non-compliance rely heavily on reforms that tighten the link between each worker's own contributions and his or her future benefits, thus creating stronger financial incentives to pay contributions. While governments have structured such incentives in various ways, the most radical approach involves scaling down the social insurance system and replacing it with privately managed individual savings schemes. The studies provide no evidence that such linkages have had the intended impact.⁵

Third, these new individual savings schemes have placed heavy demands on the collection process, including a need to generate records more frequently and in greater detail than what would be required for equivalent worker protection in social insurance.⁶ While governments have responded to

⁴ This is an arrangement whereby employees are misrepresented as self-employed in order to save the employer their share of the contribution and obtain a lower contribution base.

⁵ The strongest evidence of this is provided by Poland, which adopted a Notional Defined Contribution (NDC) scheme in which benefits are based directly on contributions, and at the same time created a mandatory individual savings scheme. There, five years after the adoption of both reforms, the covered wage bill continues to decline. Stanovnik and Fultz, Table 7, this volume. Chłóń-Domińczak argues that linking benefits with contributions has, however, made it more difficult for the Polish government to write off contribution liabilities by state-owned firms. Chłóń-Domińczak, Section 6, this volume.

⁶ What this type of system requires is a record of each contribution made on behalf of each worker each month. In social insurance schemes, such records are not necessary for benefit computation, nor are they needed to enforce the contribution requirement. Thus, few Western European schemes maintain this degree of detail in their contribution records.

these demands in different ways, in no case have they avoided new strains, disruptions, or weaknesses in the collection process.⁷

Fourth, in an effort to boost compliance, several countries have shifted authority for collection of pension contributions to the tax agency or are planning to do so. While this change has the potential for achieving greater economies of scale in collections, there are questions as to whether the institutional prerequisites for success are in place; and the studies reveal the short-term costs of this major shift of authority.⁸

As an initial effort to cast light on collection issues in a regional context, this volume also leaves important questions unanswered. The calculations used to measure compliance are gross ones that do not allow us to estimate shortfalls precisely. As no country has turned the corner decisively toward improved compliance, it was not possible to identify practices which may have contributed to such recovery. Nor could we identify the characteristics of those failing to pay contributions with any precision. The country studies do, however, identify some positive practices that bode well for future improvements in collections and others that have clearly worsened the situation. Extrapolating from this experience, we offer seven general guidelines for governments and their social partners who have an interest in becoming more active on this issue:

⁷ In Poland, they caused an initial breakdown of the system for allocating payments to the second pillar, a temporary drop in compliance, and a subsequent staff increase of 20 percent at ZUS; in Croatia, the government's establishment of a new institution, REGOS, to collect and record second pillar contributions has so far resulted in duplicative reporting requirements for employers; and in Hungary, where the tax agency collects contributions, the government lacks a set of individual contribution records to use in monitoring compliance. See Bejaković, Máté, and Chłoń-Domińczak, Sections 2, this volume.

⁸ Ross identifies these prerequisites as a modernised tax agency, a modernised social insurance agency, and a strong culture of compliance. Stan Ross, "Collection of social contributions: Current practice and critical issues," ISSA Conference on Changes in the Structure and Organization of Social Security Administration, Cracow, Poland, June 3–4 2004, p. 9.

1. *Lead by example* – Evenhanded enforcement by governments is an essential first step in improving compliance, without which other initiatives cannot be expected to succeed. Governments must collect contributions from large firms as well as small ones and, in particular, from state firms as well as private ones. Such evenhandedness is necessary to rebuild public trust in pension governance, without which linking each worker's contributions with his or her future benefits fails to provide a credible compliance incentive. Workers and employers should insist that their governments lead by example in adhering to this standard. For uncompetitive firms, enforcement of contribution liabilities may pose a risk of job loss. Yet hidden subsidies in the form of lax collections may not be the most effective tool for supporting shaky industries, and such policies delay economic restructuring and job creation in sectors where long-term employment prospects are brighter. What is needed is a two-pronged approach that combines evenhanded collections with strong transitional support for workers in affected industries.⁹ EU membership, actual and prospective, provides a new foundation for such policies.¹⁰

2. *Redefine non-compliance as a social issue* – Non-compliance is often viewed as a dry, technical, or purely financial issue that is quite divorced from pension coverage. Thus, raising public awareness of the social consequences of failing to pay contributions is another crucial first step. Governments can use their offices as bully pulpits from which to speak out on these consequences – i.e., the problems facing workers in the informal sector who are excluded from coverage, the drain on scheme revenues that result from non-compliance by formal sector firms, and the absolute loss of benefits to workers in the region's new individual savings schemes. Governments can also make compliance a focus of high-level social dialogue and engage the social partners in devising

⁹ Such a strategy is provided in the “flexicurity” approach, which points to the potential gains of a loosening of job protections and a strengthening of social protection. Sandrine Cazes and Alena Nesporova, *Balancing flexibility and security in Central and Eastern Europe*, Geneva: ILO, 2003.

¹⁰ Government policies of allowing and forgiving contribution arrears for particular companies constitute illegal state aid under EU law.

solutions.¹¹ Trade unions and employer associations have a key role to play, as both are disadvantaged by competitors who gain an unfair edge by failing to pay contributions. Employer associations can make compliance a measure of good corporate citizenship, and trade unions can educate their members on the risks of failing to pay contributions and, conversely, the important protections that compliance brings. Through taking ownership of this problem and working to find solutions, workers and employers can retain, or regain, a central role in pension policy making.

3. Invest in enforcement – Compliance is facilitated when those who are liable for contributions know that they are being monitored, and any lapse on their part will be met with a quick response. The costs of providing such monitoring can be greatly reduced by automated information systems which match the flow of funds with a master list of those who are liable for contributions. Governments can also provide a large enough team of collection agents to make auditing and enforcement actions real threats, train these agents in auditing techniques, and compensate them adequately, thus reducing their susceptibility to financial temptations. Equally important, they can create an organisational culture which respects the importance of collection agents' role as the financial "trustees" of the pension system. A formal code of conduct is useful, as is frequent in-service training. Penalties, fines, and other sanctions for non-compliance can be set to make the probable costs of cheating exceed the benefits that it might yield – but, at the same time, not so high as to make enforcement predatory. Like the other major functions of a pension scheme, collections should be monitored by a high-level body which includes representatives of scheme constituents.

4. Piggyback on existing rules and procedures – The burden of enforcing compliance can be reduced by relying on indirect methods which require employers to prove that they are up-to-date on their contributions in order to gain access to certain government benefits. For example, such a demonstration

¹¹ For example, the Bulgarian Government and its social partners agreed on minimum contribution thresholds for various industries, in an effort to combat chronic under-reporting of wages.

could be required in order to obtain an import or export license, to participate in a government tender, to obtain loans or subsidies for small business, or even to be listed on the stock market. Governments can also require that contributions be identified as a separate item in legal audits of firms. Collection institutions can develop cooperative agreements with other agencies to impose such requirements, contribute to their costs of enforcement, and assist them in monitoring employers and workers. Such indirect enforcement methods should be reviewed regularly to ensure that they remain in place only so long as required.

5. Reduce the compliance burden – Social security systems that are user-friendly promote trust and encourage compliance. To assist employers and workers in meeting their obligations, systems can provide clear, timely, and complete information. They can streamline the paperwork associated with paying contributions and create options for electronic filing. Duplicative reporting can be eliminated by unifying the collections within a single agency but also by cooperation among separate agencies. It is useful to create a special unit to offer assistance to contribution payers, including a toll-free number, Web site, and email address through which information can be provided rapidly.¹² Administrators can also hold public meetings with employers to explain collection procedures and elicit feedback and recommendations. They can also give ample public notice of proposed changes in procedures. Employer associations can assist their members in complying with the contribution requirement, and workers can help monitor employer compliance.¹³ Together with measures to streamline reporting, lower contribution rates can encourage compliance and ease its burden. The trade-off between cutting rates and maintaining or improving benefits is a sensitive one that should be resolved through social dialogue in each particular case. However, all parties must recognise that, in the regional context where labour supply exceeds demand, high rates deny workers pension coverage as surely as reducing benefits.

¹² That is, telephone lines that are not blocked by continuous busy signals and rapid turnaround time on e-mail inquiries.

¹³ For example, employers play this role today in Belgium, and the 2000 reform in Romania authorised the government to report employers' contribution arrears to the relevant trade unions.

6. *Tune it up before trading it in* – When pension systems perform poorly, policy makers must always decide whether to try to correct the underlying problems or to replace the system – that is, whether to “tune it up or trade it in.”¹⁴ In pension collections, this question arises in relation to transferring the collection function from the pension scheme to another agency, usually the tax authority. The arguments for unifying all collections under one agency are strong ones in principle: it allows the collector to achieve greater economies of scale, to obtain information on liable employers from multiple sources within the government, and to ease the reporting burden associated with compliance. Yet one is hard pressed to find empirical evidence of these advantages. Worldwide, many different types of agencies collect contributions, and their collective experience fails to demonstrate that one approach is inherently superior to others.¹⁵ Moreover, the shift from an existing system to a new one always involves transitional costs – financial losses, efficiency losses, and a very real risk that the shift will just not work out as planned for a range of unanticipated reasons. Moreover, when government systems are weak and inefficient, major overhauls are more likely to lead to major breakdowns; and the same problems that led to abandonment of the previous system are more likely to affect the new arrangement.

The real determinants of success in collections do not lie in particular administrative arrangements but in a country’s economic strength and the competencies and political will of its government. A variety of arrangements for collecting contributions can work well or poorly depending on these. Except in unusual circumstances, governments that cannot make one collection system work well will be unlikely to do better with a different one. The surest way to improve compliance is to address the weaknesses in the existing system directly, by streamlining its operations, improving cooperation both internally and with other agencies, developing information systems that bring down the costs of monitoring, and investing in staff and training.

¹⁴ Aaron, Henry J. and Robert A. Reishauer, eds., *Countdown to Reform: the Great Social Security Debate*, Century Foundation Press, 2001.

¹⁵ In Belgium, pension contributions are collected by the national social insurance office, in Germany by the health insurance funds, and in France by the pension scheme and institutions providing complementary pensions, and by the tax authority in the United Kingdom.

7. Tackle the shadow economy step by step – The recommendation offered previously for evenhanded enforcement of the contribution requirement cannot, unfortunately, be extended to the shadow economy. This sector is too vast to be brought into compliance by a single initiative. Moreover, it is not a single entity but an array of heterogeneous firms and individuals with different legal status (formal, grey, or black economy), who have varying sensitivities to positive incentives versus sanctions, and who have quite different capacities to pay contributions. In this situation, it is best to proceed incrementally, identifying those industries and sectors where workers and employers have a clear capacity to pay and where there is a clearly defined salary stream that makes enforcement cost-effective. Together with their social partners, governments can set priorities for action and devise projects to target specific problems. Such projects might involve, for example, increased monitoring and inspections; public information campaigns that stress the importance of compliance and the social consequences of non-compliance; or a minimum contribution threshold for all workers, regardless of reported wages. It is important that these initiatives not follow a predetermined model or recipe but be devised to match particular conditions and problems in the country; in short, that they be “homegrown.”

In the final analysis, promoting compliance is all about building confidence in the pension system. No amount of policing and inspectors alone can assure compliance on the part of a population determined to evade. Moreover, it is easier and less costly to collect contributions from a population that acknowledges the benefits of protection than from one that lacks confidence in the government’s ability or commitment to deliver on its promises. While all governments are working to instill such confidence, the approaches are heavily skewed toward linking contributions more closely with benefits. Much more can be done. To feel confident that contributions paid today will result in a higher future pension, workers must also perceive that the pension system is well governed – that its operations are transparent, its decision making fair, and its management forward looking.

In the current regional context, several types of initiatives could help to promote such confidence. For example, governments can establish, or strengthen, a representative advisory body to guide pension policy making.

By giving constituents a voice, such bodies provide pension schemes with an important element of legitimacy. Advisory bodies are especially needed to oversee the new mandatory second pillars, where workers generally lack such representation. Governments can also develop the capacity for forecasting of the pension scheme's long-term financial balance, make such projections regularly, and publicise the results.¹⁶ In most CEE countries, the continuing absence of regular projections leaves the public in the dark on what actions are needed to insure the scheme's future solvency. Furthermore, governments can initiate a public discussion of the major challenges facing the pension scheme, including the need to combat non-compliance, to prepare for demographic aging, and to curb the high administrative charges that are eroding worker savings in many private schemes. In many CEE countries, such issues do not command much attention in national policy discussions. Not only is open discussion the most effective way to find solutions that are workable and enduring; it is also a visible signal to the public that the pension system is in good hands.

Within these general guidelines, there is wide scope for many kinds of initiatives to improve compliance, not only by governments but also by workers and employers. The watchwords for such efforts are experimentation and innovation. International organisations have a role to play, not as leaders with sure solutions but as supporters of those who wish to find their own "homegrown" approaches. The need for such approaches is reflected in the experience of the last decade, when many reforms were adopted based on borrowed models whose mismatch with regional conditions is increasingly clear. Reliance on borrowed models is particularly ill-suited to the realm of collections, since successful collection systems always reflect the main elements of their environments, including size, resources, economic structure, and social norms. So must efforts to improve coverage through strengthening compliance.

¹⁶ To gain acceptance of the results, they can include the social partners in formulating assumptions for the exercise.

Chapter 2

The Collection of Pension Contributions – A Comparative Review

Tine Stanovnik and Elaine Fultz

A number of Central and East European countries reformed their pension systems substantially during the 1990s. A quite common characteristic of these reforms is that, during the preparations, insufficient attention was given to the design of certain elements that are vital for the functioning of these systems. It is as if ideological fervour for radical reform has gained primacy over analytical planning and pragmatic solutions, so that organisational and administrative preparations for the reform were weak. Though complete preparations are difficult to achieve even in the best of circumstances, the neglect of important institutional and administrative issues is striking.

The chapters in this volume all deal with what could be considered the neglected issue of pension reform: the collection of contributions. This chapter will draw on these country studies to present a comparative analysis of contribution collection and related issues in five Central and Eastern European countries: Poland, Hungary, Romania, Croatia and Slovenia. These countries embarked on pension reforms in the 1990s and early 2000s that each had their own special features and which also affected the design and functioning of the contribution collections systems. Our analysis will endeavour to highlight various national features, seeking communalities and broad trends. We will not refrain from value judgements, though we will abstain from advocating best practices and optimal solutions. In any case, these could hardly be said to exist, as each country had to cope with a myriad of problems that the pension

reform brought to the fore – as best as it could, taking account of its economic and social conditions, administrative capacity, political constellations and amount of ideological fervour imbued in the pension reform process. In other words, institutional and administrative change is a country-specific issue, and it would be contrary to actual experience to suggest a unique best solution.

The structure of this overview is as follows. Section 1 (*The pension system: reforms and institutional change*) will describe the organisation of pension systems and show how the pension reforms imposed new requirements that had to be fulfilled either by adaptation and modernisation of existing institutions or by creating new ones. It will be seen that in the three countries where pension reform introduced a mandatory fully funded second pillar – Poland, Hungary, and Croatia – three completely different administrative systems for collection of second pillar contributions were adopted. Section 2 (*The collection system*) describes the roles of the various social security institutions in the collection process, their relationships with the national tax agencies, and the division of tasks between them. It examines four components of the collection function in detail: control, inspection, enforcement and record-keeping.¹ This section also describes the main steps in the registration of contribution payers and insured persons. Section 3 (*Coverage, contribution bases and contribution rates*) presents a broad assessment of the coverage of the active population, the contribution bases for various groups of insured persons (employees, self-employed, farmers) and the contribution rates. Section 4 (*Contribution compliance*) deals with compliance issues. It presents several indicators for measuring contribution compliance; these indicators are particularly useful for providing rough assessments of improving or deteriorating compliance; they are perhaps somewhat less useful for cross-country comparisons. This section also describes a specific result of non-compliance – that is, contribution debt. The section concludes with an analysis of differing national policies of write-offs and deferrals and the impact of non-compliance on workers' pension rights. Section 5 offers some concluding remarks.

¹ The control function refers to monitoring and the inspection function, to auditing of company records. In effect, the first function refers to checking the correspondence between the money flow and information flow, whereas the second function consists of on-site inspections, performed by social insurance or tax inspectors. Also see Wiktorow (2004).

1. The Pension System: Reforms and Institutional Change

1.1. The Unification of Pension Schemes

During the past three decades, various pension schemes covering different segments of the active population were gradually integrated into the general public pension scheme in four of the five countries. Only Poland does not conform to this pattern, as it retained separate pension schemes for farmers and the armed services. Generally, the integration of separate schemes for farmers and self-employed into the general scheme has been weak, meaning that inclusion is mandatory only if income exceeds a certain threshold.

The public pension system in Poland still consists of three separate systems: ZUS (for employees and the self-employed), KRUS (for farmers) and a system for armed services (including military and police). Romania had three separate funds until 1998: the so-called State Social Insurance Fund, the Supplementary Pension Fund, and the Farmers Fund, all three administered by the Ministry of Labour and Social Protection. In 1998, as a pre-reform measure, the Supplementary Pension Fund and the Farmers Fund were designated as separate chapters in the budget of the State Social Insurance Fund; this treatment was continued up to April 2001, when a new social insurance law came into force and the two funds were merged into the State Social Insurance Fund. Croatia had three separate pension funds until 1998: for employees, self-employed, and farmers. In 1999 these three were merged and the Croatian Pension Insurance Institute (CPII) was formed. Slovenia has had a single public pension scheme since 1984, when the pension scheme for farmers was integrated into the general scheme. Hungary has had a single general public pension scheme since 1975.

1.2. Pension Reform, Changing Institutions and Functions

Of the five countries, four undertook significant parametric changes in the first public pillar during the 1990s as well as introducing a second (mandatory or voluntary) pillar. Poland introduced a major reform in 1999, Hungary in

1998, Croatia in 2001, and Slovenia in 1999. In Poland, Hungary, and Croatia, the reform included a mandatory, fully funded second pillar; in Slovenia the second pillar is voluntary; however, due to strong tax incentives some 50 percent of the insured persons in the first, public pillar are already insured in the second pillar. Romania introduced a number of incremental changes to its public pension system and a significant reform in 2000. However, several key provisions of this law have since been altered, and the government has not yet authorised supplemental private coverage, either voluntary or mandatory.²

These reforms imposed new tasks on existing institutions and, in some cases, reallocated existing tasks. Reallocation of tasks was not, however, an intrinsic requirement of the reforms. Thus, in Poland and Slovenia, new tasks were assigned to the social insurance institutions (ZUS and ZPIZ, respectively). On the other side of the spectrum are Hungary and Croatia, which introduced together with the pension reform a major reallocation of functions; in Hungary the tax authority has been assigned some collection functions previously performed by the social insurance institution, whereas in Croatia the reallocated collection functions have been assigned to the tax authority and a new collection agency (REGOS).

Poland, with the most radical pension reform among the four countries, did not introduce any institutional change. The Social Insurance Institution – ZUS – continues to perform its functions of collection, control and enforcement. However, ZUS's workload has vastly expanded, because the pension reform required the individualisation of monthly contribution data not only for the second pillar, but also for the first pillar, which is being converted to a Notional Defined Contribution (NDC) scheme.³ ZUS also collects contributions for the second pillar and transfers them to the new private savings funds. The magnitude of ZUS's new workload is reflected in a significant expansion of its staff.⁴

² However, the government has made proposals for both. Toma, Section 1.5., this volume.

³ In NDC, benefits are based directly on each worker's own pension contributions, necessitating individual contribution records. Chłóń-Domińczak, Section 1.1., this volume.

⁴ That is, a 20 percent increase, from 40,000 to 48,000 employees. Chłóń-Domińczak, Section 2.2.1., this volume.

Hungary, by contrast, opted for a significant reallocation of functions among the institutions involved. Following the 1998 pension reform, in 1999 the Tax and Financial Control Administration (TFCA) took over from the Central Administration of the National Health Insurance Fund (CANHI) and Central Administration of the National Pension Insurance Fund (CANPI) the responsibilities for registration of contributors and insured persons, collection, control and enforcement. Both social insurance institutions (CANPI and CANHI) are, however, still responsible for record-keeping. CANPI is also responsible for eligibility determination and benefit payments. In contrast with the situation in Croatia and Poland, mandatory contributions to the Hungarian private savings funds are transmitted directly by employers, without any government role or record-keeping.

Croatia also introduced large institutional changes. As part of the comprehensive pension reform initiated in 2001, Croatia established a new organisation, the Central Registry of Insured Persons (REGOS), which is responsible for maintaining a central database on all contributions, including those for the second pillar. It is also charged with performing a similar function for personal income taxes and surtaxes. In addition, REGOS collects second pillar contributions and transfers them to the appropriate individual savings funds. Together with the Tax Administration, it controls contribution payments; the Tax Administration is though solely responsible for on-site inspections and enforcement. In effect, the CPII has lost most of its previous functions, and its main responsibilities today are maintaining contribution records and making eligibility decisions.

Like Poland, Slovenia made very few institutional or organisational changes during the 1990s, or even following the major reform of 1999. In 1996, a new unified Tax Administration was formed, which is responsible for the collection of all contributions and taxes (except for customs duties). It must be stressed that the relevant social insurance institutions were never involved in the collection, control and enforcement functions; prior to 1996 these were the responsibility of the Central Payment Agency (for legal persons) and the Office of Public Revenues (for self-employed and farmers).

Romania made a number of institutional and administrative changes in the 1990s, gradually integrating various functions – collection, control, inspection and enforcement. Thus, in 2000 a new institution was formed, the

National House of Pensions and other Social Insurance Rights, and it assumed responsibility for the collection, control and enforcement of contributions. Further changes were introduced in 2002, when the controlling bodies of the National House of Pensions and other Social Insurance Rights and the National Agency for Employment (responsible for unemployment insurance) were unified. Another reorganisation is scheduled for 2004, when a new National Agency for Fiscal Administration will be established. It will be responsible not only for the collection of contributions, but also for registration of legal and physical persons, control of contributions paid, and other functions, including the collection of taxes.

It is interesting to observe that three different institutional arrangements for the collection of second pillar contributions emerged. In Poland, the existing social insurance institution ZUS assumed responsibility for the collection and control of these contributions. In Hungary, neither the tax authority nor the social insurance institution is responsible for these functions, and the second pillar contributions are directly transmitted from the employer to the mandatory private pension funds (MPPFs). Croatia opted for a third way, by creating a new institution – REGOS – for the collection and control of second pillar contributions. As described by Bejaković, tensions between the tax authority and REGOS are already developing.⁵ Due to overlapping functions, this is not surprising and the sustainability of such an institutional arrangement remains to be seen.

1.3. Administrative Preparations for Pension Reform, IT Systems and Individualisation of Contribution Records

The reforms imposed new and in some cases formidable tasks on existing collection systems. As three of the five countries introduced a mandatory individual savings scheme as a second pillar, this in effect meant that each worker's individual monthly contributions must be recorded. This is a far more formidable task than record-keeping for a social insurance scheme, where

⁵ Bejaković, Section 2.1.2., this volume.

benefits are based on annual wages. Individualisation of monthly contribution records required, as an essential first step, the introduction of new IT systems. Here the experiences of countries vary greatly. The Polish reform, which also introduced an NDC system in the first pillar, made individual contribution records imperative for both pillars. As we shall see below, this demand far exceeded the administrative capacity of ZUS and initially caused serious disruptions in the collection of contributions. In Hungary, the requirement for monthly individual contribution records, though legislated, was first postponed and then repealed.⁶ As Augusztinovics et al. explain, “the STCA was neither able nor willing to develop or maintain the huge register that this would require.”⁷ Similar developments occurred in Slovenia. There, the 1999 Pension and Disability Insurance Act required individual contribution records by 2003, but there has been little progress toward this goal, due to the lack of enthusiasm on the part of both partners involved – the Tax Administration and the Pension and Disability Insurance Institute. Their reluctance may relate to the heavy administrative burden of maintaining such a system, as already noted, and to Slovenia’s lesser need for individual monthly contribution records.⁸ In contrast with the other two countries, Croatia has moved with apparent smoothness toward the individualisation of contribution records in both the first and second pillar. Romania has required such records for its public pension system, but the groundwork has been weak, as even the registry of contribution payers and insured persons is far from being complete and updated.⁹ These weaknesses led to the repeal of a key provision of the 2000 reform, which had shifted the basis for workers’ pension entitlements from earnings to contributions actually paid.¹⁰

Table 1 shows the monthly reporting requirements for mandatory contributions by the employers in the five countries. Mandatory contributions include

⁶ Máté, Section 2, this volume.

⁷ Augusztinovics et al. (2002), p.49.

⁸ That is, unlike the other three countries, Slovenia does not require individualised contribution records to enforce compliance in its second pillar, which is optional, nor are they essential for computing public pension benefits, which are based on annual wages.

⁹ Toma, Section 2.2.1., this volume.

¹⁰ Toma, Section 1.4., this volume.

not only first pillar pension contributions but also – in countries that have introduced mandatory second pillar pension schemes – second pillar pension contributions.

Table 1
**Monthly reporting requirements for the employer to the tax administration (T)
or social insurance institution (S) on contributions paid, 2003**

Poland	Individualised (S)
Romania	Individualised (S)
Hungary	Aggregate (T)
Croatia	Individualised (R*) and aggregate (T)
Slovenia	Aggregate (T)

* REGOS.

Source: Bejaković, Section 2.1.4.; Máté, Section 2; Chłóń-Domińczak, Section 1.1.; Toma, Section 2.2.; and Vezjak and Stanovnik, Section 2.3.1., this volume.

Note: Romania plans to change to “T” in 2004. For Croatia, REGOS receives the R–S form, while the Tax Administration receives the monthly ID and IDD forms. In Slovenia, self-employed employing workers must present individualised lists.

Poland’s early difficulties in introducing individual contribution records and the required IT system are instructive. When the Polish reform was enacted in 1999, the old system for monitoring contribution payments was discontinued, and the new one not yet implemented. As a result, ZUS lost control over payments from employers. As the accounting system could not operate, ZUS had little knowledge of contribution revenues. A severe crisis erupted, exacerbated by the fact that contribution payers (employers) became aware of the chaotic conditions and consequent weakening of the controlling and monitoring functions. Many stopped paying contributions. Under emergency rules, a series of *ad hoc* measures was adopted to improve collection, record-keeping and transfer of individual contributions to the appropriate private pension schemes. Only in June 2002 was the processing of contribution transfers switched to the final IT platform. Except for a backlog of unidentified contributions that remains from this period, the

situation has now been normalised, and a large improvement in the accuracy of individualised documents is being reported.¹¹

The current status of compliance with the second pillar contribution requirement cannot be easily assessed for Hungary, as no public institution is responsible for monitoring second pillar contributions. The Tax Agency relies on complaints from individual savings funds to enforce compliance on employers, who transfer worker contributions directly to these funds. Máté reports that during the first nine months of 2003, the Tax Office carried out 3,586 inspections in response to such complaints focusing on arrears of contributions.¹² Augusztinovics et al. also report that, “Almost six percent of all payments paid into the Mandatory Private Pension Funds (MPPF) are unidentifiable payments,” which is a rather high figure.¹³

Romania also experienced numerous difficulties during the reform process. The introduction of IT systems has proceeded unevenly and on several fronts. There are at present three different IT systems in various stages of preparation: one is for the National House of Pensions and other Social Insurance Rights, one is for the National Agency for Employment and the third is for the National House for Health Insurance. Toma also reports major deficiencies in the quality of the registry of employers, based on the databases of the National Trade Registry and the Ministry of Public Finance.¹⁴

Reducing the number of different forms which must be regularly submitted by the employer is among the important measures which must be considered during the preparations for the reform. Thus, for example, in Croatia there are at present four different forms for reporting contribution payments to four different institutions. In order to reduce the administrative burden for the employer, the number of forms will be reduced and the so-called R-S form, which the employer transmits monthly to REGOS (and which contains individualised data on all social contributions, personal income taxes and surtaxes), will become the only required form. However, the Tax Authority is

¹¹ Chłoń-Domińczak, Section 2.1.1., this volume.

¹² Máté, Section 5.9., this volume.

¹³ Augusztinovics et al. (2002), pp.73–74.

¹⁴ Toma, Section 2.2.1., this volume.

so far resisting this change and refusing to use REGOS data, instead seeking to take over REGOS's functions.¹⁵

2. The Collection System

2.1. *The Collection System and the Tax System*

Combining the collection of social security contributions and taxes can improve compliance and result in a more efficient use of resources. This is the view taken by Bailey and Turner (1998) and McGillivray (2002). However, certain conditions must be met; Bailey and Turner, as well as McGillivray, strongly emphasise that a joint collection of social security contributions and taxes is meaningful only in countries with well-developed systems of government administration and strong fiscal administration. They also emphasise the need for trust in the joint collection agency. A similar position is taken by S. Ross: "In principle, integration of collection activities will work best where both the social insurance agency and the tax administration are both modernised so that the task of integration can be narrowly focused on the transfer of collection functions."¹⁶

One may doubt whether these conditions are fulfilled today in Central and Eastern European countries; yet a number of these countries have moved toward the joint collection of contributions and taxes. At the same time, some countries have resisted this trend, as previously noted. Of course, contribution collection is but one function within the social insurance system. Registration of insured persons, control of payments, on-site inspections, enforcement procedures and record-keeping are all essential to successful collections as well. There is no particular rationale for assigning them all to a single institution, be it the social insurance institution or the tax authority.

¹⁵ Bejaković, Section 2.1.2., this volume.

¹⁶ Ross (2004), p.9.

In three of the five countries – Hungary, Croatia and Slovenia – the tax authority is responsible for contribution collections. Starting in 2004, responsibility for the collection of employee contributions in Romania is to be shifted to the tax authority (National Agency for Fiscal Administration), whereas the collection of social contributions for self-employed and farmers will continue to rest with the relevant social insurance institutions (the National House of Pensions and other Social Insurance Rights, the National Agency for Employment and the National House for Health Insurance). Poland is the only country among the five where contribution collection remains firmly in the domain of the social insurance institution, ZUS. The “change of guards” in Hungary and Croatia occurred only fairly recently: in Hungary in 1999 and in Croatia in 2002. In Slovenia, contribution collections in the pre-transition period and up to 1996 were performed (for legal entities) by the Central Payment Agency; in 1996 part of this agency was merged into a newly formed Tax Administration.

The following steps are common to collection procedures in the five countries.¹⁷ Upon receiving a payment order from the employer, a bank sends monies (contributions due) to the tax administration or social insurance institution account within the state treasury (or national bank). If the monies are sent to the tax administration account, it then transfers the amounts to the social insurance institution account on a daily basis.¹⁸ Both accounts are located within the state treasury. In principle, controlling social insurance revenues is fairly straightforward, as the money flow into the account within the state treasury is compared with the notification payment list which the employer sends to the tax authority or social insurance institution, on a monthly basis (or upon payment of wages).

¹⁷ This description applies only to the case when the contribution payer is an employer.

¹⁸ In Croatia the monies are transferred to social insurance sub-accounts within the state budget account, as social insurance institutions are not separate legal entities and are not involved in the revenue-expenditure flow.

2.2. Procedures for Registration of Contribution Payers and Insured Persons

The procedures for registration differ across the five countries mostly with regard to whether registration is unified, so that a single registration within a social insurance institution suffices or separate registration is required for each social insurance institution. It is the employer's ("contribution payer's") duty to register with the appropriate social insurance institute: in Poland it is ZUS, and in Slovenia – quite similarly to Germany¹⁹ – the employer must register at the Institute for Health Insurance. In Croatia and Romania separate registrations for each social insurance institute are required. In Hungary, the "account holders" (employers and self-employed) must register with the Tax Office.

2.3. Control of Contribution Payments

Effective control requires a close correspondence between the flow of information and flow of monies. Because of the large increase in data required for individual savings schemes, transmission in electronic format is becoming prevalent. Reports on contribution payments are provided with each disbursement of wages and salaries. In principle, the controlling function consists of comparing the payments made to the relevant account within the state treasury with the corresponding monthly information provided to the tax authority or social insurance institution. In Hungary, Croatia and Slovenia this matching of the information flow and money flow is performed by the tax authority, whereas in Poland and Romania this is the task of the relevant social insurance institution (ZUS and the National House of Pensions and Social Insurance Rights, respectively).²⁰ Some countries also have an additional "whistle blower" within the system. Thus, banks in Romania, Croatia and

¹⁹ See Queisser (1996) and Manchester (1999).

²⁰ As previously noted, the National Agency for Fiscal Administration will take over the controlling function in 2004. In Romania social contributions must be paid simultaneously with wages; in Croatia at most eight days after the payment of wages; and in Slovenia at most six days after the payment of wages.

Slovenia are obliged to report whether wages have been disbursed from the bank account but social contributions have not been paid. It seems that this whistle-blowing is not very effective.²¹

In Poland the employer sends to ZUS on a monthly basis and for each employee data on the contribution base for each type of social insurance contribution due (pension, health care, etc.). The employer also reports to ZUS the aggregate contributions due, i.e. contributions for each type of social insurance, number of employees, etc.

In Hungary, the employer has to send to the Tax Office monthly information on contribution payments; these are aggregate data, not individualised. Employers must also provide monthly data to second pillar Mandatory Private Pension Funds (MPPFs) on the contribution payments of their employees. The data for the MPPFs are of course individualised. As previously noted, the 1997 reform legislation originally prescribed monthly reporting to the government of individual contributions for both the first and second pillars. This requirement was postponed and then repealed.

In Slovenia, employers provide only aggregate data on contributions and taxes to the Tax Administration, on a monthly basis.²² As membership in second pillar pension funds is voluntary, the Tax Administration does not collect data and monies for the second pillar pension funds.²³ In a development remarkably similar to what occurred in Hungary, the Slovene legislation prescribed that monthly reporting of individual contributions paid (for the first pillar) was to start in January 2003. Unlike Hungary, however, where this requirement was first postponed and then repealed, in Slovenia this

²¹ See Bejaković, Section 2.1.4.; Toma, Section 2.2.; and Vezjak and Stanovnik, Section 2.3.1., this volume.

²² However, the self-employed who employ workers are obliged to present individualised lists every month, with the amounts of taxes and contributions paid for each employee. The monthly frequency for providing data is due to the fact that wages are disbursed once per month. Should the employer disburse wages twice per month, he would have to provide appropriate information twice per month, i.e. after each disbursement of wages.

²³ The pension funds pressed strongly for a legal provision that would put the Tax Administration in charge of collecting information and monies for them. The Tax Administration successfully avoided this, with the argument that these pension schemes are not mandatory and are thus not in the domaine of public finance.

legally binding requirement has simply been ignored. This was doubtlessly due to the fact that such a requirement, without very thorough preparations of the necessary IT system, would cause serious administrative problems.

In Croatia, the employer must submit individualised data on calculated and paid contributions, personal income tax, and surtax on a monthly basis. This is done on the already mentioned R-S form, which is submitted to REGOS. However, the employer must also submit each month the ID and IDD forms, which contain aggregate data on contributions, taxes and contribution and tax bases; these are submitted to the Tax Administration. Bejaković describes an ongoing controversy in Croatia concerning the role of these two agencies and the Tax Administration's refusal to date to use aggregate monthly data from REGOS.²⁴

2.4. The Inspection and Enforcement Functions

The five countries under review have divided the inspection and enforcement functions in different ways between the social insurance institution and the tax authority. The role of the social insurance institution is by far the greatest in Poland. The social security law not only gives ZUS the right to inspect but also the legal authority to enforce contribution payment. In Hungary, the responsibility for performing these functions was reallocated during the 1990s. Up to 1992, the social insurance institution had only a limited role in enforcement, as this was mainly carried out through the tax authority.²⁵ In 1992 the Parliament enacted legislation giving CANHI authority to recover debts through direct collection, and during 1992–99, CANHI and the tax authority performed joint inspections.²⁶ However, since 1999 the Tax and Financial Control Administration (TFCA) is fully in charge of control,

²⁴ Bejaković, Section 2.1.2., this volume.

²⁵ At that time it was the Central Administration of National Social Insurance Fund (CANSI).

²⁶ In 1992 CANSI was split into the Central Administration of National Health Insurance Fund (CANHI) and the Central Administration of National Pension Insurance Fund (CANPI). CANHI was responsible for contribution collections.

inspection and enforcement, i.e. it initiates legal action in serious cases of breach of legal obligations. In Romania the social insurance institutions (the National House for Pensions and other Social Insurance Rights, etc.) carry out inspections and also have the legal authority to initiate enforcement procedures. However, from 2004 these functions are to be performed by the new National Agency for Fiscal Administration. In Croatia, the Tax Administration has been responsible for inspection and enforcement since 2002. It inspects records within enterprises with the support of the Croatian Pension Insurance Institute, which supplies it with relevant information on contributors. Though the Tax Administration in Slovenia is responsible for inspection and enforcement, both social insurance institutes (the Institute for Health Insurance and Institute for Pension and Disability Insurance) play very active roles in the inspection process. Both institutes have their own staffs of auditors which carry out on-site inspections at employers' premises. Enforcement is performed by the Tax Administration.

In Croatia, the tax authorities also have an obligation to control, inspect and enforce contributions for the second pillar, with the controlling function being shared with REGOS. In Hungary, where no public institution (tax authority or social security institution) has individualised contribution records to use in monitoring employers' compliance, the inspections (performed by the tax authority) are initiated mostly at the request of the private funds.

2.5. The Record-keeping Function

In three of the five countries, pension records were traditionally kept by employers.²⁷ However, the locus of this function has been changing, and it is becoming the joint responsibility of employers and social insurance

²⁷ In Romania the employer is also responsible for the disbursement of some social insurance benefits: s/he calculates the total social insurance contributions due and subtracts the social insurance benefits, which s/he disburses to the employees. The difference represents the amount transmitted to the Territorial House of Pensions and other Social Insurance Rights. See Toma, Section 2.2.B., this volume. In Slovenia, the employer disburses the allowance for part-time work (for persons with partial disability) and is reimbursed by the Institute for Pension and Disability Insurance.

institutions. Table 2 shows the current requirements for annual reporting on individual contributions paid (or on contribution bases) by the employer. This annual reporting is necessary for determining individuals' accrued pension rights.²⁸

Table 2
Annual reporting requirements by the employer to the tax administration (T) or social insurance institution (S) on individual contributions paid or earnings ("contribution bases"), first pillar only, 2003

Poland	None*
Romania	None*
Hungary	Individualised (S)
Croatia	Individualised (S)
Slovenia	Individualised (S)

* Individualised *monthly* reporting is, however, required, as described in Table 1.

Source: Bejaković, Section 2.1.5.; Máté, Section 2; Toma, Section 2.2.A.; Chłóń-Domińczak, Section 1.1.; and Vezjak and Stanovnik, Section 2.2., this volume.

Note: Croatia plans to discontinue annual individualised reporting in 2004 (forms M4P/M8P).

In Croatia and Slovenia, record-keeping is a longstanding responsibility of the social insurance institutions, in place since the early 1970s. In both countries, the employer is required to provide annual individualised data on earnings (contribution bases), and these data are then stored in the respective pension institutions.²⁹ In Croatia, which introduced monthly individualised

²⁸ However, as will be explained later, pension entitlements for the first pillar are not lost if contributions are not paid, so long as it can be established that a worker had covered earnings for the period in question. For the second pillar, the failure to pay contributions results in a direct loss of benefits, except in Poland in the narrow case where the employer becomes insolvent. Chłóń-Domińczak, Section 5, this volume.

²⁹ In Slovenia, annual reporting for the self-employed, farmers and those voluntarily included in the public pension system is done by the Tax Administration, which provides the relevant information to the Institute for Pension and Disability Insurance (ZPIZ).

reporting of earnings and contributions with its 2001 pension reform, annual reporting to the Croatian Pension Insurance Institute is supposed to be discontinued in the near future.

In Poland, up to 1999, the employer gave ZUS the individual information necessary for pension calculation only upon a worker's retirement. Since the 1999 pension reform, annual reporting is no longer required in Poland; instead employers must report individualised contribution data on a monthly basis. However, during the breakdown in ZUS's operations during the early months of implementing that law, annual reports were temporarily reinstated. In 2000, only information on sickness benefits needed to be provided on an annual basis; since 2001 only monthly reporting is again required.

In Hungary, the employer was required to keep data on earnings and contributions paid. However, legislation enacted during 1995–96 required employers to hand over all of their stored documents related to pension insurance to CANPI; and since 1997 employers are required to provide CANPI with the relevant information.³⁰ Though these annual reports are individualised, they are not checked against aggregate figures reported to the Tax Office, so there is no means of verifying whether this annual list corresponds with contributions actually paid.

In Romania, the insured person applying for a retirement pension must submit hand-written workbooks (provided by the employer) recording his contribution period prior to 2001. Since 2001, record-keeping is the responsibility of the National House of Pensions and other Social Insurance Rights.³¹ In spite of further organisational changes planned for 2004, the National House of Pensions and other Social Insurance Rights will remain the record-keeper for employees. Reporting in Romania differs from the reporting in the other four countries, as Romania never had *annual* individualised reporting of relevant contribution data. Starting in 2000, Romania introduced the reporting of individualised *monthly* data.

It is noteworthy that Slovenia, as the most developed and institutionally organised country among the five, has not introduced monthly individualised

³⁰ Máté, Section 6.1., this volume.

³¹ Of course, only for insurance periods from 2001 onward.

reporting by employers.³² For record-keeping purposes, ZPIZ relies on individualised annual reports of earnings (contribution bases). Starting from 2003, these reports also include the amount of contributions paid. This situation has important parallels with Hungary where, as discussed previously, there are no individualised records of contributions to the first pillar and employers are required to report second pillar contributions to the private funds, but not to the tax authority or social security institution. It seems as if the exigencies of monthly individualised data have been too severe for the tax authorities or social security institutions to cope with in both countries.

It is also interesting to note that, among the three countries that adopted mandatory individual savings schemes, in no case are individualised monthly contribution records maintained by the tax authority. In some sense, this is not surprising, since this function falls outside the tax authority's usual mission, which is to maximize revenue intake. The unwillingness or inability of tax agencies to maintain such records resulted in three different solutions to the record-keeping function. In Croatia the second pillar contributions are recorded by a separate public agency (REGOS), in Hungary there is no public system of individualised second pillar contribution records, whereas in Poland the second pillar contribution records are kept by the social insurance institution – ZUS.

3. Coverage of Active Persons; Contribution Bases and Contribution Rates

3.1. Coverage of Active Persons

Persons covered by a social security scheme are those who "... by law or regulation are generally obliged to contribute to it."³³ In most parts of the world, those covered by social security are a small subset of the economically

³² However, as explained in Section 3.3., the ZPIZ has so far ignored a legal mandate to establish such records.

³³ McGillivray (2001), p.4.

active population. Only in the developed countries does social security coverage typically extend to the great majority of the work force and, even here, protection tends to be limited for hard-to-cover groups such as farmers and the self-employed. The former socialist countries of Central and Eastern Europe are in a unique position between developed and developing countries in having inherited laws that cover the full population, or nearly so. Thus, in this study, we adopt a working assumption that all labour active persons ought to be covered by social security schemes.

Having adopted this wider benchmark, we compare the number of actually insured persons with the number of persons in employment. This comparison is given in Table 3.

Table 3
Insured persons (contributors) and persons in employment (in thousands), 2002

	Insured persons (contributors)	Persons in employment
Poland	14,321	13,863
Romania	4,561	9,556
Hungary	3,845	3,871
Croatia	1,422	1,527
Slovenia	814	914

Source: Bejaković, Table 6; Máté, Table 4; Chłoń-Domińczak, Table 6; Toma, Table 2; and Vezjak and Stanovnik, Table 6, this volume.

Note: For Romania and Slovenia the figures refer to 2001.

As seen from Table 3, the difference between the number of persons in employment and number of insured persons is fairly small in Poland, Hungary and Croatia. In Poland the number of persons in employment is even lower than the number of insured persons (contributors); this can be explained by the fact that insured persons also include those unemployed who receive unemployment benefits and those persons on maternity and parental leave who are insured though they are not working according to the ILO-Labour Force Survey (LFS) criteria. The gap between the number of insured persons

and persons in employment is somewhat larger in Slovenia, a phenomenon for which this study finds no full explanation.³⁴ The divergence between persons in employment and insured persons (contributors) is truly large in Romania, where more than half of the active population is not covered by the public pension insurance system.

The hard-to-cover groups are treated in various ways in these social security systems. Thus, Poland and Slovenia have bent backwards in order to include farmers. In both of these countries, those farmers that do not meet the required criteria for mandatory inclusion into the pension insurance system can opt for voluntary insurance under very favourable conditions. Farmers receive virtually flat-rate pension benefits, but they also pay very low contributions and their pensions are heavily subsidised.³⁵ In Poland, they even have a separate pension system, which the pension reform simply bypassed.

In all five countries pension insurance extends to the unemployed who receive unemployment benefits.³⁶ Persons performing duties that are in the national interest are also insured. These groups include persons in mandatory military service, persons on maternity or parental leave, and persons caring for their disabled children or other disabled members of their families. The insurance may, however, be less favourable than for regular employees. For example, in Poland the contribution base for persons providing child care is the child care benefit, which is far lower than most workers' previous or subsequent earnings. In Slovenia mandatory military service is honoured, but only for achieving the eligibility condition to retire. The computed pension is not increased because of this year of service, i.e. the accrual rate is zero percent; however, an insured person can purchase this year of service (and thus can

³⁴ A partial explanation is provided by Vezjak and Stanovnik, this volume, Section 4.1.

³⁵ In Slovenia, the government pays the employer's contribution, while in Poland the government provides more than 90 percent of the revenues for the farmers' scheme. See Vezjak and Stanovnik, Section 3.3., and Chłóń-Domińczak, Section 1.2., this volume.

³⁶ In Croatia, only unemployed invalid war veterans (of the 1991–95 Homeland War) are insured for pension purposes, as well as unemployed persons who lack at most five years for achieving the age condition for pensioning.

ex post increase his insurance period). Slovenia also took a more restrictive approach toward crediting worthy activities; prior to 2004, persons taking care of their disabled children could be voluntarily pension-insured but had to pay their own contributions. Since 2004, legal changes made the state liable for paying contributions for this group.

As already noted, Romania stands out as a country with low coverage; this is due in part to the fact that social insurance has been, since the early 1990s, voluntary for the self-employed and farmers. Since 2000 it has become mandatory for the self-employed, subject to the condition that their annual income exceeds three times the average monthly gross wage.³⁷ In spite of this low threshold, very few self-employed have come forward to register and make contributions as required by law. Their low coverage, coupled with virtual non-coverage of farmers under optional provisions, will undoubtedly cause serious problems in the long run: a large part of the elderly population will have very low incomes, and high poverty incidence might prove to be a serious social issue.

3.2. *The Contribution Base and Contribution Rates*

Looking across the countries, one sees a modest, and probably not very successful, effort to expand the earnings subject to social security contributions (the contribution base). The limited scope of these efforts is explainable in part by the high levels of legal coverage already in effect across the region. Their success should be judged not so much in terms of increasing contribution revenues but more in terms of preventing tax arbitrage, that is, the payment of earnings through channels that are subject to lower tax rates.

³⁷ Mandatory coverage was also extended to farmers by the 2000 law, but this was repealed soon thereafter due to the government's inability to enforce the requirement. Toma, Section 3.D., this volume.

3.2.1. The Contribution Base for Employees

For employees, the contribution requirement has been extended beyond earnings to various employment-related incomes and expenses. These extensions are quite varied among countries. In Poland, the gross wage and other benefits that result from work (such as bonuses, incentives, and overtime pay) are included in the contribution base.³⁸ In Romania, the contribution base for employees includes the gross wage, bonuses and incentives; and the employers' contribution base is the total gross wage bill.³⁹ In Hungary, some incomes, such as the value of a provision in kind, are included in the employer's contribution base but not in the employee's base. The contribution base for employees also includes various miscellaneous items such as trade union membership fees, fees defined in apprenticeship contracts, etc. It does not, however, include some forms of wage compensation such as sick pay and accident allowance, though these are subject to the personal income tax.⁴⁰ This is in contrast to Croatia, where various forms of wage compensation are subject to contributions but are not subject to personal income tax.⁴¹ Slovenia is the most extreme case, as wage compensation is subject to both contributions and personal income taxation. Croatia and Slovenia inherited from the Yugoslav federation a cash holiday bonus provided to employees (the so-called *regres*). In Croatia the whole amount of this bonus is subject to contributions, whereas in Slovenia it is only that part which exceeds 70 percent of the average national wage. However, in Slovenia it is also subject to personal income taxation. In Slovenia a number of fringe benefits and work-related expenses (travel expenses, daily business allowances, severance pay) are subject to both contributions and personal income tax, provided the amounts exceed a given level set by government decree. Severance pay due to bankruptcy of a firm is not taxed.⁴²

³⁸ Chłoń-Domińczak, Section 3.1., this volume.

³⁹ Toma, Section 1.4., this volume.

⁴⁰ Máté, Section 3.2., this volume.

⁴¹ Bejaković, Section 3.2., this volume.

⁴² Vezjak and Stanovnik, Section 3.1., this volume.

Three of the five countries (Hungary, Poland, and Romania) do not have a specifically set minimum contribution base for employees.⁴³ In Croatia, the minimum base is approximately 35 percent of the average gross wage.⁴⁴ In Slovenia, it is equal to the minimum wage, which is some 42 percent of the average gross wage.⁴⁵

3.2.2. The Contribution Base for Self-employed

The self-employed are a problematic group in all social security systems, though problems stem not only from low coverage but also lie in their low level of covered earnings (contribution base) and relatively small contributions. It seems that social security policy makers have abandoned all hope and ambition for “quality inclusion” of this group of insured persons.

The contribution bases and minimum bases for the self-employed are presented in Table 4.

Table 4
Contribution bases for the self-employed

	Contribution base	Minimum contribution base
Poland	Declared income	60% of average wage
Romania	Insured income	25% of average wage
Hungary	Taxable income	Minimum wage
Croatia	Taxable income	Set by government decree
Slovenia	Taxable income	Minimum wage

Source: Bejaković, Section 3.1.; Máté, Section 3.1.; Chłoń-Domińczak, Section 3.1.; Toma, Section 3.C.; and Vezjak and Stanovnik, Section 3.2., this volume.

Note: For Romania the insured income is the income stated in the insurance declaration.

⁴³ That is, a minimum amount on which contributions must be paid regardless of actual or reported earnings.

⁴⁴ Bejaković, Section 3.1., this volume.

⁴⁵ Vezjak and Stanovnik, Section 3.5., this volume.

3.2.3. The Contribution Base for Farmers

As shown in Table 5, only in Romania are farmers completely free to choose whether they will be included in the public pension system. In the other four countries, farmers must be included, provided their land ownership or annual income surpasses a given threshold. Thus, in Poland the threshold is one hectare of land; in Slovenia it is cadastral income per household member exceeding the minimum wage; and in Croatia, for most farmers, it is 40 percent of the average wage.⁴⁶ Poland and Slovenia also offer the option for rather favourable voluntary inclusion of farmers into the pension system.⁴⁷ In Hungary, farmers are mandatorily covered as self-employed individuals if their income exceeds the self-employment income threshold. Those with income below this threshold may be covered on an optional basis.

Table 5	
Pension coverage of farmers, 2003	
Poland	Mandatory (above income threshold), voluntary (below threshold)
Romania	Voluntary for all
Hungary	Mandatory (above income threshold), voluntary (below threshold)
Croatia	Mandatory (above income threshold), voluntary (below threshold)
Slovenia	Mandatory (above income threshold), voluntary (below threshold)

Source: Bejaković, Section 2.2.; Máté, Section 4; Chłóń-Domińczak, Section 2.1.2.; Toma, Section 1.2.C.; Vezjak and Stanovnik, Section 3.3., this volume.

⁴⁶ A cadastre is Venetian loan word which refers to a public record, based on a map or survey, of the quantity, value, or ownership of a piece of land to be used as the basis for taxation.

⁴⁷ The conditions for the mandatory and voluntary inclusion of farmers into the pension system in Hungary and Croatia are not clear.

3.2.4. Contribution Rates

Table 6 provides the employer and employee contribution rates for pension insurance.⁴⁸ It does not indicate the portion of the rate that is earmarked for the second mandatory pillar private savings funds. These portions are: 7.3 percent in Poland, 7.0 percent in Hungary and 5 percent in Croatia.

Table 6
Contribution rates for pension and disability insurance (in %), 2003

	Employee rate	Employer rate	Total
Poland	16.26	16.26	32.52
Romania	9.5	24.5	34.0
Hungary	8.5	18.0	26.5
Croatia	20.0	0.0	20.0
Slovenia	15.5	8.85	24.35

Source: Bejaković, Section 3.1.; Máté, Section 3.3.; Chłóń-Domińczak, Section 3.1.; Toma, Section 3; and Vezjak and Stanovnik, Section 3.1., this volume.

Note: For Romania and Croatia the normal rates are taken (and not higher rates for insurance with extended duration).

4. Contribution Compliance

Contribution compliance can be measured using various indicators. The main one calculated in all the country studies is the *covered wage bill*, which is expressed as percentage of GDP. This measure shows the hypothetical wage bill of the economy that would have, given the known contribution rate (employer + employee), produced the actual (observed) contribution revenues collected

⁴⁸ These rates include old age, disability, and survivors coverage and in some countries employment injury.

on behalf of employees. Low values of this indicator can of course also mean that wages represent a low share of GDP. However, a decreasing trend-value of this indicator strongly points toward deteriorating contribution compliance for employees, the largest group of insured persons; and an increasing trend suggests improving compliance.

Another indicator that is highly relevant for assessing the quality of employee compliance is the *effective contribution rate*. This is the ratio between (1) actual contribution revenues collected on behalf of employees, and (2) the computed aggregate contribution base for employees. The latter is obtained by multiplying the number of employees times the average (annual) wage. The effective contribution rate is then compared to the statutory (i.e. joint) employer + employee rate. The effective contribution rate is closely related to the *contribution gap*, defined as the difference between actual contribution revenue collected and the product of (1) average annual number of employees, times (2) the average annual wage, times (3) the statutory contribution rate.⁴⁹ A high *effective contribution rate/statutory contribution rate* ratio implies high compliance for the largest group of insured persons – employees.

An additional measure of contribution compliance is *contribution debt*, expressed as a percentage of GDP. This measure is the least informative, as its value depends on the government's policy of write-offs, as well as on country-specific administrative procedures. In Slovenia, for example, if an employer does not submit a monthly notification list for wages, there is no evidence of contributions due.

4.1. *The Covered Wage Bill*

As described previously, the value of the covered wage bill is not its actual value in the national economy, but rather a hypothetical value. In developed countries the real value of the wage bill is rather high, and generally greater than 50 percent of GDP. Low values (measured as percentage of GDP) can indicate that the share of the informal economy is quite large, i.e. that many

⁴⁹ This measure is described in McGillivray (2001, p.10).

active persons do not receive wages or receive wages that are not subject to contributions. In Central and Eastern Europe, where legal social security coverage extends to the great majority of workers, low values of the covered wage bill are also a strong indicator of non-compliance. Table 7 presents the dynamics of the covered wage bill in the five countries.

Table 7
The covered wage bill as percentage of GDP

	Poland	Romania	Hungary	Croatia	Slovenia
1990	—	42.5	32.0	—	—
1991	—	36.3	33.2	—	—
1992	26.8	30.2	28.8	—	42.0
1993	26.3	25.3	27.6	—	42.3
1994	27.1	21.3	27.4	—	40.0
1995	25.9	21.3	25.6	—	39.5
1996	26.3	20.3	24.4	38.4	38.8
1997	26.1	17.7	24.4	37.6	38.0
1998	25.2	18.0	24.5	38.5	38.0
1999	29.5	15.2	24.1	39.6	37.4
2000	28.0	15.3	24.1	40.0	36.1
2001	28.6	15.9	26.1	39.8	35.6
2002	27.5	16.4	27.5	40.8	35.1

Source: Bejaković, Table 9; Máté, Table 6; Chłoń-Domińczak, Table 9; Toma, Table 6; and Vezjak and Stanovnik, Table 8, this volume.

Note: In computing the covered wage bill for Poland, contribution revenue collected from the self-employed was also included, as separate data on contributions collected on behalf of the employees are not available. The large increase of the covered wage bill in Poland in 1999 was caused by a large shift of the contribution burden – from the employer to the employee – with little change in overall labour costs (wages + employer contributions). In order to prevent the decrease in real net wages, which would be caused by the introduction of the employee contribution rate, nominal wages were increased and thus also the actual wage bill of the economy (Chłoń-Domińczak, Section 4, this volume).

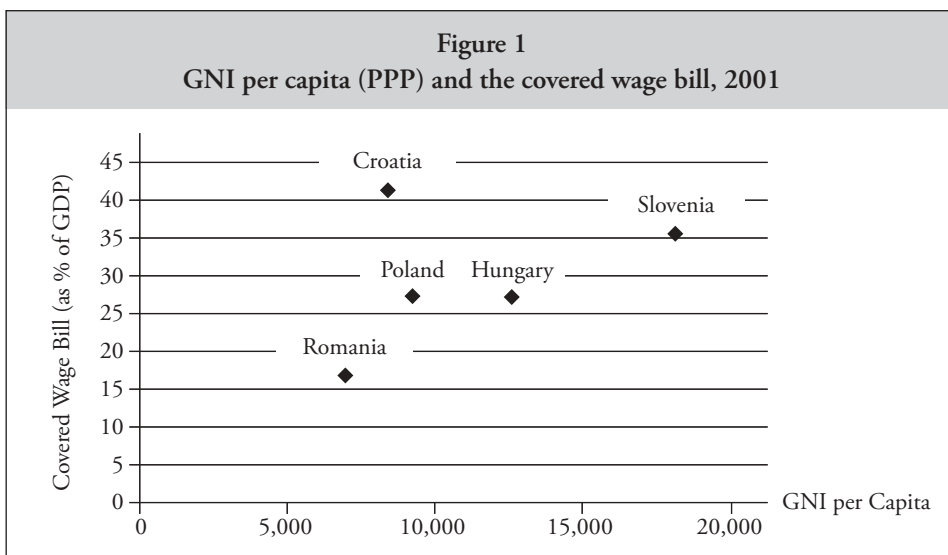
As may be seen from Table 7, the covered wage bill (measured as percentage of GDP) was decreasing in Poland, Romania, Hungary and Slovenia during the 1990s. However, in Romania and Hungary this indicator has recently shown a small increase, starting in 2000 and 2001, respectively. As yet, there is no clear sign of an upward trend in Poland and Slovenia, though the value of the covered wage bill is still relatively high in Slovenia. Croatia also seems to be experiencing improved contribution compliance, and the value of the covered wage bill in 2002 – 40.8 percent of GDP – is the highest among all the five countries. However, as noted by Bejaković, the rate may be inflated by an underestimation of Croatian GDP. Though low and decreasing values of the covered wage bill provide a strong signal for deteriorating contribution compliance, the decreasing values can also be caused by structural changes in the economy – such as an increase in the number of self-employed and decrease in the number of employees. Such structural shifts could cause a decrease in the share of wages in GDP and, consequently, also a decrease in the covered wage bill, measured as percentage of GDP.

That is why a comparison of the covered wage bill and actual wage bill provides a useful auxiliary measure, showing whether compliance is improving or deteriorating in the largest subgroup of insured persons – employees. Gál et al. (2002) show that the actual wage bill in Hungary decreased from 39.6 percent of GDP in 1992 to 34.3 percent in 2000, a decrease that is in their view caused mostly by an increase in the shadow economy. The ratio between the covered wage bill and actual wage bill in Hungary decreased from 76.5 percent in 1992 to 71.9 percent in 2000, providing clear proof of deteriorating compliance among employees during this period.⁵⁰ In Slovenia, this ratio has also been steadily declining since 1998, when its value was 83.3 percent; in 2002 its value was only 78.0 percent. This in effect means that in 2002, in Hungary some 28 percent of wages disbursed evaded contribution payment, and the corresponding percentage in Slovenia was 22 percent. Croatia can be singled out as a country with a remarkably high – and increasing – value of

⁵⁰ Gál et al. (2002). The ratio between the covered wage bill and actual wage bill, using data from Table 7 are: 72.7 percent in 1992 and 70.3 percent in 2002. Thus, according to our data, the decline in compliance was less severe, though qualitatively the conclusions remain the same.

this auxiliary indicator. In 2001, the ratio between the covered wage bill and actual wage bill amounted to 91.4 percent, meaning that only 8.6 percent of all earnings evaded contribution payment.

It is tempting to compare the values of the covered wage bill (as percentage of GDP) across countries. However, caution is warranted, since differences in the quality of national account statistics and inability to distinguish contributions collected from different groups of insured persons mostly result in overestimates of the “true” covered wage bill. Thus, for example, the computed value of the covered wage bill for Poland, presented in Table 7, overestimates the “true” covered wage bill, because it includes income of the self-employed. This is due to the fact that contribution revenues collected from the self-employed could not be separated from those collected on behalf of employees. As noted by Bejaković, it is also quite possible that the official estimates of GDP and wages for Croatia, published by the Central Bureau of Statistics, are too low, and that this causes the indicators of its contribution compliance to be overstated.⁵¹



Source: For GNI (Gross National Income) per capita: *World development report 2003*, The World Bank; for covered wage bill, Table 7.

⁵¹ It will be interesting to observe whether there will be upward revisions of GDP in Croatia, caused by the EU accession process, and – more specifically – the Eurostat requirements.

Bearing in mind these caveats, Figure 1 nevertheless clearly indicates that the covered wage bill (as percentage of GDP) is correlated with GDP per capita; countries with higher GDP per capita also have a higher value of the covered wage bill (as percentage of GDP).

4.2. Contribution Debt

Contribution debt is probably the least useful indicator for measuring the efficiency of contribution collection and compliance. The outstanding debt to social security institutions depends on the interest rates used, and these interest rates usually include a penalty interest rate. Much of this debt is “beyond the pale” and is uncollectable.

Table 8
Contribution debt (as percentage of GDP)

	Poland	Romania	Hungary	Slovenia
1992	—	—	1.48	—
1993	—	—	1.83	—
1994	—	—	2.40	—
1995	1.42	—	2.20	—
1996	1.27	—	1.81	0.62
1997	1.29	—	1.48	0.64
1998	1.58	3.00	1.39	0.59
1999	1.64	5.08	1.59	0.54
2000	1.50	8.25	0.48	0.47
2001	1.42	6.54	0.40	0.46
2002	1.63	6.19	0.43	0.45

Source: Máté, Table 8; Chłoń-Domińczak, Table 10; Toma, Table 7; and Vezjak and Stanovnik, Table 10, this volume.

Note: For Poland the debt does not include accrued interest. It includes the debt of both ZUS and KRUS, the farmers’ pension system.

Furthermore, the government, with its policy of write-offs and debt conversion into equity, can do much to modify its value. This is clearly seen in Table 8, where a sudden improvement, i.e. large drop in the debt/GDP ratio, in Hungary was the result of legislation introduced in 1999, which authorised write-offs of smaller amounts of debt.

4.2.1. The Structure of the Contribution Debt

While quality of the data and its detail are uneven across the countries, a clear pattern concerning the structure of the contribution debt nevertheless does emerge.

In Poland, the largest share of debt was from the structural debtors – these include enterprises in the steel industry, coal mining and the railway company. In Romania, large companies (i.e. those employing more than 250 employees) account for over 70 percent of contribution debt. In Hungary, the largest debtor in the mid-1990s was the Hungarian State Railways. This debt was settled by a special law and was repaid from the state budget. The very high concentration of contribution debt in Hungary is seen in the fact that in 1995, 0.5 percent of all debtors were responsible for 65 percent of the total contribution debt and 0.1 percent of all debtors were responsible for 41 percent of the total contribution debt. In Croatia, contribution debt is also concentrated among big firms: shipyards, railways and agro-processing firms. In Slovenia, most of the debt is caused by the self-employed; however, this is due to the payment technique. For the self-employed the technique is advance payment, i.e. sums which they must pay regardless of economic and financial conditions. On the other hand, legal persons can evade payment simply by failing to produce the notification list of wages disbursed (the so-called REK form), which triggers their legal liability.⁵²

⁵² Because in Slovenia employers have an obligation to pay contributions only upon submitting the REK form, they can evade the contribution requirement simply by not filing it. Vezjak and Stanovnik, Section 5.2., this volume.

4.3. *Write-offs and Deferrals*

In all five countries, social insurance institutions have very limited possibilities to write off debt. Thus, in Poland ZUS cannot by itself write off debt or any part of contributions due. In Romania, the social insurance institution can (under certain conditions) reduce or cancel only interest payments and there is a legislative framework for drawing up such arrangements. A similar policy is pursued in Hungary, where a debtor can be offered an agreement whereby late payment charges and fines are reduced or even completely cancelled; there are of course certain strings attached.⁵³ In Slovenia, ZPIZ can write off debt, but only on the recommendation of the Tax Administration and if the debt is uncollectible.

Writing-off of debt is therefore mostly a matter of government policy. Thus, Poland resorted to a partial writing-off of debt and, starting in 1999, reserves were created in order to cover uncertain liabilities.⁵⁴ In Croatia the government adopted a provisional measure in 2001 for the consolidation of agro-processing firms, by authorising relevant ministries to write off or reschedule debt or convert debt into equity.⁵⁵ In Romania, for state-owned companies in the agricultural sector, the law provides for a write-off of contribution interest and penalties when the firm is being privatised.⁵⁶

Policies for deferral are similar across these countries, and here the social insurance institutions are given somewhat more latitude. In Poland, social security law allows deferral of contribution payments if certain conditions are met: current contributions must be paid regularly and all employee contributions must be up to date.⁵⁷ As noted previously, reduction of contribution liabilities is possible only by law. Romania pursues a similar policy for deferral: social insurance institutions are entitled to grant deferral of

⁵³ Namely, “good behaviour,” meaning that this preferential term would cease if the debtor failed to meet current obligations. See Máté, Section 5.7., this volume.

⁵⁴ Chłoń-Domińczak, Section 5.1., this volume.

⁵⁵ Bejaković, Section 5.1., this volume.

⁵⁶ Toma, Section 5.1., this volume.

⁵⁷ Chłoń-Domińczak, Section 5.4., this volume.

payment of contributions, as well as reduce or cancel the payment of interest, provided that certain conditions are met.⁵⁸ In Slovenia, legal provisions in the 1999 Pension and Disability Insurance Act gave ZPIZ the authority to grant deferral of payment of contributions, as well as partial write-off or payment in instalments. This is now done upon the recommendation of the Tax Administration. The right to grant deferral of contribution payment is also in the domaine of the Minister of Labour (and the larger demands usually land on his desk).⁵⁹

4.4. Non-compliance and Protection of Workers' Rights

The policy of protection of workers rights in the case of employer non-compliance is quite similar across these countries. In a nutshell: workers' rights are protected even if the employer does not pay contributions. As stated by Máté, "... the basic concept is that employers' failure to pay contributions may not cause detriment to employees."⁶⁰ Thus, in Hungary, the time for which the employer deducted or presumably deducted contributions (presumable on the basis of the existence of insurance) is counted as period of insurance. This of course concerns rights in the first, public, pillar only. It is interesting to observe that in Romania the pension law enacted in 2000 introduced a provision whereby only periods for which contributions were paid should count as insurance periods. This provision was soon repealed.⁶¹ Similarly in Poland, workers' rights are protected in the case of non-payment of contributions, and the state budget takes over responsibility for that part.⁶² In Croatia and Slovenia, all periods for which it can be established that wages have been paid are counted as insurance periods. If there is no proof of wages being paid, but the person was formally in insurance (i.e. in the registry of

⁵⁸ Toma, Section 5.3., this volume.

⁵⁹ Vezjak and Stanovnik, Section 5.2., this volume.

⁶⁰ Máté, Section 5.8., this volume.

⁶¹ Toma, Section 5.1., this volume.

⁶² Chłoń-Domińczak, Section 5, this volume.

insured persons) this period is counted as an insurance period, but with zero percent accrual rate.⁶³

The second pillar presents a very different situation regarding the rights of workers: no payment of contributions into the private savings funds means lower accumulated pension savings. However, workers' rights are protected in Poland, and the state budget takes over responsibility, but only in case of bankruptcy or full insolvency of the firm.⁶⁴ In Croatia, there is no protection of workers' rights in case of bankruptcy of the firm and public awareness of this problem is becoming particularly acute.⁶⁵

4.5. Improving Compliance and Collection

In contemplating measures for improving compliance and collection, one cannot be satisfied with a broad wish-list of measures, some of which might prove to be quite impractical. On the other hand, one must not be too firmly embedded in reality, and cite weak administrative capacity, poor infrastructure, and lack of IT systems as reasons for inaction. The modernisation of the tax and contribution system must proceed, as it can provide greater transparency, lower the enforcement agency's costs of monitoring contribution payers, and improve the quality of information available to all the parties involved. Some countries have made considerable progress in this direction, most notably Poland and Croatia, but not without major short-term costs and disruptions. Technical modernisation can also bring an improved general awareness of the compliance issue.

Increasing the contribution rate in the vain hope of increasing contribution revenues cannot be a viable option. Romania increased the contribution rate several times during the 1990s with a concomitant decrease in contribution revenues. This is a textbook example of the Laffer curve, where higher taxation reduces tax revenues.⁶⁶ The decrease in contribution rates, coupled with strong

⁶³ Bejaković, Section 5.2.; and Vezjak and Stanovnik, Section 5.4., this volume.

⁶⁴ Chłóń-Domińczak, Section 5, this volume.

⁶⁵ Bejaković, Section 6.2., this volume.

⁶⁶ Toma, Section 4.3., this volume.

measures to increase compliance, can be beneficial for all. In this sense, the experience of Hungary, which decreased its contribution rate in 2002 by 6 percentage points as compared to 1998, and the experience of Romania, which decreased its contribution rate for employees by 4.5 percentage points in 2003, will be closely monitored.

5. Concluding Remarks

The paradigm shift that has taken place in Central and Eastern Europe, i.e. strong push for privatisation of social protection systems, and particularly pension systems – has had a clear impact on the administering institutions. However, it would be wrong to ascribe the reduced role of social insurance institutions only to the radicalism of pension reform. Of the five countries analysed in this study, Poland doubtlessly introduced the most fundamental pension reform not only in the second pillar but also in the first pillar. However, the central social insurance institution, ZUS, has retained its dominant role and all its pre-reform functions, in spite of the stumbling and fumbling which this institution experienced in the reform process. In fact, ZUS's functions have expanded enormously as a result of the reform. In Slovenia, which also introduced a far-reaching reform in 1999, the role of the pension insurance institution has also increased, with ZPIZ being given a larger mandate for inspection and contribution deferrals. This has to be contrasted with Hungary and Croatia, where key collection functions of social insurance institutions have been transferred to the tax authority; in the case of Croatia, a new collection agency was also introduced. The rationale for introducing a new collection agency could be questioned, since utilising existing collection systems is inherently more cost-effective, unless the existing systems are deemed unreformable and incapable of swift modernisation.⁶⁷

The move toward continuous (monthly) recording of individual contributions was one of the basic tenets of pension privatisation; these new and vastly increased demands were caused by the introduction of the mandatory

⁶⁷ This is also the position taken by S. Ross (2004), p.5.

second pillar. Individualisation of monthly reporting is not required for the first pillar, except in Poland, where a NDC scheme was introduced. However, the trend toward individualisation seems to have had very strong spill-over effects to the first pillar – through the use of state-of-the-art IT systems for transmission of data, processing of data, control, etc. It seems that these spill-over effects did not occur in Hungary, where there appears to be little progress in simplifying and modernising contribution collection. Romania provides yet another example that individualisation of contributions does not – *per se* – induce improved efficiency in collection. Thus, Romania still does not have a complete and regularly updated registry of contribution payers, which is one of the basic requirements for efficient reporting and allocation of contributions to individuals. Here, one is reminded of the warning by Stanley Ross that “ ... tax collection or contribution collection in modern societies requires a government-wide approach. It is necessary to have the cooperation of a number of government agencies to be effective.”⁶⁸

In sum, effective collection systems are those that take account of the broader administrative capacity and performance of government institutions. Improvements here do not happen overnight and require a slow and gradual building of trust. Citizens must come to view institutions – be they social insurance institutions or other institutions of the state – as efficient and fair. This can be achieved through greater transparency and by greater consultation among the parties involved: the government, the social insurance institutions, employers and employees.⁶⁹ Such consultations increase trust and positive public perceptions of social insurance institutions as fair and equitable mechanisms for intergenerational income (and consumption) transfers.

⁶⁸ Ross (2004), p.5.

⁶⁹ France has introduced an Agreement on Management Objectives, set out jointly by the government and the social security institution responsible for collection of contributions, which lays down a whole series of measures, devised to establish greater trust and cooperation between the contribution payers (enterprises) and the social security organisation responsible for contribution collection. Lion (2004), p.8.

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Chapter 3

The Collection of Pension Contributions in Croatia

Predrag Bejaković¹

Abbreviations

REGOS	Central Registry of Insured Persons
CES	Croatian Employment Service
CHII	Croatian Health Insurance Institute
CPII	Croatian Pension Insurance Institute
IWVs	Invalid war veterans
HAGENA	The Agency for Supervision of Pension Funds and Insurance
FINA	Financial Agency for Payment Transaction

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1. A Brief and Recent History of the Croatian Pension System

1.1. *Labour Market Developments, Pension System Parameters, and Sustainability*

The 1990s witnessed a major drop in employment in Croatia. The activity rate (labour active/working age population) fell sharply, from 65.3 percent in 1991 to 50.7 percent in 2000. The primary cause was the large-scale exit from the labour force associated with the war and the restructuring of the economy. The number of employed persons declined from 1.43 million in 1991 to 1.26 million in 2000.² The cumulative drop in employment, compared to before the transition, amounted to about 35 percent.³ A small recovery was visible only in the late 1990s.

These changes had predictably negative consequences for the financing of pensions. From 1990 to 2002, the number of insured persons decreased by almost 550,000, while pensioners increased by almost 400,000. This was in part the result of a social policy which afforded pension status to those who had lost their jobs due to war or the economic transition and, in part, due to certain design features of the pension system itself. These features included:

- A relatively low retirement age: 60 for men and 55 for women, with early retirement at 55 for men and 50 for women. Temporary reductions of 1.33 percent were applied per year of earlier retirement.⁴
- The additional option to retire with 40 years of insurance (men) or 35 years of insurance (women) regardless of age.⁵
- A loose definition of disability that provided incentives for some groups of workers to retire early and so to receive relatively high pensions.⁶

² Excluding those employed in the police and defence.

³ This applies to legal entities, excluding the army and the police (which is the only definition of employment for which comparable data are available over the entire period).

⁴ These rules have been in force since 1965 (OG 51/64).

⁵ These conditions were set in 1983 (OG 26/83).

⁶ Pension and Disability Insurance Laws 26/83, 5/86, 42/87, 34/89, 57/89 and amendments, OG 40/90.

The combination of these factors placed the system in a tight financial squeeze. In 1990 there was one pensioner for every three contributors, whereas by 2002 the ratio was only 1.36. See Table 1.

Table 1
Active insured persons and pensioners (in thousands), Croatia, 1990–2002

Year	Insured persons	Pensioners in the public pension system	Ratio	Insured persons in the mixed system
1990	1,968	656	3.00	—
1991	1,839	720	2.56	—
1992	1,725	775	2.23	—
1993	1,698	795	2.14	—
1994	1,621	825	1.97	—
1995	1,568	865	1.81	—
1996	1,479	889	1.66	—
1997	1,469	926	1.59	—
1998	1,472	955	1.54	—
1999	1,406	1,018	1.38	—
2000	1,380	1,019	1.36	—
2001	1,402	1,032	1.36	—
2002	1,422	1,042	1.36	929

Source: Croatian Pension Insurance Institute.

During 1990–98 (when a significant reform was enacted), the number of pensioners increased by some 46 percent. This was primarily due to:

- payment of pensions to refugees living in Croatia who had acquired pension rights in other republics of the former Yugoslavia;
- transfer of the financing of pensions for members of the former Yugoslav army from the federal budget to that of the CPII;
- legislation providing eligibility for disability and survivor pensions paid to persons wounded in the war as well as to family members of combatants who had lost their lives; and

- legislation extending pension eligibility to certain former political prisoners.

Until the pension reform of 1998, there were three different bodies administering pension and disability insurance in Croatia:

- the Pension Insurance Institute for Workers (employees);
- the Pension Insurance Institute for the Self-employed (craftsmen); and
- the Pension Insurance Institute for Farmers.

By far, the largest of these three was the Pension Insurance Institute for Workers, with 1.28 million insured persons (87 percent of the total) and 868,000 pensioners (almost 91 percent of the total). The Pension Insurance Institute for the Self-employed is comprised of 80,000 insured persons (around six percent of the total) and 20,000 pensioners (two percent of total pensioners). The Pension Insurance Institute for Farmers had 109,000 insured persons (around eight percent of the total) and 67,000 pensioners (seven percent of total pensioners). During 1994–98, contribution rates for these three schemes were set annually by three specific laws.

The new Law on Pension Insurance (OG 102/98) merged these three institutes to form the Croatian Pension Insurance Institute (CPII). At the same time, it established equal contribution rates for all insured persons.⁷

The system had, and has, a huge need for subsidies. In 1999, transfers from the central government budget amounted to 33.2 percent of total CPII revenues, or HRK 6.28 billion.⁸ This was partially due to the need for subsidies for privileged pensions, which were received by 142,574 persons at a cost of HRK 3 billion, or 15 percent of CPII expenditures. See Table 2. In 2000, the transfer increased to HRK 7.16 billion, accounting for 35.4 percent of total CPII revenues, about half of which was needed to subsidise privileged pensions. By April 2003, the numbers of those receiving privileged pensions had risen to 174,259 pensioners, or 16.7 percent of the total.

⁷ Until 1998 the term *pension and disability insurance* was used, and from 1999 the term *pension insurance* has been applied, although this refers to disability insurance as well.

⁸ Figures from the Ministry of Finance, 2000.

Table 2
Number of persons with privileged pension rights in Croatia, 1999 and 2002

Category	Number of persons		Pension as % of average net wage
	1999	2002	2002
Police and judiciary	12,816	13,980	74.6
Members of WW2 resistance movement (NOR)	73,466	74,668	49.7
Members of government	126	408	46.6
Members of Croatian Academy of Sciences and Arts	79	108	97.9
Croatian defenders from the WW2 Home Guard	34,090	28,705	43.0
Former political prisoners	5,668	5,772	81.1
Parliamentary representatives	112	269	206.6
Members of the former Yugoslav National Army	16,217	14,947	57.5
Croatian Army	—	6,676	74.3
Veterans from the Croatian Homeland War	—	29,425	135.5
Total	142,574	174,958	—

Notes: At the end of 2002 the average pension in Croatia amounted to 44.9 percent of the average net wage.

Prior to the disintegration of Yugoslavia, pensions for officers of the Yugoslav army were financed from the Federal government budget. Following the disintegration, the newly formed states assumed responsibility for disbursing pensions for pensioners who were members of the former Yugoslav national army.

Source: Croatian Pension Insurance Institute.

By 2001, central government budget transfers to the CPII accounted for 3.4 percent of GDP, the additional deficit that had to be covered amounted 2.4 percent of GDP, and total expenditures for pension and disability insurance amounted to 13.9 percent of GDP.⁹ See Table 3. The World Bank identified

⁹ The World Bank estimated total transfers at six percent of GDP and total pension spending at 12 percent of GDP for this same year (World Bank, 2001). The discrepancy between these estimates reflects the fact that in Croatia there are still no reliable time series on GDP, so official data is partly estimated.

high pension expenditures as a key cause for the overall high level of public expenditures in Croatia and their continuing expansion (World Bank, 2001).

On June 1, 2000, the pension contribution rate was reduced from 21.5 to 19.5 percent (OG 54/2000). This action reflected a widespread perception of the need to reduce taxes on labour in an environment of high and rising unemployment.¹⁰ However, no modelling had been done on the likely impact on CPII revenues. The impact was negative and immediate. In nominal terms, CPII contribution revenue fell in June 2000 (as compared to May) by around five percent, and did not reach nominal May 2000 levels until June 2001. There was an understanding that the central government budget would cover the shortfall resulting from the cut (Anusic, O'Keefe, Madzarevic-Sujster, 2003).

Table 3
Revenues and expenditures of the Croatian Pension Insurance Institute
(as percentage of GDP), 1996–2002

Year	Total revenues	Contributions	Other	Transfers	Total expenditures	Deficit/surplus
1996	11.5	10.1	0.3	1.1	11.4	0.1
1997	12.1	9.9	0.3	2.1	12.5	–0.3
1998	11.7	8.5	0.4	2.8	12.0	–0.3
1999	13.4	8.8	0.2	4.4	13.4	0.0
2000	13.2	8.4	0.1	4.7	13.3	0.0
2001*	11.5	8.0	0.1	3.4	13.9	–2.4
2002*	8.0	7.1	0.1	0.8	13.2	–5.2

Source: CPII and Ministry of Finance. For GDP: *Statistical yearbook of the Republic of Croatia for 2003*, Central Bureau of Statistics, Zagreb.

* Since July 2001, pension contributions and payments have been included in the central budget.

¹⁰ According to the Croatian Employment Service, registered unemployment rose from 14.5 percent in 1995 to 22.8 percent at the end of 2001.

An important accounting change occurred in July 2001, when pension contributions and payments were directly included into the central government budget and no longer appeared on the CPII balance sheet. The widening gap between expenditures and revenues, which was previously covered through explicit transfers from the central government budget, now became an inherent state responsibility.

Another revenue shortfall appeared in the public pension system in 2002. This resulted from the partial privatisation of the Croatian pension system and the diversion of a portion of contributions to privately managed individual savings accounts. Enrolment in these second pillar funds began in late 2001, and by mid-2002 a large number of insured persons had opted for the mixed system.¹¹ A quarter of the contributions made on their behalf was diverted to the second pillar, leaving a corresponding increase in the public pension financing deficit.

1.2. *Pension Reforms*

As indicated above, the first reform of the pension system took place in 1998, when Parliament enacted the Law on Pension Insurance (*Zakon o mirovinskom osiguranju* – OG 102/98). Known as the “small pension reform,” this law aimed to reduce the annual pension deficit. It increased the retirement age gradually (by six months per year) for men to age 65 and for women to age 60 by 2008. It also gradually expanded the years of work counted in the pension formula, from the best consecutive ten years to the entire working period (also by 2008). It was hoped that this would provide an incentive for workers to pay contributions, or at least reduce incentives to evade them, since doing so would decrease the amount of the future pension. The minimum age for early retirement was also increased from 50 to 55 for women and from 55 to

¹¹ Some 37 percent of those who could choose opted for the second pillar; this was below government expectations.

60 for men.¹² Early retirement pensions were permanently reduced by 0.34 percent for every month that a person retired before the statutory retirement age, which represents an increase in comparison to the previous penalty. The definition of disability was tightened, and the procedure for the determination of disability modified, resulting in a reduction in the rate of approval of new applications for disability pensions. See Table 4.

Table 4
New beneficiaries of old age and disability pensions in Croatia, 1993–2001

	Old age pensioners	Disability pensioners	Total
1993	34,498	9,541	44,039
1994	22,156	12,022	34,178
1995	28,980	16,154	45,134
1996	20,359	9,667	30,026
1997	21,271	7,041	28,312
1998	30,614	14,234	44,848
1999	31,671	37,112*	68,783
2000	28,624	2,675	31,299
2001	25,091	3,406	28,497

* The one-time increase in 1999 was caused mainly by a provision of the Law on Pension Insurance (OG 102/98) that made certain invalidity insurance rights (such as allowances for part-time work and reassignment) part of the disability pension system. The holders of these rights thus became disability pension recipients.

Source: Croatian Pension Insurance Institute.

¹² In general, an early retirement pension can be taken within five years before the required age for a full old age pension. In 2003, the age threshold for early retirement was 57.5 with 35 years of employment for men; and 52.5 with 30 years of employment for women. By 2008, the age threshold will increase to age 60 with 35 years of employment for men, and 55 with 30 years of employment for women.

In 1995, the Croatian Government began to work on another reform with the help of the World Bank. This involved partial privatisation of the system. This second pension reform, called “the great reform,” was adopted in two acts: the Mandatory and Voluntary Pension Funds Act (OG 49/99) and Act on Pension Insurance Companies and Benefit Payment Based on Individual Fully-Funded Retirement Savings (OG, 106/99). The reformed pension system has three pillars:

- a mandatory pay-as-you-go public pension system;
- a mandatory individual capitalised savings system. All those under age 40 at the time of the reform had to participate. Those between ages 40 and 50 could opt either to remain in the pay-as-you-go system or to divert part of their contributions to one of a number of competing individual savings funds. By law, these funds must invest at least 50 percent of their assets in conservative government securities issued by the Republic of Croatia or the Croatian National Bank.¹³ In addition, no more than 15 percent of pension fund assets may be invested outside the Republic of Croatia.¹⁴ All contributions are exempt from taxation, and the pension is subject to a personal tax allowance;¹⁵ and
- a voluntary savings system based on capitalisation for those who want even more insurance against the risks of old age, disability, and death. The insurance operates according to the same principles as the second pillar with one exception – the insured person decides on the amount of

¹³ According to the Articles 68–79 of the Mandatory and Voluntary Pension Funds Act.

¹⁴ Such regulation does not preclude investments in equities: five percent of a fund's assets may be invested in short-term bank deposits and other short-term securities, and up to 30 percent may be invested in equities on organised capital markets.

¹⁵ In 2003 personal tax allowance (exemption) for pensioners was HRK 2,550 per month. On the amount of pension between HRK 2,550 and HRK 3,500 per month, tax is paid at the rate of 15 percent; on the next HRK 3,750 (from over HRK 3,000 and up to HRK 6,750 per month), at the rate of 25 percent; on the next HRK 14,250 (from over HRK 6,750 and up to HRK 21,000 per month), at the rate of 35 percent; and over HRK 21,000 per month, at the rate of 45 percent.

the contribution s/he makes. In addition to private pension companies, these third pillar funds may be established by trade unions and employers. The state provides an annual subsidy of up to HRK 1,250, and allows a deduction of up to HRK 1,050 per month from personal taxable income. This means that there is a double benefit – state subsidy and tax deduction – for these contributions.

Proponents of the reform cite the following positive features:

- The management of worker savings by one type of fund (pension management fund) and the payment of benefits by another (pension insurance companies) should diversify and reduce the risks for the whole system.
- Funds on the account are owned by the insured person, and not by the fund or another entity. It was hoped that this would increase workers' willingness to pay contributions.
- Funds on the account are protected from court enforcement, bankruptcy or liquidation, as well as use before retirement by their owner.
- Insured persons have a free choice of their pension management fund, as well as the possibility of transferring the account into another fund, which should increase the competitiveness and quality of funds' operations.
- The account is portable, and the funds remain under the ownership of the individual, regardless of changes in employment, until retirement.
- Insured persons are informed about the transmittal of their contributions by their employers, which might lead them to press for their employers' compliance with the contribution requirement.

Current pensioners and older insured persons remain entirely in the first pillar. The pension contribution rate was increased to 20 percent. For some categories of insured persons (younger than 40 at the time of the reform, and those between age 40 and 50 who opted for the mixed system) the contribution rate for the first pillar is 15 percent of the gross wage, while five percent is diverted to the second pillar.

Between November 15, 2001, when people started enrolling in the mandatory pension funds, and December 31, 2002, the end of the open season,

nearly one million (928,709) insured persons became members of the mandatory individual savings funds. Insured persons who were younger than age 40 and who failed to select a fund within the legally prescribed period (three months from the beginning of compulsory pension insurance) were assigned by REGOS in accordance with a prescribed algorithm. The first such assignment took place in early April 2002. In 2003, REGOS continued to assign insured persons who had not chosen a fund within three months of the inception of their employment.¹⁶

For 2002, the cumulative amount of collected gross contributions for the second pillar was HRK 1.94 billion and administrative fees were HRK 14.3 million, so net contribution was HRK 1.9 billion (HAGENA, Monthly Report for January 2003). At the end of September 2003, there were 1,035,210 insured persons in the second pillar.

2. An Overview of the Current Contribution Collection System

2.1. *The Institutional Setting and the Contribution Collection Mechanism*

2.1.1. The Situation Prior to Reform

Until mid-2001, Croatia had separate systems for collection of social insurance contributions and personal income taxes. Contributions were collected by the CPII and Croatian Health Insurance Institute (CHII), while personal income taxes were collected by the Tax Administration. According to the World Bank (2002), this produced a number of problems:

¹⁶ In January 2003, 9,725 insured persons who exceeded the period of three months from their new employment as at December 31, 2002 were allocated. In February 2003, 8,791 insured persons whose last chance to select a fund personally was the last day of January were allocated.

- a heavy reporting burden on employers, who had to submit information on contributions and taxes to different institutions, all of which had their own reporting format. In all, employers were required to submit some 20 different forms on either a monthly or annual basis;
- a further burden on firms resulting from dual systems for control and enforcement of the contribution requirement, with multiple separate inspections and verifications;
- administrative inefficiency, caused by parallel networks of staff engaged in collecting revenues and processing data in the CHII, CPII, and the Tax Administration. These institutions dealt with the same set of employers. For example, in the CPII alone, in 2003 the estimated number of staff dedicated to these functions is around 1,000 (out of a total 3,300);
- a lack of accountability and transparency in the system, as each institution negotiated specific payment arrangements with employers and failed to share contributor data with other institutions;
- a lack of coordination in developing, implementing, and evaluating strategies to increase compliance; and
- a heavy demand on public audit functions, which were already overstretched.

2.1.2. The New Arrangements

The partial privatisation of the Croatian pension system created a need for new procedures for collecting, processing, and transmitting contributions. Changes were necessary to ensure transmittal of contributions to the new individual savings funds and to provide detailed monthly accounting of the amounts so transferred. The funds also require government regulation to protect workers' interests. These needs are being met by two new institutions, as described earlier: REGOS (*Sredisnji registar osiguranika*, or Central Registry of Insured Persons) and HAGENA (*Agencija za nadzor mirovinskih fondova i osiguranja*, or the Agency for Supervision of Pension Funds and Insurance), as well as by a redefinition of the roles of CPII and the Tax Office. The new division of responsibilities is as follows:

REGOS

When REGOS was first established in 1999, its mandate related exclusively to the new second pillar: it was to establish and maintain a system of individual accounts for members of the new mandatory savings system.¹⁷ However, with the passage of two additional laws in 2001 and 2002, its functions were extended considerably to include the collection of data on *all* social insurance contributions, personal income tax, and surtax.¹⁸ These laws redesigned REGOS to unite the functions of several different state institutions. Its responsibilities under this expanded mandate are to:

- register insured persons with the second pillar individual savings funds (since the beginning of 2002);
- collect second pillar contributions, control them by checking them against the associated employer reports (R–S forms), and allocate them to the appropriate second pillar funds;
- maintain a central database of all individual accounts, employers, and pension funds;
- provide information to mandatory fund members and authorised institutions;
- report to the mandatory funds on the structure of their membership and provide them with relevant data from employer reports (R–S forms);¹⁹
- collect and process data on each insured person, including data on wages, mandatory social insurance contributions, personal income tax, and surtax; and

¹⁷ This authority is provided by the Mandatory and Voluntary Pension Funds Act (OG 49/99, 63/00 and 103/03 – PFA in further text) and the Decree on Establishing the Central Registry of Insured Persons (REGOS) (OG 101/99).

¹⁸ These were the special Law on Collection of Data on Insured Persons, Mandatory Contributions, Personal Income Tax and Surtax (*Zakonom o prikupljanju podataka o osiguranicima, o obveznim doprinosima, porezu na dohodak i prirezu*, OG 114/01 and 153/02).

¹⁹ The R–S form is “Insured person specification on calculated and paid mandatory contributions, personal income tax and surtax” (*Specifikacija po osiguranicima o obračunatim i uplacenim obveznim doprinosima, porezu na dohodak i prirezu poreza na dohodak*).

- control other mandatory payments, including contributions for the first pillar, health insurance contributions, unemployment contributions, and personal income tax and surtax.²⁰

The first five of these responsibilities are related to the original mandate of REGOS, and the last two, to the expansions in 2001 and 2002.

REGOS data are also supposed to be used by other institutions for control of payments, as well as for determining worker eligibility for pensions, health insurance, and unemployment benefit. However, this data sharing does not yet work well, particularly with the Tax Administration and CHII. See Section 2.1.4.

It is important to note that REGOS does not perform on-site inspections, as this is the responsibility of the Tax Administration.

REGOS is financed from the state budget and not from contribution revenues.

The Tax Administration

Since July 2001, the Tax Administration, an entity of the Ministry of Finance, has been responsible for the control of collections for all mandatory social insurance contributions (health insurance contributions, unemployment insurance contributions, and first pillar pension contributions).²¹ Since January 2003, it has also been responsible for on-site control of second pillar contributions.²² See Section 2.1.4. As explained previously, it is supposed to receive and use REGOS data for this purpose.

However, this arrangement is not yet in place. The main reason is overlapping legal statutes and discrepant interpretations of the law by the two agencies. While the law requires that other government agencies make use of REGOS data, the Tax Authority's authorising legislation also calls for it to collect data through its own forms. So, the Tax Authority continues to collect

²⁰ Through its IT system, REGOS controls calculation of contributions as stated on the R-S form.

²¹ Article 3 of the Law on the Tax Administration (*Zakon o poreznoj upravi* – OG 67/01).

²² Law on Mandatory Contributions, as previously cited.

its own data, offering the explanation that the R–S form cannot completely substitute for its own since there are inherent differences in the two data sets. Namely, tax data refers to incomes that are *actually paid* in a particular year no matter when they are *legally earned*, while social insurance data covers incomes that were *legally earned* in a particular year no matter when *actually paid*.

The Tax Authority is responsible for *enforcing* the contribution requirement for all social insurance benefits, a responsibility that, unlike the *control* function, is clearly exclusive.

The Croatian Pension Insurance Institute (CPII)

Under the new arrangements, CPII ceded its responsibilities for collection of contributions to the Tax Administration and REGOS. However, legislation states that the CPII should continue to control contributions and other relevant data related to pension rights.²³ CPII will perform these functions for some time, particularly for individual wage histories of those workers who are missing records for some years.²⁴

CPII also continues to maintain records of insured persons for the first pillar, though under the new arrangements its main data provider will be REGOS (data from the R–S form). Actually, the CPII record-keeping function is even expanded, as it is now using pension registration data (the M-1, M-2 and M-3 forms²⁵) as well as data from REGOS (the R–S form) to create its own annual records of insured persons.²⁶

²³ Specifically, CPII is assigned “control of accuracy and calculation of contributions,” as well as the *ex post* control of wages declared and contributions paid.

²⁴ The CPII should fill in this data at the latest during the process of computation of pension entitlements.

²⁵ The M-1P form is a form for registering into insurance; if the employee changes employer, the employer must submit the M-2P form, i.e. registering out of insurance. The M-3P form contains data that refer to changes that occurred during the insurance period – such as new surname, education degree, etc. All these forms are provided by the employer.

²⁶ This is similar to the M-4P form, which contained annual individualised data on insured persons provided to the CPII by employers. The M-4P was abolished as of January 2004.

The CPII's official budget has been trimmed along with its responsibilities. Since January 2004, its budget includes only agency administrative costs, whereas in 2002 and 2003 it still included some pension expenditures, such as pensions paid abroad.

The CPII remains a "first pillar institution." As before, it is governed by a 13 member tripartite board, appointed by the government.

HAGENA

HAGENA is responsible for the monitoring and regulation of pension funds. Its basic task is to protect the interests of pension fund members and participants in voluntary pension insurance. It issues and revokes licences for pension funds, monitors their operations and that of REGOS, and enforces the laws governing the second pillar.

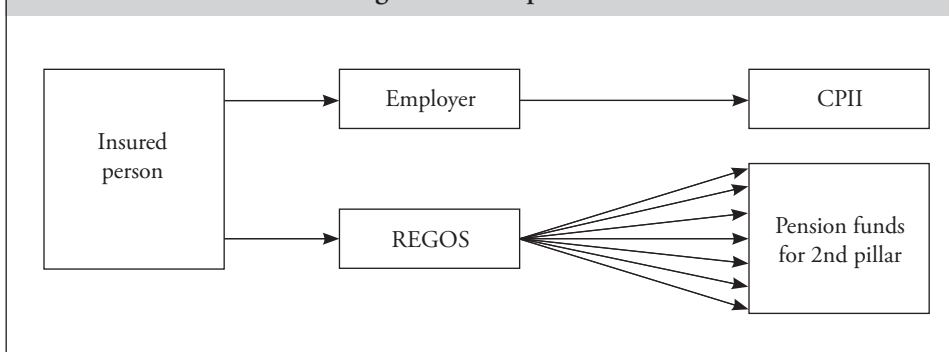
2.1.3. Registration

Employers are obliged to register each new employee with the CPII within 15 days of the commencement of employment. They do so on form M-1P, Insurance Application (*Prijava na osiguranje*), which requires basic information: the name of employee and employer, type of work, identification numbers, education and qualification level, working time, etc.

This same 15-day time limit also applies to employee registration with REGOS for the second pillar. See Figure 1. Significantly, under this procedure, there is no need for the employer to know the employee's choice of a particular pension fund, but only whether s/he is participating in the second pillar. This feature of the registration system avoids the employer's interference in the employee's decision.

Currently in Croatia there is no unified registry of insured persons. This means that the employer must submit separate registration forms for pension insurance (CPII) and health insurance (CHII). The self-employed are required to present certain attestations in order to register: either proof of registration in the business registry or, for farmers, documents proving that they are owners, tenants, or lessees of farmland or forestry.

Figure 1
Process of registration for pension insurance



2.1.4. Payment and Control of Contributions

The payment and control of contributions involves a number of agents and institutions whose roles are described below.

An employer pays contributions on behalf of employees from the employer's bank account to a Tax Administration account within the State Treasury,²⁷ except for second pillar contributions, which s/he pays to a special REGOS transfer account (*prolazni racun*) in the Treasury.²⁸

²⁷ The actual payment of contributions from employers is still mostly done by the Financial Agency (FINA), the successor agency of the central payments system. The agency serves as an outsourcing agent for the banks. Formerly this agency was ZAP (*Zavod za platni promet*), the central payment agency. Because of its strong IT support, many banks decided to outsource the function of financial transactions to FINA. However, with the development of IT at the banks, the role of FINA will probably diminish in the future.

²⁸ There is a separate subaccount for each type of contribution, except the second pillar contributions, which go to a REGOS account. This is a transitory account with the central bank. REGOS actually also has an account within the state treasury, but it is used only for its operating costs, and these are covered by the central government budget. In other words, second pillar contributions do not mix with operating expenses of REGOS. The employer's bank is obliged by law to inform the Tax Administration if the employer paid wages but failed to pay related contributions, no later than eight days after the wages were paid. However, this requirement is not being enforced.

At the same time, the employer is obliged to complete the R–S form. The R–S form includes individualised monthly data on:

- calculated pension contributions for the first and second pillars,
- health insurance contributions,
- unemployment contributions, and
- personal income tax and surtax.²⁹

Thus, the R–S form contains information on all compulsory contributions and direct taxes, which is a completely new way of collecting these data.

The employer sends the R–S form only to REGOS.³⁰ It is envisioned that this form will become the employer's sole report to government, and REGOS will then share this information with other agencies. Thus, the new system should reduce the administration costs to businesses through reducing the number of forms that employers have to complete in paying contributions and wages, and unifying them under one R–S form (World Bank, 2003).³¹ While this unified reporting promises great simplification, it has not yet been achieved. Under current procedures, employers are also required to send monthly reports to the Tax Administration – the ID and IDD forms.³² This

²⁹ Persons liable for personal income tax and who have a domicile or a common residence in the area of the commune/municipality that has prescribed the surtax on income tax are also liable for surtax. The surtax base is the amount of income tax. Rates are determined according the following rule: a commune at the rate of up to 10 percent, a city with a population below 30,000 at a rate of up to 12 percent, a city with a population over 30,000 at a rate of up to 15 percent, and the city of Zagreb at a rate of up to 30 percent.

³⁰ The R–S form is supposed to be submitted each time contributions are paid. If in one month a wage is paid in two or three instalments, the R–S form should be submitted each time.

³¹ It is envisioned that data exchange procedures between institutions will be developed according to contracts that will be, according to the legislation, signed between these institutions.

³² ID and IDD forms contain cumulative monthly data on contributions due and paid contributions and taxes. These are submitted by persons who are legally obliged to perform calculation and payment (employers and payers without established labour relation). The forms ID and IDD are sent once a month and do not contain individualised data on insured persons.

duplicative procedure is obsolete, and in the future the Tax Administration will have to find ways to rely on the R–S form instead of obtaining its own separate information.

Once REGOS receives the R–S form, it matches actual contributions paid for the second pillar to the contribution amounts reported on the form. For first pillar contributions, the REGOS procedures are less comprehensive: applying IT procedures, it simply checks the internal consistency of the information on the R–S form, ensuring that the contributions which are reported correspond to the level of reported wages and the applicable contribution base and rate.³³ It does not check these reported amounts against actual contributions paid. REGOS performs similarly limited control procedures for health insurance contributions, unemployment insurance contributions, and income tax data. Thus, except for the second pillar, REGOS only collects data and checks its internal consistency. It does not perform the entire IT data processing necessary for full control.

After REGOS completes these procedures, it transfers the second pillar contributions to the different private savings funds according to fund membership data. See Figure 2. Contributions for the first pillar are not transferred to a CPII account but rather remain in the State Treasury account for direct disbursement of pensions.³⁴ The money flow from the State Treasury to the CPII, indicated in Figure 2, refers to the monies provided for CPII administrative costs and other CPII operations.

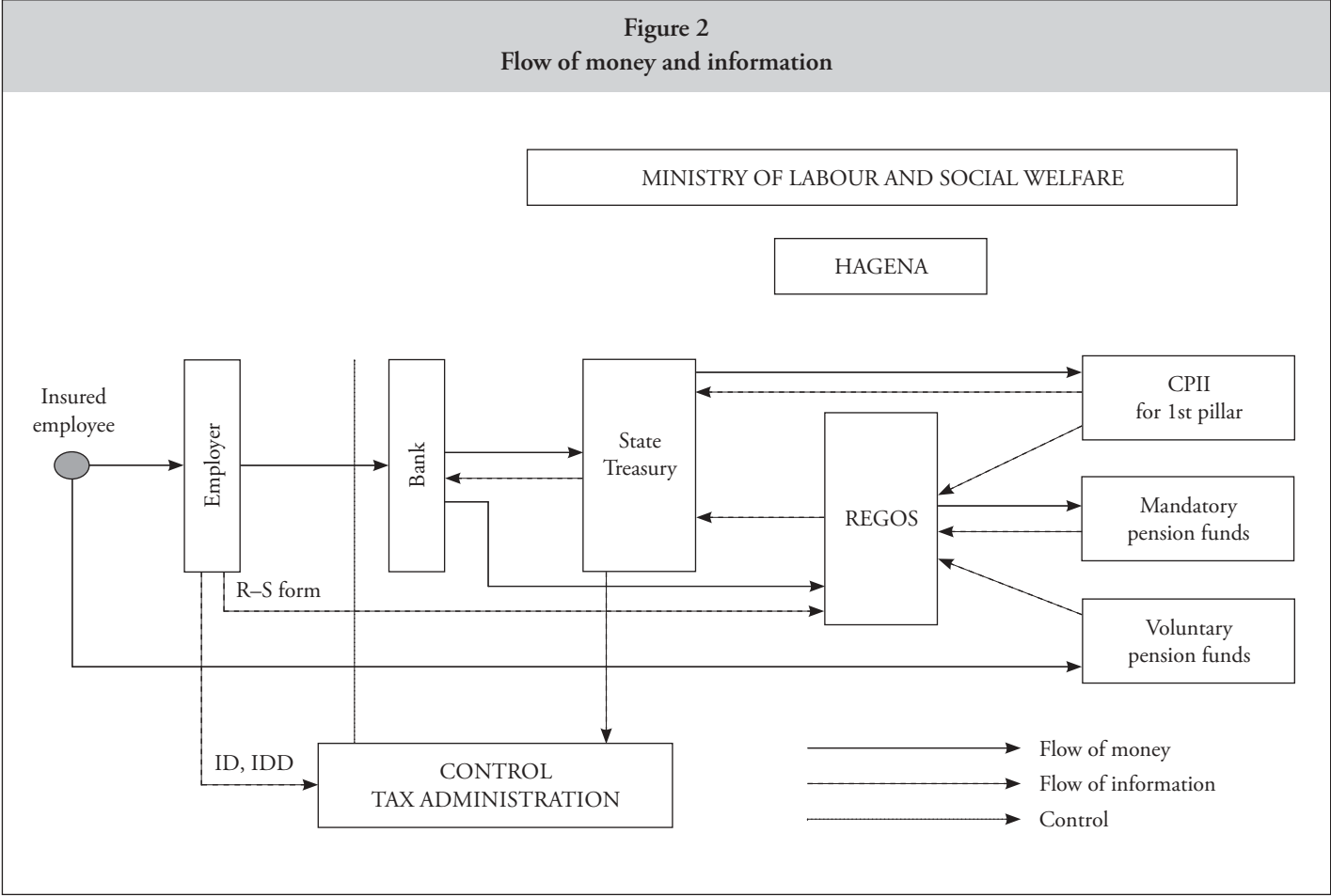
The shift of responsibility to the Tax Authority took place in several steps:

- In July 2000, the Tax Authority – through the single Treasury account – was given authority for the collection and control of pension contributions for all workers except the self-employed. CPII remained directly responsible for this group, because the Tax Authority did not yet have the necessary IT procedures in place.
- In July 2001, the Tax Authority was given responsibility for contribution collection for the CHII.

³³ The R–S form contains data on contribution base (wages, etc.) and calculated first pillar contributions on the individual (page B of R–S) and employer level (page A of R–S).

³⁴ The CPII provides the Treasury with data on pension payments to be made.

Figure 2
Flow of money and information



- Effective 2002, the Tax Authority became responsible for all auditing of enterprises (on-site control), with support by the CPII for control functions on employer reporting of employee status.
- In mid-2002, the Tax Administration assumed responsibility for unified control and enforcement of all social insurance contributions, including those of the self-employed.

The Tax Administration is also responsible for enforcement actions to collect all (including second pillar) contribution payments.

The new unified system of collections is expected to improve resource utilisation. Some preliminary information from the World Bank suggests that, during its first nine months of operation, compliance improved. (However, some officials of the CPII call this into question, asserting that the methodology for measuring compliance has changed.) The direct state responsibility for covering the CPII deficit has also helped to rationalise cash management, as there is no longer a need for the CPII to take out short-term loans from commercial banks. Furthermore, the CPII has been freed to concentrate on its basic task, i.e. the administration of public pension benefits.

2.1.5. IT System, Information Exchange, and Duplication

The CPII maintains three main databases: insured persons, pensioners, and contribution payers. Its operations have been only partially computerised, and there are important functions which continue to lack the required level of IT support. The most important individual records kept by the CPII are still based on annual reporting by the employer.³⁵

Since REGOS collects individualised data on a monthly basis, it is possible for CPII, as well as other agencies, to develop more up-to-date records. Moreover, these agencies have a legal obligation to reorganise their procedures

³⁵ The employer reports on the M-4PP form and on the form, “Recapitulation of paid salaries, wage compensations and contributions for pension insurance” (*Rekapitulacija isplacenih placa, naknada i doprinosa za mirovinsko osiguranje*).

and forms to make use of data collected by REGOS instead of requiring employers to duplicate, on a yearly basis, data previously submitted monthly on the R-S form.³⁶ However, this reorganisation has not yet been achieved; and in the meantime employers are making serious complaints about overlapping data requirements. They point out that virtually the same data must be provided to the REGOS on the R-S form, to the Tax Administration on forms ID and IDD, to FINA on form SPL, to the CPII on forms M-4P, M8P, etc. These duplicative requirements increase businesses' compliance costs, which estimates show are high in Croatia.³⁷ The situation is projected to improve in 2004, when several forms are to be cancelled.³⁸

REGOS uses its data to send an "Annual Report for Fund Members" to all persons participating in mandatory individual savings schemes under the second pillar. The report contains information on the transactions that occurred in the member's individual account during the previous calendar year, as well as the member's account balance on December 31. Members can check this data, as well as the up-to-date status of their individual accounts, via the "Individual Account" application on the REGOS Web page. They may also request an up-to-date statement at REGOS counters.

REGOS data is confidential, and governmental regulations pose restrictions on who may access and use it and under what conditions. Pursuant to these regulations, REGOS has taken measures to ensure the security of its data and to protect the privacy of workers and employers. It uses special algorithms to encrypt documents, including secure hash marks issued by the US National Institute of Standards and Technology.

³⁶ It is envisioned that in the beginning REGOS will share this monthly data through transfers, later by direct access to host databases.

³⁷ See Zuber (2003a) and Blazic (2004).

³⁸ These are the M-4PP (M-8P) form containing annual individual data on working periods and salaries, the M-5P (M9P) containing data on insurance periods and compensations of salaries after the cessation of employment relation paid by CHII, the M-6P (M-1P0P) form containing data on insurance period, compensation of salary and contribution base in relation to professional rehabilitation and disability pension due to professional incapacity to work, and the M-1P6P (M-1P7) form containing data on compensations of salaries paid by centres for social work and welfare.

REGOS has also made efforts to use technology to facilitate communication with the public. All the required programmes for preparing the R–S form can be downloaded from the REGOS Web site. At the beginning of 2003, it opened a call centre to provide fast and accurate replies to the questions of citizens and insured persons. The call centre receives on average 250 calls per day. Most questions are answered immediately, while the more complex ones are referred to affiliated institutions.

2.1.6. REGOS and the Second Pillar

As described previously, REGOS maintains an accounting system for second pillar individual savings accounts. Its records show that, in 2002, the total amount of contributions to the second pillar was HRK 1.97 billion. From this, HRK 1.938 billion was allocated to the personal accounts of fund members by December 31, 2002. This means that 98.4 percent of contributions paid to the second pillar were allocated. The remaining 1.6 percent could not be matched with data on the R–S form. This might be, for example, because the payment document (key for connecting the data with the payments) included an incorrect reference number, because the contributions were made on behalf of newly-employed persons who had not yet selected a fund, or because the individual on whose behalf the contributions were made was not eligible to have a second pillar account.

After all the controls are applied, if data are not reconciled in a three-day period, contributions are transferred from the regular REGOS account to a *temporary* second pillar contributions account. At the same time, R–S records are transferred to a special database that contains unmatched data. This temporary account is under the responsibility of the Ministry of Finance, but REGOS administers the data and performs the necessary procedures.

REGOS makes efforts to match data in the temporary account and R–S data on a daily basis. When data are reconciled and matched, contributions are credited to the appropriate individual accounts and transferred to the second pillar fund. Also on a daily basis, REGOS makes electronic transmissions of both individualised and consolidated data to the funds; and it transfers related contributions to the fund accounts. In cases where R–S data are

correct but contributions are less than they should be, contributions are proportionally allocated to the second pillar accounts. For example, if 70 percent of all contributions are paid, 70 percent of contributions due to the individual accounts are allocated. R–S records are simultaneously updated with this information, and an “unresolved” status code is assigned until all due contributions are paid. When missing contributions related to that particular R–S form come in, contributions are credited to the second pillar account and transferred to the fund.³⁹

REGOS also receives the requests of insured persons who are applying for or want to change their mandatory individual savings fund. In the future, when insured persons will retire and wish to convert their individual savings to a monthly annuity, REGOS will transfer the balance in their fund to a pension insurance company selected by the individual.

2.2. Who is Covered by Mandatory Pension Insurance?

Pension coverage in Croatia is very broad: it applies to all employees, self-employed persons, and farmers.⁴⁰ In addition it extends to:

- members of management boards, unless they are insured on another basis;⁴¹
- priests, monks, nuns and other clerical officers, during their service in a religious community, unless they are insured on another basis;⁴² and

³⁹ Each contribution bill contains matching data that connects it with the particular R–S form record – employer ID number, wage bill year and month, and bill sequence number.

⁴⁰ According to the Law on Pension Insurance (OG 102/98), Article 12, farmers and members of their households who perform agricultural activities as their only or principal occupation must be mandatorily insured. Persons are not deemed to perform agricultural activities as their only or principal occupation if they are mandatorily insured on another basis, or if they receive pensions, or if they are enrolled in regular educational institutions.

⁴¹ Article 13 of the Law on Pension Insurance (OG 102/98) stipulates that members of management boards of trading companies must be insured mandatorily.

⁴² Article 14 of the Law on Pension Insurance (OG 102/98).

- parents who stay home to care for a child during its first year of life, provided that the parent is not insured on another basis.⁴³

The law also provides an option for voluntary insurance for persons whose mandatory pension insurance has terminated. They may insure themselves under the so-called “prolonged insurance scheme” within 12 months of termination. This option applies to persons who are:

- on unpaid leave;
- caring for a child under age three;
- receiving vocational training following the termination of the employment contract or cessation of self-employment;
- unemployed and registered with the Croatian Employment Service; and
- sailors after cessation of a temporary employment contract.

2.3. *Method of Paying Contributions*

The law provides that it is employees alone who must pay pension contributions for both the first and second pillars, without a matching contribution from their employers. However, withholding, reporting, and transmission of contributions are the employer’s obligation.⁴⁴ For some particular forms of employment (arduous and unhealthy jobs, police and military service, etc.), or where the employee has a particularly serious illness (multiple sclerosis, blindness, etc.), insurance periods are counted in so-called “extended duration”: that is, 12 months of insurance are counted as longer periods (from 14 to 18 months).⁴⁵ In these cases, besides the regular contributions paid by employees,

⁴³ Where both parents perform such parental duties and they are not insured on another basis, the mother of the child will be insured unless the parents decide otherwise, according to Article 15 of the Law on Pension Insurance (OG 102/98).

⁴⁴ Article 40 of the Compulsory and Voluntary Pension Funds Act.

⁴⁵ Article 17 of the Law on Pension Insurance (OG 102/98). Pension insurance with extended duration (*Osiguranja s povecanim trajanjem*) according to the appropriate Law (OG 71/99) is provided for some particular forms of employment (arduous and unhealthy jobs, police and military service, etc.), or where the employee has a particularly serious illness (multiple sclerosis, blindness, etc.); insurance periods are counted in extended duration.

employers must also pay special contributions to both pillars (as with regular contributions, a quarter goes to the second pillar).

The employer calculates all mandatory social contributions and pays them in one amount for all employees, at the same time that wages are paid. The employer simultaneously prepares the R-S form. An employer with more than 20 employees must prepare and deliver this in electronic form, while small employers may deliver it on paper. As explained previously, this form contains individualised data on wages, contributions (both first and second pillar), and taxes, as well as a summary total. (Health and unemployment insurance contributions are not individualised because all these contributions are the employer's obligation and are calculated as a certain percentage of the wage bill for all the employees. However, the health and unemployment systems may require individualised data in the future.)

The R-S form has two parts. The first part (page A) contains data at the employer level that identify that particular R-S and serves to connect the R-S form with the related contribution payment bill. It also provides the total amount of wages, health insurance contributions, and the first and second pillar contributions. The second part (page B) contains individualised data on each employee, including the second pillar contribution data.

Page A data must match the data on page B, and these values must also match the actual amount of contribution payments. As explained earlier, it is the job of the Tax Authority to perform on-site control of contributions to ensure that these values match. For purposes of control, REGOS should provide the Tax Authority with data from the R-S form.⁴⁶ If values do not match, an error code should be flagged, and the employer should prepare a new form or to correct data in the previously submitted document (data file).⁴⁷

⁴⁶ Since 2002, payment clearing activities may be performed by commercial banks. However, most of them concluded contracts with FINA for outsourcing this function. Thus, the majority of payment clearing activities is still performed by FINA.

⁴⁷ By the end of 2003, the first pillar data should have been consolidated. This means that the data will be compressed on a yearly basis according to the rules legislated for the first pillar. For example, instead of 12 or more records that contain data on each wage and contribution payment, wages will be summarised at the year/employer/employee

However, these procedures are not yet in place. As explained previously, the Tax Authority refuses to use REGOS data and still collects its own on its own forms. As a result, the objectives of the 2003 law are not yet fulfilled.⁴⁸

3. The Contribution Base and Rates for Different Groups of Contributors

3.1. Overview

Contribution bases and rates have changed frequently in Croatia over the years. Therefore, the situation must be examined from year to year; the period of analysis here will be from 1995 to 2003.

Since the beginning of 1995, the base for paying contributions has been linked to, and determined in accordance with, definitions in tax law. Thus, salary is defined as all forms of remuneration paid by an employer to an employee that are subject to personal income tax. This definition is still in effect.

Beginning in 1996, employers that failed to pay salaries for the previous month (by the 15th day of the current month) nevertheless had to pay pension contributions on the minimum contribution base.⁴⁹ Such contributions were deemed as an “advance payment,” i.e. a portion of the contributions that would become due in full when salaries were finally paid. This rule applied until the beginning of 2003, when it was repealed.⁵⁰ Since then, the employer

level. These processes will be automated and will include a comparison between actual contribution payment data and the R–S form.

⁴⁸ Furthermore, in June 2004 the Tax Authority proposed that REGOS’ role should be limited to the second pillar and that it (the TA) would instead collect information on wages, contributions, income tax, and surtax on its own forms, process this data, and supply it to the CPII, CHII and other agencies. The issue is unresolved, leaving considerable uncertainty for the future of the collections system.

⁴⁹ Prior to 1996, this base applied only to health insurance contributions.

⁵⁰ The cancellation was done in the Book of Rules on Mandatory Insurance Contributions and the Order on the Mandatory Insurance Contribution Base (OG 158/02).

has been obliged to pay the full amount of contributions due on time; and so-called “advance payments” (which in fact allowed a deferral of the remaining contributions due) are not permitted.

There has been no minimum wage in Croatia since January 1, 1996. For purposes of calculating pension contributions, a minimum base is set each year in an order by the Minister of Finance. It amounts to 35 percent of the average monthly gross salary for full-time work in the preceding year, as published by the Croatian Bureau of Statistics.⁵¹ A long list of separate bases also apply for various groups of self-employed and farmers.⁵² There is a ceiling

⁵¹ The monthly minimum contribution base for all insurance (health, pension) was as follows (in gross amounts): 1995 – HRK 906 monthly (applied and relevant only for health insurance); 1996 – HRK 1,100; 1997 – HRK 1,210; 1998 – HRK 1,370; 1999 – HRK 1,500; 2000 and 2001 – HRK 1,700; from April 1, 2002 – HRK 1,800 HRK; and for 2003, HRK 1,850.50 (OG 158/02).

⁵² The bases for 2003 were: HRK 1,858.50 for prolonged pension insurance of permanent seasonal workers and volunteers; HRK 3,451.50 for insurance of craftsmen whose income is established on the basis of business accounts; HRK 5,841 for insurance of self-employed persons whose income is established on the basis of business accounts; HRK 2,920.50 for insurance of craftsmen and persons practicing independent professions, in the case when income tax is paid in a lump sum; HRK 5,841 for insurance of craftsmen, persons practising liberal professions and activities in agriculture and forestry, when their income is subject to profit tax and no entrepreneur's salaries are paid. Namely, they pay profit tax instead of PIT and do not receive entrepreneur's salaries; HRK 2,124 for insurance of farmers, when their income is not subject to income tax, or when income tax is paid lump sum, and for insurance of clergy; HRK 2,655 for insurance of farmers whose income is established on the basis of business accounts; HRK 5,310 for insurance of freelance journalists, sportsmen and artists who pay income tax after deductions, as well as for members of the management board of companies; and for work performed abroad with foreign employers or international organisations and for work performed in Croatia with employers who have their seats in foreign countries. For prolonged insurance of seamen: HRK 2,655 for unskilled workers or persons with no qualifications, HRK 3,717 for persons with low qualifications or semi-skilled workers, HRK 5,310 for persons with secondary school qualifications or skilled workers, HRK 7,434 for persons with post-secondary qualifications or highly skilled workers and HRK 8,496 for persons with university degrees.

on contributions, also determined as a percentage of average gross wages of employees in Croatia in previous year(s). It is currently set at 600 percent.

As for the contribution rate, all insured persons including farmers currently pay 20 percent of their gross wages for mandatory pension insurance.⁵³ In Croatia, as previously explained, the contribution is paid fully by employees without an employer matching payment.

An additional word of explanation is needed concerning the second pillar contributions of two special groups described in Section 2.3., those who opt for voluntary “prolonged insurance” and those with difficult jobs or physical limitations whose insurance periods are of “extended duration,” that is, given extra weight in the benefit formula. Originally the first category was exempt from the second pillar contributions.⁵⁴ However, since July 4, 2003, they must be insured under the second pillar under the same conditions as other workers. The contributions for insurance periods with extended duration vary from 4.86 percent to 17.58 percent of wages or contribution base, depending on the degree of extension, and are distributed proportionally between the two pillars.⁵⁵

In 2002, the contribution requirement was extended to an important new category of income, namely, from *temporary contracts* and *atypical self-employment*.⁵⁶ By paying contributions on this income, these individuals acquire the status of an insured person during the year in which the contributions are paid. In that way the obligation to, and rights arising from, pension and health insurance will be equalised across different forms of work. Also, distortions on

⁵³ The Law on Contributions for Mandatory Insurance (*Zakon o doprinosima za obvezna osiguranja* – OG 147/02) states that the insured persons and contribution bases are the same for both pillars.

⁵⁴ Article 17 of the Pension Insurance Law (OG 102/98).

⁵⁵ Law on Insurance with Extended Duration (OG 71/99).

⁵⁶ Examples are teleworking and honoraria. In the latter case, many media companies paid their employees at the minimum wage (thus allowing them to receive health insurance and the minimum pension insurance). The employees then received their additional income as honoraria or through contracts that were not subject to contributions. This extension of the contribution requirement was made by the Law on Contributions for Mandatory Insurance (*Zakon o doprinosima za obvezna osiguranja* – OG 147/02).

the labour market caused by differing labour costs will be reduced, the future pension rights of atypical workers will be greater, and revenues from pension contributions increased.

For voluntary pension and health insurance, contributions of up to HRK 1,050 per month are deductible from personal income tax.

3.2. *Employees*

Contribution rates for pension and disability insurance during 1994–2003 are shown in Table 5. It shows a progressive shift of the contribution from employers to employees. Since 2003, the contribution has been paid entirely by employees. However, one should not overestimate the significance of this shift, because the overall shares of employee and employer social contributions have not changed significantly. Thus, in 2002, the total employer social contribution rate was 17.07 percent; and the total employee social contribution rate was 20.60 percent. Beginning in 2003, the total employer social contribution rate is 17.2 percent; and the employee social contribution rate is 20.0 percent. To put it simply, the health insurance contribution is now borne wholly by the employer, whereas the pension insurance contribution is borne wholly by the employee.

Beginning in 1994, firms, institutions and other legal entities were relieved of paying contributions for pension and disability insurance on the salaries of Croatian soldiers; that is, Homeland War veterans that they employ, as well as for those workers who have participated in professional rehabilitation. Firms that employ disabled persons were also exempted from paying contributions on their wages.

As can be seen in Table 5, contribution rates for pension and disability insurance were reduced in 1995 (OG 95/94). This was done in concert with a broadening of the contribution base to include some fringe benefits – i.e. holiday remuneration and supplements for daily meals. However, those forms of compensation, subsidies, and awards that are exempt from Personal Income Tax are still not considered as part of the salary and are thus also not subject to contribution payment.

Table 5
Contribution Rates for Pension and Disability Insurance, 1994–2002 (in %)

Year	Employee	Employer
1994	13.50	13.50
1995	12.75	12.75
1996	12.75	12.75
1997	12.75	12.75
1998 ¹	10.75	10.75
1999	10.75	10.75
2000 ¹	10.75	8.75
2001	10.75	8.75
2002	10.75	8.75
2003	20.00	0.00

Note: For 1998 the employee rate is valid from February 1; for 2000, the employer rate is valid from June 1.

Source: *Zakon o placanju doprinosa za MIO radnika*, OG 117/93, 95/94, 106/95, 108/96, 164/98, 71/99, 149/99, 54/00, 63/00, *Zakon o mirovinskom osiguranju* 102/98.

Starting in 1999, the three categories of contribution rates were eliminated (see Section 1.1.), thereby equalising the rates of pension insurance for all workers. In addition, the exemption from the contribution requirement for employers of war veterans was limited to one year.

3.3. *Self-employed*

The contribution base for self-employment income has been brought in sync with the personal income tax base.⁵⁷ Items which are treated as self-

⁵⁷ The personal income tax base is defined as income after deduction of social contributions and other allowed tax deductions.

employment income include earnings from a small business, an independent profession (e.g., lawyer, architect, journalist), and agriculture and forestry, as well as other self-employment activities.⁵⁸

3.4. *Farmers*

From 2000 to 2002, the contribution rate for farmers and members of their families was 9.75 percent, while government contributed the remaining 9.75 percent. Experience with compliance during these years was negative: the government paid its share on time, but fewer than 25 percent of farmers did so. Since 2002, the contribution rate of 20 percent is fully paid by farmers, with no government match.

The contribution base for most farmers is 40 percent of the average wage in Croatia. For those classified as self-employed or incorporated businesses (VAT payers), it is the earnings that are counted for income tax purposes, as described in subsection 3.3.

⁵⁸ Income from small businesses includes manufacturing, services, trading, catering, and transportation. In addition, the sale of more than three items of real property (or property rights of the same type) in a period of five years is taxed as a small business activity, as is leasing out an entire small business. Two types of professional income can be distinguished: income from independent professions and income from other self-employment activities. Independent professions are those carried out by physicians, veterinary surgeons, writers, artists, inventors, translators, scientists, lecturers, etc. Other self-employed activities are those carried out by (a) members of Parliament, members of supervisory or management boards in firms, bankruptcy administrators and (b) occasional independent activities, such as those of scientists, artists, experts and journalists, provided this activity is besides some other primary activity or employment. Occasional activity is defined as not being performed within regular employment, and if the activity is being carried out from time to time, with longer discontinuity and only for a short period. If the self-employed person is insured in the second pillar, s/he pays 15 percent of the contribution base to the first pillar and five percent to the second pillar.

Like the self-employed generally, if small farmers are included in the second pillar, the contribution rate is divided: a 15 percent contribution rate is earmarked for the first pillar and five percent to the second pillar.⁵⁹

3.5. *Others*

When disabled war veterans receive compensation in lieu of salary or if they are unemployed, the Croatian Employment Service pays their pension contributions. For insured persons with special rights to pension insurance (for example, the blind or recipients of disability pensions who have the right to a full pension with reduced contributions), the differences between what they would otherwise be required to pay and what they actually pay is covered by the Republic of Croatia. This rule has applied since 1996.

For certain persons with disabilities, pension insurance for extended duration (as described in Section 2.3.) is paid by the Republic of Croatia at the rate of 7.84 percent.⁶⁰ This has been in effect since 1999.

In 1999, the contribution requirement was extended to so-called salary compensation. This compensation is paid to insured persons who do not work because of justified reasons (illness, maternity leave, part-time work because of caring for a disabled child, etc). Until the end of 1998, these periods of non-gainful activity were included in the insurance period, though no pension contribution was paid. Under the new requirement, the contributions are paid by the Republic of Croatia Centres for Social Work and Welfare and the Croatian Health Insurance Institute at the rate of 16.50 percent. The salary compensation is, however, still exempt from income tax, health insurance

⁵⁹ Small farmers are farmers not registered with the Tax Administration, either for VAT or as self-employed persons. If farmers are registered for VAT or are registered as self-employed persons, their treatment for contribution payment is the same as that of self-employed persons.

⁶⁰ These include insured blind persons, persons suffering from dystrophy and similar muscular diseases, cerebral and child paralysis, multiple sclerosis, and rheumatic arthritis; paraplegics, deaf people, and persons that have functional problems and are unable to move without a wheelchair.

contributions, and unemployment contributions. For unemployed Croatian war invalids from the Homeland War, the Croatian Employment Services pay the pension contribution at the rate of 16.75 percent. Generally though, unemployed persons are pension insured only if they are sufficiently close to retirement age.⁶¹ If the insured person is included in the second pillar, a proportional share must be paid to his or her chosen second pillar savings fund.

Since January 2003, the above institutions no longer pay first pillar contributions but continue to pay the second pillar contribution, where applicable. The rationale is that if the latter are not paid, the individual's future pension will be negatively affected, whereas periods out of the work force for the reasons mentioned above are counted by law in the computation of first pillar benefits, whether or not contributions are paid. Significantly, the Centres for Social Work and Welfare and the Croatian Health Insurance Institute pay these contributions at the rate of five percent of *net* compensation. This means that a smaller amount of contributions is paid on their individual accounts in selected savings funds.

4. Number of Contributors, Pension Coverage, and Measures of Effectiveness of Contribution Collection

As can be seen in Table 6, the total number of active insured persons in the public pension system decreased by almost 590,000 during 1990–2000. The absolute reduction was greatest for employees (almost 460,000), while the relative decline was greatest for farmers, as their number in 2000 represented only some 36 percent of the 1990 figure. However, the number of contributors started to increase in 2001 (by some 22,000), with a further increase in 2002 (by some 20,000).

In order to obtain a broad estimate of the number of active persons not included in the pension system, the total number of contributors can be

⁶¹ That is, if they will reach pensionable age in five years or less. In that case the state budget covers the contribution.

compared with the number of persons in employment. The precision of this estimate is weak due to the changing methodology of the Labour Force Survey (LFS) and the changing sample design. Bearing this in mind, one could nevertheless state that the extent of non-inclusion is rather low.

Table 6
Number of contributors to the public pension system and persons in employment, 1990–2002

Year	Employees	Self-employed	Farmers	Total	Persons in employment (thousands)
1990	1,682,971	68,744	217,022	1,968,737	—
1991	1,555,734	68,535	214,996	1,839,265	—
1992	1,442,406	66,000	216,386	1,724,792	—
1993	1,410,638	66,726	220,774	1,698,138	—
1994	1,384,594	73,461	163,846	1,621,901	—
1995	1,340,951	77,549	149,481	1,567,981	—
1996	1,267,650	81,095	130,230	1,478,975	1,540.3
1997	1,270,226	79,962	118,750	1,468,938	1,493.0
1998	1,282,576	80,021	108,912	1,471,509	1,543.8
1999	1,239,200	76,629	90,262	1,406,091	1,491.6
2000	1,224,178	77,331	79,001	1,380,510	1,553.0
2001	1,247,709	78,783	73,610	1,402,102	1,469.5
2002	1,274,293	80,471	67,217	1,421,981	1,527.2

Notes: Until 1994, the data includes all insured farmers, and from 1994, only those insured farmers are included for whom assessment and contribution collection were performed.

The Labour Force Survey started in 1996. In 2001 and in previous years the database of the Croatian Electric Utility was used for the sample frame. In 2002 a new sample, based on the 2001 census data, was used.

Source: Croatian Pension Insurance Institute, and for last column on the right, Central Bureau of Statistics: *The labour force survey, 2002. Statistical yearbook of the Republic of Croatia for 2002*. Zagreb: Central Bureau of Statistics.

Table 7 shows the amount of contributions collected by groups of insured persons in the period 1990–2002.

Table 7
Contributions collected by groups of insured persons
(thousands HRK), 1990–2002

Year	Employees	Self-employed	Farmers	Total
1990	33,660	459	138	34,256
1991	41,113	756	225	42,094
1992	162,255	2,431	935	165,621
1993	2,476,626	37,102	8,059	2,521,787
1994	7,608,790	157,268	23,058	7,789,110
1995	9,449,789	179,489	57,328	9,686,605
1996	10,577,652	215,154	78,059	10,870,865
1997	11,871,307	266,378	76,663	12,214,348
1998	11,439,117	244,446	82,763	11,766,326
1999	12,039,717	302,768	116,138	12,458,624
2000	12,415,552	322,503	116,032	12,854,087
2001	12,854,136	315,144	91,978	13,261,258
2002 ¹	12,138,155	312,646	79,355	12,530,156

Note: From the beginning of 1999, the data for self-employed and farmers are taken from payment accounts at the CPII.

For the years before the introduction of the Croatian Kuna (HRK), data is recalculated.

For 2002, the amount refers only to the contributions collected for the first pillar. The amount collected for the second pillar was HRK 1,923,552,000, giving a total of contributions collected in the first and second pillars of HRK 14,453,708,000.

Source: Croatian Pension Insurance Institute, except the cumulative amount of collected gross contributions for the second pillar in 2002, where the source is HAGENA: *Izvjescje o mirovinskim trzistima u Republici Hrvatskoj*, Zagreb, 2003, p.24.

In order to look more deeply at compliance trends, we will analyse two additional measures. The first is the effective contribution rate. It is obtained

by dividing (a) the actual contribution revenue collected; and (b) the aggregate contribution base.⁶² The effective contribution rate can be compared with the statutory contribution rate in order to ascertain how much of the potentially collectable contributions are actually collected. Here we in fact analyse only compliance for insured persons – either subgroups (such as employees) or the whole group – i.e. all insured persons. Table 8 presents the relevant data for Croatia for the period 1996–2002.

Table 8
The statutory and effective contribution rate for:
(a) employees and (b) all insured persons, 1996–2002

	Employees			All insured persons		
	Statutory contribution rate	Effective contribution rate	Ratio (2)/(1)•100	Statutory contribution rate	Effective contribution rate	Ratio (5)/(4)•100
	(1)	(2)	(3)	(4)	(5)	(6)
1996	0.255	0.214	84.1	0.255	0.189	74.1
1997	0.255	0.212	83.3	0.255	0.189	74.1
1998	0.216	0.180	83.3	0.216	0.161	74.7
1999	0.215	0.178	82.7	0.215	0.162	75.5
2000	0.203	0.174	85.3	0.203	0.159	78.4
2001	0.195	0.170	87.0	0.195	0.156	79.9
2002	0.195	0.171	87.8	0.195	0.158	81.2

Source: CPPI and 2003 *Statistical yearbook of the Republic of Croatia*.

⁶² The effective contribution rate can be computed for employees, in which case the contribution revenue collected refers to collected contributions on behalf of employees; the aggregate contribution base is computed by multiplying the average wage by the number of employees. The effective contribution rate can also be computed for all insured persons. In that case the contributions collected refer to the actual total amount of collected contributions from all insured persons, whereas the aggregate contribution base is computed by multiplying the average wage by the number of insured persons. Of course, such a computed aggregate contribution base does not take into account the fact that the average contribution base for the self-employed and farmers is not equal to the average wage, even in the best of circumstances.

Table 8 suggests that contribution compliance has been improving since 2000. Thus in 2000 contributions collected on behalf of employees reached 85.3 percent, and in 2002, 87.8 percent of the maximum attainable amount. Similarly, the ratio between the effective contribution rate and statutory rate for all insured persons has also been increasing and in 2002 reached 81.2 percent of the maximum attainable amount.⁶³ Though the increase in this ratio is caused by improved compliance among the largest group of insured persons – i.e. among employees – this is not the only cause. The improvement might also be due to the changed structure of insured persons; in particular the share of low contributors – insured farmers – decreased. Another factor which might have increased the ratio is the relative increase in the contribution base for the self-employed: in 1996 the average amount of collected contributions per self-employed amounted to 32 percent of the average amount of collected contributions per employee, and by 2002 this increased to 41 percent.

The second important measure of contribution compliance is the covered wage bill. This measure shows the amount of wages which, assuming the given statutory contribution rate, would have generated the actual amount of contribution revenues collected on behalf of employees. The covered wage bill is usually related to GDP. Its values are presented in Table 9.

The relatively high values of the covered wage bill which we observe in Table 9, compared to other countries in this study, can signify not only relatively high contribution compliance by employees but also rather low shares of other income sources in GDP.⁶⁴ In particular, we refer to mixed income (i.e. income

⁶³ We have to repeat that this figure is obtained on the basis of several assumptions. We assume that the average contribution base for all groups of insured persons is equal to the average wage. This assumption is actually valid only for employees, whereas the self-employed and farmers have different contribution bases. We also assume that the statutory contribution rate for all contributors is equal to the statutory contribution rate for employees, which is not valid for farmers, as their contribution rate is only half of the contribution rate for employees.

⁶⁴ As can be observed in the overview chapter, the level of the Covered Wage Bill in Croatia is higher than in all other countries in this study, including Slovenia. This may be attributable to the fact that wage and GDP statistics in Croatia are still not fully reliable and probably underestimate the true values. Namely, Croatia has not yet applied

from self-employment) and gross operating surplus, i.e. corporate income. The trend value of the covered wage bill (measured as percentage of GDP) has been slightly on the rise, as the covered wage bill amounted to 38.5 percent of GDP in 1998 and 40.8 percent in 2002. However, it is not possible to ascertain what factor explains this slight (but important) improvement: is it pension reform in general, institutional reform and administrative changes, or improvement of general economic conditions? This would doubtlessly require further study.

Table 9
The covered wage bill (as % of GDP), 1996–2002

	GDP (million HRK)	Employee contributions (million HRK)	Contribution rate (employee + employer)	Covered wage bill (as % of GDP)
1996	107,981	10,578	0.255	38.4
1997	123,811	11,871	0.255	37.6
1998	137,604	11,439	0.216	38.5
1999	141,579	12,040	0.215	39.6
2000	152,518	12,415	0.203	40.0
2001	165,639	12,854	0.195	39.8
2002	176,429	14,047	0.195	40.8

Sources: For GDP, the 2003 *Statistical yearbook of the Republic of Croatia*; for employee contributions collected, the CPII.

Yet another measure of contribution compliance may be obtained by comparing the covered wage bill with the actual wage bill; the actual wage bill is obtained from the national accounts statistics. This is provided in Table 10, which shows an increasing value of this ratio. In other words, contribution

the European System of Accounts (ESA), and an estimate of unrecorded activities is not incorporated in GDP, while these estimates are – to a certain extent – included in the GDP estimates of most of the other countries.

compliance has been improving within the formal sector. Table 10 indicates that in 2001 less than nine percent of all earnings (i.e. of all labour income) in the formal sector evaded payment of pension contributions.⁶⁵

Table 10
The covered wage bill and actual wage bill (in million HRK), 1998–2001

	Covered wage bill (1)	Actual wage bill (2)	$1/2 \cdot 100$
1998	52,958	61,272	86.4
1999	56,000	65,283	85.8
2000	61,067	69,570	87.8
2001	65,918	72,139	91.4

Source: Central Bureau of Statistics, Republic of Croatia (for actual wage bill).

5. Non-compliance and Evasion

5.1. Non-compliance in Large Enterprises

Company bailouts and debt conversion into equity are the most common measures resorted to by the Croatian Government as a form of state aid to loss-making firms and/or as an attempt to rehabilitate state-owned enterprises (SOE). The problems of non-compliance in large enterprises are still serious and primarily involve shipyards, railways, and agro-processing firms, which were accustomed to receiving explicit transfers, soft loans, and discriminatory

⁶⁵ Madzarevic-Sujster (2001) reached a somewhat different conclusion with regard to contribution compliance. She carried out simulations for the period from 1994 to 2000, and concluded that the evasion of direct taxes and contribution as a percentage of GDP rose from 4.3 percent to 5.9 percent in the same period. Madzarevic-Sujster underlines that the mentioned simulation gives the lower limit of the estimation.

protection, as well as exemptions from fiscal obligations. Thus, in February 2001, the government adopted a provisional measure for the consolidation of companies in agriculture, in which it authorised the relevant ministries to write off their claims, reschedule them, or convert them to equity. According to government estimates, the contribution and tax debts of the large agricultural companies amounted to some HRK 2.2 billion (*Jutarnji list*, 2001). Madzarevic-Sujster (2001) estimates that during the period 1994–2000, the cumulative amount of contributions that should have been paid, but which was written off by governmental decree or legislative acts, is in the range of 0.3 to 0.5 percent of GDP.

While these measures were aimed at protecting the jobs of employees in state-owned enterprises, it can be argued that they actually had the opposite effect: by delaying restructuring and maintaining unequal conditions for private investment, they discouraged the entry of new firms, expansion of existing firms, and sustainable job creation.

As the privatisation process in Croatia was non-transparent, it also had a direct influence on the pension system and on contribution compliance. Some privatisation transactions involved direct sales and transfers of state shares in these enterprises, without settling the contribution debt.

5.2. Evasion or Weak and Partial Compliance in the Formal Sector

In Croatia, many employers pay contributions for their employees on the minimum contribution base. These employers tend to be concentrated in the building industry, hotels and catering, and retail trade – all types of employment that are likely involve younger workers who must also be insured in the second pillar. Since benefits from the second pillar will depend directly on contributions paid and, under the accumulation system, those contributions paid earlier in life will normally yield greater investment returns, this form of evasion can be expected to cause a significant reduction in future pensions. Before REGOS began providing annual information on contributions paid, there were no reliable data on the numbers of these workers. The new REGOS data provide some insights. For June 2003, of all the received R-S forms, 8.1 percent included an insurance base of less than

HRK 1,858.50, and in 3.3 percent the base was equal to HRK 1,858.50. See Table 11. In other words, by mid-June 2003, some 11.4 percent of all insured persons in the mandatory pension system had a contribution base that was below the minimum contribution base for employees.⁶⁶

Table 11
The distribution of R–S forms received for June 2003

	Insurance base (in HRK)		
	Less than 1,858.50	Equal to 1,858.50	More than 1,858.50
Paid	91,055	33,889	1,010,221
Unpaid	6,052	5,630	51,590
Total	97,107	39,519	1,061,811

Source: REGOS.

These workers face serious disadvantages with respect to the calculation of their pensions. If an employee is registered for purposes of social insurance, but there is no proof of wages actually having been disbursed and pension contributions paid, this “insurance period” is counted only for purposes of acquiring sufficient years for pensioning. The pension amount is computed only on the basis of actual wages disbursed (i.e., there must be proof that the worker was paid). If there is no proof of wages being paid, the accrual rate for pensions for that “insured” year is 0 percent.

Zuber (2000) points to some additional areas in which evasion may be occurring. She notes that, while the minimum contribution base and number of insured persons who pay contributions on the lowest base are both known in Croatia (as shown in Table 11), there is no information on whether these persons have, from the same payer, any income from profit sharing or dividends, which in many private firms is an important form of remuneration.

⁶⁶ The insurance base HRK 1,858.50 is for full-time work. Some of the insured persons could be insured for part-time work.

There is also no information on the frequency of part-time work (except that provided by the Labour Force Survey), nor is there any information on the numbers of occasional and temporary jobs. Yet another unknown is the amount that pensioners earn in addition to their pensions.

5.3. *The Problem of Arrears*

No doubt the problem of arrears in Croatia is serious, but there is a lack of relevant information and data, as the CPII has ceased to analyse and monitor this phenomenon. According to the internal publication of CPII (*Hrvatski zavod za mirovinsko osiguranje*, 2000), arrears in 1998 amounted to HRK 4.03 billion, with the largest part representing arrears from legal entities (54.5 percent, or HRK 2,194) while the remainder (45.5 percent, or HRK 1.834 billion) was attributable to craftsmen, farmers, and self-employed. The largest share of arrears by legal entities was that of shipyards (38 percent, or HRK 822 million). In 1998, total arrears amounted to 24.4 percent of CPII expenditures.

6. Improving Compliance

6.1. *Legal Changes and Related Problems*

Over the last two years (2002–03), there were important amendments of laws and regulations related to pension contributions (see Section 3), as well as some significant organisational improvements in collections.

With the amendments of the Labour Law accepted by Parliament on July 14, 2003 (OG 114/2003), legal preconditions were established for an employee to sue his/her employer for unpaid *gross* salary. However, conforming changes are still required in other laws to remove inconsistencies with this new right.

At the same session, however, Parliament amended the Bankruptcy Law (OG 123/03), so that workers in insolvent firms can sue an employer for only the *net* wages, while contributions are defined as claims of authorised bodies.

Taken together, these laws mean that workers can sue their employers for the unpaid amount of *gross* wages (which includes personal income tax and pension contributions) but, in the case of an insolvent firm, they can sue only for the unpaid amount of *net* wages.

Wages and contributions are treated quite differently in the new process. If an employer fails to pay all the mandatory contributions, the Tax Administration will enforce collection. There is though no coercive mechanism for ensuring that workers receive their net wages. However, once a firm is bankrupt, net salaries and severance pay take priority in settling liabilities to employees. After these liabilities are met, there may be no funds left to pay pension contributions.

6.2. *Administrative and Organisational Changes*

As previously described, the government introduced a number of measures in 1990 to reduce the administrative burden on employers and improve the efficiency and transparency of the tax and contribution systems. Apart from the introduction of the R-S form for unified reporting, the main measures to consolidate control and enforcement have been linked with the changed role of the Tax Administration. See Section 2.1.4. According to the World Bank (Anusic, O'Keefe, Madzarevic-Sujster, 2003), these reforms will lead to a more efficient system of control and enforcement of contributions. Yet it will be possible to make a full evaluation of these changes only after they are complete. Currently there is still much replication in collecting data, which burdens contribution payers and increases administrative costs. Furthermore, continuing controversy on the respective roles of REGOS and the Tax Authority makes the future direction of policy making on collections difficult to predict.

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Chapter 4

The Collection of Pension Contributions in Hungary

Levente L. Máté

You might have started a revolution, gentlemen.
József Antall, Prime Minister of the Hungarian Republic

Terminology

For the convenience of readers, this study will use the term employee's contribution to refer to all types of contributions deducted from employee earnings, instead of translating the name of each of the specific types of contributions used in the historically shaped terminology of the Hungarian social insurance system.

For the same reason, the term employer's contribution will be used to refer to any contribution the employer is obliged to pay.

Another simplification is the use of the term "Tax Office" to substitute for the unbearably long name of that institution, the Tax and Financial Control Administration.

Acronyms

SI	Social Insurance
SIPS	Social Insurance Pension Scheme
PAYG	Pay As You Go
SIF	Social Insurance Fund (notwithstanding the name "Fund," the method of funding it is PAYG)

PIF	Pension Insurance Fund, a separate part of the SIF since 1992
HIF	Health Insurance Fund, a separate part of the SIF since 1992
CANSI	Central Administration of National Social Insurance Fund since 1989
CANPI	Central Administration of National Pension Insurance Fund since 1992
CANHI	Central Administration of National Health Insurance Fund since 1992
MPPF	Mandatory Private Pension Fund since 1998
MS	Mixed System, the combination of SIPS and MPPF
TFCA	Tax and Financial Control Administration
CSO	Central Statistical Office
SFSA	State Financial Supervisory Authority (supervising MPPFs among other financial institutions)

Introduction: The Pre-transition Scene

Since 1907, the term insurance has continuously been part of each of the various titles of Hungary's more than one hundred-year-old social security system. In 1928, the modifier social was added, and that term too has remained part of the title ever since. After the Second World War, however, and in spite of the continuity in the title, the insurance principle faded away in all aspects of the system. By the late 1980s, in the mature Hungarian pay-as-you-go pension system, no real connection existed between pensions and the contributions that pensioners had paid during their active years.

Over this same period, the range of covered contingencies was expanding, making the system more comprehensive and unified. An insured person could gain entitlement to sick pay, maternity allowance, child care benefit, and accident allowance as well as to old age, survivors' and disability pensions.

The social insurance system itself played no role in obtaining revenues to pay benefits, in determining the extent of benefit obligations, or in achieving a balance between these. Like those of other state-funded systems, its revenues and expenditures were set each year in the state budget, and its accounts were presented in the final accounts of the annual state budget.

Before 1988, the so-called pension contribution was in reality a progressive tax on wages.¹ The employee's contribution rate varied between three percent and 15 percent, depending on monthly pay. The contribution base was the entire wage. The employer's contribution rate depended on the sector of the economy into which the firm was classified. A typical contribution rate was 40 percent, but in some sectors it was much lower (33 percent, 29 percent, 10 percent or even zero percent). Employers had to pay contributions on all of a worker's wages and a number of other types of payments as well. Employers were required to deduct the employees' contributions and remit them together with their own contributions to the social insurance authority.

In years immediately preceding the transition, intensive economic reforms were already in progress. Partly as effects of these and partly parallel to them, significant changes were made in social insurance as well. The changes reached a climax in 1988. The year began with major reforms in taxation, including the introduction of the personal income tax. The progressive feature of the pension contribution was eliminated as part of this initiative. New regulations prescribed a uniform 10 percent employee's contribution on all covered income. The employer's contribution continued to vary depending on the sector of the economy.

Other significant changes were made during the course of 1988. Suddenly insurance became a high-profile topic in public discourse and, in the spring, Parliament passed a resolution to separate the social insurance budget from the state budget. A few days before Christmas, and just one day after approving the next year's budget, Parliament passed Act XXI of 1988, which aimed to establish a Social Insurance Fund (SIF).

¹ Moreover, this tax was badly designed. Contributions were not calculated based on the progressive bracket system that was in wide use at the time. Rather they were based only on the highest bracket that a particular worker's wage reached. The rate for this bracket was then applied to the worker's entire wage. As a consequence, a general increase in wages could have the perverse result of causing a worker's take-home pay (wage minus deductions) to decline.

The SIF, although given an unusually high degree of independence, did not have an independent budget, but only comprised an independent chapter in the state budget. According to the new law, the SIF was to have three revenue sources: contributions, state subsidies, and proceeds from its own business activities.

The expenditures of the SIF were, however, defined less clearly or, one might say, defined more flexibly. The SIF was obliged to use its resources to finance not only social insurance pensions, but also a variety of pension-like benefits.² Operating costs were to be financed by the SIF as well.

This mandate may be explained by the fact that the government, well before the establishment of the SIF, created and has ever since been granting a number of pension-like benefits for persons in particular life situations, while obliging the social insurance institution to finance and administer them. These were entirely unrelated to contributions; actuarially they were totally unfair. This huge burden was shifted to the SIF, which had just been separated from the state budget.

The 1988 law also required that the SIF set up a liquidity fund and a reserve fund, both of which were to be financed initially from the central budget. The law designated the Central Administration of National Social Insurance Fund (CANSI) to manage the SIF and required it to report to Parliament each year.

The changes in 1988 were the first steps in an incremental reform of Hungary's social insurance system which continues to this day. In retrospect, the reform process can be viewed as the result of an expanding crisis in the Hungarian economy, which made it impossible to fulfill earlier social insurance related promises. This process has been comprised of uncertain, exploratory, unharmonised, and often contradictory, insignificant-looking little steps.

One of its main driving forces in this process was widespread support for increasing the significance of the insurance principle, which had been pushed into the background for several decades. This in turn brought about relegation of social and solidarity features dominating before.

² For example, these included miners' pensions and several types of early pensions for individuals who were close to retirement.

The last days of the old era saw the adoption of two other important reform measures. First, effective January 1, 1989, the differentiated employers' contribution rate was replaced with a single rate, set at 43 percent. Later in the year, by creating and passing Act XLVII of 1989, the Parliament revamped the SIF's organisational mission, a change that would alter its future operations very significantly. When this law came into effect, the family allowance ceased to be a social insurance benefit. At the same time, curative and preventive medical services which had, until then, been funded by the state budget, were shifted to SIF administration and financing. It is noteworthy that, with this move, the state assumed responsibility for a benefit which was continuously diminishing due to declining birth rates, while the SIF was given new responsibility for services whose costs were increasing sharply.

Act XXI of 1988 had stopped short of giving the SIF an independent budget. However, in November 1990, the first government of the new era sent the newly elected Parliament a bill documenting the achievement of the SIF budget for 1989. This bill was enacted as Act LXXXI of 1990. When implemented, it cast new light on the financing of social insurance, which had been obscure during the preceding decades since both revenues and expenditures were commingled with other items in the state budget. Surprisingly, it turned out that the SIF closed the first year of its existence with a 10 percent surplus; i.e. its revenues exceeded its expenditures by 10 percent. Equally surprising was the fact that 98 percent of the revenues came from contributions.

1. A Brief and Recent History of the Pension System, with Particular Emphasis on Collections

1.1. Starting Points in the Year of the Transition

The year 1990 brought no fundamental changes in the sphere of social insurance, especially none in the management of resources. As in 1989, 98 percent of the SIF revenues were derived from contributions. However, due to inflation, this amount was 21 percent larger than in the previous year.

At the same time, pension expenditures, including pension-like benefits, were 29 percent higher than in the year before. While revenues increased due to inflation-related growth of the contribution base, the main cause for higher spending was a massive escape by workers into retirement, driven by the economic shocks of the early transition. This resulted in a 3.2 percent increase of the number of those receiving benefits from the SIF. The government's occasional cost of living increases in pensions also contributed to the expenditure increase.

In that year, the final accounts of the 1990 SIF budget specified the budgetary shortfall due to non-compliance. This amounted to nearly HUF 22 billion, or 6.2 percent of the total amount of contribution revenues collected. The appearance of this item in the text of the law was rather surprising; this had never before nor has ever since occurred.

In 1990, the average number of insured persons was still about 5.2 million.³ The number of beneficiaries, i.e. those receiving pensions or pension-like benefits, exceeded 2.5 million.

1.2. The First Milestone in the Reform Process: Parliamentary Decree No. 60/1991

On October 29, 1991, Parliament passed Resolution 60/1991, which provided a conceptual blueprint for revitalising social insurance. This resolution contained a coherent and ambitious plan for reform, identified the first steps to be taken, and provided a detailed schedule for government action.

The resolution contained the following findings and tasks:

- (1) *Reform is urgently needed.*
- (2) *Social insurance is the most important means of protecting the security of society.*
- (3) *The role of insurance and the principle of solidarity must be harmonised, in the sense that social care should be financed not from contributions but separately by the state budget.*

³ That is, persons covered by social insurance and required to pay contributions.

- (4) *The financing of different branches of insurance must also be separated. Funding must follow the principle of pay-as-you-go, but the system must be endowed with reserve funds.*
- (5) *To achieve long-term financing stability in social insurance, child-bearing should be encouraged by making it count as service time for mothers.*
- (6) *A three-tier pension system is desirable. This should include a basic pension, an additional benefit depending on the level of the person's earnings and contributions during their working life, and a benefit available through a voluntary supplementary insurance.*
- (7) *The retirement age should be raised.*
- (8) *Reform measures for 1991: a ceiling to be imposed on the employee's contribution; an increase of one year in the period counted in calculating pensions; valorisation of the first of these four years (that is, from the best three out of the last five years to the last four years, total); new operating regulations for the SIF; and a net wage index for benefits (beginning in 1992).⁴*
- (9) *Reform steps for 1992.⁵*
- (10) *Curative and preventive health provisions should be placed on an insurance basis.*
- (11) *A new system of health care.*
- (12) *Separation of the pension insurance and health insurance branches of the SIF in the budget.*
- (13) *A refocusing of the SIF's mandate, achieved through shifting the financing of pension-like benefits from contribution revenues to the state budget.⁶*
- (14) *Preparation of specific bills concerning the modernisation of social insurance.*

⁴ The change from three out of five to four years total was effective beginning March 1, 1992.

⁵ This item included a list of 10 fundamental reform issues which were to be addressed in the first half of 1992.

⁶ Parliament termed this refocusing "profile clearance," conveying the idea of freeing the PIF from using contributions for what was widely seen as an unjust purpose.

Parliament took the first step in this reform, as required by the above decree, by enacting Act LXXXIV of 1991. This law declared the autonomy of social insurance and made it independent from the government. It also divided the Social Insurance Fund into two independent parts: the Pension Insurance Fund (PIF) and the Health Insurance Fund (HIF). Both funds were placed temporarily under the supervision of committees elected by Parliament. The law also prescribed that, through a subsequent election, self-governing bodies would be established to take over these committees' responsibilities.

Under this division of the SIF, the new PIF was given the role of financing old age pensions, disability pensions for people over the retirement age, and widows' and widowers' allowances. The financing of disability pensions and accident allowances of those below the age of retirement was assigned to the HIF. However, its main role was, and is, to finance all health insurance services, cash benefits, and benefits in kind.

A portion of the contribution rate then in effect was earmarked for each of the two funds, effective March 1992. Out of the 44 percent employers' contribution for that year, 24.5 percentage points were dedicated to the PIF, and 19.5 percentage points to the HIF. Out of the employees' contribution, which remained at 10 percent, six percentage points went to the PIF and four to the HIF. The contribution base remained unchanged for both funds.

In the summer of 1993, national elections were held for the sole purpose of constituting the two self-governing bodies. In autumn, the newly elected Self-Governments of Pension Insurance and Health Insurance assumed their new roles.

1.3. Measures to Balance the Budget

In the history of the Hungarian pension system, the 1990s were a period of continuous struggle to compensate for the catastrophic decline in employment. Between 1989 and 1997, the number of job slots (and thus the number of contribution payers) fell from 5.2 to 3.9 million, while the number of those receiving pensions or pension-like benefits grew from 2.5 million to just over 3.1 million.

This unbearable increase in the system dependency ratio posed a threat of collapse to the pension system, against which all possible means of avoidance were applied.⁷ At the same time, in great tension with this effort was another goal: to curb the growth of the contribution rate, because the need to make the country's economy competitive did not allow limitless growth of labour costs.

1.4. Refocusing the PIF's Mandate ("Profile Clearance")

In an incremental process that extended from 1990 to 1994, the SIF was freed from the requirement to finance various pension-like benefits. A further narrowing occurred, this time at the expense of the SIF, when the latter was divided into two agencies in 1992. As part of this reorganisation, the financing of pensions for disabled persons below the retirement age (both partially and totally disabled) was relocated to the HIF.

As Table 1 shows, these changes left the PIF with about 80 percent of total pensioners and pension expenditures (1992). Between 1992 and 1997, the portion of those whose pensions were provided by the PIF dropped from about 81 percent to 75 percent and the portion of pension spending financed by the PIF declined from about 78 to 76 percent.

This trend was partially reversed in 1998, when the financing of pensions for those who were 100 percent disabled and under the statutory retirement age was transferred back from the HIF to the PIF. In the following years, PIF-financed pensions rose modestly from 76 to 77 percent and the portion of pension spending covered by the PIF rose from 79 to 81 percent (1998–2002).

⁷ The system dependency ratio is equal to the number of beneficiaries divided by the number of contributors.

Table 1
The PIF's role in pension administration and financing in Hungary

Year	Number of beneficiaries of:		Percentage of beneficiaries whose pensions were provided from the PIF	Expenses allotted to:		Percentage of expenses covered by the PIF
	Total pensions and pension-like benefits ¹ (total)	Pensions covered by the PIF (subset of previous total)		Pensions and pension-like benefits ¹ (total)	Pensions covered by the PIF (subset of previous total)	
	(thousand)		(%)	(million HUF)		(%)
1989	2,452	—	—	156,492	—	—
1990	2,520	—	—	202,118	—	—
1991	2,626	—	—	262,846	—	—
1992	2,751	2,219	80.67	321,757	252,235	78.39
1993	2,840	2,249	79.19	392,017	299,334	76.36
1994	2,972	2,276	76.59	498,440	379,169	76.07
1995	3,027	2,303	76.09	582,205	443,169	76.12
1996	3,082	2,326	75.48	669,812	504,866	75.37
1997	3,123	2,337	74.83	804,752	608,539	75.62
1998	3,157	2,411	76.37	989,040	781,849	79.05
1999	3,141	2,408	76.66	1,117,236	894,332	80.05
2000	3,103	2,399	77.31	1,228,474	995,867	81.07
2001	3,084	2,380	77.17	1,420,133	1,150,272	81.00
2002	3,070	2,369	77.17	1,696,306	1,376,489	81.15

Sources: Statistical Yearbooks of the CANPI.

Note 1: Until 1992 all pension-like benefits were covered by the SIF.

It is important to note that, since the benefits taken from the PIF's jurisdiction continued to exist, these changes did not alter total benefit expenditures but only those of the PIF.

The total expenditures of the PIF, measured as a percentage of GDP, have also changed considerably during the 1990s, as can be observed in Table 2. The sharp drop in expenditures in the mid-1990s is noteworthy: from a high 10.4

percent in 1994 to an all-time low of 7.3 percent in 1997. For this decrease, the indexation rule is the “culprit” – as more fully described in Augusztinovics et al. (2002, p.65). A somewhat more favourable indexation rule (see section 1.7.) also resulted in an increase in the expenditures of the PIF in 1998–99. Similarly, a continuous decrease in own revenues of the PIF up to 1997 can be ascribed to contribution erosion, i.e. weaker compliance; this will be more fully explored in the following sections. In the latter period, i.e. since 1998, the gradual decrease of own revenues was caused by the partial privatisation of the pension scheme and creation of the MPPFs, coupled with a decrease in the statutory contribution rate. As can be seen in Table 2, this fall in own revenues was “neutralised” by a matching increase in government transfers.

Table 2
Own revenues, government transfers and expenditures of the PIF
(as % of GDP), 1992–2002

	Own revenues	Government transfers	Revenues	Expenditures	Deficit/Surplus
1992	9.5	0.0	9.5	9.8	–0.3
1993	9.2	0.0	9.2	9.4	–0.2
1994	9.8	0.0	9.8	10.4	–0.5
1995	8.8	0.0	8.8	9.1	–0.3
1996	8.1	0.0	8.1	8.5	–0.4
1997	7.4	0.0	7.4	7.3	0.1
1998	7.5	0.2	7.7	7.9	–0.2
1999	7.5	0.6	8.0	8.0	0.0
2000	7.1	0.5	7.6	7.8	–0.1
2001	7.0	0.9	7.9	7.9	0.0
2002	6.7	1.6	8.3	8.4	–0.1

Source: Laws on final account of the PIF budget.

Note: “Government transfers” include compensation for revenue shortfall (because of channeling of contributions to MPPFs) and other central government subsidies. “Own revenues” include contribution revenues and revenues from interest.

1.5. *Stricter Requirements for Entitlement*

It would have been possible to achieve genuine PIF cost reductions by introducing stricter entitlement criteria. However, the two main changes taken along these lines turned out to have limited impact, and a third option was passed over completely. First, the required service time to qualify for a pension was increased from 10 to 20 years. However, this made virtually no difference in the short run to the eligibility of new pension applicants.⁸ The great majority of these individuals had obtained the service time needed for the pension in the old era of full and obligatory employment.⁹

Second, the system had an obvious brake to curb spending in the form of the statutory retirement age. A 1993 law prescribed a gradual rise in the statutory retirement age for women from 55 to 60, beginning in 1995. As it turned out, however, this increase was negated by contradictory rules in this same piece of legislation. In 1996, Parliament enacted another law on the retirement age, this time prescribing a gradual increase to 62 for both sexes. Today the new unified retirement age of 62 applies to men, since only a two year increase was required to achieve this. Since 1997, the retirement age for women has been gradually increasing by one year every two years.¹⁰ Thus, in 2003 the statutory retirement age for men was 62 years and for women, 59 years.

⁸ The increase in the required length of service from 10 to 20 years became effective from 1991, but this change had been included in a 1982 law with this distant effective date, adopted to give workers time to adjust.

⁹ In fact, the effect was quite the contrary. According to a new partial pension rule which was introduced simultaneously with the restriction, a more favourable formula was used between January 28, 1991 and June 30, 1993 than the one used for full but delayed pensions based on the same type of entitlement. So far as can be determined, this was a legislative mistake.

¹⁰ These large steps may lead to strange outcomes. In 2002, for example, not a single woman reached retirement age. Those born in 1943 had already reached it in 2001, and those born in 1944 reached it in 2003.

However, the option of flexible retirement, introduced simultaneously with the increase in the retirement age, allows earlier retirement. This caused the actual retirement age to rise significantly less than expected.

A third possible area for tightening entitlement conditions, disability pensions, is as yet unaddressed despite the fact that a large number of the unemployed, especially older persons, find compensation for lost earnings by escaping into disability status.¹¹ Parliamentary Decree No. 78/1997 contained a promise to the social partners and a statutory prescription for Parliament to develop disability reform legislation. However, neither the promised nor the statutorily prescribed reform has been introduced so far.

1.6. Changes in the Pension Formula

Hungarian pensions are calculated as the product of two factors; the first, countable earnings, has to be multiplied by the second, the accrual rate achieved by the individual, which depends on his or her length of service. During the course of the 1990s, several important changes were made in the former.

First, the number of years of countable earnings was increased. The computation is slowly evolving from one in which only final earnings were counted to one where a worker's entire lifetime earnings influence his or her pension. Before March 1, 1992, countable earnings consisted of the average of the best three out of the last five years before retirement. Effective as of that date, this concept was redefined as the average of all earnings since January 1, 1988. This average calculation, which at first included just four years and has since expanded year by year to include 16 years, results in lower countable earnings for almost all new pensions.

Second, simultaneous with the lengthening of the time period for the average earnings calculation, partial valorisation was introduced for the years of earnings used in the averaging. The valorisation is partial in two aspects.

¹¹ Given the division of responsibility for disability pension financing, such restrictions, if enacted, would not affect the PIF significantly but they would reduce the overall cost of social insurance.

The valorised earnings are not adjusted to the level of the year of retirement, only to two years earlier; and the last three years prior to retirement are not valorised at all.¹²

Table 3
Contribution rates in Hungary, 1989–2002

Year	Rate of employer		Rate of employee			Rate of membership fee	Joint rate (%)	Ceiling (HUF/day)	
	Contribution								
	to SIF	to PIF	to SIF	to PIF	to PIF	to PIF			to MPPF
	(% of gross contribution base)								
	Without ceiling			With ceiling					
				Non-members	Members of mixed system				
1989	43.0		10.0	—	—	—	—	53.0	—
1990	43.0		10.0	—	—	—	—	53.0	—
1991	43.0		10.0		—	—	—	53.0	—
1992		24.5		6.0	—	—	—	30.5	2,500
1993		24.5		6.0	—	—	—	30.5	2,500
1994		24.5		6.0	—	—	—	30.5	2,500
1995		24.5		6.0	—	—	—	30.5	2,500
1996		24.5		6.0	—	—	—	30.5	2,500
1997		24.0		6.0	—	—	—	30.0	3,300
1998		24.0		—	7.0	1.0	6.0	31.0	4,290
1999		22.0		—	8.0	2.0	6.0	30.0	5,080
2000		22.0		—	8.0	2.0	6.0	30.0	5,520
2001		20.0		—	8.0	2.0	6.0	28.0	6,020
2002		18.0		—	8.0	2.0	6.0	26.0	6,490

Sources: Laws on Social Insurance.

¹² For example, a person retiring in 2003 had 13 years of earnings whose value was adjusted to the 2001 level (from 1988 to 1999 and 2001 itself), while 2000, 2002, and part of 2003 earnings are kept at their nominal value. Thus, the calculated average of more than 15 years is heavily influenced by the level of 2001 earnings in the case of the 2003 retirement.

Third, in 1992, countable earnings were decreased by the imposition of a contribution ceiling on the employee's contribution. See Table 3. No employee's contribution is paid for earnings that exceed this ceiling (employers, however, continue to be liable for contributions on all their employees' earnings). In addition to decreasing contribution revenues, an important secondary effect of this ceiling is to make starting pensions lower, since earnings above the ceiling are not included in countable earnings.¹³

Fourth, the extent of redistribution toward workers with lower earnings (so-called digression) in the pension formula was altered. In the Hungarian pension formula, digression is achieved through applying a progressive scale to average countable earnings. The scale is divided into brackets, and a specified percentage of the earnings that fall into each bracket are disregarded. This percentage is lower for lower average countable earnings and rises progressively as average countable earnings rise, disadvantaging those at the upper end of the income scale.

Before 1991, this type of digression was relatively modest: even in the uppermost bracket, which had no upper limit, only 40 percent of countable earnings were disregarded. Then progression became much steeper. From 1991 on, the portion to be disregarded in the uppermost earnings bracket was 95 percent.

During the inflationary period of the early 1990s, legislators neglected to maintain the bracket boundaries. This pushed workers' countable earnings up the scale into progressively higher brackets where larger portions were disregarded for benefit computation purposes. The result was lower starting pension levels and substantial savings for the PIF.

Parliament addressed this situation in 1997. It enacted a provision that raises the bracket boundaries eight percent faster than the actual rise of net average earnings. At the same time, Parliament eliminated the brackets that

¹³ It is also noteworthy that, because employees continue to pay the smaller portion of contributions, placing a ceiling on their countable earnings results in a far smaller revenue loss than if the ceiling were applied to both employers and employees.

fell above the contribution ceiling.¹⁴ These changes will eliminate digression gradually, becoming fully effective in 2009.¹⁵

1.7. Indexing Pensions

Over the past decade, the PIF has realised substantial savings as a result of irregular adjustments in pensions. These adjustments, when provided, were structured in such a way as to maintain the purchasing power of only the lowest pensions. This compressed the range of pension payments, further weakening the link between a worker's past contributions and the level of his/her pension.

Between 1975 and 1991, the law only required an annual increase of two percent. A new regulation introduced in 1992 based indexing on the increase in net wages from the previous year. In a period when real wages were decreasing, this restricted the growth of pensions far more effectively than price indexing.

This regulation was changed in 1997, when the actual net wage index as calculated at the end of the year turned out to be greater than the one predicted in the annual budget law. The new regulation called for the use of the latter instead of the net wage index for the 1998–99 adjustment.

In that same year, there were deliberations on yet another change. This was because, beginning in 1996, there were certain signs of an economic boom. Many of those in government who were responsible for pension reform legis-

¹⁴ Accordingly, the two uppermost, i.e. the 90 percent and the 80 percent, brackets ceased in 2001 and 2003, respectively.

¹⁵ In addition, Parliament made a prospective change in the second part of the pension formula, the accrual rate. Under current law, this rate advantages those with shorter working periods. Specifically, the first ten years of earnings provide an accrual rate of 33 percent, whereas from 10 to 25 years the accrual rate falls to two percent per year, and for 25–36 years it falls to one percent per annum. After 36 years, it increases to 1.5 percent again. Beginning in 2013, this rate will be standardised. For those retiring from the public pension system, it will be 1.65 percent of average earnings of each year of service. For those in the mixed system (with part of their contributions in a mandatory private pension fund), it will be 1.22 percent.

lation wanted to switch from wage to price indexing as a means of avoiding an increase in PIF expenditures. Representatives of the unions as well as those of employers, however, insisted on maintaining the net wage index. A compromise was reached in the summer of 1997: a mixed indexing system was to be introduced with two years' delay. Thus, in the year 2000, a 30–70 percent weighted average of the price and the net wage index, respectively, was to be applied, while from 2001 onwards, an evenly weighted average (50–50 percent) was to be applied. This distant effective date meant that the real value of pensions would lag behind growth of net wages for at least two more years.

After the general elections in 1998, however, the new Parliament changed this regulation, replacing it with a single ad hoc increase on January 1st 1999. As a result of this change, pensions were increased by only 14.2 percent instead of the 18.4 percent called for by the previous regulation. This act is a telling indication of policy makers' strong will to restrict pension-related increases in state expenditures.

Indexing has an interesting feature in the post-transition era. It is strongly modulated by the timing of elections. It seems that somehow, after elections, the pension index turns out to be smaller than expected, while in pre-election years, pensions receive a bit more than they otherwise would have.

1.8. Increasing Contribution Revenues

Among the most common ways to increase pension revenues is to increase the number of those obliged to pay contributions. However, the fully matured Hungarian pension system offered no room for such an expansion. By 1992, the self-employed had already been drafted into the army of contribution payers.¹⁶ However, this did not enlarge that army, but rather served to prevent

¹⁶ This was also the year when farmers disappeared from the group of contribution payers. In 1991, there were still a few farmers among the insured population. Since then, only those farmers have been regarded as self-employed whose annual tax base is higher than a certain threshold, which is rather low. Those whose tax base is below this threshold fall in the category of primary agrarians, a sector that is not obliged to pay contributions to the PIF.

those who had left financially troubled enterprises from escaping the legal requirement to pay contributions.

A second approach was to require contributions from pseudo-employees, that is, individuals who are not actually employed but live instead on a benefit, allowance, or other form of public aid. In the course of the 1990s, people receiving educational allowance, nursing benefit, unemployment allowance, and various child care allowances were required to pay the employee contribution on the amount of the benefit. The employers' contribution on such benefits is paid by the central budget or by the special funds that administer these benefits.

Yet another approach was to extend the contribution requirement to new types of earnings.¹⁷ In Hungary, however, this approach could not achieve a major financial impact, because the earnings that were not already subject to this obligation were limited.

1.9. External Resources

In principle, another way to narrow the financing deficit of the PIF was to tap external resources. During the 1990s, there were three possibilities: the sale of assets, state subsidies, and privatisation revenues.

1.9.1. Assets Gratis

When establishing the SIF, legislators saw a clear need to enhance its independence by providing it with certain reserve assets.¹⁸ Earnings from these

¹⁷ A major step was taken in 1992, when wages from second jobs were included in the contribution base. A further step was taken in 1995, when the contribution base was defined as a list of items that was practically identical to the tax base. A 1996 law went one step further, declaring that the contribution base was identical to the tax base, including all wages, salaries, premiums, and dividends (however, the constitutional court subsequently found the latter unconstitutional). For a few years, certain types of authors' royalties were included in covered earnings. In some years, severance pay was also subject to contributions.

¹⁸ The reserve assets of the SIF were real estate, equities, and bonds.

could be used to fill the gap between contribution revenues and benefit obligations. The SIF was expected to manage these assets independently, i.e. to invest them or to loan them out in order to earn dividend or interest income. The idea of the SIF being provided with assets for free was accepted simultaneously with the privatisation of state assets.

Naturally, to supply the enormous amount of assets needed to transform the matured pay-as-you-go system into a funded system was never declared as a goal. At the beginning, however, it was intended that the SIF should receive a considerable amount of reserves. First, in 1992, the amount was HUF 300 billion. However, the actual amount transferred turned out to be less than 20 percent of this. In 1998, this concept was abandoned. The assets just received had to be returned to the state and used to finance pension expenses. At the same time, the government ceased its previous practice of charging symbolic interest on loans to the PIF from the central budget.¹⁹

1.9.2. State Subsidies

Thus far, the state has not assumed the role of a normative financier in the funding of the PIF. Its willingness extends only to being the guarantor of the fund and providing occasional supplementary resources.²⁰

1.9.3. Privatisation

During the 1990s, pension privatisation was widely perceived as a way of reducing the responsibilities of the state. Strongly supported by the World Bank, this approach was a topic of extensive debate and was finally approved by Parliament in 1997. Since 1998, Hungary's mandatory pension system

¹⁹ Symbolic, because the state is by law the guarantor of the PIF, so its losses, including interest-related debts, are funded from the central budget.

²⁰ From time to time, new items appear in the deficit-forecasting budgets of the PIF, providing some surprises to close observers of the system. One recent example is the state subsidy to the PIF for "contribution to the expenses concerning preferential pensions of members of the armed forces," which has been included in the revenues of the PIF since 2000.

has been standing on two pillars: the preexisting social insurance scheme financed on a pay-as-you-go basis and a new system of privately managed and prefunded individual savings accounts. The members of the private pension funds are said to belong to the so-called mixed pension system (MS). Since the end of 1999, the mixed system has included more than half of the total covered population. See Table 4.

Table 4
Number of persons in Hungarian PAYG and mixed pension systems
compared to number in employment²¹

Year	Number of persons				
	in PAYG system ¹	in mixed system ²		in employment ³	
1989	5,209	—	4,822.7	—	—
1990	5,146	—	4,795.2	—	—
1991	4,804	—	4,668.7	—	—
1992	4,672	—	4,241.8	—	4,025.7
1993	4,396	—	3,866.9	—	—
1994	4,362	—	3,700.7	—	—
1995	4,232	—	3,636.4	—	—
1996	4,080	—	3,615.0	3,648.1	—
1997	3,889	—	3,611.4	3,643.3	—
1998	3,886	1,350	3,634.8	3,697.7	—
1999	3,818	2,060	—	3,811.5	—
2000	3,843	2,190	—	3,849.1	3,856.2
2001	3,836	2,253	—	—	3,868.3
2002	3,845	2,214	—	—	3,870.6

Note 1: Average number of insured persons in the year (Statistical yearbooks of the CANPI).

Note 2: Number of members of MPPFs at the end of the year (Reports of the SFSA).

Note 3: On January 1 for column 4 – 1998 *Statistical yearbook of Hungary*; for column 5 – 2000 *Statistical yearbook of Hungary*; for column 6 – 2002 *Statistical yearbook of Hungary*.

Sources: Statistical yearbooks of the CANPI and reports of the SFSA.

However, because the members of the mixed system pay a set part of their employee's contribution to their chosen private savings fund, the 1997 law has so far not caused any decrease in the financial burden on the PIF. On the contrary, the PIF has lost a significant portion of its revenues. From 1999 to 2002, these contributions to MPPFs diverted six percent of the part of the contribution base that remained below the ceiling to the new private pension funds, and members of the mixed system paid only the remaining two percent of the employees' contribution to the PIF.

In Act LXXX of 1997, the government promised to provide full compensation for the contribution revenues that the PIF lost as a result of a part of the contribution rate being diverted to the new private pension funds. In practice, however, the state budget regularly refunds the PIF losses only to the extent of its full deficit.²² If the government had kept its promise, it would have been possible to enact larger decreases in contribution rates over this period or, in the alternative, to reduce state budget subsidies to the PIF.²³

²¹ The average number of insured persons in the year is less than the number of all persons in the PAYG system. This is because persons for whom no contribution was paid in a year do not lose their pension rights accrued in earlier years. In 2000, the number of persons who accrued pension rights (i.e., their employer paid some contribution for them) was above 4.6 million.

²² Such refunds are regularly less than the sum of the contribution revenue diverted to the second pillar for each member of the mixed system. Thus, without the privatisation, the PIF deficit would have been smaller in some years and, in others, would have been in surplus.

²³ By law, the annual budgets of the PIF and HIF must be in exact balance; i.e. neither surplus nor deficit is permitted. However, in a large pay-as-you-go system whose revenues and expenditures are both affected by economic changes, such precision is virtually impossible to achieve. This difficulty may explain the regular underestimation of the costs and overestimation of the revenues in the budgets of both social insurance funds. As described previously, the reserve assets of the PIF and the HIF were re-nationalised in 1998, and since then there have been no surpluses, so the absence of rules for surplus management has caused no problem. However, some reserve assets would be very useful in maintaining financial balance, since too frequent adjustments of contribution rates are in conflict with the requirement of stability.

2. An Overview of the Current Contribution Collection System

Act XL of 1928 required employers to pay social insurance contributions. At the same time, it allowed the employer to deduct and retain half of the amount paid from each employee's wages. Thus, an employee contribution did not exist formally at that time, and only the employer had a current account with the social insurance institution. This explains the use of the term "contribution account holder" or briefly "account holder" to refer to the employer as a contribution payer. Although the rules of contribution payment have changed, the account holder's role has remained the same.²⁴

Since January 1, 1999, the Tax and Financial Control Administration (hereinafter referred to as the Tax Office) has been the main institution involved in collections. The Tax Office has the duty to assess and collect contributions, to carry out inspections, to keep records of contribution obligations, payments, and debts, and to initiate legal action in serious cases of breach of legal obligations. In all matters related to pension contributions, account holders are considered to be the Tax Office's partners. Their actions are central in the process by which employees accrue pension benefit rights.

The term "employer," with respect to contribution collection, is to be interpreted rather broadly, as shown in the following definitions from Act LXXX of 1997:

An employer is:

1. any legal entity, natural person, unincorporated business partnership, or other organisation or agency operating on the basis of a budget, or any personal association that employs insured persons;
2. in the case of trainees under an apprenticeship contract, the employing party, whether a business organisation or self-employed person;

²⁴ For members of the mixed system, whether employees or self-employed, the term account holder is used to refer to those obliged to pay and report to mandatory private pension funds (MPPFs) as well.

3. in the case of partnership members, the partnership proper;²⁵
4. in the case of persons who receive unemployment benefits, including the pre-retirement type, and who are treated as insured, the disburser of the unemployment benefit;
5. in the case of persons who receive child care benefit, child care aid, child care support, or nursing benefit, the organisation disbursing the benefit, aid, or support;
6. in the case of employers under the accountancy of any Regional Administration of the Hungarian Treasury (including Budapest's Administration of the Hungarian Treasury), the regional treasury administration itself;
7. in the case of working activities described under Chapter XI, Part Two of the Labour Code, unless otherwise specified, the lender; and
8. with respect to activities such as contribution calculation, data management, obligatory information provision, and reporting on the insured, the units that perform centralised payroll-related accounting for agencies belonging to the central budget.

²⁵ In order to solve some riddles lurking here, it is necessary to examine two other definitions from the same law. Partnership is defined to include: (1) a general partnership (including associations with, and without, legal liability as entities); (2) a deposit-based partnership; (3) a partnership with unlimited liability; (4) a partnership with public welfare purposes; (5) a joint venture; (6) an association; (7) all of the above, during periods of operation as a pre-partnership; (8) a partnership of patent attorneys, (9) an association of driving instructors, (10) an association of trainers, (11) a law office; and (12) a distrainer's office (that is, an office that ceases and holds property to compel reparation, as in a debt). A member of a partnership is defined to include: (1) a member of a deposit-based partnership who has either full or limited liability; a member of a general partnership; a member of a partnership with limited liability; a member of a partnership with public welfare purposes; a member of a joint venture; or a member of an association, provided that s/he actually and personally participates in the activity of the partnership and this participation does not take place in the framework of employment or under a collaboration contract; and (2) a member of a patent attorneys' partnership, if s/he actually and personally takes part in the activity of the partnership; a member of a lawyer's or distrainer's office; or a member of community of trainers or driving instructors.

Another way of acquiring entitlement to a pension is through self-employment. Here the legal definition from the same statute is as follows:

1. a natural person who possesses an entrepreneur's license, as well as those natural persons who, according to legislation being effective before the introduction of the rules of self-employment contained in Act V of 1990, were classified as craftsmen and private traders;
2. natural persons engaged as entrepreneurs in such fields as health care and social work, medical practitioners, specialised psychologists, veterinary surgeons, and pharmacists (together classified as health care entrepreneurs);
3. private lawyers;
4. private patent attorneys;
5. public notaries; and
6. private distrainers that execute court orders.

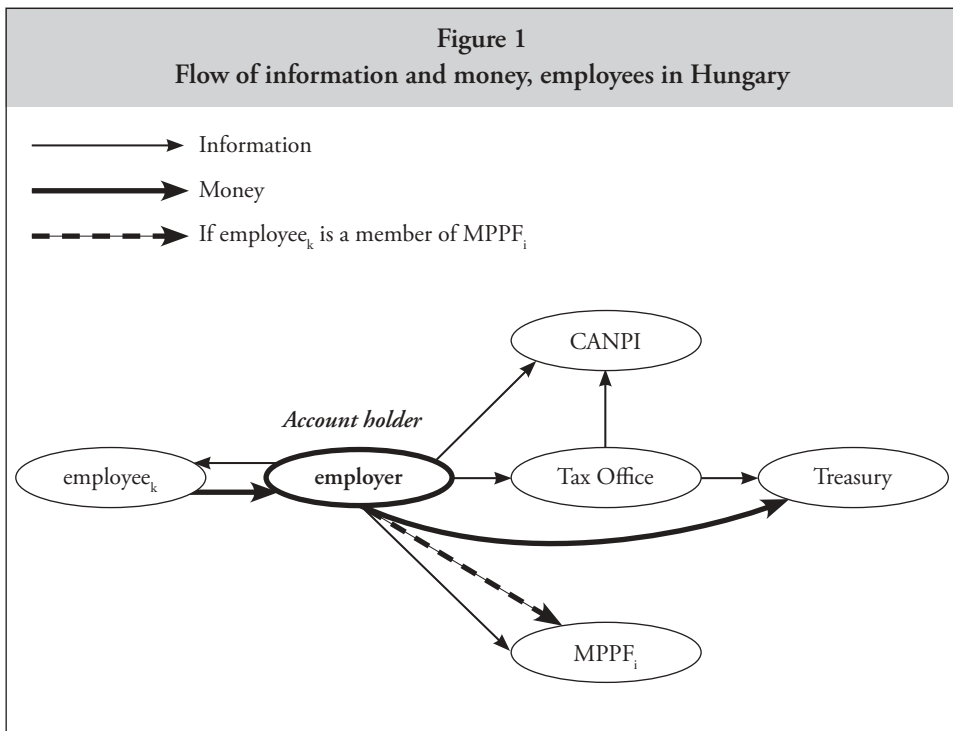
All of the above-listed employers as well as the self-employed are account holders.

A third necessary definition, *employee*, can be derived with reference to the other two. Employees are defined to include all those who are not categorised as self-employed and are employed by any of the above-listed employers. As explained previously, employees are not contribution account holders.

The main path by which employees acquire pension rights is through the payment of contributions. Current law calls for two payments: one from the employer and one from the employee. However, all of the tasks associated with remitting and reporting contributions are carried out by the account holder, as shown in Figure 1. The employee only has to endure the deduction of the contribution from his/her earnings.

There are two institutions whose requirements employers must satisfy when performing these tasks: the Tax Office, which is the target of the payments, and the CANPI, which keeps records of the employees' entitlement accruals.

Employers are required to deduct each employee's contribution and match it with their own contribution on that worker's behalf. Then they must total up the contributions for all their employees and transfer this sum to the PIF's current account kept with the Hungarian State Treasury. They must also prepare and submit a report (return) on each such payment to the Tax

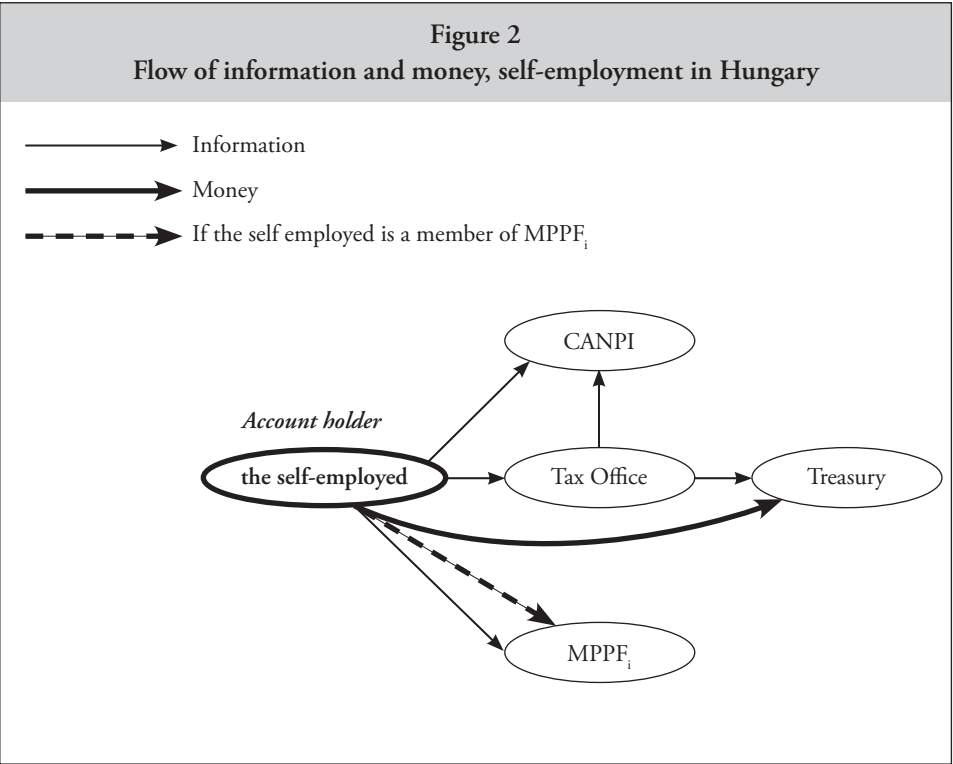


Office, in a format that it prescribes. In this document, neither amounts paid nor employees are individualised; both are aggregates. (In addition, this document details payments to the public scheme only. Neither the Tax Office nor CANPI receive reports of employer transfers on behalf of employees to the private pension funds.) Cash payments are not permitted; contributions may only be paid by bank transfer. Reports are accepted in paper form or on magnetic media.

Employers must also maintain a record on each of their employees. The content of these records is strictly prescribed so that CANPI can easily determine the pension rights that employees accrue while working for that employer. Employers are required to prepare a report each year on the entitlement accrual of each of their employees and send it to CANPI. Like employer reports to the Tax Office, this report does not include amounts that employers are required to withhold from employees' earnings and transfer to mandatory private pension funds.

This record-keeping arrangement relies on a close relationship between employers and employees. In addition to withholding and deducting employees' contributions, employers must supply employees with documents that detail all deductions from their earnings, including those withheld from wages and those paid by the employer. Such documents may be used to prove pension entitlement. In reality, however, this is rarely the case; their use for this purpose is mostly limited to dubious legal situations.

In the case of the self-employed (Figure 2), the employer and the employed are one and the same person; and legislation requires the self-employed to meet the same record keeping and financial obligations as described above. There are certain differences in the frequency of payments and information provision which serve to simplify these tasks for the self-employed, but the contents are identical. Obligations in connection with the members of the mixed system are defined analogously by law for both employers and the self-employed.



As shown in Figures 1 and 2, both employers and self-employed (account holders) are required to transfer the total of their employees' contributions plus their own employer's contribution to the Tax Office.²⁶ At the same time, they must report to the Tax Office on their aggregate contributions. However, as mentioned previously, these aggregate reports are not detailed enough to serve as a basis for records of contributions made on behalf of individuals.

When enacted by Parliament, Act LXXX of 1997 included a requirement for such individualised record keeping. It prescribed detailed reporting by employers to both the CANPI and the MPPFs. The aggregated reports were to have had an attachment stating for each employee:

- name;
- social insurance identification number;
- a designation of those workers who are members of mandatory private pension funds; and
- the base for each contribution, its amount, and the annual total.

However, a week before Act LXXX of 1997 came into force, another piece of legislation, Act CLIII of 1997, postponed the application of the above obligations until 1999. The following year, Act LXVIII of 1998 repealed this part of the law. As a result, there is today no public record of individual contributions in Hungary.

As far as money matters are concerned, the level of contributions for a member of the mixed system is identical to that for an individual in the public system alone. However, additional administrative and reporting requirements apply to the former. The employer must transfer the required contributions to the relevant MPPE, as well as sending each MPPF a list of the individuals on whose behalf each such transfer was made. The purpose of providing such details is to enable the MPPFs to maintain their own systems of individual accounts for their members.

²⁶ The Tax Office has an account at the Treasury for receiving contributions on behalf of the PIF. The employer sends contributions to this account. On daily closing, the Tax Office orders the money collected on this account to be transferred to the account of the PIF at the Treasury.

These payment and reporting obligations must be fulfilled on a monthly basis by employers. In the case of the self-employed, contributions must to be paid quarterly, and only annual reports are required.

The financial accounts of the PIF are kept with the Hungarian State Treasury.

The CANPI is responsible for keeping records of the pension rights that workers accrue based on the employer obligation to pay contributions. Since 1997, employers have been obliged to report annually to the CANPI on these rights. Their reports are individualised for each employee and contain such details as insurance periods, contribution bases, and employers' and employees' contributions due. However, these reports cannot serve as a basis for a national system of individual contribution records, because they are not checked against the aggregated figures reported to the Tax Office. Thus, the CANPI cannot verify the amount of the contribution actually paid on behalf of the insured individual.

It is noteworthy that, during the period that an employee accrues pension rights, s/he has no personal connection with the CANPI. Rather, each employer serves as the intermediary between its employees and the CANPI.

By virtue of its role in managing the PIF, the CANPI receives, on a daily basis, information on changes in the PIF account balances, including contribution receipts from the Tax Office. Again, these figures are aggregates only, and no usable information on the accrued rights of individual contributors can be derived from them.

3. Different Contribution Bases/Rates for Different Contribution Payers

3.1. *Contribution Bases*

As a general matter, the legal relationships through which particular forms of income are generated determine whether they must be included in the pension contribution base. For workers, whose employment is the legal basis for their working activity, the contribution base is generally equal to their taxable

income.²⁷ Partnership members' contribution base is the taxable income resulting from their personal activities. In the case of the self-employed, the amount they withdraw from their enterprise is the contribution base.

For full-time self-employed and partnership members, the contribution base is subject to a minimum that is equal to the minimum wage.²⁸ Other contribution bases do not have a minimum.

The employee's contribution base may differ from that of employers, since employees are not obliged to pay employee's contribution upon the value of what they are provided in kind. They also (and unlike employers) enjoy exemptions for anniversary-related rewards, dismissal pay, restart aid, non-disclosure fees, and compensation for unused leave.

As noted previously, the employer's pension contribution base has no ceiling, while the employee's pension contribution base has one. This ceiling is the same in all sectors of the economy.

3.2. Differences between the Contribution Base and the Personal Income Tax Base

When the personal income tax (PIT) was introduced in 1988, its base differed significantly from the contribution base. The differences reflected the divergent purposes of these two revenue-raising instruments. The PIT, whose purpose was to fund the activities of the state, included a broad array of incomes, whereas the pension contribution, levied in order to replace wages lost as a result of old age, disability, or death of a breadwinner, applied only to wages and wage-like payments. During the transition, the chronic shortfall of pension contribution revenues led Parliament to include additional types of income in the contribution base, thereby bringing the two bases closer together.²⁹ Today it appears that this process has run its course and ceased.

²⁷ However, important exceptions will be discussed later.

²⁸ Such persons are regarded as self-employed full time or as full-time partnership members whose weekly working time with any of their employers is more than 36 hours.

²⁹ See Footnote 17 for a list of these expansions.

The remaining differences between the two bases comprise two categories, income that must be included in the contribution base but not the personal income tax base, and vice versa. Prime examples of the first category include trade union membership fees, earnings based upon apprenticeship contracts, and foster parent allowances. In addition, earnings from so-called low-amount disbursements must be included in the contribution base, although it is optional whether to withhold personal income tax from them.³⁰

On the other hand, capital gains realised from the sale of a person's assets must be included in the person's income tax base but are left out of his/her contribution base. The same treatment applies to some social insurance benefits (i.e., accident allowance, sick pay, accident-related sick pay, and maternity/birth benefits), as well as to the value of products and services that are provided as business gifts.

The above differences show that making the two bases identical would be possible only at the cost of further blurring the principles of the two systems: on the one hand, replacing lost earnings due to specified contingencies and, on the other, enabling the state to function.

3.3. *Contribution Rates*

In 2003, the employers' pension contribution rate was 18 percent without a ceiling.

The employees' pension contribution rate was 8.5 percent with a ceiling of HUF 10,700 per day for those who did not belong to the mixed pension system. For mixed system members, the employees' contribution was 1.5 percent subject to the same ceiling as above, and employees were required to pay a seven percent membership fee (on income up to this same ceiling).

Self-employed persons who did not belong to the mixed system were obliged to pay the 18 percent employers' pension contribution with no ceiling

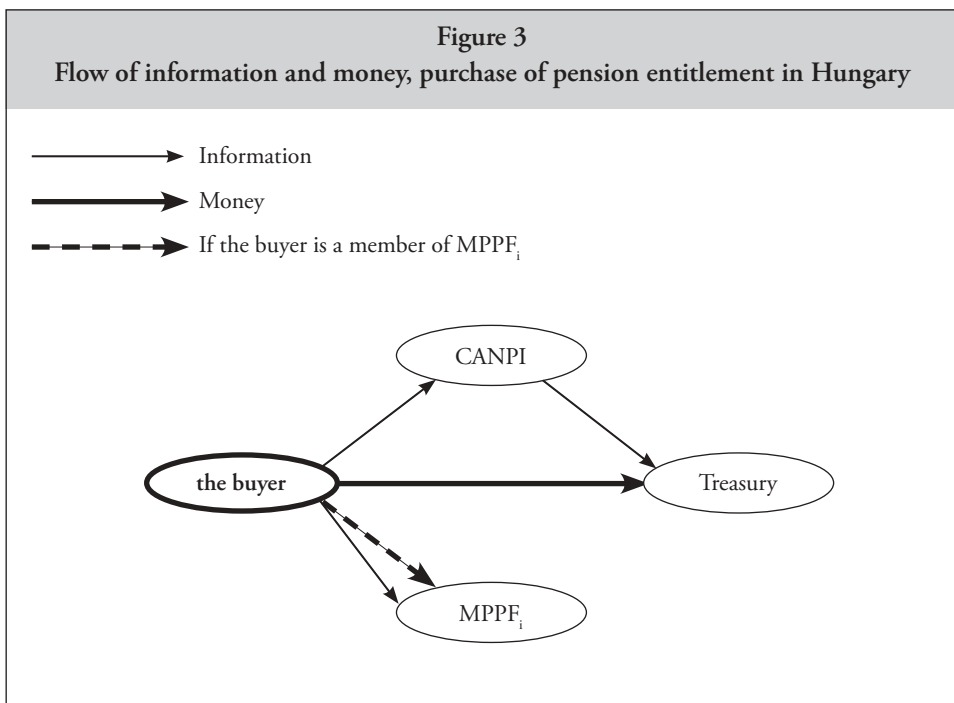
³⁰ These are small payments for small jobs, subject to a special tax rate in Hungary. If they are not subject to income tax withholding, then the disburser, using the maximum tax rate, deducts and pays the tax upon disbursement of this income.

and the 8.5 percent employees' pension contribution with the same ceiling as applied to employees. Self-employed members of the mixed system had to pay the 18 percent employers' pension contribution with no ceiling and the 1.5 percent employees' pension contribution plus a seven percent membership fee (both subject to the ceiling).

3.4. Purchase of Pension Rights

Certain individuals may contract with the CANPI to purchase pension rights. See Figure 3. There are three options: prospective purchase, retroactive purchase, and purchase just prior to retirement.

Under the first option, rights are purchased gradually over time as if they were being earned through working and paying contributions. This option is available to those who have a residence in Hungary, do not have a pension based on their own work record, and are not covered by social insurance.



The second option, retroactive purchase, involves buying rights for past periods. It is available to certain individuals who were deprived of a right to accrue a pension without making contributions.³¹

The third option applies to persons who have reached retirement age and intend to retire but lack the necessary contribution period. They may contract to purchase up to five years of rights needed for entitlement.

In agreements for retroactive acquisition of pension rights or for obtaining missing pension rights just prior to retirement, the contribution base is the minimum wage in effect on the day of the agreement. For acquiring pension rights prospectively, the contribution base must be determined but can be no lower than the current minimum wage and no higher than the ceiling.

In all three of these cases, a rate of 26.5 percent must be paid on the contribution base, unless the individual is a member of the mixed system, in which case the rate is 19.5 percent.³²

4. Number of Contributors, Measures of Contribution Collection and its Effectiveness

In 1989, the average number of contributors was 5.2 million, reflecting the policy of full employment then in effect.³³ By 1999, this number had dropped

³¹ For example, periods of study at institutions of higher education before January 1, 1998 are regarded as service time even without contributions having been paid. However, study at similar institutions after December 31, 1997 is not counted as service time unless purchased by way of contracting simultaneously or retroactively.

³² Contributions to MPPFs cannot be paid retroactively. However, agreements with the MPPFs are permitted for prospective acquisition of pension rights.

³³ Statistics do not reveal the average number of actual contribution payers. Therefore the average number of insured persons is used throughout this study; that is, the number of those who are covered by social insurance by law and therefore required to make contributions. The term “average” is used taking note that insured status is not necessarily continuous and people may have multiple jobs as well. Given labour mobility, the number of people acquiring credit toward a pension may be significantly higher than the average number of jobs. In 2001 and 2002, there were roughly 4.2 million people in Hungary who, in the given period, accrued some new pension rights.

by one and a half million. Since 2000, statistics have shown minor, uncertain, and wavering growth. The decline bottomed out at 3.6 million, and at present, on average, there are 3.8 million contributors. Naturally, the majority of them are employees. In 1989, their average exceeded 3.9 million; and even after the large loss of employment in Hungary during the 1990s, there were still more than 3 million (1999).

Table 5
Contributions to Hungarian Pension Insurance Fund (PIF)
and Mandatory Private Pension Funds (MPPFs), 1989–2002

Year	Contributions ¹ collected	Contributions diverted to MPPFs	Average contributions	Average contributions diverted to MPPFs	Joint average
	(Million HUF)			(HUF/year)	
1989	291,696	—	55,998	—	55,998
1990	352,436	—	68,487	—	68,487
1991	407,355	—	84,795	—	84,795
1992	261,794	—	56,035	—	56,035
1993	306,347	—	69,688	—	69,688
1994	364,501	—	83,563	—	83,563
1995	421,853	—	99,682	—	99,682
1996	487,327	—	119,443	—	119,443
1997	595,022	—	153,001	—	153,001
1998	710,579	28,600	182,856	21,185	190,216
1999	764,491	56,500	200,233	27,427	215,032
2000	872,016	86,300	226,910	39,406	249,367
2001	966,643	104,131	251,992	46,219	279,138
2002	1,045,502	117,105	271,912	52,893	302,369

Note 1: Prior to 1992, contributions to SIF; from 1992 contributions to PIF.

Note 2: Contributions on behalf of pseudo-employees are excluded.

Sources: Statistical yearbooks of the CANPI and reports of the SFSA.

A sudden drop in contributions collected can be observed in 1992 (see the last column of Table 5). This is explained by the fact that, before 1992, the

contributions taken into account were those to the SIF, while from this year onwards only PIF collections were counted.

Another cause of change in aggregate collections is variation in the contribution rate. In 1999 and again in 2001, this rate was reduced by two percentage points.

It can also be observed that the average contribution has grown faster than the gross average earnings of employed persons. This difference might result from non-compliance and evasion being forced down to a certain extent. The effective contribution rate (average contributions paid/average gross wage) fell to under 70 percent of the joint rate in 1996, which is its lowest rate in the decade. Since then, it has been increasing. In 2001, for the first time since the beginning of the transition, it exceeded 80 percent.

The preceding figures do not include the groups termed earlier as pseudo-employees, that is, individuals outside employment who are nevertheless required to pay contributions. In 2003, their approximate numbers were as follows:

- those receiving unemployment benefit: 120,000–130,000;
- those receiving child care benefit: 54,000–63,000;
- those receiving child care aid: more than 190,000;
- those receiving nursing allowance: 27,000–30,000; and
- other smaller and/or unknown groups.

For these individuals, the provider of the benefit performs the same function as the employer, deducting the employee contribution from the benefit paid and matching it with an amount equal to the employers' contribution. As with real employees, pseudo-employees earn pension rights on the basis of their contributions. If each pseudo-employee is considered to be a contribution payer, then the present yearly average of contribution payers would exceed 4.4 million. Table 6 shows the value of the covered wage bill, measured as percentage of GDP. The covered wage bill shows the hypothetical amount of aggregate wages, which would have generated the actual observed contribution revenue, assuming of course the given contribution rate.

Table 6
The covered wage bill as percentage of Hungarian GDP

Year	Employer's contribution rate ¹ (%)	Employer's contribution ^{2,3} (million HUF)	GDP (billion HUF)	Covered wage bill (million HUF)	Covered wage bill (% of GDP)
1989	43.0	237,096	1,723	551,386	32.01
1990	43.0	287,613	2,089	668,867	32.01
1991	43.0	329,008	2,308	765,135	33.15
1992	24.5	207,648	2,943	847,543	28.80
1993	24.5	239,695	3,548	978,347	27.57
1994	24.5	292,860	4,365	1,195,347	27.38
1995	24.5	351,896	5,614	1,436,310	25.58
1996	24.5	411,828	6,894	1,680,931	24.38
1997	24.0	499,413	8,541	2,080,888	24.36
1998	24.0	593,727	10,087	2,473,861	24.53
1999	22.0	604,031	11,394	2,745,595	24.10
2000	22.0	698,438	13,172	3,174,719	24.10
2001	20.0	775,280	14,850	3,876,402	26.10
2002	18.0	827,300	16,744	4,596,112	27.45

Note 1: Employee's contribution has a ceiling; thus it is not used in the estimate.

Note 2: Employer's contribution for pseudo-employees excluded.

Note 3: Contribution of the self-employed for their employees might be excluded in some years.

Sources: Statistical yearbooks of the CANPI.

Table 6 shows that the estimated covered wage bill (as percentage of GDP) fell to its lowest value in 1999 and 2000, and has since then been increasing.³⁴ Even so, it is still far below its level before the transition. This drop reflects the large loss of formal employment that occurred in Hungary.

³⁴ Since there is a common ceiling for the employee's contribution and the membership fee for the mandatory private pension funds, using them in calculating the covered wage bill would underestimate the actual value. Thus, they were excluded in this calculation.

Government statistical reports provide information on the division of the employer's contribution by sectors. They use the following categories:

- budget-dependent organisations;
- enterprises;
- non-profit organisations; and
- self-employed.

However, these statistics are not disaggregated to show the employees' contribution figures by sectors. Officially, the employees' contributions have been divided into only two categories since 1998: those for members of the mixed system and for non-members.

Until 1992, government statistics included a category of contribution payers called private farmers. These 40,000 or so people had remained outside collectivised agriculture. By 1993, the pre-transition forms of collectivised farming had ceased to exist, and new types of cooperatives and private farms had been established. At the same time, the statistical category of private farmers was eliminated. Those who had any cultivated land of their own became entitled to declare themselves primary agrarians. The present number of primary agrarians is as high as 1.3 million.³⁵ Primary agrarians are outside the social insurance system. Estimates, however, show that the overwhelming majority of them are insured through other work. Many of them are self-employed; others are partnership members, or even employees. Some of them have made agreements with the PIF for purchasing pension rights.

5. Non-compliance and Evasion

Over the last century, non-compliance, evasion, and accumulation of arrears have counted as national sports in Hungary. Therefore, in retrospect, the early 20th century concept of clear and unambiguous differentiation between taxes and contributions appears to have been a brilliant idea. This distinction, too,

³⁵ This number was provided by the Tax Office. It is described as an upper limit since, to this author, it seems extremely high.

might explain why peoples' willingness to pay contributions was far greater than their willingness to pay taxes. During the course of the transition period, a process of intermingling these two diverse obligations has been underway. Now contributions and the personal income tax not only have almost the same base, but they are even collected by the same organisation, the Tax Office. This situation results from a process starting with the introduction of the personal income tax (PIT) in 1988. Then the PIT base and the contribution base differed on principal grounds. Incomes as such were subject to the PIT, while only wages and wage-like incomes were contribution bases.

During the transition, one means by which politicians sought to increase contribution income was broadening the contribution base. Thus, they tried to bring the contribution base as close to the PIT base as possible. To the same extent that the contribution came to be regarded as a tax, contribution-paying morale fell to the level of the taxpaying morale.

5.1. A Wandering Task

Before 1992 when the social insurance fund (SIF) was divided into the PIF and HIF, it was the responsibility of the Central Administration of National Social Insurance (CANSI) to collect contributions. After this division, the Central Administration of National Health Insurance (CANHI) Fund was placed in charge of all contribution collections. This arrangement continued until 1999. Between 1992 and 1999, inspections were performed by the Central Administration of National Pension Insurance (CANPI) Fund. Since 1999, the Tax and Financial Control Administration (Tax Office) has been responsible for all contribution-related tasks.

Accessible data concerning non-compliance or evasion have become scarce. It is only arrears, the tip of the iceberg, that are available for analysis. Other forms of evasion such as underreported earnings and non-registered enterprises and employees are impossible to estimate based on existing statistics. Even the roughest estimate of the extent of such phenomena, or the resulting revenue loss, seems hopeless due to a lack of any trustworthy data.

In 1996, Parliament enacted legislation authorising employment inspectors to declare dubious cases to be "fictitious self-employment." This authority was

strengthened in July 2003. However, no statistics on the effectiveness of such inspections have so far been published.

5.2. *Dynamism*

In the course of the transition, the structure of the Hungarian economy completely disintegrated, followed by a process of renewal. In the initial period of privatisation (early 1990s), the number of account holders increased threefold, while the number of insured persons greatly decreased. The former was due to the disappearance of larger enterprises or their breakup into smaller units. In 1990, the number of current accounts handled by CANSI totaled 650,000. Five years later, this number at the CANHI increased by over a million.

The collection agency was unable to cope with such a rapid increase. The information technology (IT) which the CANHI inherited from the CANSI was of the late 1980s vintage, and the development of a new system was impeded by numerous delays and unfulfilled promises. By 1998, this effort had become completely stalled.

Until 1992, the CANSI had only restricted authority over the contribution-related debts. It could not collect overdue contributions directly from employers or the self-employed (account holders) but could only send a payment request.³⁶ Stricter means of collection were only possible through the tax authority or by initiating legal actions on the basis of misdemeanor.

In 1992, as a response to the apparent increase in debts, Parliament enacted legislation giving the CANHI authority to recover debts through direct collection (that is, seizure of liquid assets) and collection enforcement (i.e., confiscation and sale of physical assets).³⁷

³⁶ The CANSI had the authority to collect directly from individuals. However, since worker contributions are withheld and paid by employers, individuals do not themselves owe contributions. Thus, the right to collect directly from them was not useful for contributions. This right was used only to recoup benefits paid to individuals to which they had not been entitled.

³⁷ Specifically authority for direct collection enables the collection agency to withdraw funds from a firm's bank account without its authorisation. Since many firms were operating on a cash basis in this period, this authority was of limited value; and

5.3. *The Structure of the Arrears*

In the early 1990s, the portion of social insurance arrears attributable to unpaid late charges was increasing sharply. Of the total amount of arrears, company debts comprised nearly 85 percent. A huge proportion of contribution debts were old. At the end of 1995, more than one-fourth of all receivables, which amounted to HUF 230 billion, were late payment charges.

As the privatisation process accelerated, it became impossible to divide employers by sectors. Not only was the number of companies soaring, but the circle of owners was changing dynamically too. The number of the self-employed was increasing, and together with it, their debts. By the end of the 1990s, company debts had declined as a portion of all receivables to two-thirds, while the debts of the self-employed had risen to almost one-third. The debts of organisations included in the state budget were oscillating between two percent and 2.5 percent of all receivables.³⁸

5.4. *Large Debtors*

The distribution of debts in 1995 is shown in Table 7. As can be seen, a very small proportion of debtors was responsible for a huge proportion of all receivables. As shown in the first two columns,

- Fewer than one-thousandth of the debtors were responsible for 41 percent of the debts.³⁹
- About a half percentage of debtors were responsible for 65 percent of the debts.
- About 2.8 percent of debtors were responsible for 86 percent of debts.

additional authority for collection enforcement was needed. Here a distrainer (that is, a person authorised to seize goods as a security against debt) goes to a firm and surveys its assets, placing a lien on whatever he finds of value. This prevents the firm from selling or destroying it. Later a public sale is organised, and the proceeds are used to cover the firm's contribution debt. Any remaining proceeds are left to the firm.

³⁸ State budget organisations include ministries, some research institutes, and other organisations staffed by civil servants.

³⁹ Each owed more than HUF 50 million.

Table 7
The structure of arrears in Hungary at the end of 1995

Debtors as percentage of number of account holders	37.13							
Debts as percentage of contributions collected	37.63							
Percentage of late payment charge in all debts	25.44							
Amount of debt on account is:	All debtors		Ceasing ¹ debtors		Debtors under distraint		Debtors under agreement	
	represent percentage of		represent percentage of		represent percentage of		represent percentage of	
	number of debtors	debt	number of debtors	debt	number of debtors	debt	number of debtors	debt
More than 1 HUF	100.00	100.00	27.72	46.02	2.45	8.75	3.94	21.11
More than 1,000 HUF	81.52	99.99	22.23	46.02	2.36	8.75	3.78	21.11
More than 1,000,000 HUF	2.89	86.12	1.06	42.45	0.26	7.91	0.43	20.03
More than 5,000,000 HUF	0.95	73.93	0.43	38.30	0.10	6.89	0.19	18.48
More than 10,000,000 HUF	0.51	65.26	0.25	34.64	0.05	5.99	0.12	17.06
More than 50,000,000 HUF	0.09	41.46	0.05	23.13	0.01	3.5	0.03	11.51

Note 1: Ceasing here includes debtors under winding up, liquidation, and bankruptcy processes as well as ceased debtors.

One single debtor, the Hungarian State Railways, was responsible for more than eight percent of all debts.

Together the debts owed to the PIF and HIF totaled about HUF 230 billion, or nearly 38 percent of contribution revenues in that year. Of the 1.65 million account holders, more than 37 percent have a debit balance on their account.

Of all debtors, 28 percent were winding up, in a liquidation or bankruptcy process, or ceased. These hopeless debtors were responsible for almost half of all debts.

5.5. *The Biggest*

The debts of the Hungarian State Railways grew to such a huge amount that the Parliament, losing all hope, passed a special law to settle these debts. Act LXXXIV of 1994 prescribed, as an exceptional measure, the settling of the Railways' more than HUF 16 billion debt to the PIF. This law and the budgetary measures taken according to it gradually settled the Railways' debts, paying the PIF the entirety of what was owed from the state budget. This was not a case of writing off a company's overdue debts, but rather of the company owner fulfilling its liability.

5.6. *Debt Management*

If a firm's contribution account was in debit, the relevant social insurance authorities would issue a payment request, followed by such actions as blocking of the debtor's bank accounts, obtaining a direct collection order from the courts, or entering into an agreement. If such actions proved unsuccessful, the next step was distraint of the debtor's movable and property assets.⁴⁰ If even this did not result in proper settlement of the debts, and, or at least, an agreement, then the relevant social insurance authorities would initiate a winding-up action.

⁴⁰ Distraint is the legal act of seizing and holding goods as security against a debtor, as for rent, damages, or the like.

At various stages of this process, debtors would be offered an agreement by which their late payment charges and fines could be reduced or completely cancelled. However, the principal debt had to be settled, in one or several installments. All such agreements contained a provision stipulating that the preferential terms would cease to be effective if the debtor again failed to meet current obligations, including both the agreed installments and the currently due contribution.

During 1993–95, Parliament and the government provided loans under favorable terms for certain firms on the verge of insolvency. Such loans could be used, among other purposes, for paying contribution debts. Just one one-thousandth of all debtors made attempts to wipe their slates clean and settle their debts to the social insurance through these arrangements. This group was responsible for about 15 percent of all debts. However, this debt consolidation did not lead to a major decrease in social insurance receivables. Only 30–35 percent of the participating companies entered into agreements to settle their contribution debts and, of these, only 10–15 percent actually did so.

5.7. The Present Situation

In 1999, full authority for all tasks related to contribution collection was shifted to the Tax Office. Under this arrangement, the Tax Office is authorised to:

- check the contribution returns submitted by contribution payers, as well as their record keeping;
- sanction infringements of contribution-related obligations whether they are related to payments or to the provision of data; and
- collect all contribution-related debts, including taking actions such as distraint.

Furthermore, all contribution payments and information returns must be directed to the Tax Office. When a new business becomes liable to pay contributions or a closing business ceases to be liable, they must report this to the Tax Office as well.

At the beginning of 1999, the Tax Office took from the CANHI and CANPI not only the above responsibilities but also the premises, infrastructure, personnel, database and the balances in accounts related to them.

In the summer of 1999, Parliament enacted Act LXIV of 1999, which obliged the Tax Office to restructure social insurance contribution accounts. As a result, every account holder received a new current account, the starting balance of which was set through a reconciliation process between the Tax Office and the account holder. In this process, the contribution directorate of the Tax Office had authority to reach individual agreements with contribution payers on the amount of their outstanding debt and to cancel late charges and fines if the contribution payer could verify repayment.

Furthermore, if the debit in the contribution account did not exceed HUF 10,000, the contribution directorate cancelled it together with late payment charges and fines. The cancellation of these small debts and associated late charges and fines affected about 35,000 account holders and their HUF 400 million debts.

As Table 8 shows, the receivables of the PIF seem to have fallen to one-third of their previous level. The major decrease, this author believes, was due to the above rearrangements rather than to sudden improvement of contribution-paying moral.

Table 8
Contribution debts to the Hungarian Pension Insurance Fund

Year	Debts as % of contributions collected	Debts as % of GDP
1992	16.04	1.48
1993	20.32	1.83
1994	27.79	2.40
1995	28.59	2.20
1996	21.5	1.81
1997	17.86	1.48
1998	16.58	1.39
1999	23.24	1.59
2000	7.14	0.48
2001	6.01	0.40
2002	6.89	0.43

Source: Author's calculations based on internal data from CANPI and CANHI.

In 2000, the relatively independent contribution directorates of the Tax Office were ceased and fully integrated into the organisation of the Tax Office.

5.8. Effects of Contribution Debts on Pension Entitlement

Under Hungarian law, a worker's pension entitlement is based on his or her service time.⁴¹ After service time surpasses a threshold number of years required for basic eligibility, longer work is rewarded in the pension formula by a higher benefit amount. Thus, accrued service time plays an important role in both establishing entitlement and determining the amount of the pension.

Since 1998, the only way in which a worker can acquire service time for most types of pensions is by paying the employee share of the contribution.⁴² However, there is also a basic concept that the employer's failure to pass on worker contributions must not disadvantage the employee. Thus, the time for which the employer has deducted but not paid the employees' contributions is also regarded as service time. Even if the deduction of the employees' contribution is, due to lack of evidence, only presumable on the basis of the existence of the insurance, the period of insurance is still counted.

In the case of the self-employed and partnership members, service time can only be obtained by all contributions having actually been paid. The period for which the contribution remained unpaid can be recognised as service time only after the debt has been paid.

5.9. Contribution Collection for the Second Pillar

In addition to deducting social insurance contributions, employers are also obligated to deduct the contribution for the second pillar (in Hungary, termed the membership fee) from the earnings of those of their employees who are in

⁴¹ The only type of pension that is provided without regard to a worker's period of service is the accident-related disability pension. However, the amount of even this type of pension depends on the service time achieved.

⁴² Exceptions relate to military service and sick pay.

the mixed system. The employer must then send this fee to the private fund to which the employee belongs along with a monthly report. By law, this report must contain such details as the member's natural identifiers, social insurance number, and the base for, and amount of, the membership fee.⁴³ The self-employed are also obliged to perform all these actions, but by themselves.

In cases of unpaid contributions to MPPFs, the private insurance fund is obligated to call upon the account holder to settle the debt within eight days. If the call is unheeded, the private insurer is supposed to inform the Tax Office of the debt immediately, and at the same time inform the worker.

The employer not only has to pay a late charge and fine for failing to pay the deducted membership fee but is responsible as well for the damage caused to the insurance fund member.

Between January 1 and September 30, 2003, at the request of MPPFs, the Tax Office carried out 3,586 inspections focusing on arrears of contributions to MPPFs. As a result, the inspectors discovered HUF 52.5 million in membership-related debts to the MPPFs. For these arrears, the Tax Office charged the employers a total of HUF 38.5 million in fines. The total of the late payment charges to be paid was more than HUF 15 million.

6. Improving Compliance

Over the past decade, attempts to improve compliance have come from four directions.

6.1. *Stricter Data Management and Control*

As explained previously, employers have always had to keep records of their employees' accrued pension entitlement; in other words, of their service time in employment. This kind of bookkeeping also had to include covered wages

⁴³ Natural identifiers are full name, date of birth, place of birth, and mother's maiden name.

(i.e., contribution bases) and contributions paid. Employers were required to store these records and, on the basis of them, to provide information whenever a relevant event occurred – e.g., the worker left his/her employment, retired, or died.⁴⁴ The employer also had to provide information to the social insurance agency whenever so requested, with a response deadline of 15 days. Under these arrangements, most of the burden for contribution-related record keeping was imposed on employers. However, social insurance inspectors were strict and efficient in checking the existence of the records and their completeness, trustworthiness, and appropriateness.

This period (1929–97) could be termed one of classic – or lazy – methods. It stands in marked contrast to the greedy methods introduced subsequently, after the PIF came to the conclusion that it was unsafe to leave records with employers. Legislation enacted during 1995–96 obliged employers to hand over all of their stored documents related to pension insurance to the CANPI. Beginning in 1997, the obligation to report such information annually to the CANPI was also imposed on employers.

In recent years, instead of sending the CANPI heavy piles of paper, employers have used magnetic data carriers. Together with the CANPI's newly introduced IT systems, this has allowed for efficient checks of data at the point of receipt. Consequently the general quality of data has been improved.

6.2. *Stronger Authorities for Collectors to Check and Sanction*

As described previously, the first step in strengthening collections was the 1992 legislation giving the CANHI authority to recover debts through direct collection (seizure of liquid assets) and collection enforcement (confiscation and sale of physical assets).

During 1992–99, the efficiency of collection efforts was increased significantly by inspections performed in cooperation with the Tax Office, as well

⁴⁴ In the first case, documents certifying a worker's service time and accrued entitlement had to be submitted to the database-management unit of the social insurance institution in the spring following the termination of his/her employment. In the second and third cases, the data had to be provided within 15 days.

as by the sharing of information so acquired. Efficiency, measured as the ratio of contributions actually collected to contributions due, exceeded 95 percent throughout this period (in reality, efficiency was lower because this method of measurement excludes accrued debts, late charges, and fines, as well as the liabilities of the large number of unregistered employers in the informal economy).⁴⁵

In addition, the late payment charge was increased from time to time: two percent per month beginning in the late 1980s, four percent as of August 21, 1990, and then beginning on April 1, 1995, a daily charge of 0.13 percent. Since January 1, 1998, the daily charge has been one-365th of twice the bank rate.

Sanctioning authority was not extended again until 1999, when the Tax Office took over collections.

6.3. Contribution Burden Lightened

As the employer contribution is widely regarded as part of the employers' burden of paying wages, devout believers in the free market hoped that reducing this burden would motivate employers to move out of the shadow economy and conduct their activities in greater harmony with the law.

After extensive disputes and compromises among different interest groups, Parliament in 1997 provided for yearly cuts on the employer's contribution rate. The decrease became reality, although not at the prescribed rate. In 1998, the employer's contribution rate remained unchanged at 24 percent, but in 1999, it was reduced to 22 percent; in 2000, to 20 percent; and in 2002, to 18 percent. As can be seen in Table 5, total contributions increased significantly in these and subsequent years. However, it is impossible to determine the extent to which this growth resulted from greater compliance motivated by lower labour costs or from the coinciding economy boom.

⁴⁵ Analyses carried out on an ongoing basis during this period show that the efficiency of contribution collection was 96.9 percent in 1996, 98.0 percent in 1997, and 98.4 percent in 1998.

6.4. *Closer Contact with Clients*

Since 1997, employers have been required to provide their workers with a report on the contributions paid on their behalf after the close of each year. This report contains information similar to what employers are obligated to provide to the Tax Office.

In 2000, legislators, as protectors of the public interest and, as such, fighters against non-compliance and evasion, concluded, not at all illogically, that workers are not sure to attach enough weight to the figures contained by these statements of their acquired rights. They thought this situation could be remedied by establishing a direct connection between the worker as an acquirer of pension rights and the institution responsible for pensions, the PIF. It was hoped that the worker, when provided with data concerning his or her own future pension entitlement, would contribute to the “purification” of the economy by placing pressure on employers to pay owed contributions.

In 2001 and 2002, based on information provided by employers, the CANPI informed workers about the pension rights they had acquired in the previous year and the amount of their annual covered earnings. Such information was not provided to those who acquired no rights at all in the previous year and those whose only income came from self-employment.

This was a major initiative, as indicated by the numbers of those contacted by the CANPI. In accordance with the new law, the CANPI sent notices in both years to all of the 3.9 million people about whose entitlement accruals for the previous year it had been informed.

Further, the CANPI set up a call center to handle workers’ responses to the notices. However, there was little feedback in either year. In 2001, only 5.5 percent of the notified workers responded to the information they received. In 2002, the response rate fell below one percent. Moreover, fewer than half of the responses dealt with crucial information in the notice; that is, the figures concerning pension accruals.

While it may be tempting to attribute this low response rate to highly accurate record keeping by the PIF or to a low level of the evasion or non-compliance by employers, either explanation would be off target. Rather, to this author, it seems more likely to reflect a combination of disillusionment, indifference, and lack of confidence that the pension system will deliver on its promises.

This reaction, however, caused legislators to repeal the obligation to provide this kind of annual information in March 2003.

7. Concluding Remarks

Even at the conclusion of this long, detailed, and sometimes dry analysis, the author does not feel that he has license to give advice to the policy makers overseeing Hungary's social insurance-based pension system, which is celebrating its 75th anniversary in 2004. He does feel tempted, however, to try to influence his readers in a different way, namely, by sharing some of his personal beliefs about the pension system:

1. Just as the pension system has not always existed, so it will, probably, not last forever. But as long as it does exist, it is worth handling with care. Although it has many weaknesses and shortcomings, no better system has ever been invented.
2. The time horizon of pension systems is much longer than that of most other systems in society. Thus, managing it requires techniques that are entirely different from what we are accustomed to in problem solving in other fields.
3. The pension system is robust; it can bear a lot. But effects of changes can only be realised after an unusually long time. Most of today's problems originate from bad policies built into the system well before the transition by administrators who have since been replaced.
4. People used to believe in the pension system, but today this is no longer true. They do not believe they will receive reasonable value in return for the contributions they pay. This has caused contribution-paying morale to fall.
5. Attempts to establish direct relations between the payers of the contributions, i.e. the acquirers of pension insurance rights, and the spender of the contributions, i.e. the CANPI, failed, but the author is convinced these attempts have to be repeated, since the awareness of what-I-have-paid-for-what is a prerequisite of a contribution-conscious, contribution-paying attitude.

6. It might also benefit the pension system if politicians could be stopped from using it as part of their battlefield. Instead of too much political activity, well-targeted initiatives, based on sound and well-documented diagnoses, might lead to curing some diseases of the pension system.

A long-lasting boom in the economy, with its favourable effects on employment, might also cause the problems of contribution collection to appear less serious.

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Chapter 5

The Collection of Pension Contributions in Poland

Agnieszka Chłoń-Domińczak¹

This paper presents the development of the collection system in Poland in the 1990s. As conceived here, collection systems include several elements – the transfer of funds from employees and employers to social security systems, the organisation of this transfer, the transfer of information necessary to allocate the contributions properly and the way the information is sent. Each of these elements is necessary for the good functioning of the collection system. As the Polish example shows, introduction of the new pension system with individual accounts can create a challenge to the collection system. The system needed to be reorganised in order to record and recognise individual contributions to individual accounts.

1. The Pension System in Poland and Recent Modifications

The pension system in Poland is fragmented. It includes three main subparts:

- the pension system for employees and self-employed, which is the largest;

¹ The views and opinions presented in this paper are those of the author. The author would like to thank Ireneusz Fafara, Deputy President of ZUS, Hanna Zalewska and Tomasz Kaczor from ZUS and President Jan Kopczyk from KRUS for providing the information necessary for the preparation of this report as well as Paweł Kolski for his research assistance and Clifford Bates for editing. Elaine Fultz from the ILO and Tine Stanovnik provided valuable comments.

- the pension system for farmers; and
- the pension system for armed services (military, police, etc.).

The first two systems are contributory, while the costs of the latter are financed directly from the National Budget. The pension expenditure in Poland reaches 14.9 percent of GDP (of which 11.4 percent is the employee pension system, 1.4 percent that of the armed services and 2.1 percent covering the farmers' social security system). In 2002, nearly a quarter of the Polish population were receiving pensions (9.2 million people). Of that 9.2 million total, 7.4 million are in the employee pension system and the pension system for the armed services; 1.8 million are in the farmers' pension system.

Table 1
Pension expenditure in Poland, as percent of GDP

	Employee pension system	Farmers' social security	Armed services	Total
1992	11.8	2.4	1.3	15.5
1993	11.9	2.5	1.1	15.5
1994	12.4	2.8	1.2	16.4
1995	11.6	2.5	1.5	15.6
1996	11.4	2.4	1.4	15.2
1997	11.6	2.4	1.4	15.4
1998	11.3	2.3	1.4	15.0
1999	11.4	2.3	1.4	15.1
2000	10.6	2.0	1.3	13.9
2001	11.3	2.1	1.4	14.8
2002	11.4	2.1	1.4	14.9

Source: Ministry of Economy, Labour and Social Policy.

1.1. Pension System for Employees

The pension system for employees was changed significantly in the 1990s. Between 1991 and 1997, several parametric changes were introduced. Some of

the changes were made as part of a general adjustment of pensions in response to the inflationary period that occurred at the end of the 1980s. In 1991, all pensions were revalued, compensating for the high inflation levels in the preceding years. After the revaluation, the average pension level increased from 56.8 percent of the average wage in 1990 to 65.3 percent of the average wage in 1991. Moreover, early retirement was offered to a large number of workers, resulting in a significant increase in the number of pensioners (including both old age and disability pensions). This policy was aimed to reduce labour market pressure at the time, when the unemployment rate reached two-digit levels. But, as a result of this change, pension expenditure rose rapidly.

On the other hand, measures were taken to reduce expenditure (Czepulis-Rutkowska, 2000). These measures constituted the following:

- Wage history taken into account in the calculation of pension was gradually increased from the final salary in 1992 to a calculated 10-year-average in 1999.
- Pension indexation was equal to average wage growth between 1992 and 1995; between 1996 and 1998 it was equal to CPI; and from 1999, it was equal to the mixed price-wage index (80 percent and 20 percent respectively).
- The early retirement scheme introduced in the late 1980s was replaced in 1997 by the system of pre-retirement benefits (which is financed from the Labour Fund for unemployment policies, not from social security contributions).

Until 1999 the pension system operated as a “pay-as-you-go” defined benefit scheme. In 1999, a new old age pension system was introduced. The new pension system is comprised of two components – non-financial notional defined contribution (NDC) and financial defined contribution (FDC) accounts.² Each insured person has two accounts.³

² For a detailed description of the Polish pension system see: Chłóń-Domińczak (2002). For the discussion of the NDC system see for example: Góra and Palmer (2002).

³ This applies for those persons covered fully by the new pension system (born after 1968). Persons born between 1949 and 1968 could decide to have only one account in ZUS, while those born before 1949 are covered by the old defined benefit scheme.

The first account is held in the Social Security Institution (ZUS). Contributions are registered on the account and they earn an interest rate related to the covered wage bill growth in the economy (measured as increase of the total contribution base). ZUS manages the Social Insurance Fund (FUS). Contributions are paid by employers to FUS. All pensions and other social insurance benefits are financed from FUS, which is divided into four sub-funds: the old age fund, the disability and survivors' fund, the sickness and maternity fund and the work injury fund.

The second account is held by an open pension fund (OFE), that is, a fund whose membership is open to all workers in the mixed system. (The contribution to the OFEs is equal to 7.3 percent of the wage). The open pension fund's assets are managed by a Pension Fund Society (PTE). Until the end of 2004, one PTE could manage only one OFE. After that date, one PTE will be allowed to manage two funds. Contributions are invested in financial markets and they earn an interest rate reflected by the performance of the financial markets. As of 2003 there were 16 OFEs operating in Poland (in 1999 there were 21 OFEs established).

All the social security contributions in Poland are collected by the Social Security Institution (ZUS), which is responsible for general management of the social security system. Until 1999, the collection system was relatively simple. ZUS did not collect information on individual workers, except from smaller companies (employing up to 20 persons that were obliged to present individual information) and the self-employed. Contributions were transferred via the banking system (or cash payments) to ZUS.

The changes of the early 1990s resulted in an increase of pension expenditure and the subsequent increase in the contribution rate. The contribution rate grew from 25 percent of the wage bill in 1981; to 35 percent in 1987–89; and to 45 percent from 1990 up to 1998. The high level of social security contributions, which could not be further increased, was one of the reasons for the 1999 pension reform.

Up to the end of 1998, contributions were fully financed by employers. Social security contributions were calculated as 45 percent of the company's wage bill. The social security contribution covered pensions, sickness, maternity and work injury risks. Employers (those that employed more than 20 persons) presented individual information necessary for pension calculation to ZUS

only at retirement. Thus, the majority of the individual records were kept only by employers.

From 1999, following the pension reform, employers are obliged by the social security law to report the contributions of each individual worker to ZUS. Social security contributions are divided between employees and employers. Self-employed persons entirely finance their own contributions to the system. Additionally, contributions are divided among various risk categories – old age pensions, disability and survivor pensions, sickness benefits and work injury benefits. All employers are obliged to provide individual information on wages and contributions to ZUS on a monthly basis. It must be noted that in 1999 employers were nevertheless required to provide annual individualised data; this was due to problems in recording monthly declarations.⁴ Because of the new employee-employer contribution split, gross wages in 1999 were increased by 23 percent (to cover the part of the contribution that was to be financed by workers) and, as a result, the overall contribution rate – calculated from a higher wage base – decreased to 36.69 percent of the gross wage. This was a revolutionary change to the collection system – as the amount of information collected increased more than ten times. Additionally, all information needed to be processed very quickly, in order to transfer contributions to the OFE within a few days from the receipt of money and information.

Historically in Poland, the compliance rate for contributions was rather high. But, it was calculated as a ratio of contributions paid to contributions reported as due. Thus, there is no information on the proportion of contributions that were not paid, because they were not reported.

The pension system for employees was subsidised from the state budget throughout the entire 1990s and still requires significant subsidies. See Table 2. The total subsidy level varied over time. The largest subsidies were accounted in the early 1990s, while lowest was noted in 1997. The level of subsidies reflects both the economic situation (in the periods of highest employment and high growth the subsidy level was falling) and legal changes in the pension system (for example, in 1997 the price indexation of benefits was introduced, which led to lower pension expenditure). After 1997 the subsidy started to increase

⁴ From 2000, recording is based exclusively on monthly declarations.

again, due to falling contribution revenue combined with pension reform implementation in 1999, when a subsidy covering transition costs needed to be added. From 1997, despite the growing subsidy, FUS recorded deficits. In 1997 and 1998 these deficits were financed from accumulated reserves. From 1999, following changes in the social security law, FUS started to take loans from commercial banks to cover the remaining deficit.

Table 2
Revenue and expenditure of the Polish Social Insurance Fund (FUS),
as percent of GDP

	Revenue					Expenditure	Deficit/ surplus
	Total revenue	Contribution revenue	Total state budget subsidies	Of which: supplementary subsidy	Of which: subsidy covering transfer to OFE		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)=(1)–(6)
1992	16.405	11.895	4.307	2.916	—	16.296	0.109
1993	16.121	11.640	4.240	3.130	—	15.845	0.276
1994	16.182	12.039	3.943	2.805	—	16.120	0.062
1995	13.626	11.417	1.947	1.356	—	13.369	0.257
1996	13.459	11.678	1.555	0.977	—	13.206	0.253
1997	13.260	11.591	1.482	0.934	—	13.514	–0.254
1998	13.000	11.347	1.588	1.015	—	13.149	–0.150
1999	11.983	10.418	1.530	1.009	0.368	13.086	–1.103
2000	11.394	9.193	2.154	1.695	1.058	12.011	–0.617
2001	12.209	9.311	2.818	2.326	1.153	12.807	–0.598
2002	12.341	8.834	3.495	3.049	1.229	12.798	–0.458

Source: Author's own calculations based on ZUS and GUS data.

1.2. Pension System for Farmers

In 1978, a separate pension system for farmers was created in Poland. From 1991, that system was separately administered by the Farmers' Social Security

Institution (KRUS). The system covers all farmers that have more than one hectare of land and if they are not covered by any other social security system. Farmers with less than one hectare of land can be covered by the pension system upon their request.

The system is relatively simple. Each insured farmer (and family member[s] working on the farm) pays a quarterly contribution for pensions and short-term benefits. Contributions do not depend on the size of the farm or the wealth of the farmer but are flat-rate. Pensions are also not related to the farmer's income and they reflect only the period of insurance. As a result, there is much lower differentiation of farmer's pensions compared to the pension system for non-agricultural employees.

Table 3
Revenue and expenditure of the Farmers' Pension Fund, as percent of GDP

	Revenue:			Expenditure	Deficit/surplus
	Total revenue	Contribution revenue	State budget subsidies		
	(1)	(2)	(3)	(4)	(5)=(4)-(1)
1992	2.082	0.120	1.955	2.021	0.061
1993	2.120	0.136	1.980	2.121	-0.002
1994	2.389	0.132	2.244	2.383	0.006
1995	2.109	0.118	1.980	2.104	0.005
1996	2.087	0.115	1.947	2.068	0.019
1997	2.132	0.116	1.999	2.129	0.003
1998	2.051	0.111	1.924	2.043	0.008
1999	2.262	0.112	2.096	2.233	0.028
2000	1.975	0.103	1.852	2.006	-0.031
2001	2.109	0.112	1.982	1.970	0.139
2002	2.124	0.121	1.993	2.124	0.000

Note: The table covers only pension fund contribution and revenue; it does not include short-term benefits provided by the Contribution Fund, which is separate and, as a rule, contributions cover all expenditure.

Source: Author's own calculations based on KRUS and GUS data.

From the beginning of the functioning of the separate pension system for farmers it was assumed that it would be heavily subsidised by the state budget. Following a high inflation period in the early 1990s, the share of the state budget subsidies in total revenue increased to more than 90 percent. See Table 3. Thanks to high state budget subsidies, there has been virtually no deficit in the Farmers' Pension Fund for the past ten years. Some small deficits in 1994 and 2000 were financed from accumulated reserves.

2. Current Contribution Collection System

2.1. *Institutional Setting and Contribution Collection Mechanism*

2.1.1. Social Security System for Employees

Contributions for all parts of mandatory social insurance (including funded pensions) are collected by ZUS. As far as the collection system is concerned, ZUS's tasks can be grouped as follows:

1. Collecting information from employers.
ZUS registers the information on all employers and employees, which is necessary to divide the collected contributions among individual accounts. It also serves as a basis for the monitoring of the contribution payments.
2. Registering information on pension fund members.
Open pension funds inform ZUS about their members; this information is used by ZUS to transfer the contributions to respective pension funds.
3. Collection of contributions for mandatory social insurance, including that for all types of risks.
4. Transferring second pillar contributions to the pension fund chosen by the worker.
5. Collection of contributions for other elements of the social security system:
 - collection of contributions for the health insurance system (from 1999) and maintenance of the database for health care insurance

- purposes (of insured and their dependants – some 30 million accounts); and
- collection of contributions for the Labour Fund.

The institutions that are involved in the contribution collection system in Poland include:

- employers (payers), who pay contributions and send information necessary to divide contributions among risks and distribute them to individual accounts;
- banks, which transfer contributions to a ZUS account; and
- ZUS, which receives and processes money and information.

Along with contributions, contributor information is collected monthly. Information is transferred directly to ZUS, while payments into the system are deposited through the banking system. All contributions are paid to ZUS's account in the National Bank of Poland; the money is then distributed to regional offices for pension payments. Contributions due to pension funds are transferred to respective pension funds within 14 days from the day when ZUS receives both required information and notification of deposit.

The payers use pre-designed forms to send the information to ZUS. Those that employ more than 20 persons are obliged to send information electronically,⁵ using pre-designed software (the PLATNIK programme), which is provided by ZUS. Others can send documents (hard copy of the form) – either as printouts from PLATNIK (the programme used for this purpose) or by manually filed forms, designed for OCR (optical character recognition).

Contribution payments are made in the form of bank transfers from payers' bank accounts. Such form of payment is mandated by the social security law. This allows for better identification of the sender of the money. In order to improve identification the banks use special forms that include the identification number of the payer in ZUS's database.

⁵ Such requirement was introduced in the law in 2001, after initial experiences showed significant differences in the number of errors in documents provided in paper and electronic formats.

Collection of contributions for social insurance is done separately from personal income tax, which is done by the tax administration. This is primarily due to the fact that there are multiple forms of payments of personal income tax (which is paid on most of individual income) and social security contributions (paid only on income from labour or other strictly specified benefits). Another difference lies in the frequency of information processing – in social security the contributions are processed monthly; in tax administration, taxes are paid monthly, but all the reports are filed annually.

The process of contribution collection for social insurance can be divided into registration and reporting, which are presented below.

Registration of Employers

Newly established businesses are obliged to register with ZUS. The registration can be done only on a paper form that needs to be signed by the employer. The registration document includes:

- identification numbers of payer;
- full and short name of the company or name;
- date of birth of the filing person; and
- bank account number.

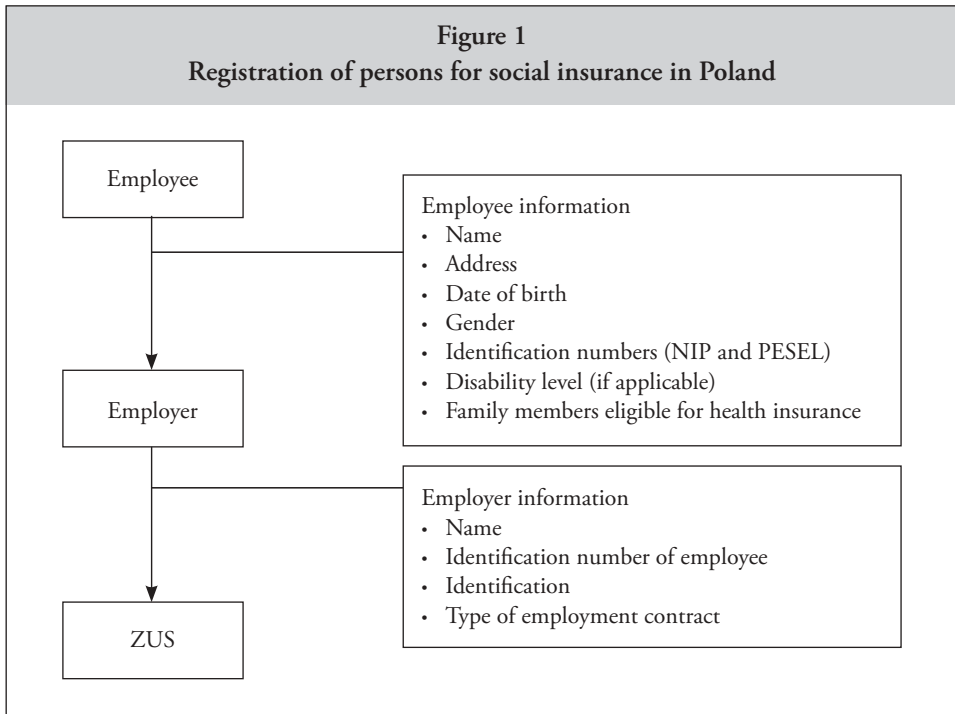
Based on the information provided, the contribution payer is registered in the information system, which then allows for the monitoring of payments.

Registration of Individuals

Employers are obliged to register all new employees at ZUS. The self-employed are required to register themselves at ZUS. This allows for the creation and updating of individual records in the database of insured persons. Such a system is necessary to reconcile the various contributions made into the system and individuals who will in the future (or currently) claim some benefit from the system. This process involves employee, employer and ZUS. See Figure 1.

Registration of insured persons includes only information transfer, in electronic or paper formats. For registration purposes, employers and employees use their ID numbers (most frequently the so-called NIP – tax number for payers and PESEL – personal identification number – for insured).

Other ID numbers used for cross-checking are the NIP for individuals and REGON (statistical number) for companies.



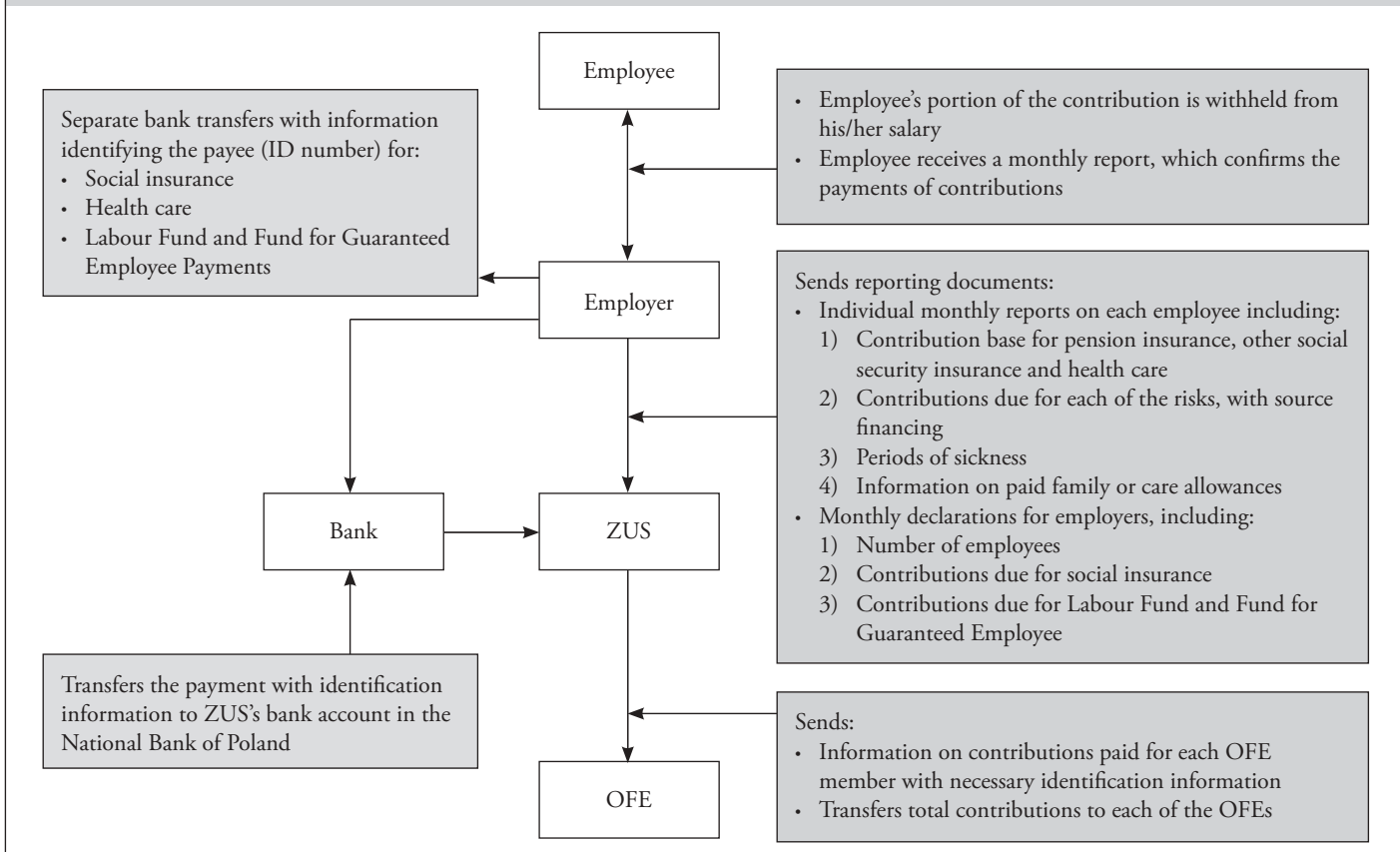
Collection of Payments

Collection of payments is carried out on a monthly basis. Employers, using electronic transfer or paper documents, send information on each individual contributor, as well as summary information for the entire company, to ZUS. At the same time, the contributions are paid into ZUS's accounts. The money transfer is divided into three parts:

- social insurance contribution (including funded pensions);
- health care contribution; and
- contribution for the Labour Fund and the Employees' Guarantee Benefit Fund (these are paid based on the company's wage bill and are not calculated for individuals).

The flow of information and monthly payments is shown in Figure 2.

Figure 2
Monthly information and payments, Poland



In order for the contribution to be properly recorded in ZUS, the transfer should be identified and the proper amounts registered on individual pension accounts. This requires matching the information provided by employers with that provided by banks. Once the identification process is complete, contributions are transferred to the open pension fund.

If an insured person is a pension fund member, then the company managing this fund, called the PTE, informs ZUS of the affiliation at the point that s/he joins. Based on this information, the part of the contribution (7.3 percent of the contribution base) is transferred to the pension fund.

Collection of contributions for funded pensions consists of three main functions performed by ZUS: registration of contracts with the OFE, matching with the individual record of the insured person, and the monthly transfer of contributions. ZUS also sends information about affiliation and transfers to the supervision body of pension funds (KNUiFE).

In the registration, as previously noted, the PTE informs ZUS about an individual worker's affiliation to a given pension fund. ZUS verifies the individual data provided by the PTE and also checks for multiple affiliations. If all the data are correct and if the registered member is not a member of another (or the same) pension fund, registration is completed. The contribution transfer is contingent upon the identification of the worker's individual account, as described earlier.

ZUS's activities are supported by a newly developed IT system – the Complex Informative System (KSI), which is the most important tool facilitating management activities (contribution collections, handling of individual accounts, etc.). Currently, the KSI system is being developed and its key components were operational only from 2002. Delays in the implementation of the KSI system (the contract for the development of the system was signed in 1997) were one of the reasons for various initial difficulties in processing and collection of ZUS related information.

Implementation of the new pension system and the new reporting mechanisms was a challenge not only for ZUS, but also for employers. The virtual absence of planning time for the implementation of the 1999 reform resulted in numerous errors in documentation submitted by employers to ZUS. Additionally, most documentation was sent solely in paper form. The PLATNIK programme was not fully developed and included many errors. There were

also many problems with existing identification numbers. Many employers did not use their NIP numbers correctly, which led to difficulties in assigning employees to the correct employers in the databases.

Initially, pension funds and ZUS used two alternative numbers for the identification of individuals – the NIP or the PESEL. Thus, the corresponding accounts could not be matched and contributions to pension funds were not transferred. Banks were also not used to sending all information correctly and made frequent errors in identification numbers. Finally, the KSI system was not operational at the time, which meant that ZUS had no capacity to correct errors and process individual reports. Additionally, the old system used for monitoring payments was discontinued while the new one had not yet been implemented.

As a result, in 1999 ZUS lost its capacity to monitor payments from employers. This circumstance resulted in lower contribution collections. Additionally, because the accounting system could not operate, there was little knowledge on contribution revenues. This situation was mainly due to the delays in the KSI implementation. In effect, compliance diminished as employers became aware of this situation. Only by the end of 1999, when a new, more extensive process of controls started, did the collection rate improve.

As there were many errors in the documentation, which could not be corrected in the IT system as planned, only a portion of the contributions were transferred. Initially, this portion was estimated at five percent of the amounts due (in May 1999). That is, ZUS was unable to transfer 95 percent of the contributions due to the new mandatory private pension funds.

Under a crisis situation in 1999, several steps were taken. ZUS developed an emergency plan, accompanied by some legislative changes. The plan included the following:

- improving collections by reinstating old software, adjusted to the KSI system;
- developing a new plan for implementation of the KSI system, with clearly defined stages;
- requiring employers to send annual reports, summarising their obligations, in order to have financial information necessary to close the financial books for the year 1999; and

- requiring pension funds and employers to use both ID numbers (NIP and PESEL) for individuals, in order to assign proper pension funds to individuals.

After a series of actions aimed at improving the identification of payments made into the system, at the end of 1999 the amount of contribution transfers improved significantly. It was estimated by ZUS at 70 to 80 percent of the total amount of contributions due.

In the course of the next couple of years, employers were obliged to use an electronic transfer of data, which reduced the number of errors in the documentation. The KSI system was also further developed, allowing for better information processing.

The process of registering contributions on individual accounts started only in August 2001. Prior to that month, information was processed only to the level that would allow for the contribution transfers to the private pension funds. Almost a year later – in June 2002 – all processing of contribution transfers was switched to the final IT platform.

The correct information on all individual contributions was not retrieved from the ZUS database until the end of 2002. As a result, by the end of that year, the total amount of contributions due to the open pension funds was estimated at 10 billion PLN. This includes both the principal amount and interest due.⁶ In that the amount was quite significant, the Polish government proposed a law transferring to the state budget ZUS's liabilities resulting from outstanding contributions to open pension funds. This was adopted by the Parliament on July 23, 2003. The new law provides for payment of this debt in the form of a special type of government bond.⁷ The law covers all contributions and interest not paid into the system during the period between

⁶ Initially the interest rate on outstanding contributions was set in the law on pension funds at the level of statutory penalty interest. Beginning in 2002, following an amendment to the law on pension funds, it was set equal to the interest rate on Treasury bills.

⁷ As will be explained, this amount had not been set aside but had been used to pay benefits in the pay-as-you-go system and was not available.

1999 and the end of 2002. The bonds are transferred to open pension funds, instead of cash, once the contributions are recognised by ZUS. The maturation period of the bonds cannot be more than eight years – thus, all bonds will be paid back by the government by the end of 2011. The interest rates are set in the law at the level of 52-week Treasury bills.

In 2001, ZUS introduced a “100 percent” plan. The goal of this plan is to achieve 100 percent accuracy in information processing. There were four major areas of errors identified:

- identification of employers;
- identification of employees;
- accuracy of other information (formal control); and
- identification of payments.

Table 4
Indicators of the correctness of documents, Poland (as percentage)

	Identification of employers	Identification of employees	Formal control	Identification of payments	Overall efficiency
	1	2	3	4	1*2*3*4
September 2001	95.85	91.66	85.26	94.00	71.14
December 2001	97.88	92.90	90.41	94.00	77.28
March 2002	97.88	94.30	93.07	96.00	82.47
June 2002	98.53	94.99	95.72	96.64	86.58
September 2002	98.85	96.02	97.64	97.22	90.10
December 2002	99.27	96.01	97.84	98.10	91.48
March 2003	99.44	98.86	97.88	98.48	94.76
June 2003	99.71	99.12	97.76	98.80	95.46
Change in the analysed period (in percentage points)	3.86	7.46	12.50	4.80	24.32

Source: ZUS.

Between September 2001 and June 2003 the overall accuracy of the information increased from 71.14 percent to 95.46 percent. The largest improvement has been observed in the identification of the employees and

formal control; that is, control aimed at ensuring that all informational inputs are correct.⁸ It has to be noted that much of this improvement is a result of increased control of documents, which was one of the reasons for the 20 percent increase in the employment level in ZUS between 1999 and 2003 (from 40,000 to 48,000 employees).

In 2003, ZUS straightened out all individual accounts to an extent that allowed sending individual reports on contributions paid in 2002. The reports were sent at the end of 2003 and the beginning of 2004. This is a big step towards full individualisation of contribution payments. However, this process is still not complete, as full information on individual accounts can be distributed only after reconciliation of contributions paid between 1999 and 2001.

2.1.2. Social Security System for Farmers

The farmers' social insurance covers farmers, their spouses and working household members. There are two types of social insurance:

- work injury, sickness and maternity insurance; and
- pension insurance.

The organisation of the farmers' system is much simpler. KRUS is responsible for the collection of the farmers' contributions. The farmers' insurance is mandatory for farmers who fulfill conditions specified in the law. Selected categories of farmers can be insured voluntarily.

A farmer is obliged to register himself or members of his household at KRUS within 14 days from the point in time at which the social insurance obligation emerges, as well as report all changes that may affect the status of the social insurance obligation.

The registration form has to be submitted by the farmer (i.e. owner of the farm) to the KRUS regional office. The form covers information about:

- size of the farm;
- date of commencement of agricultural activity;
- number of persons working on the farm; and

⁸ However, this formal control did not apply to identification (names of employees and employers).

- information about any coverage by other types of social insurance for each person working on the farm, including the spouse and any other family member.

Afterwards, farmers are obliged to pay quarterly social insurance contributions.

2.2. Who is Covered by Mandatory Social Insurance?

2.2.1. Social Security System for Employees

The rules of contribution payments and obligation of social insurance are described in the law on social security system of October 13th, 1998. The law specifies, among other things:

- who is covered by mandatory social insurance;
- what is the size of contributions for various purposes; and
- who pays the contributions.

The Polish social security system covers almost every economically active person (i.e. employers, self-employed people and co-working members of their families).

The definition of an employee is quite broad for the purposes of social insurance. The concept refers to people with any employment, specific, ad hoc or any other contracts for providing services – regardless of the specified time of those contracts. It applies also to persons working in a cottage industry, members of an agricultural cooperative or agricultural cooperating groups, and members of the clergy.

Self-employed persons are those who run their own non-agricultural businesses, creators and artists and people performing so-called “free occupation” (under the regulations on reduced personal income tax from some revenues).⁹

⁹ Farmers and members of their families working with them are covered by a separate social security system for farmers, which is run based on separate legislation and by a separate institution – the Farmers’ Social Insurance Fund (KRUS).

Family members who work with the self-employed also have a right to social security as co-workers.

Additionally, the contributions of several specific groups are paid into the social security system from public sources. Those groups covered by public sources are the following:

- the unemployed with a right to unemployment benefits;
- persons performing mandatory military service;
- persons on maternity or parental leave; and
- persons taking care of their disabled children or other disabled family members.

In the case of working disabled persons, some elements of contributions are financed from the State Fund for the Rehabilitation of Disabled Persons (PFRON), and in the case of the clergy, contributions are partially covered from the Church Fund.

The pension reform of 1999 divided insured individuals into the following groups:

- Persons born before 1948 (who were more than 50 years of age when reform was introduced) remain in the old, defined-benefit pay-as-you-go system.
- Persons born between 1949 and 1968 are covered by a reformed “pay-as-you-go” system based on individual accounts and may additionally choose whether they want to have their pension financed purely from a non-financial system or have mixed financing.
- Persons born after 1968 are compulsorily covered under the new system.

Persons from the second group made their choice during the course of 1999. Around 60 percent of them opted to participate in the funded pillar. In total, in 2002, some three-quarters of insured persons were affiliated with one of the OFEs.

2.2.2. Social Security System for Farmers

As previously described, the rules for farmers’ pension insurance are regulated by the law of December 20, 1990 on farmers’ social insurance. The law provides for both mandatory and voluntary insurance.

The mandatory insurance covers those farmers who conduct agricultural activity on a farm located on Polish territory, the size of which exceeds one hectare, or if it is engaged in a so-called special type of production. The insurance also covers spouses and working family members. If a person is covered by other social insurance (i.e. employee social insurance) or receives a pension, s/he is automatically excluded from farmers' insurance.

Voluntary insurance covers those farmers who do not fulfill the above-mentioned conditions. In particular, they can be insured voluntarily if the total size of the farm is less than one hectare. In recent years, KRUS has been encouraging such farmers to be covered, which has resulted in an increase in the number of insured persons. Persons who are subject to other social insurance can be voluntarily insured for short-term benefits. Similarly, pensioners can be covered by the work injury system.

2.3. Techniques of Contribution Payment and Information Collection

2.3.1. Social Security System for Employees

Payments to ZUS are made on a monthly basis. The employer is obliged to withhold an appropriate part of the social security contribution and health care contribution from the employee's wage and to pay the employer's part directly.

The law on the social security system specifies three dates of payments of contributions and submission of documentation:

- until the fifth of each month for public institutions;
- until the tenth of each month for the self-employed; and
- until the fifteenth of each month for private employers.

In a given month, contributions are paid based on wages and salaries (or declared revenue) from the month preceding the contribution payment (i.e. in February contributions are paid for January). Payments are based on cash accounting, which means that contributions are based on actually paid (not accrued) salaries. In case of late payment, a statutory interest is charged. The same applies to the situation, where proper information documents have not been submitted.

2.3.2. Social Security System for Farmers

Payments to KRUS are submitted quarterly, on the last day of the first month of a given quarter, namely:

- on January 31 for the first quarter;
- on April 30 for the second quarter;
- on July 31 for the third quarter; and
- on October 31 for the fourth quarter.

Contributions are paid to the bank accounts of local KRUS offices, via bank or post office. The owner of the farm pays contributions for all insured persons. In the case of late payment, a penalty interest is charged.¹⁰

Each quarter, the KRUS offices distribute printed bank payment forms, which support the appropriate payments to KRUS. As contribution rates change frequently in Poland, these are not printed on the form; and farmers must therefore find the rate for a given year themselves. Pre-payments can be made, so that at the end of the quarter the entire contribution is paid. The law also allows KRUS to deduct contributions owed by farmers from the benefits it pays them. This can of course only happen in the case when a farmer who owes contributions to KRUS applies for a benefit.

3. Contribution Base and Contribution Rates

3.1. Social Security System for Employees

The contribution base varies for three specified groups of insured persons in the employee pension system. Employers pay contributions based on the gross wages of their employees. A part of the employee's wage representing the mandatory contribution is withheld by the employer and transferred to ZUS together with the employer's portion. Other forms of employee compensation

¹⁰ That is, a higher rate of interest than the normal statutory interest rate.

related to work, such as bonus payments, are also covered. Contributions are paid for the periods of employment and paid leave. Periods of sickness leave or unpaid leave are not covered by social security and are not counted as periods of insurance for pension purposes. In the Polish legislation a rule is applied that a person that benefits from social insurance (who receives sickness benefits, for example) cannot contribute to this insurance at the same time. The only exception applies to maternity benefits, as periods of maternity leave are covered by social security financed from the state budget.

The social insurance law and bylaws specify exclusions from the social insurance base. These are, for example, some in-kind benefits (company car or cell phone), Christmas coupons to shops (whose value does not exceed PLN 380), or compensating benefits (for example, as a result of wrongful behavior towards an employee). Benefits paid from social insurance (sickness or work injury) are also excluded.

Although there is no official minimum contribution base, there is a minimum wage law (in 2003 it was PLN 800 per month and in 2004, PLN 824) – thus, in practical terms, this level is the minimum base for social insurance.

Contributions for the self-employed are fully paid by the self-employed individual. In the case of the self-employed, the contribution base is equal to declared income, which cannot be lower than 60 percent of the calculated average wage in the economy. As practice shows, almost all self-employed declare this minimum level of income. There is no relation between social security and personal income tax paid by the self-employed. All social security contributions are tax exempt.

Contributions financed from public sources are based either on the size of the relevant benefit (i.e. unemployment benefit or maternity benefit), the minimum wage or the social assistance allowance.

The contribution base differs from the personal income tax base. In the case of employees, the personal income tax base is the gross wage reduced by mandatory social security contributions. In the case of the self-employed, the personal income tax base depends on the type of rules for personal income tax that is used by the person. The tax regulations allow for several types of account keeping that also are related to tax payments. In any case, the base for tax payment is income received from an economic activity, which is different

from the minimum declared income used by social insurance regulations. Payments of social insurance contributions are tax deductible.

There is also a ceiling on the wages subject to pension contributions, which was introduced in 1999. The annual ceiling is equal to 30 times average monthly wages annually (or 250 percent of annual average wage) expected for a given year. The division of social security contributions by various types is presented in Table 5.

Table 5
Contributions for social insurance in Poland (as of 2002)

Type of insurance	Rate ^a	Of which percentage rate financed by:	
		Employee	Employer
Old age ^b	19.52	9.76	9.76
of which: NDC	12.22	—	—
FDC	7.30	—	—
Other pensions (disability and survivor's pensions, funeral grants)	13.00	6.50	6.50
Sickness	2.45	—	2.45
Work injury ^c	1.62	1.62	—
Total	36.59	17.88	18.71
Labour Fund (unemployment) ^d	2.45	2.45	—
Health insurance ^e	7.75	—	7.75

Note a: Percentage of gross wage (up to the ceiling in the case of old age and other pension contributions, without a ceiling for other types of insurance).

Note b: Old age contribution is divided between FDC and NDC on the total level; there is no such division on the employee and employer level. However, in the case of lower payment, ZUS assumes that contributions made on behalf of workers are paid first; from the remaining part, the priority is given to the old age contribution.

Note c: Contribution rate for work injury from 2003 varies based on the work injury risk. This can range from 0.4 percent to 8.12 percent of salary.

Note d: Labour Fund contribution is financed by employers based on the total wage bill in the company.

Note e: Contribution calculated in relation to the net wage of other social security contributions and deducted from the personal income tax due.

3.2. Social Security System for Farmers

The social security contributions for farmers are flat-rate and they do not depend on the size of the farm or relative wealth of the farmer. There are two types of contribution:

- for pension insurance; and
- for work injury, maternity and sickness insurance (short-term).

The pension contribution per quarter is equal to 30 percent of the minimum monthly pension, which equals, on an annual basis, 120 percent of the minimum monthly pension. It is the same for farmers insured both mandatorily and voluntarily. In 2002 the annual contribution for pensions was PLN 663. According to actuarial calculations, this contribution level reflects about a fifth of the cost of the benefits paid from the system. This is one of the reasons for high national budget subsidies to this system (which cover more than 90 percent of farmers' expenditure). The other reason for the high level of subsidy is an unfavourable relation between contributors and pensioners. From the beginning of the functioning of this system, there were more pensioners than contributors in KRUS. The Board of Farmers (the supervisory board) sets the level of contribution for short-term benefits. The Contribution Fund, from which short-term benefits are financed, is fully covered by contribution payments and is not subsidised from the state budget.

In the fourth quarter of 2003, the contribution for pensions was equal to PLN 165.80 (or approximately EUR 40) per quarter, while the short-term contribution was set at the level of PLN 54. Persons covered by voluntary short-term insurance pay a third of the full amount (i.e. PLN 18). In return for this lower contribution, they receive the same level of benefits, but they need to be insured for at least a year to have a right to receive a sickness benefit or maternity allowance.

4. Number of Contributors, Coverage and Effectiveness of Contribution Collection

At the end of 2002, the total number of persons covered by social security amounted to 14,320,000. During the last decade the number of insured

persons was declining, mainly due to unemployment that had appeared and continued to rise as the result of the social and economic changes in the country. Additionally, there was a significant inflow of persons into the pensioners' group in early 1990s.

In the case of ZUS, the changes in the number of insured are pro-cyclical; as in the period of economic growth in the mid-1990s, the number of insured increased. By the same token, the number of insured in KRUS is anti-cyclical; as in periods of high growth, some family members move to other jobs. In periods of slower growth, they return to their farms.

Information on the number of self-employed is limited. However, it can be estimated that among the universe of those covered by ZUS, around 1.2 to 1.4 million are self-employed.¹¹ In addition, it may be estimated that more than half a million are either unemployed, persons in mandatory military service, those on maternity and parental leave or in some other categories.

Comparing the number of insured with the number of employed, interesting conclusions can be drawn. First of all, the number of insured, until 2000, was lower than the number of employed, showing that some proportion of the population was not covered by social security. However, in 2001 and 2002 the situation was reversed – there were more insured persons than the employed. This phenomenon can stem from two facts. Firstly, it is the increasing number of the unemployed who are receiving unemployment benefits – and by definition not working. Secondly, from 1999 persons on maternity and parental leave are also insured, although they are not working according to the LFS criteria.

Over the past ten years, total contribution revenues in relation to GDP level have been falling. The reduction was observed both in the case of the ZUS and KRUS systems. The contribution revenues relative to GDP in 2002 in both systems were nearly a fifth lower than in 1992.

The fall in contribution revenues corresponds to the fall in employment, observed after 1997. Moreover, over the past few years, the growth of real

¹¹ Estimates are based on the health insurance information. However, all self-employed are covered by mandatory health insurance, while only those self-employed that do not have employment contracts have to pay social security.

wages was lower than economic growth, which also contributes to the relatively lower amount of contribution revenues. Reduction in revenues was particularly strong in 2002, when not only real but also nominal contribution revenues dropped.

Table 6
Persons in employment and number of contributors, Poland, 1992–2002

Year	Contributors			Employment	
	(thousands)				
	ZUS	of which: OFE ^a	KRUS	Total	According to LFS ^b
1992	13,199.0	—	1,650.0	14,849.0	15,181
1993	12,665.2	—	1,567.8	14,233.0	14,894
1994	12,787.4	—	1,475.1	14,262.5	14,802
1995	13,205.8	—	1,426.6	14,632.4	14,929
1996	13,219.8	—	1,387.2	14,607.1	15,089
1997	12,937.1	—	1,418.1	14,355.2	15,308
1998	12,737.3	—	1,414.9	14,152.2	15,477
1999	13,270.6	8,693.9	1,428.2	14,698.8	14,865
2000	13,059.9	9,973.3	1,452.4	14,512.3	14,620
2001	12,851.0	10,637.4	1,502.1	14,353.1	14,288
2002	12,761.0	10,989.8	1,559.5	14,320.5	13,863

Note a: The number of OFE members is based on the KNUiFE registry. Some registered persons may not be covered by mandatory social insurance.

Note b: Annual averages based on OECD employment statistics.

Source: Author's own calculations based on ZUS, KRUS, KNUiFE and OECD.

There is a growing discrepancy in the contribution level per individual insured person in the ZUS and KRUS systems. While in 1992, the ZUS contribution was five times higher than that for KRUS, in 2002 it is more than seven times higher. The nominal level of ZUS contributions was increasing during the entire period, except in 2002, where it was at the level observed in the previous year.

Table 7
Contribution revenues collected by type of system, Poland, 1992–2002

Year	Revenues							
	(millions PLN)				(% of GDP)			
	ZUS	OFE	KRUS	Total	ZUS	OFE	KRUS	Total
1992	13,853.0	—	250.9	14,103.9	12.1	—	0.218	12.3
1993	18,412.8	—	346.2	18,759.0	11.8	—	0.222	12.0
1994	25,665.5	—	411.6	26,077.1	12.2	—	0.196	12.4
1995	35,841.9	—	540.1	36,382.0	11.6	—	0.175	11.8
1996	45,968.1	—	671.0	46,639.1	11.9	—	0.173	12.0
1997	55,402.3	—	785.7	56,188.0	11.7	—	0.166	11.9
1998	62,810.7	—	888.2	63,698.9	11.3	—	0.160	11.5
1999	64,084.4	2,285.5	981.6	67,351.5	10.4	0.4	0.160	10.9
2000	65,578.6	7,603.5	1,030.7	74,212.8	9.2	1.1	0.144	10.4
2001	69,904.0	8,706.9	1,156.2	79,767.1	9.3	1.2	0.154	10.6
2002	68,217.1	9,546.4	1,255.8	79,019.3	8.8	1.2	0.163	10.2

Note: KRUS contribution revenue covers contributions for pensions and for short-term benefits.

Source: Author's own calculations based on ZUS and KRUS data.

Table 8
Average contribution per contributor, Poland

Year	Revenues/Contributors (thousands PLN)	
	ZUS&OFE	KRUS
1992	1.0	0.2
1993	1.5	0.2
1994	2.0	0.3
1995	2.7	0.4
1996	3.5	0.5
1997	4.3	0.6
1998	4.9	0.6
1999	5.0	0.7
2000	5.6	0.7
2001	6.1	0.8
2002	6.1	0.8

Source: Author's own calculations based on ZUS and KRUS data.

Table 9
Collected contribution revenue, estimated compensation of employees and the covered wage bill, all as percent of Polish GDP

	Joint contribution rate (1)	Collected contribution revenue (2)	Estimated compensation of employees (wages plus all employer social contributions) ^a (3)	Covered wage bill ^b (4=2/1)
1992	45.0	12.05	38.80	26.78
1993	45.0	11.82	38.10	26.27
1994	45.0	12.20	39.30	27.11
1995	45.0	11.63	37.48	25.85
1996	45.0	11.85	38.19	26.34
1997	45.0	11.73	37.79	26.06
1998	45.0	11.35	36.56	25.21
1999	36.6	10.79	36.27	29.49
2000	36.6	10.26	34.48	28.04
2001	36.6	10.47	35.20	28.62
2002	36.6	10.07	33.85	27.52

Note: The estimates for compensation of employees (3) and covered wage bill (4) overestimate the “true” estimates, as they include mixed income (i.e income from self-employment). Namely, contributions paid by self-employed could not be separated from the total contribution revenue.

Note a: Compensation of employees includes all wages and all social contributions paid by employers to social security institutions. This information is fully comparable in time. (Gross) income of the self-employed is also included.

Note b: The covered wage bill is equal to the estimated gross wages of the national economy). The difference between 1998 and 1999 is caused by an administrative increase of gross wages in 1999, when the social security contributions were split between employers and employees, whereas previously the contribution was paid fully by the employer. (Gross) income of the self-employed is also included.

Source: Author’s own calculations based on ZUS and KRUS data.

Lower contribution revenues also mean a reduction of the covered wage bill, measured as total wages and contributions, as a percent of GDP. See Table 9. Between 1992 and 2002, the covered wage bill was reduced by almost five percentage points. As in the same time the number of insured persons was reduced

only by some three percent, the bulk of the total reduction of the covered wage bill was caused by the relative reduction of the contribution base.

As seen from Table 9, there has been no discernible improvement in contribution collection since the reform. True, the covered wage bill (measured as percentage of GDP) experienced a sharp increase in 1999, but this was mostly caused by a split in the contribution rate, with the employees now taking approximately half of the burden. In order to prevent a decrease in real net wages, this “introduction” of the employee contribution rate occurred concomitantly with an increase in wages. The compensation of employees (which here also includes the self-employed) provides a better indication of the overall trend in contribution collection, because it has not experienced a quantum leap in 1999. As seen from the table, it has not shown any signs of improvement after 1999.

5. Non-compliance and Evasion

Based on the results presented in the previous section, it can be assessed that most economically active persons are covered by social insurance. However, probably not all of their labour income is reported to social insurance. Unfortunately, there is no accurate means to effectively calculate such non-reporting, because there are no good estimates on the labour income in the informal economy. Thus, the issue of non-compliance and evasion is mainly related to the reported contributions due to the social security system for employees discussed below. Additionally, as the farmers’ pension system is not related to labour income and financed mainly from state budget transfers, non-compliance in that sector does not influence the total financing of that component of the social security system. Information on the social security system for farmers is only provided where relevant.

In the pension system for employees, workers’ rights are protected in the case of non-payments. Disability and survivor pensions are calculated based on the periods of work, not paid contributions. In the case of old age pensions, ZUS registers on the individual accounts both contributions due and the ones paid. If contributions were not retrieved, benefits will be calculated based on the owed contributions and the state budget will take over responsibility

for that part. According to the government proposal of the amendment to the law on social insurance, presented in 2003, the same applies for the part of the contribution that goes to the funded scheme, but only in the case of bankruptcy or full insolvency of the employer. Contributions not paid to the open pension funds will be registered on the notional account, earning a notional interest rate.

As the KRUS system is basically a system for a special subcategory of the self-employed, such protection in this case does not exist, as farmers pay for themselves and accrue no rights unless they do so.

5.1. Non-compliance in Large Enterprises

Non-compliance of the large enterprises in Poland contributes significantly to the overall level of liabilities to FUS. During the transition period, the government several times proposed, and Parliament approved, legislation that regulates the writing off of social security debt for selected industries. After adoption by the Sejm (Parliament), this legislation covered in particular the mining sector, the railway company and health care. Such practices were quite common until the pension reform of 1999. Creating a stronger link between contributions and benefits and splitting the contributions between employee and employer resulted in reduced attempts to write off debt towards social security.

In 2002 a restructuring law was implemented that allowed companies that presented restructuring programmes to write off the contribution due from employers for disability and work injury insurance (in total 7.12 percentage points of contribution) plus the interest due. It covered debt accrued before the end of 2001. The law includes the following additional conditions: all contributions made on behalf of employees and old age contributions made by employers are paid; and all current payments are made regularly.¹² It means

¹² The same conditions are used by ZUS to allow for deferred payments or reduced penalty interest. However, the law on social insurance does not allow ZUS to write off any contributions.

that no old age pension contributions can be written off. A few hundred companies applied for such relief, including coal mining companies and companies from the steel industry. This is a form of public aid to companies. There are arguments both for and against such support. The companies that receive this support are usually large employers – without reduction of their liabilities they would need to close down and a large number of jobs would be destroyed. On the other hand, granting public aid to companies that are experiencing difficulties for a longer period of time, might not lead to the improvement in their functioning and, in the longer run, they would close down anyway. Given the current labour market situation in Poland (with the unemployment rate close to 20 percent), the government decided that giving public support to large enterprises could help to keep the existing jobs and protect workers from unemployment and poverty.

According to European Union regulations, such aid will not be allowed after Poland becomes a member of the EU.

In 1999 for the first time ZUS created reserves in the balance sheet of FUS to cover the uncertain receivables, which means that reported receivables were reduced significantly and the total assets of FUS (as a book entry) also decreased significantly.¹³ The overall liabilities to FUS of the branches of industry undergoing restructuring, including the steel industry, coal mining and the railway company (structural debtors), at the end of 1999 were almost PLN 6.5 billion. The liabilities from those branches represent two-thirds of the total debt to ZUS. Following the recommendations of the auditor, ZUS set the reserve for these liabilities at the level of PLN 4.5 billion. Another reserve covered the amount of accrued interest (PLN 7.75 billion). As the debtors were not paying contributions regularly in 2000, this debt increased to almost PLN 7.9 billion (or 76 percent of total debt) by the end of 2000. In 2001 the situation improved slightly and the level of total liabilities from the structural debtors amounted to PLN 6.2 billion (61 percent of total debt). In 2002, the

¹³ FUS assets at the end of the year represent the value of cash and receivables at the end of the accounting year. According to practice, the cash at the end of the year should be sufficient to cover approximately half of monthly payments from FUS at the beginning of the next accounting year. The remaining part represents receivables.

total debt (including all arrears) grew faster than the debt of the structural debtors. As a result the share of structural debtors' liabilities declined to 58.5 percent of total debt, even though their debt exceeded PLN 7 billion.

5.2. Evasion or Weak and Partial Compliance in the Informal Sector

From the comparison of the number of insured and employed, it seems that almost all workers are registered in the social security system. On the other hand, the estimated size of the informal economy in Poland is quite significant, although it is decreasing. According to the estimates of the Central Statistical Office, the scale of the informal economy decreased from 17.2 percent of GDP in 1994 to 14.3 percent of GDP in 2001. However, others estimate this phenomenon as two times larger (27.4 percent of GDP in 2001).¹⁴

Given the large size of the informal economy and the nearly complete coverage of the employed, a hypothesis can be formulated that the most significant form of evasion in Poland takes the form of lower payments to social security. There are basically three scenarios that are quite common. First is a partially informal payment of salaries to workers or employment of foreign workers (mainly coming from the former Soviet Union countries). There is evidence that these practices are particularly common in the case of construction or household services.

The second one is fictitious self-employment, which allows employers to lower the costs of contribution. As the cost of contributions for the self-employed is lower, employers encourage their employees to register companies. Such a practice is common in the case of company managers and lawyers. However, in recent years it has also become quite common in other sectors. Although there is no quantitative evidence, the scale of such practices seems to be quite big. As the scale of these abuses increased, in 2002 the trade unions requested changes in the labour code, prohibiting such practices. After discussion in the Tripartite Committee they withdrew their request, due to difficulty of defining legally which contracts take the form of factual employment.

¹⁴ Prof. F. Schneider from Linz University.

The third case is employment of workers who are officially registered as farmers. Owners of land or the farmer's family members register at KRUS and pay very low contributions, while their main source of income is outside agriculture. Anecdotal evidence shows that this can also be quite common.

5.3. Evasion or Weak and Partial Compliance by the Self-employed

Polish law does not allow ZUS to monitor the actual income of the self-employed. The basis for the contribution is declared income. Virtually all of the self-employed declare the minimum income (60 percent of the average wage). This low contribution base for the self-employed results in lower pension protection in the future.

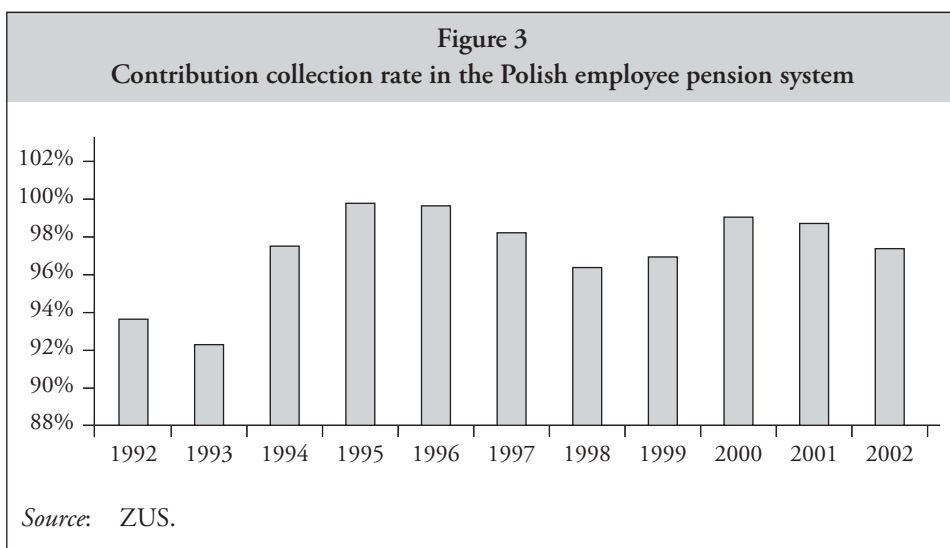
Based on the information from the Household Budget Survey, the self-employed comprise the socio-economic group that has the lowest incidence of poverty. Thus, it seems that the actual income of the self-employed is usually higher than the declared minimum; however, it is quite difficult to assess the level of such evasion.

According to ZUS estimates, in recent years, the share of self-employed in the total number of insured is increasing. This leads also to lower contribution revenues to the pension system. Linking the contribution base of the self-employed to their actual income (corresponding to the revenue reported to the tax authorities) would both lead to increased pension protection of this segment of the workforce and, additionally, should improve the overall level of collections. Such a change would also allow for differentiating contributions among various groups of the self-employed (for example individual craftsmen and owners of medium and large companies), who currently pay the same contributions, despite significantly different levels of income.

5.4. The Problem of Arrears

One way to measure the level of non-reporting is to calculate the collection rate, i.e. the ratio between contributions paid and contributions due. Such a measure adopted to the employees' pension system shows that the collection

rate was highest in the mid-1990s as well as in 2000–02. The drop in the collection level, observed especially in 1998 and 1999 was due to the increasing difficulties on the labour market and, additionally, in 1999, ZUS reduced control over the payments. After 1999, ZUS improved its collection policy, which resulted in a reduction of overdue receivables as well as improved discipline of current contribution collection.¹⁵ However, such a measure can only show the payments due for registered employees.



The social insurance law permits ZUS to allow for deferred payment of overdue contributions or payment in installments. This applies only to the contribution part paid by employers. ZUS can make an agreement with an employer, under the following conditions:

- all contributions made on behalf of their employees as well as old age pension contributions are paid; and
- all current contributions are paid regularly.

¹⁵ Thus, ZUS is also in charge of the enforcement function and has – in this respect – the same capacity as the tax authorities in doing so.

ZUS cannot by itself write off any part of contributions due.

The contributions that are not paid accrue penalty interest, which from June 2003 amounts to 13.5 percent annually.¹⁶ ZUS can also impose a fine of up to 100 percent of contributions due.

The recorded arrears to the social security systems are shown in Table 10. The overall debt to social insurance systems in relation to GDP is approximately 1.6 percent of GDP, of which the bulk is related to the employees' system. In that system, the relation of the debt to revenues has been increasing, mainly due to the relative fall of the contribution revenues.

Table 10
Cumulative Polish contribution debt in ZUS and KRUS

Year	GDP (PLN million)	ZUS				KRUS			
		Revenues (million PLN)	Debt (million PLN)	Debt/ Rev.	Debt/ GDP	Revenues (million PLN)	Debt (million PLN)	Debt/ Rev.	Debt/ GDP
1995	308,103.7	35,841.9	4,200.0	11.94	1.36	540.1	193.9	35.9	0.06
1996	387,826.6	45,968.1	4,700.0	10.38	1.21	671.0	242.1	36.1	0.06
1997	472,350.4	55,402.3	5,800.0	10.59	1.23	785.7	291.5	37.1	0.06
1998	553,560.1	62,810.7	8,389.1	13.34	1.52	888.2	337.7	38.0	0.06
1999	615,115.3	64,084.4	9,740.5	15.22	1.58	981.6	394.7	40.2	0.06
2000	713,391.0	65,578.6	10,308.4	15.71	1.44	1,030.7	442.6	42.9	0.06
2001	750,786.0	69,904.0	10,237.9	14.59	1.36	1,156.2	487.0	42.1	0.06
2002	772,248.0	68,217.1	12,078.2	17.74	1.56	1,255.8	536.3	42.7	0.07

Note: The debt does not include accrued interest.

Source: Author's own calculations based on ZUS and KRUS data.

When comparing the relative size of debt to contribution revenues, there is a notable difference between ZUS and KRUS systems – in ZUS it is more than two times smaller than in KRUS. Yet cumulative debt as a share of GDP is much higher in the ZUS system, given its larger overall coverage and size.

¹⁶ Penalty interest refers to a higher rate of interest than the normal statutory rate.

In both systems, this indicator was rising from the mid-1990s. The rise has been particularly sharp during recent years, when the economic growth was lowest. As a result of the general economic situation, employers and farmers had increased difficulties meeting their obligations.

The difference in the debt level between ZUS and KRUS can be attributed to institutional and macroeconomic factors. From an institutional perspective, ZUS may be more efficient in its enforcement procedures. From a macroeconomic perspective, the agricultural sector in Poland is undergoing a significant crisis – between 1995 and 2002 the agricultural production relative to GDP halved from 6 percent to 2.7 percent.

5.5. *Second Pillar*

Contribution collection in Poland is centralised in the sense that second pillar contributions are collected by ZUS and passed on to private pension funds. As a result, there is no special problem of evasion in the case of second pillar contributions. But, given difficulties in the implementation of the IT system, there are two problems that are indirectly linked to contribution collection.

The first one is the problem of arrears of ZUS payments to pension funds. As mentioned before, in the period from 1999 to 2002 a significant proportion of the second pillar contributions was not transferred to open pension funds, due to difficulties in the proper identification of payments. Contributions that were not transferred financed current pension payments. The total debt (with interest due) accrued until 2002 was too high to finance from current budget revenues. The overall level of the debt (contributions and interest) accumulated between 1999 and the end of 2002 was estimated at PLN 10 billion. In 2003, the Parliament adopted a law that allows financing the debt by issuing special government bonds. The bonds, representing the value of recognised contributions, are transferred to pension funds when ZUS identifies the past contributions that were not paid.

The second issue is the number of inactive accounts, i.e., accounts created at the OFE that do not have a single contribution paid. This can be a result of either lack of proper identification or wrong affiliation of persons who are not covered by social security. In mid-2003 the overall rate of inactive accounts

was 17.7 percent of total accounts (among individual OFEs it ranged from 4.45 percent to 55.09 percent of total accounts). The situation is improving. Two years before, the same indicator was 27.6 percent (and among individual OFEs it ranged from 14.46 percent to 88.10 percent of total accounts). The improvement results from the better quality of the databases held in ZUS and eliminating from the OFE's registers the accounts of persons who were not insured.

6. Improving Compliance and Collections

The contribution compliance and collection issue in Poland can be viewed from several sides.

Firstly, it is the discussion on the public finance situation. The National budget is heavily subsidising both employees' and farmers' social insurance systems.¹⁷ Each year the government tries to maximise the contribution collection level and in a way that limits the need for the national budget to subsidise both systems. This is particularly important in the case of the ZUS scheme. Discussion on this issue seems to be the most important during the time of drafting the national budget law, when assumptions on compliance effect the overall financial plan of ZUS and the national budget subsidy. A part of the financial difficulties in ZUS observed in 1999 stemmed from unrealistic assumptions on the compliance level. After that year, the assumptions on compliance have been quite moderate. As for the involvement of the social partners, they are represented in the Supervisory Board of ZUS. Thus, their representatives need to approve the draft financial plans. The members of the Board, in their opinion submitted to the government, usually point out that assumptions on the compliance rate should be prudent. Additionally, the social partners receive the draft national budget law for consultation, before submitting the law to the Parliament. In their opinion they also frequently

¹⁷ In 2002 the total value of the state budget subsidies to both systems amounted to more than PLN 42 billion or 5.5 percent of GDP. This was more than the total state budget deficit.

refer to the assumptions for the social security system financing, pointing out possible threats in the financing of pension payments. However, as the final decision on the FUS financial plan is made by the government and submitted to the Parliament, the assumptions on compliance level remain on quite a high level.

Secondly, sectors undergoing restructuring (i.e., coal mining, railways and health care) are not fulfilling their contribution payment obligations. As a result, their debt increases, making their situation, as well as the situation of the social security system, more difficult. Until 1999, the government frequently proposed writing off contributions, which was also supported by social partners and adopted by the Parliament. After 1999, as part of the contribution is made from employees' wages, it cannot be written off, as non-payment of the employees' part is treated as non-payment of wages. Also, as there is a direct link between old age pension contributions and pensions, workers support proposals of write-offs to a lesser extent. As a result, after 1999, the government, with exception of the 2002 law, did not propose any write-offs of any part of the social security contribution. This can be viewed as one of the positive elements of the new pension system. Restructuring processes are usually discussed with trade unions of particular branches and industries. In these discussions, the compliance issue does not seem to be treated as important, although some of the trade unions favour larger write-offs of contributions that in theory could increase the chance for economic recovery and keep their jobs.

Thirdly, in Poland the overall level (i.e. the amount to be paid) of contributions to the social security system, and thus the tax wedge, is one of the highest in the OECD countries. It is an obstacle for the employers who wish to hire workers. Thus, it creates incentives for evasion and contributes to the development of the informal economy. Entrepreneurs and employers' organisations seek reductions in the social security contribution level. According to the survey conducted by the National Bank of Poland (see: NBP, 2003), in the third quarter of 2003 some 45 percent of enterprises want a general reduction of the social security contribution rate for all employers. Such declarations were made especially in the construction industry. On the other hand, the level of social security contribution ranks in this survey as eighth out of ten most important barriers for the development of enterprises in Poland.

The most important ones are low demand, late payments and bad financial standing of clients.

Finally, there are technical aspects of collection that stem from difficulties in the implementation of the IT system in social security. These technical difficulties result in problems in the transfer of contributions to open pension funds. In this respect, the debate is mainly public, as open pension fund members are concerned about their future pensions and security of their pension savings. This, however, applies to the technical capacity of ZUS to support the collection system.

7. Recommendations

The national debate on social security systems in Poland hardly touches the issue of collection. The debate starts only when particular aspects of the collection issue gain attention, and when problems are already acute, which is usually very late. In order to improve this situation, a more comprehensive and long-lasting approach to the issue of public information should be taken. For example, issues of social security could be made a part of general education on the secondary level. In that way, future workers entering the workforce could be more aware of the importance of social insurance, and pension coverage in particular.

Workers in Poland seek social security coverage. However, from existing evidence it can be viewed that the wages covered by social security are rather low. This can be a combination of the current labour market situation, under which employers can dictate their conditions, and low pension awareness of those covered by the new pension system, where lower contributions would generate low pensions in the future. Another hypothesis is that the social insurance coverage for many workers, in particular the self-employed, can have mainly a short-term value of health care and sickness protection, rather than a long-term perspective of future pension level. Building awareness of workers could help in increased reporting and compliance. This, however, requires actions by government and social partners, who could together initiate actions to improve the “pension literacy” of workers.

The new old age pension system closely links future benefits to contributions. Despite this change introduced in 1999, the level of contributions has been

rather stable or even declining. Thus, the first recommendation would be to raise public awareness of social security issues, in particular related to pension insurance. In this light, the first individual reports sent to the insured at the end of 2003 should be easy to understand and should bring the clear message to individuals about the link between contribution payments and future pensions.

From 2003, the Social Security Institution prepares long-term projections of the situation of the old age segment of the pension systems. The government, in its recent programme of social expenditure rationalisation, adopted in January 2004, proposed creation of the National Actuary, which would be responsible for preparing long-term projections of the financial situation of the social security systems. Long-term projections of ZUS and the National Actuary could be a basis for discussion among social partners about the future of the social security systems and possible measures to improve the financial situation of the Social Insurance Fund. Such discussion should lead to formulating policy recommendations about, for example, the social security contribution rates, provided that contribution revenues (also due to higher compliance) make room for such reductions.

Most of the contribution arrears to social security are from large debtors from sectors undergoing restructuring. The restructuring process in most of these sectors has been going on for many years without significant improvements leading to sound economic performance. On the contrary, these sectors have been enjoying significant public support, in particular write-offs of the social security debt. In the future, in particular after accession to the EU, public support to such companies should be limited. Additionally, public support should be received only once.

The second recommendation to improve compliance is to finalise the restructuring of large industries – in particular coal mining, health care and railways, which hold the bulk of the debt towards social security. The restructuring process has been quite slow, as the conditions of restructuring (mainly reduction of the workforce), proposed by the government, were not accepted by the trade unions. In the case of the mining industry, after heavy negotiations, following protests of miners' trade unions, the restructuring legislation was approved by the end of 2003. At this time, the government

prepared the new restructuring programme for the railway industry. The programme included a significant reduction of regional networks that in the future would be managed by regional authorities. The programme also included significant cost reductions, especially in regional networks. Such proposals did not receive support of the trade unions, which resulted in the railway workers' strike. After increasing railway subsidies in the draft state budget law in the Parliament, the strike was suspended. However, the restructuring programme is starting to be implemented and its final outcome in terms of increased compliance depends also on the efforts and cooperation of enterprise managers and the trade unions to improve the economic situation in the company.

There is also a need to modify the contribution collection rules for the self-employed. Currently, as virtually all self-employed pay the same contributions (in PLN terms), the contribution burden in relation to the revenues of different groups of the self-employed varies significantly. While for some professions (such as lawyers or managers), social security contributions are not a significant cost, for others (such as craftsmen or household workers) contributions are very high, which may lead to evasion and staying in the informal economy. Thus, the rules for payment of social security contributions for the self-employed should be adjusted, linking the contribution base to the revenue or profit reported for tax purposes. This could be combined with the lowering of the minimum base, allowing some of the self-employed to lower their too-high costs. Although such a change would result in lowering benefits for some groups within the self-employed, it could help to increase the coverage, creating more incentives for those staying currently in the informal sector to make their businesses formal.

Finally, the farmer system should also be modified. Firstly, access to the system should be tightened, allowing only those farmers that live mainly from agricultural income to be covered. Secondly, the contribution level should reflect the revenue of farmers (both from work in agriculture as well as additional non-agricultural income). Thirdly, national budget subsidies should be targeted to contributions of farmers that cannot afford to pay the full amount; rich farmers should pay contributions that at least fully finance their future benefits.

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Chapter 6

The Collection of Pension Contributions in Romania

*Cristian Toma*¹

1. A Brief and Recent History of the Contributions Collection Systems

1.1. Introduction

The December 1989 Revolution found Romania with several social security systems, operating on the traditional pay-as-you-go financing principle.

Social security coverage was fractured by the existence of a number of independent systems for certain professions or sectors of activity. Besides the state social insurance system and the supplementary pension system, there were separate systems for farmers and servicemen, as well as smaller systems for unions of workers in the creative arts (writers, musicians, artists, filmmakers), clergy, workers in handicraft cooperatives, and lawyers. The economic turmoil of the early 1990s caused a major decrease in the number of contributors, which led to insufficient financing for these schemes. During 1993–98, the systems for artists, clergy, and handicraft cooperatives were gradually integrated into the state social insurance system.

¹ The views and opinions presented in this paper are those of the author. The author would like to thank Elaine Fultz and Tine Stanovnik for providing valuable observations during the preparation of this report.

Throughout the 1990s, the Ministry of Labour and Social Protection administered the state social insurance fund, the supplementary pension fund, the farmers' fund and the unemployment fund.² The covered risks were sickness, maternity, employment injuries, occupational diseases, invalidity, old age, survivorship, and unemployment. The Ministry of Health administered the health fund that covered the health risk.

In 2000, the Parliament approved the first major reform of the social security system – Law No. 19/2000. It contained important provisions for the extension of social security coverage and the improvement of contributions collection. The law was implemented on April 1, 2001. Significant amendments were enacted soon thereafter which changed some of the main provisions.

The remainder of this section describes the social insurance system as it operated in the 1990s and then presents the main provisions of the 2000 reform and the subsequent revisions.

1.2. The Social Insurance System of the 1990s

A. The State Social Insurance Fund

The state social insurance fund was the largest fund and covered sickness, maternity, employment injuries, occupational diseases, invalidity, old age and survivors. It was mainly based on the existence of an individual labour contract and on the payment of social insurance contributions solely by the employer. The employer calculated and paid, on a monthly basis, the social insurance contribution. The contribution base was the total monthly gross wage bill. A 1992 law differentiated the contribution rates according to three levels of working conditions – very arduous, arduous, and normal. These rates varied through the years, from 14 percent in 1990 up to 30 percent for the third, 35 percent for the second, and 40 percent for the first work group just before the 2000 reform. In 1990, for the first time, the self-employed were given the option to become contributors to this fund. Their regime was voluntary and the participation, negligible.

² The Ministry's role in coordinating social security policies was a longstanding one, extending back to 1920 when it was first established.

Until 1991, the state social insurance fund budget was part of the state budget. Beginning in 1992, it was separated and given independent status, according to the 1991 Constitution. In 1995, the state social insurance fund operated at a deficit for the first time.

B. The Supplementary Pension Fund

Regulations also existed regarding the supplementary pension fund. It covered invalidity, old age and survivors.³ All employees registered in the state social insurance system owed the supplementary pension contribution. The three percent rate was calculated based on each individual's monthly gross wage and the permanent bonuses that were legally stipulated in his or her individual labour contract. In 1999, the rate was raised to five percent. It was withheld and transferred by the employer to a special interest account at the Romanian Savings Bank.

The Ministry of Labour and Social Protection was authorised to take measures to protect and use the amount temporarily available, keeping it in bank accounts or at the Romanian Savings Bank. The supplementary pension fund was the only scheme based on the principle of advance funding. In 1990, for the first time, the self-employed were given the option to participate in this fund. Like their voluntary coverage this same year under the state social insurance fund, participation turned out to be negligible. In 1997, the supplementary pension fund registered a deficit for the first time.⁴

C. The Farmers' Fund

Farmers were covered mandatorily under a special scheme until 1992, at which point their regime became voluntary. The farmers' fund covered sickness, maternity, invalidity, old age, and survivors. However, only a small proportion of farmers agreed to pay the voluntary contribution. The seven percent rate was calculated based on the monthly-insured income stated in the insurance contract.

³ The rationale for the setting up of this fund was to ensure a supplementary pension besides the basic pension received from the state social insurance fund.

⁴ That is, the invested funds were inadequate to pay promised benefits, and the government therefore had to subsidise payments to these individuals.

In order to compensate for the weak participation of farmers, the government imposed a tax on companies that produced, processed, and marketed food and agricultural products. The rates ranged from two percent to four percent, depending on the activity. The tax base for companies that produced and processed food and agricultural products was their monthly gross income. For companies that marketed food and agricultural products, the tax was calculated based on the difference between the cost of production and the sales price.

The role of companies, through taxes, and of the state, through subsidies, in the financing of the fund was essential. In 1995, the farmers' fund registered a deficit for the first time. In 1997, the farmers' fund derived 46 percent of its revenues from the taxation of companies and 52 percent from subsidies. Only two percent was derived from the contributions paid by farmers themselves.

D. The Unemployment Fund

While the previous funds existed before the December 1989 Revolution, the unemployment fund was established only in 1991, when unemployment was officially recognised by the state. Employees and employers financed unemployment benefits for the former, while the self-employed were given the option of voluntary participation. The employee contribution rate was one percent, based on the individual monthly gross wage. The employer contribution rate was five percent, based on the total monthly gross wage bill. The contribution rate for the self-employed was five percent of the income stated in the unemployment insurance contract.

The unemployment fund also granted severance payments as part of government programmes for the restructuring, privatisation, and closing of firms. This practice contributed to unfavourable financial trends from 1998 until 2000, when the unemployment fund registered a deficit.

1.3. The Pre-reform Collection Mechanism

Throughout the 1990s, responsibility for the collection of the social insurance contributions, as well as contributions for the supplementary pension, the farmers' fund and unemployment fund, resided with the Ministry of Labour and Social Protection.

In 1991, the Ministry was empowered with control duties and authority in order to perform inspections and strengthen collection. However, during the years that followed, the government's human resources policy was not flexible enough to ensure an adequate number of inspectors. See Section 4.4.

In 1996, in order to accelerate debt recovery, the Parliament passed special legislation on the administrative enforcement of contribution collections from delinquent businesses. Prior to 1996, the Ministry of Labour and Social Protection instituted legal proceedings against debtors and officers of courts were responsible for enforcement. According to the new legislation, the enforcement officials of the Ministry were granted substantial new powers, namely, the right to sell the assets and freeze the accounts of non-compliant companies.

Starting in 1997, employers were obliged to submit, on a monthly basis, to the county branches of the Ministry of Labour and Social Protection, declarations of aggregate contributions owed to the state social insurance fund, supplementary pension fund, farmers' fund, and unemployment fund. The declarations were in paper format and comprised the total contributions owed, the employers' liabilities, and the social insurance benefits subtracted from the social insurance contributions, as the case may be.⁵ The goal of introducing these declarations was to create records of the contributions paid and those that were outstanding. Such records were a vital first step in improving compliance (as regards the individualised declarations of contributions made by and on behalf of insured persons, they were introduced only in 2001 for the social insurance system and in 2002 for the unemployment and health systems).

Employers paid contributions via transfer from their bank account to the account of the county branches of the territorial treasury.

The records were kept at each of these 42 county branches of the Ministry. However, problems arose because these branches used unsuitable software in processing the declarations and payment orders.

⁵ Employers subtracted certain benefits from their social insurance contributions and dispersed these directly to their employees. This included cash benefits for days of missed work due to sickness following those days for which the employer was directly liable, temporary change of work benefits, shorter work-schedule benefits, quarantine benefits, maternity benefits, child raising benefits, sick child care benefits, and death benefits.

During the 1990s, discrepancies appeared between the amounts owed and those paid, indicating a significant increase in evasion. In the mid-1990s, many business entities, some with large numbers of employees, ceased to meet their social security liabilities.⁶

In 1998, as another pre-reform measure, the supplementary pension fund and the farmers' fund were designated as separate chapters in the budget of the state social insurance fund. However, this treatment was repealed in April 2001, when the new social insurance law was passed.

In 1999, the first institutional reforms took place in health insurance and unemployment. Two specialised agencies were established, the National House of Health Insurance and the National Agency for Employment. The first dealt with health risk and became the collector of health insurance contributions, while the second dealt with unemployment risk and took over the collection of unemployment contributions from the Ministry of Labour and Social Protection. Besides collection, the agencies were also endowed with control and enforcement responsibilities. The National House of Health Insurance is overseen by the Ministry of Health, while the Ministry of Labour, Social Solidarity and Family oversees the National Agency for Employment.

1.4. Reform Law No. 19/2000

Following a decade of short-term policies, the government adopted Law No. 19/2000 on the public system of pensions and other social insurance rights. This law entered into force in April 2001. It represented the government's first attempt to implement more consistent parametric reforms.

The main features of this new law were:

- The organisation of a single public pension system. The reform abolished the former state social insurance fund, supplementary pension fund and farmers' fund and organised a unique system.
- The establishment of the National House of Pensions and other Social Insurance Rights, an autonomous, national institution of public interest,

⁶ For the factors that induced this behaviour, see Section 5.3.

operating as a legal entity in charge of the public pension system management and financial administration. In this respect, the Ministry of Labour, Social Solidarity, and Family is the policy maker in the social insurance field and this new agency implements this policy. A Secretary of State within the Ministry is the President of the National House of Pensions and other Social Insurance Rights and of the Board of Administration. The members of the Board represent the government, employers, and insured persons.

- The mandatory coverage of all physical persons who worked and earned incomes above a certain level. The rationale for the change was to extend coverage to the entire active population. This in effect brought coverage to four major new groups: the unemployed, individuals working on civil contracts, the self-employed, and farmers.⁷ The last three of these were mandatorily covered only when they had earnings over a threshold amount.
- The modification of the social insurance contribution structure, so that for the first time employees were liable for a portion of the social security contribution. The involvement of employees in the contribution payment was a way to emphasise their personal responsibility for their own retirement, as well as to create a stronger rationale for employers to transfer owed social insurance contributions to the new National House of Pensions. The social insurance contribution rates are set in the annual state social insurance budget law and vary according to working conditions. For arduous and very arduous working conditions, the contribution rates are higher and employers pay the difference between these rates and the individual rate. The self-employed and farmers bear responsibility for the full social insurance contribution.

⁷ The 2000 law also covered civil servants as a separate group, but this was a technical change without significance for their social security contributions or benefits. Before the reform, they were covered by virtue of having individual labour contracts. In the late 1990s, a separate law changed their status, so that they worked by appointment rather than contract. The 2000 law made a conforming change in their social security coverage. A number of smaller groups were covered in 2000 as well. See Box 1. Civil contracts are described in Section 2.3.

- The establishment of various contributory periods for eligibility for a pension or other social insurance benefit. The law defined these as periods for which the social insurance contributions were *paid*, rather than *owed*, thus linking an individual's benefit eligibility directly to his or her actual contributions to the system.
- The enlarging of the social insurance contribution base. As previously mentioned, before the reform, the employee paid the supplementary pension contribution based on the individual monthly gross wage and the *permanent* bonuses that were legally stipulated in the individual labour contract. While abolishing this supplementary pension fund, Law No. 19/2000 subjected *all* the bonuses and incentives stipulated by law or collective labour agreement to the employee social security contribution.
- The rationalisation of arduous and very arduous occupations, certain jobs being reclassified and the proportion of workers in arduous and very arduous occupations reduced.
- The imposition of a ceiling on contributions that implicitly limits benefit levels. The contribution ceiling for the employers was three times the average monthly gross wage, multiplied by the average number of insured persons in the month for which the employer owes contributions. The contribution ceiling for employees, the self-employed, and farmers was three times the average monthly gross wage.
- Increase in the retirement age from 62 to 65 for men and from 57 to 60 for women over a 14 year period.
- The setting up of social insurance courts or specialised panels of judges to resolve disputes related to social insurance rights and obligations, with the goal of greater fairness and promptness in appeal decisions.

While Law No. 19/2000 was intended to provide a more coherent approach to social security reform than had been taken previously, a number of significant amendments were adopted soon after its enactment. The amendments were first passed by the government as emergency ordinances and then approved by Parliament. Two of them stand out:

- The mandatory coverage of farmers was repealed.

- The new rule basing a worker's eligibility for a social insurance benefit on contributions actually paid was also eliminated.

This latter amendment undercut the basic philosophy of the 2000 reform, which was to provide greater incentives for compliance by strengthening the relationship between contributions paid and benefits received.

In addition, starting with 2003, the new contribution base was raised significantly, from three to five times the average monthly gross wage.

1.5. Future Reforms

For a number of years, Romania has been considering the implementation of a national system of capitalised privately managed pension funds in order to diversify the retirement income sources, to increase private savings, and to develop the capital market. The process started in 1997, when a White Paper focused on analysis and proposals for the private pillars was issued. The Social Democratic government considers that the diversification of the retirement income sources is a priority target. To this end, it is planned that the social insurance system will have a multi-pillar structure.

According to the government programme, the implementation of the mandatory private funds will be supported only if an additional source of funding can be found to cover the transition costs; that is, the deficits that will occur in the public pension scheme as a result of diverting a portion of contributions to individual savings accounts.

A second draft law provides a legal framework for employers and trade unions to develop voluntary occupational pension schemes. According to the new draft Fiscal Code, the contributions to the occupational pension schemes will be tax deductible, within the annual limit of EUR 200 from the taxable income.

The government is planning that both the draft laws regarding the mandatory privately managed pension funds and the occupational pension funds will be passed in 2004.

2. An Overview of the Current Collection Systems

2.1. *The Institutional Setting*

As explained previously, the new National House of Pensions and other Social Insurance Rights is overseen by the Ministry of Labour, Social Solidarity and Family. The 2000 reform charges the National House of Pensions with performing the following activities related to contributions collection:

- to keep records of all public system contributors and their social insurance rights and obligations, based on their social insurance personal code;⁸
- to assure the implementation, extension, maintenance, and protection of computer and other record keeping systems;
- to collect and transfer social insurance and other forms of contributions;⁹
- to guide and control physical and legal persons regarding their social insurance rights and obligations;
- to certify annually each insured person's contributory period;
- to supply data required in the justification and drafting of the state social insurance budget by the Ministry of Labour, Social Solidarity and Family;
- to report to government and the social partners on the administration of the state social insurance budget and to publish activity reports twice a year; and
- to enforce international agreements concerning social insurance to which Romania is party and to develop relationships with social insurance authorities in other countries, on the basis of such agreements.

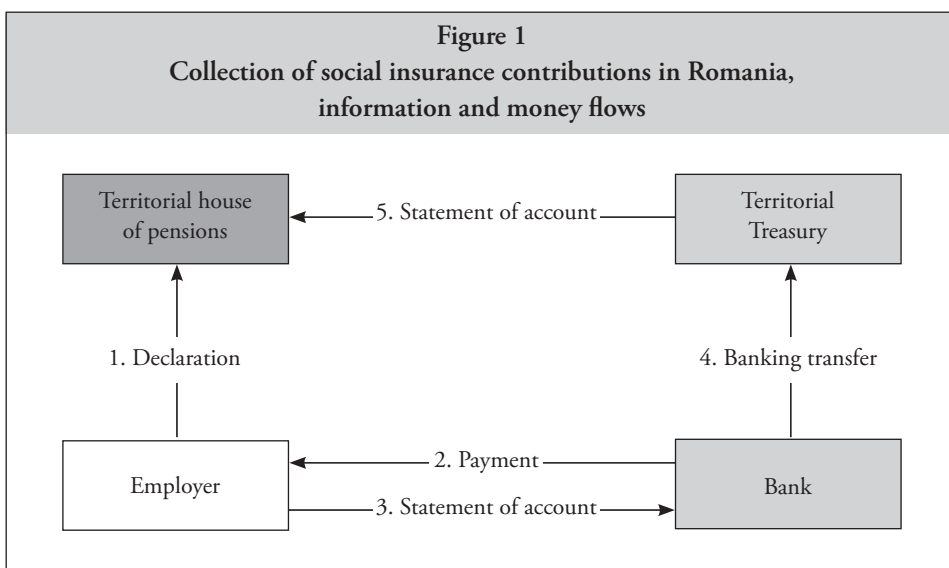
⁸ This is the same as the personal numeric code.

⁹ The function of collecting and transferring other forms of contributions was granted with a view to the partial privatisation of the pension system and the establishment of a new system of privately managed individual savings accounts.

2.2. The Collection Mechanism

The following sections describe the information and money flows involved in the collection of social insurance contributions, as well as delineating the most important responsibilities of the actors involved. The flows are divided into three large blocks related to: (a) the collection of contributions, (b) the payment of social insurance benefits,¹⁰ and (c) the certification of contributory periods.

A. The Collection of Social Insurance Contributions



1. Each month, employers submit individualised declarations to the territorial house of pensions. These may be in paper format for employers with fewer than 20 employees. For larger ones, both paper and electronic formats

¹⁰ It is necessary to describe benefit payments since employers deduct some benefits owed to their employees from their monthly contributions.

are required. The electronic format is prepared with software provided by the National House of Pensions. The first declaration constitutes the registration of employees in the social insurance system (no separate registration is required). In order to verify information on the employer's declaration, the National Trade Register shares its database of employers with the National House of Pensions.

The individualised declaration includes:

- for employees:
 - a) identification of employee (name, personal numeric code, type of employment);
 - b) number of days worked according to work category (very arduous, arduous, or normal) and number of days of receipt of social insurance benefits;
 - c) employee contribution base according to work category;
 - d) employee contributions owed; and
 - e) social insurance benefits to be subtracted from social insurance contributions.
- aggregate information on the employer:
 - f) identification of employer (name, unique registration code, bank accounts);
 - g) average number of employees for the month;
 - h) employer contribution base according to working conditions;
 - i) employer contribution owed;
 - j) total employee and employer contributions owed; and
 - k) total social insurance benefits subtracted from social insurance contributions.

The National House of Pensions has experienced three serious problems in implementing these requirements. First, there have been many errors in the employer declarations. These resulted in part from the failure of the government to carry out a public awareness campaign on the new requirements. Second, the keying of the declarations presented in paper format has proven to be a costly and inefficient operation which has produced many additional errors. Third, the databases on contributors used by the National House of Pensions to cross-check compliance are

incomplete. This means that there is no reliable master list against which to verify the accuracy of the declarations.

The existing databases are:

- The National Trade Register, which includes all companies, with or without employees, but excludes public institutions; and
- The Ministry of Public Finance database, which includes all entities that have to submit balance sheets. However, companies submit balance sheets even if they have no activity, i.e. they have no employees. Moreover, public institutions are excluded, since they submit their balance sheets to the public central institutions to which they are subordinated.

Thus, neither database includes public institutions, nor does either provide information on the number of employees of an employer.

In 2001, the National House of Pensions and other Social Insurance Rights assumed the database of the National Trade Register, but it was not subsequently updated. As regards the database of the Ministry of Public Finances, it was assumed, following a protocol, only at the end of 2002.

2. The employer pays social insurance contributions via money transfer from the bank to the account of the territorial house of pensions, opened with the territorial treasury. There are 42 territorial houses of pensions – one in each county.

The 2000 law stipulates that, regardless of their legal status, employers must submit to the bank, together with documents for the payment of salaries and other incomes of the employees, documents for the payment of contributions owed to the state social insurance budget. The payments must be made simultaneously, under the bank's control. However, this provision has so far not been enforced. The main reason is the lack of sanctions for non-compliance by banks.

3. The bank issues the statement of account for the employer.
4. Within 48 hours, the bank credits the budgetary account opened with the territorial treasury and debits the employer's account, according to the banking transfer regulations.

5. The territorial treasury submits the statement of account to the territorial house of pensions.

The manual processing of the statement of accounts consumes a great deal of personnel time. It has also led to errors because of the lack of a special payment document, specific to social insurance, to provide information needed by the territorial house of pensions.

Once it receives the statement of accounts from the territorial treasury, the territorial house of pensions matches the declarations received from the employer with it, thus matching the information and financial flows.

The databases created in this way are updated based on information gained through inspections. These are focused on verifying that social insurance contributions were actually paid and that the payments followed the requirements of law.

If contributions are found to be due, the territorial house of pensions collects these through enforcement procedures or grants debt repayment arrangements, as the case may be.

The main tool of the National House of Pensions for preventing the accumulation of arrears is close monitoring of contributors' financial behaviour. However, both monitoring and notification of non-compliant contributors are hampered by software flaws.¹¹ These are serious problems since such notifications make employers aware of the agency's capacity to supervise them.

B. The Payment of Social Insurance Benefits

Employers are obliged by law to provide certain benefits directly to employees and to calculate and disburse other benefits, subtracting these amounts from their social insurance contributions. The employers' direct liabilities include the payment of:

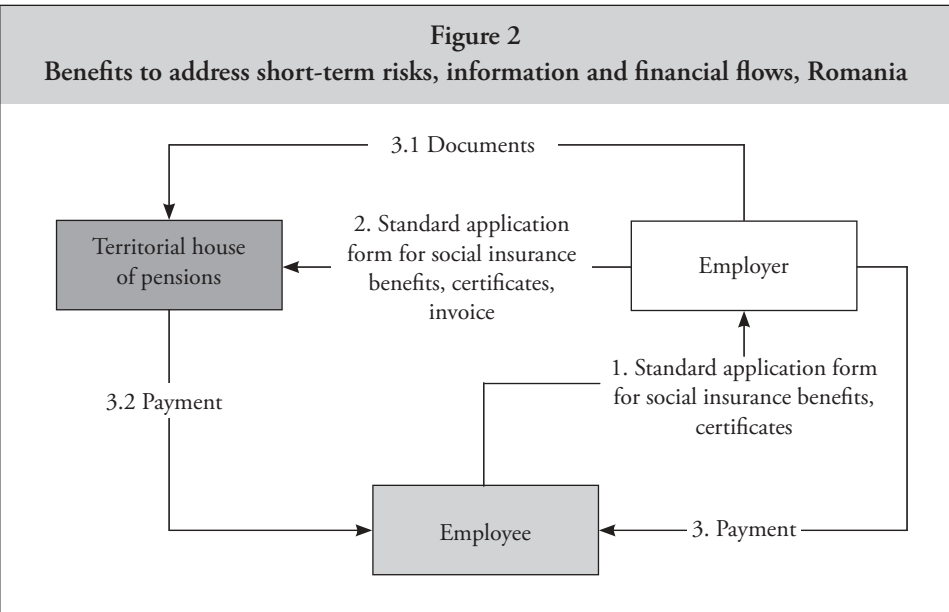
¹¹ For example, the current software does not automatically calculate interest due, nor does it provide an automated notification (summons) to the non-compliant employer.

- Cash sickness benefits. The number of days of benefits that employers must pay depends on the size of their work force at the time that a worker's temporary work disability arises, as follows:
 - a) from the 1st to the 7th day of temporary work disability, for up to 20 employees;
 - b) from the 1st to the 12th day of temporary work disability, for 21 to 100 employees; and
 - c) from the 1st to the 17th day of temporary work disability, for more than 100 employees;
- Employment injury or occupational disease benefits. When the employer is responsible for the worker's employment injury or occupational disease, he pays the benefits from the first until the last day of temporary work disability, or until the retirement date.

The benefits subtracted from the social insurance contributions and disbursed by the employer are:

- cash sickness benefits, for the days following the ones paid for by the employer until the last day of temporary work disability, or until the retirement date;
- employment injury or occupational disease benefits, in case the employee is responsible for the employment injury or occupational disease;
- temporary change of work benefits;
- shorter work schedule benefits;
- quarantine benefits;
- maternity benefits;
- child raising benefits;
- sick child care benefits; and
- death benefits.

For benefits to address short-term risks, the information and financial flow encompasses additional steps, shown in Figure 2.

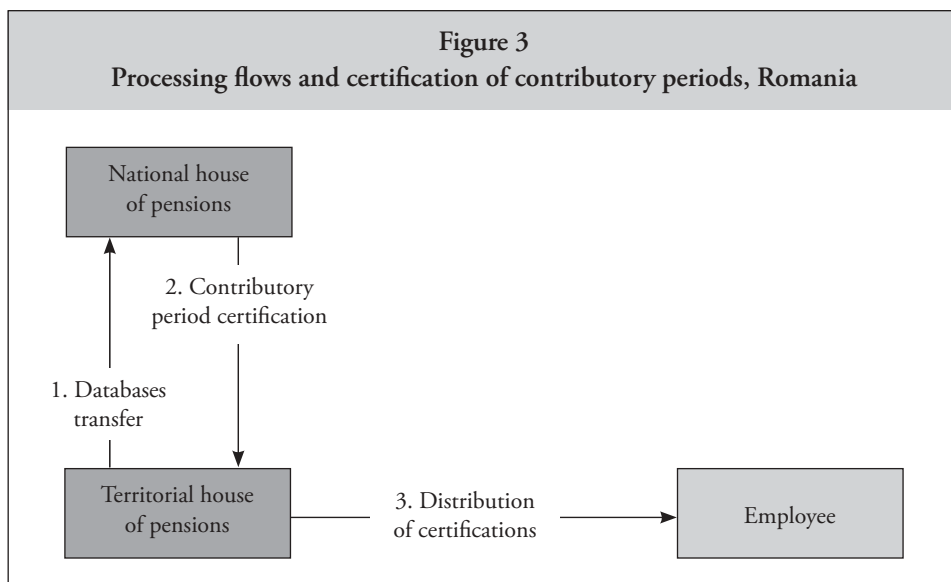


1. The employee completes the standard application form for social insurance benefits and registers it with the employer, together with the legally required certificates.
2. The employer completes the same standard application form for social insurance benefits and submits it to the territorial house of pensions, along with the declaration. For a month in which the amount of contribution owed to the state social insurance budget is lower than the benefits paid by the employer directly to the employees, or for a month in which the social insurance contribution is not owed, the employer submits the invoices together with the legally required documents to the territorial house of pensions, in order to recover the differences from the state social insurance budget or, as the case may be, the amount equivalent to the paid benefits.
3. The employer calculates and pays both his liabilities and the social insurance benefits subtracted from the social insurance contributions.

If the employer closes his business or the individual labour contract term expires, the process includes two more steps:

- The employer submits the legally required documents to the territorial house of pensions.
- The territorial house of pensions pays the social insurance benefits that the employee was entitled to prior to the closing down of the business or the termination of the individual labour contract.

C. The Certification of Contributory Periods



The sequence shown in the figure is as follows:

- 1) The territorial house of pensions is supposed to transmit its databases of contributors and employees to the National House of Pensions and other Social Insurance Rights on a monthly basis.
- 2) The National House of Pensions and other Social Insurance Rights is supposed to process the databases and certify each employee's contributory period. This should be done on an annual basis. For the first time, this duty was assigned to the agency on April 1, 2001 when the social insurance

reform was implemented. However, it must be stressed that this certification is to be performed through aggregation of monthly individualised data, as the 2000 law did not introduce any requirements on the part of employer for annual reporting of contributions paid on behalf of employees.¹²

However, until now, this essential function has not been implemented. Among the chief difficulties encountered were errors in employer reports, resulting both from their own mistakes and from those of the staff who processed them manually. In 2002, three successive procedures were performed to correct errors by asking the employers to rectify their invalid declarations.

In the absence of these procedures, other stop-gap measures are being used. In the case of retirement, for the period before implementation of the 2000 reform law (April 1, 2001), the territorial house of pensions uses the data from handwritten workbooks. Since the reform, due to lack of suitable software, it requests that the employee submit a certification issued by employers verifying his or her contributory period.

- 3) The territorial houses of pensions are supposed to distribute the individual contribution certificates to each employee.

The procedures just described for collecting social insurance contributions are basically the same as those for the collection of unemployment and health insurance contributions.

Most of the problems that confront the National House of Pensions in implementing the new law relate to information technology. The development of information systems is not yet complete. In fact, the National House of Pensions and other Social Insurance Rights is operating an interim information technology system. However, there are two separate projects financed by the World Bank, in various stages of implementation for both the National House of Pensions and other Social Insurance Rights and

¹² This in effect means that employers' annual reporting of individualised (or even aggregate) data on employee wages or contributions to the relevant social insurance institutions has never been required.

the National Agency for Employment. As regards the National House of Health Insurance, it is developing a self-funded project.

2.3. The Extension of Mandatory Coverage

Law No. 19/2000 on the public system of pensions and other social insurance rights extended mandatory coverage to four major new groups of workers: the unemployed, individuals working on civil contracts,¹³ the self-employed, and farmers. The last three categories were mandatorily covered only when their income exceeded a prescribed threshold. See Box 1.

However, the mandatory coverage of the last group, farmers, was short-lived. Soon after enactment of Law No. 19/2000, this provision was repealed by an emergency ordinance, issued first by the government and then approved by Parliament, effective for 2003. This decision was taken after farmers resisted the new coverage requirement, and it was determined that the National House of Pensions had no effective means of enforcing it. Now the coverage of farmers under social insurance is again voluntary.¹⁴

¹³ A civil contract was a written agreement concluded for: (1) regular work not exceeding an average of three hours per day, or (2) work performed for landlords or tenants' associations. Persons employed under civil contracts were not entitled to unemployment benefits, were entitled to health benefits, and were entitled to pension benefits if (for the latter case only) their gross income in a calendar year exceeded three times the average monthly gross wage and if they were exclusively on a civil contract (if they had both a civil contract and an individual labour contract, they paid social insurance contributions and received social insurance benefits only from the employer with whom they had an individual labour contract). The new Labour Code required that all these contracts be converted to individual labour contracts (full-time or part-time), thus providing the holders with the full rights and benefits stipulated by the Labour Act, including social insurance.

¹⁴ A similar problem of enforceability exists for the mandatory coverage of the self-employed. However, no action has been taken as yet in response to it.

Box 1

Social insurance coverage in Romania under Law No. 19/2000

The following categories of persons were mandatorily covered under social insurance:

- persons employed with individual labour contracts and civil servants;
- persons in elected positions or appointed by the executive, legislative or judicial authorities, during their legal mandate, and also members of handicraft cooperatives, whose rights and obligations are assimilated to those of the employees;
- persons receiving unemployment insurance;
- persons whose gross incomes from one of the following categories in a calendar year are equivalent to at least three times the average monthly gross wage and are, according to circumstances:
 - a) unique partner, sleeping partner, shareholder or partner;
 - b) administrators or managers hired on administration or management contract terms; members in family partnerships;
 - c) authorised independent workers;
 - d) employees of international institutions, if not insured by the latter;
 - e) land and forest owners and/or tenants;
 - f) individual farm workers or private forest workers;
 - g) members of farming companies or of other forms of farming partnerships;
 - h) persons employed without an individual labour contract, in recognised religious institutions;
- persons whose cumulative gross incomes from two or more of the categories above in a calendar year amount to at least three times the average monthly gross wage; and
- persons whose gross income in a calendar year amounts to at least three times the average monthly gross wage and who are exclusively on a civil contract, with the exception of old age pensioners.

3. Contributions Bases, Rates and Techniques of Collection

For 2003, the contribution bases, rates, and techniques of collection are described below for five categories of scheme participants – employees, employers, the self-employed, farmers, and the unemployed. Contributions are paid separately

to three specialised agencies – for pensions, employment, and health – that maintain their own databases.

A. *Employees*

Employees owe three types of contributions: social insurance, unemployment and health contributions. All are calculated monthly, fully withheld, declared, and transferred by the employer to the appropriate territorial house (pensions, employment, health) in the area where its headquarters is located.

- (1) *Social insurance* – The contribution base is the individual's own monthly gross wage, including the fringe benefits stipulated by law or a collective labour agreement.¹⁵ The base is subject to a threshold and a ceiling: it cannot be less than the minimum monthly gross wage or more than five times the average monthly gross wage.

The employee contribution rate is set in the annual law on the state social insurance budget, and in 2003 is 9.5 percent.

- (2) *Unemployment insurance* – The contribution base is the individual's own monthly gross wage excluding fringe benefits (and thus differing from the social insurance base just described).

The unemployment insurance contribution rate is set by a separate law at one percent.

- (3) *Health insurance* – The contribution base is the individual's own taxable income (the same base for the personal income tax).

The health insurance rate is currently 6.5 percent of covered wages. Like the unemployment rate, it is set in a special law.

¹⁵ Excluded from the social insurance contribution base are: the social insurance benefits disbursed by the employer; the amounts paid in case of individual labour contract termination (with the exception of the amounts paid for preliminary notice); daily allowances, allowances for travel on business, transfer and posting; copyright benefits; the amounts received by the employees out of the employers' profit; and bonuses or other benefits excluded by special laws.

B. Employers

The employer must match each worker's contribution. The employer's contribution must be calculated monthly, declared, and paid to the appropriate territorial house.

- (1) *Social insurance* – The contribution base is the employer's total monthly gross wage bill, subject to a ceiling equal to five times the average monthly gross wage multiplied by the average number of insured persons working for that employer during the month.

The rate is set in the annual law on the state social insurance budget. It is the difference between the contribution rates for various working conditions (34 percent; 39 percent; 44 percent) and the rate paid by the employee.

- (2) *Unemployment insurance* – The contribution base is the employer's total monthly gross wage bill (no ceiling).

The rate is set by a special law at 3.5 percent.

- (3) *Health insurance* – The contribution base is the employer's total monthly gross wage bill (no ceiling).

The rate is set by special law at seven percent.

C. The Self-employed

Depending on their status, the self-employed may pay one, two, or three types of contributions: social insurance and/or unemployment insurance and (mandatorily) health insurance. Social insurance is mandatory for all self-employed individuals with incomes above a certain threshold; others may participate on a voluntary basis. Unemployment insurance, by contrast, is voluntary for all the self-employed.

- (1) *Social insurance* – Self-employed individuals with income in a calendar year equal to at least three times the average monthly gross wage must participate in social insurance. Their contribution base is the monthly insured income stated in the insurance declaration, subject to a threshold and a ceiling; it cannot be less than 1/4 and more than five

times the average monthly gross wage. Whether covered mandatorily or voluntarily, the self-employed owe the full social insurance contribution rate (that is, both employer and employee share) corresponding to the working conditions of their activity (34 percent; 39 percent; 44 percent). The self-employed pay contributions in response to bills calculated, certified, and mailed by the territorial house of pensions.

- (2) *Unemployment insurance* – The contribution base for this optional protection is the monthly insured income stated in the self-employed individual's unemployment insurance contract, which cannot be less than the minimum monthly gross wage. The self-employed rate is set by a special law at 4.5 percent. Self-employed persons pay the unemployment contribution monthly to the territorial employment agency in his or her area of residence.
- (3) *Health insurance* – The contribution base for this mandatory benefit is the self-employed individual's taxable income. The individual rate is set by special law at 6.5 percent. The self-employed pay the health contribution on a quarterly basis to the territorial health house.

D. Farmers

Farmers have the same social security status as self-employed persons with one major exception: effective in 2003, the mandatory coverage under social insurance of those with incomes above the threshold was repealed. Thus, today, both social insurance and unemployment insurance are optional for farmers. Only health insurance continues to be mandatory.

- (1) *Social insurance* – The contribution base is the monthly-insured income stated in the farmer's social insurance contract. This amount is subject to a threshold and ceiling which are the same as in the case of the self-employed: not less than 1/4 or more than five times the average monthly gross wage. Farmers who establish optional coverage are liable for the full social insurance contribution rate (that is, both employer and employee share) corresponding to normal working conditions. Farmers pay contributions in response to bills calculated, certified, and mailed by the territorial house of pensions.

- (2) *Unemployment insurance* – The contribution base for this optional protection is the monthly insured income stated in the farmer's unemployment insurance contract, which cannot be less than the minimum monthly gross wage. The individual unemployment insurance rate is set by a special law at 4.5 percent. Farmers pay the unemployment contribution monthly to the territorial employment agency in his or her area of residence.
- (3) *Health insurance* – For farmers whose income is exclusively from farming activity, the contribution base is based on their taxable income, that is, the identical definition of income used for personal income tax purposes. When their taxable income is less than the minimum monthly gross wage, the base is 1/3 of the minimum monthly gross wage. This may be viewed as a kind of social subsidy for farmers. The individual health contribution rate is set by special law at 6.5 percent. Farmers pay health contributions in quarterly installments.

E. The Unemployed

The unemployed are covered on a mandatory basis by social insurance and health insurance coverage. There is no coverage under unemployment insurance of the unemployed. Both mandatory coverages are financed by the unemployment insurance budget.

- (1) *Social insurance* – The contribution base is the amount of monthly unemployment benefits paid from the unemployment budget. The rate is that for normal working conditions, 34 percent. The territorial employment agency calculates and pays the contribution on a monthly basis.
- (2) *Unemployment insurance* – None.
- (3) *Health insurance* – The contribution base for the unemployed is the same as the social insurance base, described above. The individual health contribution rate is set up by special law and is 6.5 percent. The territorial health insurance agency calculates and pays the contribution on a monthly basis.

As can be observed, there are many legislative similarities among the social insurance, unemployment, and health contributions for insured persons, as well as among the contributions bases and techniques of collection. This is not the case with personal income tax. The main differences between contributions for employees and the personal income tax are described below:

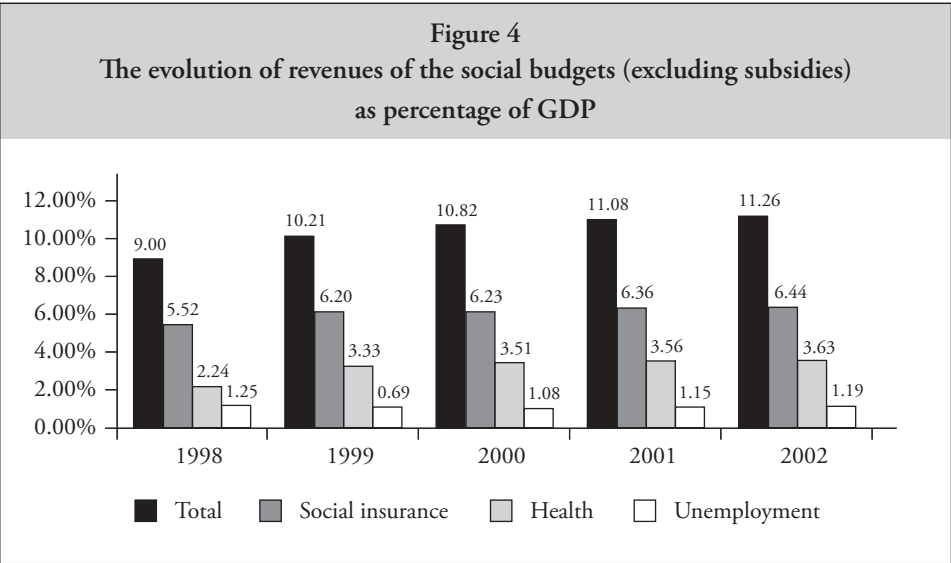
Table 1
The principal differences between the contributions for employees and Personal Income Tax in Romania

Criterion	Contribution	Personal income tax
Function	Insurance	No insurance
Contribution base	Total gross wage Total monthly gross wage bill Ceilings for social insurance	Income reduced by legal personal deductions No ceiling
Rate	Fixed	Progressive in order to protect the persons with small incomes
Technique of collection	Part withheld from the employee's monthly gross wage, declared monthly and transferred by the employer; and part declared monthly and paid by the employer	Paid in advance monthly by the persons themselves with annual regularisation on the basis of employee's and employer's income tax returns that allows for cross-checking

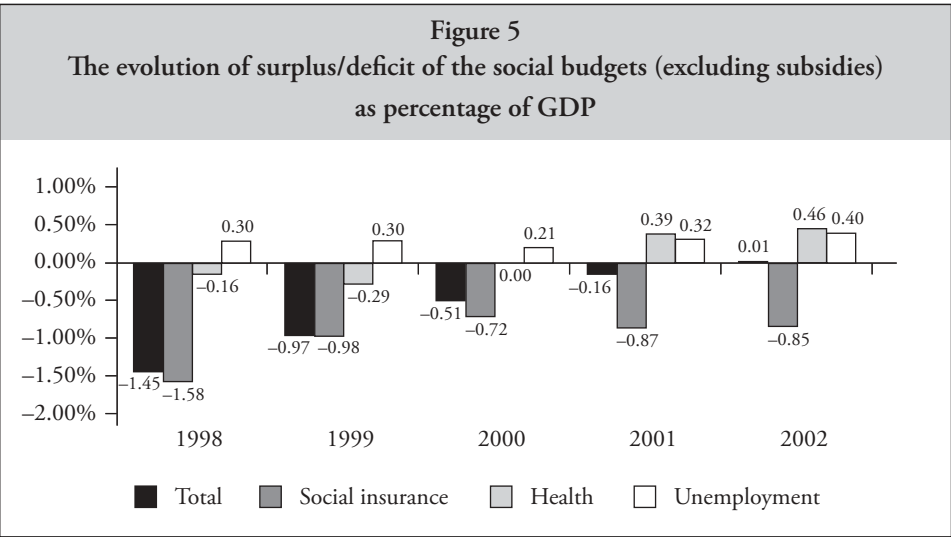
4. Measures of Effectiveness of Contributions Collection

4.1. *The Financial Balance of the System*

The financial performance of the state social insurance, unemployment and health budgets during 1998–2002 are presented in Figure 4 and Figure 5.



Source: Author's own calculations based on statistics from the National House of Pensions and other Social Insurance Rights, National Agency for Employment, National House of Health Insurance, and National Institute for Statistics.

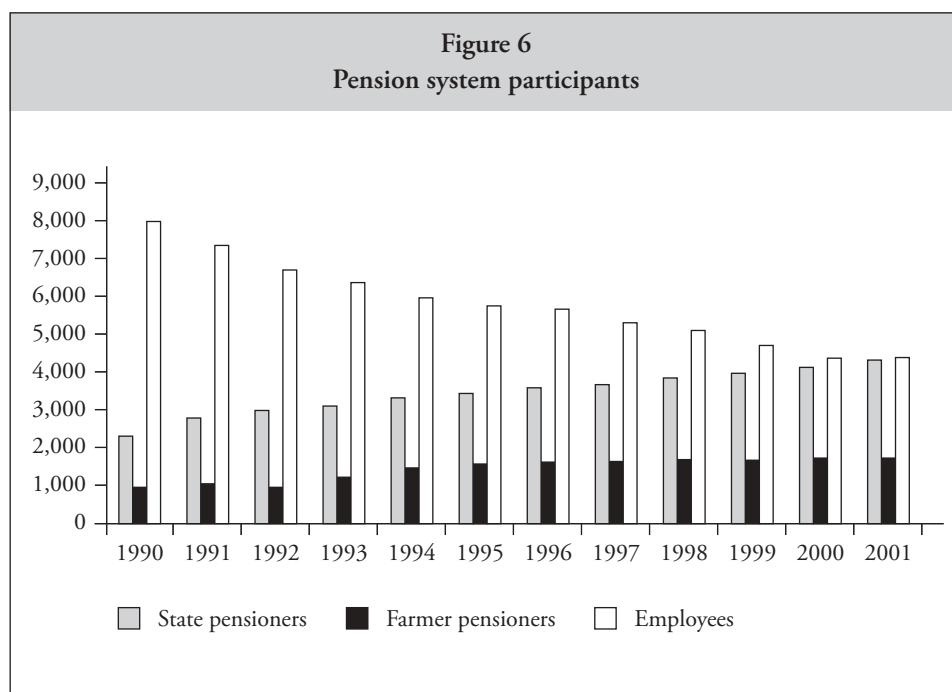


Source: Author's own calculations based on statistics from the National House of Pensions and other Social Insurance Rights, National Agency for Employment, National House of Health Insurance, and National Institute for Statistics.

4.2. Contributors and Beneficiaries

During the transition decade, the social insurance system was used as a mechanism to absorb redundant labour. Although the legal retirement age was 62 and 57 for men and women, respectively, before the reform, workers who had fulfilled the entire length of service required by law could retire five years earlier with no penalties. The number of disabled persons receiving benefits also increased due to lax rules and workers claiming disability as a means to cope with high unemployment. The total number of beneficiaries from state and farmers' schemes rose from 3.4 million in 1990 to 6.2 million in 2001. During the same period, the number of insured persons nearly halved from 8.2 million in 1990 to 4.5 million in 2000 and 2001.

The social insurance beneficiaries and main groups of active insured persons are shown in Figure 6.



Source: National House of Pensions and other Social Insurance Rights, National Institute for Statistics.

A dramatic decline in the number of contributors can be observed. Its major causes were an increased number of self-employed, growth of the informal sector, and increased unemployment.

Change over time in the number of mandatory contributors in the social insurance system, as well as persons in employment and unemployment, is presented in Table 2.

Table 2
Number of mandatory contributors in the Romanian Social Insurance System and persons in employment and unemployment (thousands)

Year	Employees	Self-employed including farmers	Total	Persons in employment*	Persons in unemployment
1990	8,156	—	8,156	10,840	0
1991	7,574	—	7,574	11,123	337
1992	6,888	—	6,888	11,387	929
1993	6,544	—	6,544	11,226	1,164
1994	6,133	—	6,133	11,234	1,223
1995	5,884	—	5,884	10,491	998
1996	5,759	—	5,759	10,036	657
1997	5,416	—	5,416	9,904	881
1998	5,187	—	5,187	9,838	1,025
1999	4,777	—	4,777	9,550	1,130
2000	4,456	—	4,456	9,636	1,007
2001	4,502	53	4,561	9,556	826

Source: Author's own calculations based on statistics from the National Institute for Statistics, National House of Pensions and other Social Insurance Rights.

* Includes employees (that is, column 1), self-employed and farmers (column 2), and others who are active in work (e.g., persons with part-time contractual work).

The policy of the Social Democratic government elected in 2000 was to reduce the level of subsidies allocated to the state social insurance budget and to increase the collection of revenues, as shown in Table 3.

Table 3
The evolution of the financial indicators of the state social insurance budget
as percentage of Romanian GDP

Year	1998	1999	2000	2001	2002
Own Revenues	5.52	6.20	6.23	6.36	6.44
Subsidies	0.73	0.75	0.14	0.25	0.17
Total Revenues (own revenues + subsidies)	6.25	6.95	6.37	6.61	6.61
Expenditures	7.10	7.18	6.95	7.23	7.29
Deficit	0.85	0.23	0.58	0.62	0.68

Source: Author's own calculations based on statistics from the National House of Pensions and other Social Insurance Rights, National Institute for Statistics.

It can be observed that the allocated subsidies did not cover the deficits. But the social security laws stipulated explicit government liabilities, with the government performing the role of a financial guarantor. This is why the deficits of the social security schemes were finally covered by the state budget. Thus, the figures presented above do not tell the final story, but only show the government's initial allocation of subsidies to the funds for these years.

In 2001, the National House of Pensions forecasted that, as a result of Law No. 19/2000, mandatory coverage would expand to 1.1 million self-employed and farmers and 0.5 million persons working exclusively with a civil contract and to the unemployed. The forecasted figures, used to justify the budget, proved unrealistic. Only 45,000 self-employed and 8,500 farmers registered with the system. The phenomenon of non-registration continues to be very pervasive.

4.3. Contributions Collected and the Effectiveness of Collection Efforts

Tables 4, 5, and 6 show contributions collected, average amounts of contributions paid for each insured person, and the estimated covered wage bill as percentage of GDP.

Table 4
Contributions collected in the Romanian mandatory social insurance system
(billion ROL)

Year	Employees	Self-employed including farmers	Unemployed	Total
1990	63	—	—	63
1991	184	—	—	184
1992	519	—	—	519
1993	1,446	—	—	1,446
1994	3,022	—	—	3,022
1995	4,376	—	—	4,376
1996	6,296	—	—	6,296
1997	12,746	—	—	12,746
1998	19,182	—	—	19,182
1999	31,096	—	—	31,096
2000	45,982	—	—	45,982
2001	66,796	503	990	68,289

Source: Author's own calculations based on statistics from the National House of Pensions and other Social Insurance Rights.

In 2001, only a small minority of self-employed and farmers paid contributions from the minimum contribution base. The rest declared higher incomes. About 600 self-employed and 2,700 farmers paid contributions from the minimum base (ROL 1,037,163).

Large increases in the social insurance contributions' rates were imposed in 1991 and 1992, as well as in 1999. Set against the background of the substantial diminishing of the number of contributors, these rates may have contributed to the observed diminution of the covered wage bill. Starting with 2000, we note an ascending trend of the estimated covered wage bill as percentage of GDP. The positive trend was mainly the result of the improved collection through enforcement measures and debt repayment arrangements.

While in 1998 the enforcement measures and debt repayment arrangements amounted to only 0.08 percent of GDP, in 2001 they accounted for 0.44 percent of GDP. Another factor may be the determination of the Social Democratic government to reduce the contribution rates and implicitly to stimulate the transition to the formal sector as well as the increase of wages in real terms. In 2003, the government continued to reduce the contribution rates and also raised the wage bill ceiling (as previously explained, from three to five times the average monthly gross wage, multiplied by the number of workers employed). It is expected that the overall effect of these measures will be an increase in contribution revenues.

Table 5
Average amounts of contribution paid for each insured person, Romania
(thousand ROL)

Year	Employees	Self-employed including farmers	Unemployed
1990	8	—	—
1991	24	—	—
1992	75	—	—
1993	221	—	—
1994	493	—	—
1995	744	—	—
1996	1,093	—	—
1997	2,353	—	—
1998	3,698	—	—
1999	6,510	—	—
2000	10,319	—	—
2001	14,837	9,428	1,651

Source: Author's own calculations based on statistics from the National Institute for Statistics, National House of Pensions and other Social Insurance Rights.

Table 6
The estimated covered wage bill as percentage of Romanian GDP

Year	Joint contribution rate (employer + employee) in %	Contribution revenue collected for employees (billion ROL)	GDP (billion ROL)	Estimated covered wage bill (as % of GDP)
1990	17	63	858	42.51
1991	23	184	2,204	36.30
1992	28.50	519	6,029	30.20
1993	28.50	1,446	20,036	25.32
1994	28.50	3,022	49,773	21.30
1995	28.50	4,376	72,135	21.29
1996	28.50	6,296	108,919	20.28
1997	28.50	12,746	252,925	17.68
1998	28.50	19,182	373,798	18.01
1999	37.50	31,096	545,730	15.19
2000	37.50	45,982	800,308	15.32
2001	36.50	66,796	1,154,126	15.86
2002	36.50	87,942	1,471,395	16.37

Source: Author's own calculations based on statistics from the National Institute for Statistics, National House of Pensions and other Social Insurance Rights. The joint contribution rate is an average rate of employer rates specific to working conditions and employee rate.

4.4. *Enforcement Capacity*

Despite these initiatives, limited enforcement capacity remains a critical problem. In 2002, this activity was performed by only 461 social insurance and unemployment contribution inspectors, responsible for almost 500,000 employers, according to statistics from the Labour Inspection. This means that, on average, one contribution inspector was responsible for 1,000 companies. At the same time, at the level of the Ministry of Public Finances, one tax inspector was in charge of inspections for taxes owed by 100 companies.

Taking into consideration that one contribution inspector can perform on average 50 inspections per year and that the statute of limitations on an inspector's right to challenge the legality of contributions payment is five years, almost three-quarters of the companies remained beyond the reach of the inspection process.

These issues will be returned to in Section 6.

5. Evasion and Non-compliance

5.1. *Evasion and Non-compliance by Employers*

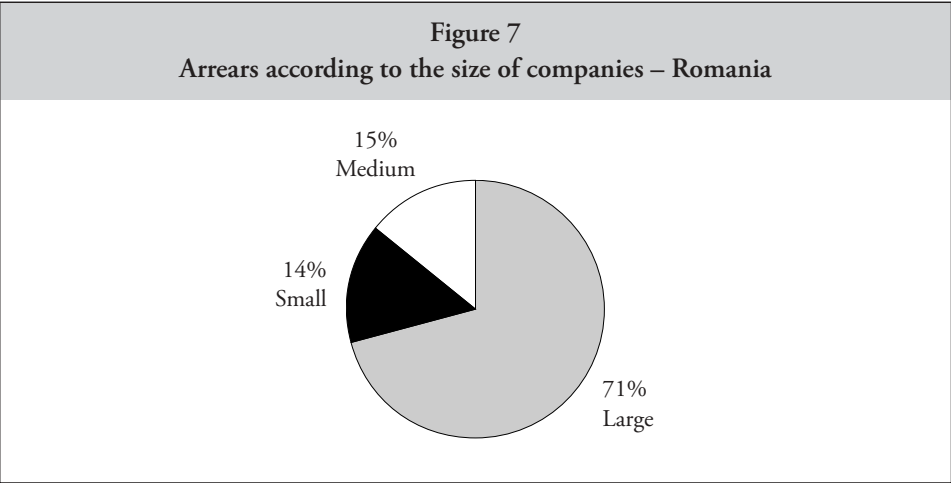
As described previously, employers are required by law to register an individualised declaration with the territorial house of pensions. The first such declaration also serves as the registration of the employees of that employer in the social insurance system.

The failure of employers to register all their workers is a problem in Romania, as shown by the work of the Labour Inspection. When the new Labour Code took effect on March 1, 2003, there were 1.6 million civil contracts that should have been converted to part-time individual labour contracts.¹⁶ This conversion was required by the new Code. From the perspective of social

¹⁶ A civil contract was a written agreement concluded in the following cases: (1) regular work not exceeding an average of three hours per day, or (2) work performed for landlords or tenants' associations. Persons employed under civil contracts were not entitled to unemployment benefits, were entitled to health benefits, and were entitled to pension benefits if (for the latter case only) their gross income in a calendar year exceeded three times the average gross monthly wage and if they were exclusively on a civil contract (if they had both a civil contract and an individual labour contract, they paid social insurance contributions and received social insurance benefits only from their employer with whom they had an individual labour contract). A person employed under an individual labour contract becomes an employee and is entitled to such rights and obligations as specified by labour law, collective labour agreements, and the individual labour contract itself.

security coverage, it aimed to achieve the same outcome as the provision of Law No. 19/2000 which extended coverage to certain workers on civil contracts, that is, mandatory coverage of these individuals. However, six months later, only 100,000 civil contracts had been converted. Thus, the problem of non-compliance remains large.

However, the most common form of non-compliance is not the failure to register but rather the non-payment, underpayment, or late payment of contributions for registered workers.¹⁷ This assessment is the result of the author's analyses of indebted companies, inspected up to July 2003. The analysis focused on the distribution of social insurance arrears according to company size, the nature of their share capital, and their business activity. The distribution of the arrears is presented in Figures 7, 8 and 9.



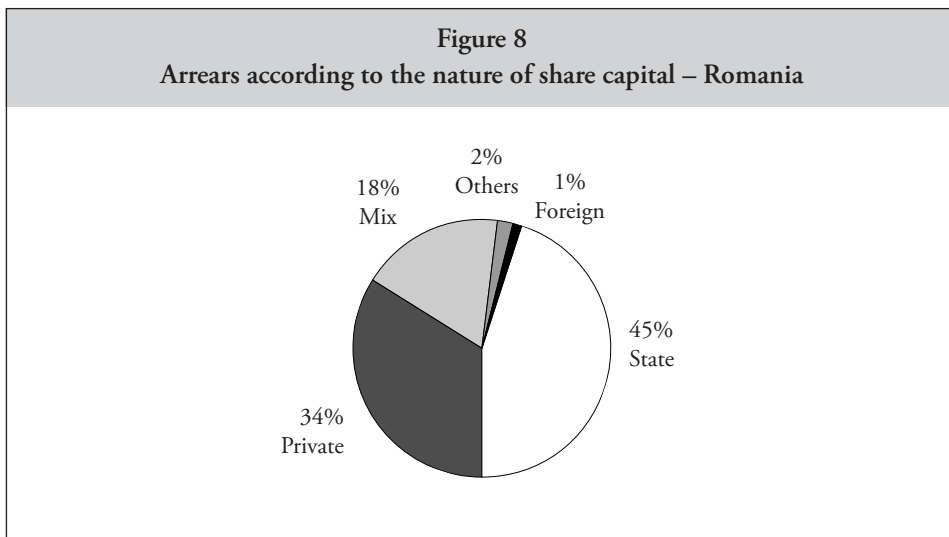
Source: Author's own calculations based on statistics from the Ministry of Labour, Social Solidarity and Family – Control Division.

In the above chart, large companies have more than 250 employees, medium companies have between 50 and 250 employees, whereas the small ones have 50 or fewer employees. As can be observed, large companies account

¹⁷ Because the self-employed can choose their own contribution base, their failure to pay contributions on their entire income is not treated as non-compliance. See Section 5.2.

for over 70 percent of arrears. The large companies are mainly state-owned and dependent on subsidies, which they use mainly for paying wages.

Figure 8 shows clearly that state-owned companies are the major debtors, as is the case in many Eastern European countries.

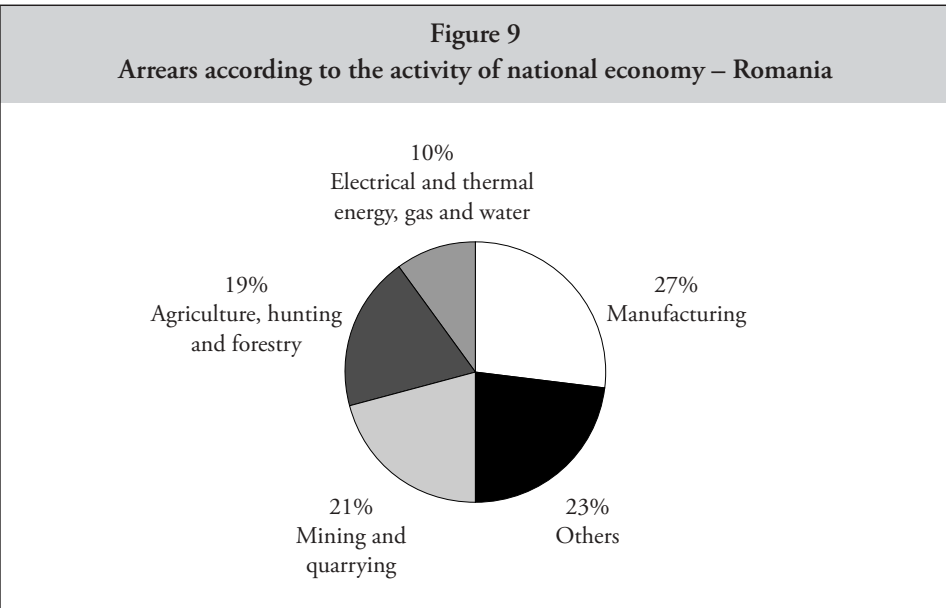


Source: Author's own calculations based on statistics from the Ministry of Labour, Social Solidarity and Family – Control Division.

Punitive measures against state debtors, such as fines or criminal prosecution, have no real impact because the companies are usually financially constrained to subsidies – so that the managers can easily plead not guilty. For the private sector, the situation is different and the fines or criminal prosecution take effect.

Current law provides the authority for enforcement action against all kinds of contributors. For both state-owned companies and private firms, the freezing of accounts is the most commonly used procedure. In 2001, 97 percent of recovered social insurance arrears came by channeling the inflows of the firm's bank account into the state social insurance budget.

As may be observed in Figure 9, mining accounts for 21 percent of total arrears, followed by agriculture, hunting and forestry with 19 percent, whereas electrical and thermal energy, gas and water account for 10 percent. Together these sectors account for 41 percent of total employment.



Source: Author's own calculations based on statistics from the Ministry of Labour, Social Solidarity and Family – Control Division.

The mining industry is a particularly difficult one to tackle in all countries, from both the economic and social point of view. Nevertheless, for all privatising companies, the government envisaged increasing the pace of privatisation by reviewing their debts.

In this respect, for the state-owned companies in the agricultural sector, the law provides for a write-off of contributions, interest, and penalties when the firm is being privatised.

Non-compliance of the large, mostly state-owned companies is not only a problem of the past. This is demonstrated by an analysis of the payment of current social insurance contributions in the first quarter of 2003. At the national level, the largest 420 debtors to the state social insurance budget paid only 46 percent of the employer's contribution and 75 percent of the employee's contribution. These are mainly, but not exclusively, state-owned companies. All other companies that declared social insurance contributions to the territorial houses of pensions paid 91 percent of the employer's contribution and 100 percent of the employee's contribution. The largest 420 debtors account for almost 60 percent of the total arrears.

Contribution collection agencies generally take part in bankruptcy procedures initiated by other creditors of indebted companies.

The impact of non-compliance on the rights of employees differs depending on the insured risk. For social insurance and unemployment, non-compliance affects the contributory periods that determine a worker's eligibility for a benefit, whereas in the health system, it affects the right to the basic medical services package.

Based on Law No. 19/2000 as it was originally enacted, contributory periods for social insurance were counted by adding up the months when contributions were paid by both the employee and employer. If the employee paid the contribution but the employer did not, the contributory period taken into account represented only one-third of the respective month. However, after amendments to the law, starting from July 2002, the contributory period is determined by adding up the periods when the contributions are owed (but not necessarily paid) by both employer and employee.¹⁸ This change violates the contribution principle on which the 2000 reform was based. The lack of any links between contributions paid and benefits received stimulates non-compliance. The original rule, which counts contributory periods only when social insurance contributions have been paid, remains valid only for the self-employed, thus discriminating against this group relative to employees.

In the unemployment system, the contributory period is the period when the contribution was paid by both the employee and employer. Such periods are also counted when the employer does not pay a contribution but is under enforcement, judicial restructuring, bankruptcy, operational closure, or liquidation, or if the employer fails to pay because of a force majeure.

In the health system, the non-payment of health contributions by either the employer or the employee causes a restriction of the basic medical service package.

¹⁸ This amendment was adopted due to trade union opposition to the more stringent rule for counting contribution periods.

5.2. Evasion and Non-compliance by the Self-employed

The self-employed enter the social insurance system by registering an insurance declaration at the territorial house of pensions. However, the rate of registration is extremely low. This can be explained in part by the lack of a public awareness campaign, but also by the high contribution rates that the self-employed must pay and by myopia on their part. In addition, as explained above, they are now subject to a more stringent rule for the crediting of contributory periods. Given these disincentives, it is certain that the failure of this category to secure its retirement will make it a high-risk group for poverty in the future.

The underreporting of earnings by the self-employed does not constitute evasion for the social insurance and unemployment systems, in the sense that the insured person is entitled to stipulate in the insurance declaration his or her monthly-insured income. The only condition is that it has to be within the minimum and maximum limits set by law. Thus, in effect, the self-employed have the ability to choose their contribution base within these limits. The situation is different in the health system, where taxable income must be stipulated in the declaration. This is defined in the same manner as under the income tax law. In this situation, the self-employed face criminal liability for underreporting.

The contribution collection agencies are authorised to take punitive measures against cases of non-compliance. However, the high costs of debt recovery means that this course of action is seldom used.

Non-compliance produces different effects on the social security rights of the self-employed, depending on the insured risk.

In the social insurance system, the contributory period is established by adding up the periods when the insured person both owed and paid contributions. The linkage of the actual payment of contributions to eligibility for benefits constitutes a major difference compared to the more favourable treatment of employees, as already described.

In the unemployment system, the contributory period is one in which the insured person actually paid an unemployment contribution.

In the health system, the non-payment of health contributions by the insured person leads to the diminution of the basic medical services package, in the same manner as described above for employees.

5.3. *The Problem of Arrears*

Data on the accumulation of total outstanding debt, including both contributions and interest, is provided in Table 7.

Table 7
Total outstanding debt as percentage of social insurance contributions collected
and as percentage of Romanian GDP

Year	Debt as percentage of contributions collected	Debt as percentage of GDP
1998	54.36	3.00
1999	81.93	5.08
2000	132.35	8.25
2001	102.90	6.54
2002	96.14	6.19

Source: Author's own calculations based on statistics from the National Institute for Statistics, National House of Pensions and other Social Insurance Rights.

The owed contributions are revalued periodically by law. Changes over time in interest rates on social insurance debt is shown in Figure 10.

Before 1998, the pace of arrears' increases was insignificant.

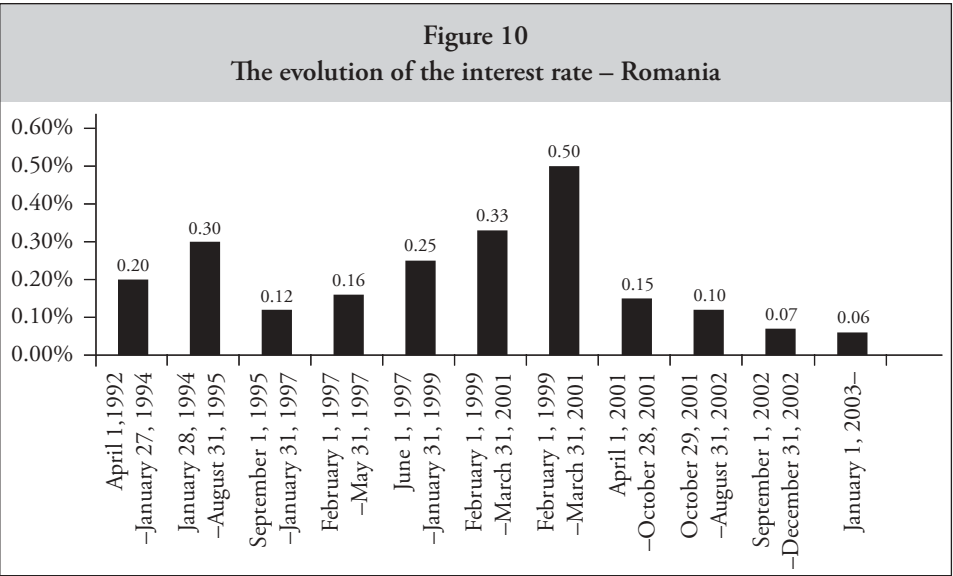
After 1998, arrears rose steadily due to a series of factors, reaching a high of 8.25 percent of GDP at the end of 2000. These factors were:

- the removal of a ceiling on the total interest owed;¹⁹
- the introduction of a new algorithm for calculating debts;
- increasing interest rates; these reached a maximum between February 1999–March 2001 when the interest rate was set at 10 percent of the amount owed if the payment was made within 30 days of settlement, and 15 percent of the amount owed for each month or fraction thereof if the payment was made more than 30 days after settlement; and
- a decrease in financial discipline during 1996–2000, when a decline in economic activity followed a superficial restructuring of industrial sectors.

¹⁹ Until 1996, when the new law on administrative enforcement of budgetary debts went into effect, the total amount of interest owed was subject to a ceiling. It could not exceed the social insurance contribution principal.

Starting with 2001, the Social Democratic government took three types of actions to reduce arrears:

- lowering interest rates to reflect reduced inflation;
- strengthening enforcement measures; and
- granting debt repayment arrangements.



Source: Author, based on government decisions.

Note: Between February 1999–March 2001 the interest rate was set at 10 percent of the amount owned if the payment was made within 30 days of settlement (equivalent to 0.33% /day), and 15 percent of the amount owned for each month or fraction thereof if the payment was made more than 30 days after settlement (equivalent to 0.5% /day). Therefore, the interest rate varied significantly according to the “guilt” of the non-compliant contributors.

Under the law, those who fail to pay contributions owe both interest and penalties. The interest rate is set by government decision, based on a proposal by the Ministry of Public Finance and taking into account the Romanian National Bank reference interest rate. It is set once a year in December, for the next year, and may be changed during the year if it is modified by more

than five percentage points. The level of the penalties can be modified by government decision, based on a proposal by the Ministry of Public Finance. For 2003, interest rates were reduced to 0.06 percent for each late day, i.e. around 22 percent annually. Penalties, having a punitive function, are calculated at 0.5 percent for each late month and/or fraction of a month, i.e. 6 percent annually.

In addition to enforcement measures that may be initiated by the contributions collection agencies, it is possible for the agencies to enter into arrangements for debt repayment. They are entitled to grant deferral of payment of contributions and deferral and/or reduction and/or cancellation of interest payments. There is a legislative framework for drawing up such arrangements, which is applied to taxes as well as contributions. Its main purpose is to encourage both current contribution payment and debt recovery.

The legislation lays out objective financial and economic criteria for a company wishing to apply. Eligibility is barred for companies engaged in the organisation of games of chance and debtors condemned for tax evasion, as well as debtors that withheld the employees' social contributions and failed to transfer them.

According to the score that the company achieves, it will receive shorter/longer grace periods, deferment of contribution payments, and deferment/reduction/cancellation of interest payments.

The debtor owes interest on deferred contributions, but it does not owe a penalty. These penalty and debt reductions or cancellations represent the state aid conferred to debtors.

Once an arrangement for debt repayment is granted, enforcement measures are halted, but at least one inspection must be performed annually in order to verify fulfillment of obligations. Debtors are obliged to submit a letter of guarantee and to pay current contributions. During the deferral process, debtors may not participate in any privatisation organised by specialised public institutions or privatisation agencies.

The statute of limitations on an inspector's right to challenge the legality of contributions is five years.

6. Improving Compliance

The Social Democratic government of Romania has proven to be strongly committed to balancing social security contributions and outlays, based on better collection of revenue, stronger financial discipline, and a restrictive policy on debt repayment arrangements. The most important measures for improving compliance are as follows:

6.1. Reducing Contribution Rates

There is strong evidence that high contribution rates foster evasion. In order to break the vicious circle of higher contribution rates and higher evasion, the government proposed and the Parliament approved for 2003 a total reduction of social security contributions of five percentage points. The reduction of the contribution rates for employees is presented in Table 8. Starting with 2003, the employer also pays a contribution of 0.5 percent for the setup of the initial fund for employment injuries and occupational diseases.

Table 8 Reduction of contribution rates in Romania for workers and employers						
Type of insurance	Total (%)		Employer (%)		Employee (%)	
	2002	2003	2002	2003	2002	2003
Social insurance:						
Very arduous	45	44	33.33	34.5	11.67	9.5
Arduous	40	39	28.33	29.5	11.67	9.5
Normal	35	34	23.33	24.5	11.67	9.5
Unemployment	6	4.5	5	3.5	1	1
Health	14	13.5	7	7	7	6.5
Handicapped	2	0	2	0	0	0
Work injuries	0	0.5	0	0.5	0	0
Total	57	52.5	37.33	35.5	19.67	17

Source: Author's calculations based on the relevant social security laws.

The reductions for self-employed and farmers are shown in Table 9. The total reduction of the contribution rates for these contributors was 2.5 percentage points.

Table 9
Reduction of contribution rates in Romania for self-employed and farmers

Type of insurance	Self-employed		Farmers	
	2002	2003	2002	2003
Social insurance:				
Very arduous	45	44		
Arduous	40	39		
Normal	35	34	35	34
Unemployment	6	4.5	6	4.5
Health	6.5	6.5	6.5	6.5
Total	47.5	45	47.5	45

Source: Author's calculations based on the relevant social security laws.

6.2. *Preventing Moral Hazard*

Measures to reduce or cancel outstanding debts induce moral hazard on the part of contributors to the social security system. They also provide a negative signal to companies that they can expect a cancellation of their debts and thus encourage them not to pay their current contributions.

With a view to eradicate this phenomenon, the government issued an ordinance that, starting with 2004, it will not grant new debt repayment arrangements, except for firms being privatised.

6.3. *Conditioning the Access of Contributors to Governmental Contracts upon Debt Payment*

In 2001, the government conditioned the access of companies to governmental contracts upon certification that they have paid social contributions. To this end, according to the law, any candidate/bidder that did not pay social contributions was excluded from a public tender procedure.

6.4. Enhancing the Institutional Framework for Collection of Social Security Contributions

In February 2002, the Ministry of Labour and Social Solidarity decided to unify the controlling bodies of the National House of Pensions and other Social Insurance Rights and of the National Agency for Employment that are under its coordination.

The Ministry set a goal of “zero tolerance for fraud.” To this end, a special law on enforcement of the requirements for social insurance and unemployment contributions was enacted. It sought to make the rules for these inspections consistent with the ones regulating tax inspections. Special procedures were established to provide for the flow of information between the unified control and the enforcement bodies within the two agencies. A protocol was signed with the Ministry of Public Finance on performing joint inspections for contributions and taxes to prevent duplication and reduce bureaucracy. In order to monitor cases of non-compliance rigourously, a special electronic register was created at the level of the unified controlling body. It contained the results of inspections previously performed, as well as information on the employees’ membership in trade unions. It was hoped that informing the trade unions about the debts of the companies where their members were employed would lead trade unions to pressure the debtors in order to improve compliance. Actions were also taken to standardise and computerise the inspections with a view toward reducing the possibilities for corruption of inspectors.

These actions were the first steps in the process of enhancing the institutional framework, with a single collection agency envisaged.

Key among the strategic reform objectives in managing public revenues, adopted by the Ministry of Public Finance for 2002–06, is the establishment of the National Agency for Fiscal Administration.

To this end, the government decided to set up the National Agency for Fiscal Administration in January 2004 to be overseen by Ministry of Public Finance.

By establishing this agency, the Ministry of Public Finance wants to:

- improve the management system by unifying all the functions of fiscal administration in a single entity – registration, declaration, collection, control, claims solving and the related support functions;

- increase the level of public trust in the fiscal administration system by a larger degree of transparency; and
- ensure human resources needed to fulfill the agency's objectives.

Beginning with this same date, the new agency will assume from the Ministry of Labour, Social Solidarity and Family and from the Ministry of Health the task of collection of contributions from employers and employees: social insurance, unemployment insurance, health insurance, and fund for employment injuries and occupational diseases. Collection of contributions from the self-employed and from farmers will remain with the respective ministries.

The objectives of this change are to:

- increase the collection rate of social contributions;
- eliminate parallelisms in managing budgetary revenues;
- unify administrative procedures for collecting all contributions and harmonise them with the procedures used to manage the state budget revenues;
- increase the compliance rate;
- treat contributors more consistently; and
- reduce the burden of making declarations for contributors.

Inspections to control for compliance with social contributions were taken over by the Ministry of Public Finances in October 2003.

7. Recommendations

It is imperative that all reform measures are devised with the goal of strengthening the social protection of workers. From this perspective, the new institutional framework for the collection of social contributions should provide needed improvements. At the same time, the following actions should help to make this new process smoother:

Reforms must be responsive to both employers' and workers' needs.

Important reforms, such as those relating to the collection of social contributions, require prior consultation with the social partners. Social security is a

basic human right, and representatives of civil society must be convinced of the necessity and fairness of reforms, in order to avoid resistance and distortions.

Therefore, the Social and Economic Council, whose advisory opinion should be taken into account, must always play an important role in the reform process.

Establishing tripartite management of the National Agency for Fiscal Administration would also provide a role for trade unions and employers' organisations as "social partners" in achieving common goals.

Reforms Are Always Achieved by People

With a view to increasing the efficiency of the new agency, qualified, trained and specialised civil servants are needed. The need for specialisation must be underlined, especially in the field of inspections, due to the complexity of the legislative framework. A well-motivated staff would lower the potential for corruption.

Reforms Must Always Be Achieved for People

Protection of Employees' Rights

According to current regulations, beginning in January 2004, the collection of employees' social contributions will be performed by the new agency. It will also keep national records of all the employers and their outstanding contributions. However, the national records of the employees will continue to be kept by the National House of Pensions and other Social Insurance Rights, the National Agency for Employment, and the National House of Health Insurance. These agencies will continue to certify contributory periods and pay social security benefits based on employers' individualised declarations. Nevertheless, it is not yet specified that these individualised declarations will be the focus of an inspection, nor that any errors found in the course of the inspection will be automatically passed on to the benefit agencies so that corrections can be made. This creates a possibility for wrong calculations of benefits, wrong periods of benefit payments, and late payments that could lead to a mistrust of the employees in the social security schemes.

In order to avoid these shortcomings, the new collection agency and the agencies that pay benefits should develop an effective flow of information and update the databases to reflect the findings of inspections. Special attention should also be given to these findings in order to improve legislation.

Account should also be taken of the great need for social security benefits and the enormous importance that people attach to them. They are targeted to a large number of beneficiaries, thus having an important social and political impact. They are also recurrent, paid on a monthly basis, and thus create a great dependency by the beneficiaries.

To this end, the new agency should allocate at least the same priority, time and human resources to the collection of contributions as for taxes. As demonstrated earlier, there is currently a great imbalance in the resources devoted to these two collection activities. If properly implemented, unified collections provide an opportunity to address this imbalance.

Employers will submit individualised declarations of the insured persons to the payers of benefits. They will also submit the fiscal declaration to the new agency.

The preservation of the former individualised declarations might create a perception of excess bureaucracy or even suggest that the individualised declarations are useless.

In this respect, a public awareness campaign for the new regulations is needed.

Protection of the Rights of Self-employed and Farmers

Beginning in January 2004, the collection of employees' social contributions will be performed by the National Agency for Fiscal Administration, whereas the collection of social contributions for self-employed and farmers will continue to rest with the National House of Pensions and other Social Insurance Rights, the National Agency for Employment and the National House of Health Insurance. In these conditions it is possible that the confidence of the self-employed in the ability of these institutions to identify those who are under mandatory coverage and enforce compliance, might drop radically.²⁰

²⁰ As explained previously, farmers are now again voluntarily covered; and self-employed are voluntarily covered if their earnings are below the threshold, mandatorily covered if they are above it.

Therefore, the National House of Pensions and Other Social Insurance Rights should focus intensively on enforcing the mandatory coverage of those self-employed with income above the threshold and encouraging greater voluntary participation by farmers and the remaining self-employed. The National Agency for Employment should concentrate on encouraging greater voluntary participation of self-employed and farmers while the National House of Health Insurance should focus on the mandatory coverage of self-employed and farmers.

More Reforms? More Economies of Scale?

The establishment of a single social security contribution, levied on both the employer and the employee, by uniting the existing social contributions could be a useful next step in the ongoing reform process.

A single rate for employers would discourage the current practice by some of paying only some selected contributions, usually the ones with lower rates. The establishment of only two rates, two bases of calculation, and one declaration would reduce bureaucracy and provide greater economies of scale. The establishment of legal quotas for allocating the collected revenues to each of the social security systems would remove the suspicion of a preferential allocation. Also, it would be useful to establish a reserve fund that could be used to address special situations, such as unexpected deficits which arise during the budgetary cycle.

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Chapter 7

The Collection of Pension Contributions in Slovenia

Karmen Vezjak

Tine Stanovnik¹

1. A Brief and Recent History of the Pension System and the Contribution Collection System in Slovenia

1.1. *The Pension System*

The pension system in Slovenia is quite monolithic, as the Institute for Pension and Disability Insurance (IPDI) is the single institution responsible for the public pension system. It includes all groups of active persons – employees, self-employed, and farmers as well as a group of voluntarily insured persons. It disburses various types of benefits: old age pensions, disability pensions, survivors pensions, pension income supplements, and various benefits associated with disability or physical impairment.² This unified structure has been in place since 1984, when the pension scheme for farmers was integrated into the general system.

Following independence in 1991, Slovenia rushed to enact its own social insurance laws. Thus, in 1992 the Pension and Disability Insurance Act (PDIA) was passed. This act slightly tightened eligibility and entitlement conditions for pensioning, by gradually increasing the retirement age and somewhat

¹ Both authors would like to thank Katka Prevolnik Rupel for research assistance.

² Pension income supplements are a social assistance measure.

restricting possibilities for early retirement. The tightening of conditions was somewhat late in the day, as the massive inflow of early retirees into the system already occurred in 1990 and 1991 (and the beginning of 1992).

The pension reform, enacted by the Pension and Disability Insurance Act of 1999, introduced further very important changes in the system. It increased the severity of entrance conditions, i.e. conditions for pensioning, and decreased pension entitlement conditions (mainly by decreasing accrual rates) for the first, public, pillar. The 1999 PDIA also introduced significant tax incentives for the second pillar. Although a small part of the second pillar also covers mandatory insurance (for about 26,000 persons working in more hazardous and arduous occupations), second pillar institutions are mostly about voluntary insurance – be it collective or individual. Membership in the second pillar pension funds is quite high: as of September 30, 2003 some 200,000 persons were enrolled, or about 25 percent of all insured persons within the first public pillar.³ Because of strong tax incentives – premiums are exempt from corporate income tax, social security contributions and personal income tax – the employers are strongly motivated to enrol their employees in collective pension schemes. Individual pension schemes are rare, since premiums paid by individuals are exempt only from personal income tax. Preparations are well under way for employees of the public sector to join these pension schemes, which will result in a further large increase in membership and will most likely approach 50 percent of all persons insured in the first pillar, by the end of 2004.

While it is premature to pronounce a definite judgement on the success of the reform, there are a number of encouraging signs. Thus, the average age at retirement has been increasing and in 2002 was 59 years and 11 months for men, a considerable improvement from the low value of 56 years and 2 months in 1992. The retirement age for women has also increased, and in 2002 was 55 years and 6 months. Since the reform, the ratio between the average (net) old age pension and average net wage has been decreasing and in 2002 amounted to 72.8 percent, its lowest value since 1990.

³ Pogačar, P. (2004). *Nacionalna strategija Slovenije na področju pokojninskega sistema v okviru Odprte metode koordinacije*.

All this points towards the short- and medium-term financial sustainability of the pension system. However, much depends on the ability of the system to collect sufficient revenues; that is why the contribution collection system is quite important: pension reform without improved compliance will do little in improving the overall performance of the pension system.

1.2. The Financial Balance of the Pension System

The pension system remained roughly in financial balance, in spite of large increases in pension expenditures. Up to the mid-1990s, the government did transfer monies from the central government budget, but these transfers were earmarked for those groups of insured persons for whom the state assumed responsibility for provision of more favourable pensions. These included various groups of insured persons, such as military personnel, police, customs duty officers, members of Parliament, former resistance fighters of World War II, etc. In 1996 the government decided to reduce the employer rate radically, from 15.5 percent to 8.85 percent. Concomitantly, it committed itself to provide substantial transfers from the central government budget to the IPDI. The extent of these transfers is apparent from Table 1.

Although the joint (employee and employer) pension and disability contribution rate had not changed since July 1996, own revenues were continuously sliding and in 2002 amounted to 9.5 percent of GDP.

The financing of the deficit of the IPDI was not done through the government budget. Up to 1995 the deficit was financed by the reserve fund, held by the IPDI. The sources of the reserve fund dried up and a new provider was sought. This was the Capital Fund (*Kapitalska druzba*), an institution originally formed within the IPDI, with its initial capital obtained from privatisation proceeds. *Kapitalska druzba* was required to “foot the bill” and cover the deficit. This was originally done for the period 1999–2001, followed by a new arrangement for 2002–04. The plan envisages that, starting from 2004, the monies from *Kapitalska druzba* will be used to repay the principal; up to now the monies have been used to finance the current deficit. It must be noted that the IPDI has the possibility to incur debt, but only with explicit permission from the government.

Table 1
Own revenues, government transfers and expenditures of the institute for pension and disability insurance (as % of GDP), Slovenia 1992–2002

Year	Own revenues	Government transfers	Revenues	Expenditures	Surplus/deficit
1992	13.5	0.0	13.5	13.8	–0.3
1993	13.9	0.5	14.4	14.0	0.4
1994	13.1	1.0	14.1	14.4	–0.3
1995	12.9	1.0	13.9	14.7	–0.8
1996	11.0	2.7	13.8	14.5	–0.7
1997	10.1	4.0	14.1	14.4	–0.3
1998	10.2	4.2	14.4	14.3	0.1
1999	9.9	4.3	14.2	14.4	–0.2
2000	9.6	4.0	13.6	13.9	–0.3
2001	9.6	4.2	13.8	13.8	0.0
2002	9.5	4.4	13.9	13.9	0.0

Source: *Bulletin of Public Finance No. 9/2003*, Ministry of Finance.

Note: Government transfers include not only central government transfers but also transfers from other public finance entities.

1.3. A Brief History of the Collection System

Up to 1996, the tax administration of Slovenia consisted of two separate entities: the APPNI (*Agencija za placilni promet, nadzor in informiranje* – Agency for Payments, Control and Information) and RUJP (*Republiška uprava za javne prihodke* – Department for Public Revenues). The APPNI was in fact a centralised payment agency, through which legal persons effectuated payments to other legal entities and natural persons; every legal person had to have an account with the APPNI. Only payments by natural persons could be effectuated through the banking system. This agency also performed the function of tax collector for legal persons. The tax control function was quite efficient: if taxes and social contributions were not paid in a given month,

the agency simply prevented the disbursement of wages the following month. APPNI also performed the role of inspection and enforcement. The RUJP was the tax collector for natural persons.

In 1996 these two separate entities were formally merged. In fact, only one part of the APPNI (the part “in charge” of taxes and contributions) was integrated with the RUJP into the newly formed unified tax administration – DURS (*Davčna uprava Republike Slovenije*), henceforth the Tax Administration. Formally, some of the APPNI staff were transferred to the new Tax Administration. In the same year, the agency was renamed to APP (*Agencija za placilni promet* – Agency for Payments), as it lost its controlling function. These changes were a cause for serious concern at the IPDI, which feared that a rapid deterioration of compliance would occur. At the time, the IPDI was – as a defensive measure – even considering establishing its own collection administration.⁴ These fears proved exaggerated, and the institutional changes did not cause a deterioration in tax and contribution compliance.

The APP – Agency for Payments was further downsized in 2002, when payments between legal (private) entities were transferred to the banking system. The agency split into two parts. Thus, UJP – Office for Payments between Public Entities (*Uprava Republike Slovenije za javna placila*) is in charge of payment transfers between public entities, i.e. institutions financed from the central government budget. The other part is AJPEŠ – Agency for record-keeping and services for institutions subject to public law (*Agencija Republike Slovenije za javnopravne evidence in storitve*). The mission of AJPEŠ with respect to contribution payments is not clearly defined, and a period of uncertain division of responsibility followed. Namely, the monthly statement of account for wages, which the employers previously sent to the APP, is now being sent to AJPEŠ, but it is not yet obvious to what use this information will be put, as the Tax Administration also collects quite similar monthly data from legal persons for its own purposes – this is the so-called REK-1 form.⁵

⁴ It is interesting to note that the IPDI even commissioned a study on collection compliance (Stanovnik et al., 1996), in order to obtain some analytical background for a decision on whether to introduce its own collection system.

⁵ The monthly statement is an aggregate account, for all employees.

In spite of this hazily defined and allegedly final split of the APP, one can nevertheless say that in 2002 Slovenia achieved a payment system compatible with systems in market economies. Thus, the banking system executes financial transactions, whereas the Tax Administration is in charge of collection, control and enforcement of tax and contribution payments. This is important to note, as the system in the 1996–2002 period could quite justifiably be described as “schizophrenic.” Namely, the functions of the newly formed “unified” Tax Administration were not really integrated, as the APP retained the functions of collection and control, whereas the function of enforcement was transferred to the Tax Administration.

Throughout the 1990s, the APP regularly provided the IPDI with relevant financial statements, as well as data on contribution compliance by legal persons. The APP also charged a fee for each financial transaction it performed. Interestingly, the Tax Administration tried to “emulate” the APP and started charging the IPDI a collection fee, which the IPDI never paid. This issue was finally resolved in 2002, when the government withdrew its lawsuit against the IPDI.⁶

2. An Overview of the Current Collection System

Slovenia has separate social security schemes for:

- pension and disability insurance;
- health insurance;
- maternity leave; and
- unemployment insurance.

The employer pays pension and disability insurance contributions to the Institute for Pension and Disability Insurance (IPDI); for health care and sickness s/he pays contributions to the Institute for Health Insurance (IHI), whereas for unemployment insurance and maternity leave s/he pays

⁶ As a curiosity, let us mention that the Institute for Health Insurance does pay a collection fee to the Tax Administration.

contributions to the state budget. Although the National Employment Service is in charge of unemployment disbursements, it is not a separate entity outside the state budget.

The collection of social security contributions is the responsibility of the Tax Administration of the Republic of Slovenia, which also collects taxes and other mandatory levies.⁷ Contributions are paid together with the personal income tax. The procedure for payment of social contributions is similar to the advance payment of personal income tax: the employer pays social contributions into tax sub-accounts within the unified treasury account.

2.1. The Tax Administration and the Tax Registry

The Tax Administration is an entity of the Ministry of Finance. It is authorised not only to collect mandatory levies (taxes, social contributions etc.), but also to control, inspect, and enforce the contribution requirement. It is also authorised to manage and maintain a tax registry and to keep records of the payment of taxes, and is responsible for the organisation and management of the tax information system.

The Tax Administration is composed of a head office, regional tax offices and a special tax office, which is responsible for a selected number of legal persons, such as banks, insurance companies, the Ljubljana Stock Exchange, broker firms and firms licensed for gambling. The special tax office is also responsible for larger firms, i.e. firms having an annual turnover in excess of SIT 5 billion.

The tax authorities carry out control and inspection on the basis of the law governing tax procedures and the law governing administrative procedure. Inspection of the payment of taxes encompasses verification of the correctness and promptness of tax settlements, the business transactions of taxpayers, the verification of bookkeeping and other records, the investigation of unreported income and the imposition of measures specified by law.

⁷ The Tax Administration of the Republic of Slovenia collects all taxes, except customs duties, excise duties and value added tax on imports, which are collected by the Customs Administration of the Republic of Slovenia.

The Tax Administration maintains a uniform registry of taxpayers on the basis of the taxpayer's number and other information concerning the taxpayer. This tax registry contains the following information on individuals:

- tax number;
- personal information: name, surname, date and place of birth;
- information on nationality;
- address of permanent or temporary residence;
- data on capital investments;
- bank account and savings account numbers; and
- employment information.

The tax registry also contains information on legal persons and individuals who conduct business activities. This information includes:

- tax number;
- company name, head office and address;
- *tolar* (SIT) and foreign currency bank and savings account numbers and account numbers held by branches in foreign countries; and
- number of employees at the time of entering the registry, tax numbers of employees and the date on which monthly salaries are paid.

The tax registry includes the following legal and natural persons:

- persons subject to entry in the court registry;
- independent businesspersons who are subject to entry in the registry of businesspersons;
- other legal and physical persons who conduct business activity and are registered in any other registry in the Republic of Slovenia;
- foreign legal and physical persons whose head offices or other registered organisations are not located within the Republic of Slovenia, if they operate in the Republic of Slovenia;
- other income taxpayers not included in the previous categories; and
- persons subject to the payment of other taxes according to other laws.⁸

⁸ This for example includes foreigners who are not registered in Slovenia and are about to perform a one-time taxable activity in Slovenia. They are obliged to apply for registration into the tax registry prior to the start of their activity.

2.2. Registry of Insured Persons and Social Insurance Beneficiaries

The registry of insured persons and social insurance beneficiaries (henceforth: Registry) is the basic registry for social insurance in Slovenia. It contains data not only on active insured persons, but also data on social insurance beneficiaries. Though this registry is mostly geared toward the demands of the IPDI, it is also used by other institutions, such as the Institute for Health Insurance, National Employment Service, etc. The Institute for Health Insurance is responsible for the maintenance of this Registry and the person obliged to provide information on the insured persons thus has to contact only one institution.

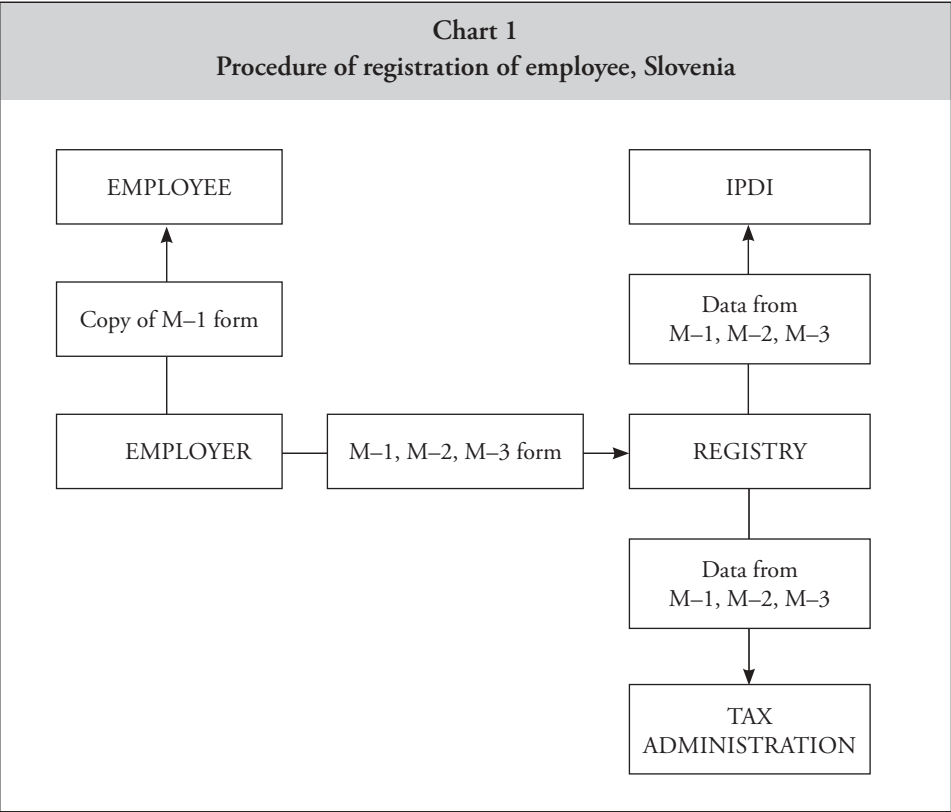
Every person, subject to the obligation of contribution payment, receives an identification number (registration number of the contribution payer), which identifies the person in all relevant documents. In the case of employees the contribution payer is the employer.

Data are entered into the Registry on the prescribed forms. The form M-1 is for new applicants for insurance, M-2 is for termination of insurance and M-3 is for changes during the insurance period. These forms are submitted by business entities or natural persons who are responsible for providing the necessary data. For example, employers are obliged to provide data for their employees, self-employed are obliged to provide data for themselves as well as for persons they employ, etc. Farmers are obliged to provide data for themselves and for members of their household, even if the farmers themselves happen to be insured with some employer. The registration procedure is described in Chart 1. After the Registry receives the M-1, M-2 and M-3 forms, the relevant data are transferred to the Office for Record-Keeping of the IPDI, as these data are vital for ascertaining an insured person's pension rights.

The Registry must also provide the necessary data, on a monthly basis, to the Tax Administration. Persons obliged to provide data to the Registry also have obligations toward the Office for Record-Keeping of the IPDI. The employer (and self-employed with workers) must provide an annual M-4/M-8 form directly to the Office for Record-Keeping of the IPDI; this contains individual data on insurance base, insurance period and contributions paid for each employee; similar requirements are also in place for the self-employed who employ workers. In this sense one can say that the IPDI has at its

disposal all the necessary data relevant for establishing an individual’s pension rights.

Chart 1 shows the main steps relevant in the process of registering an employee into insurance.



2.3. *Payment and Control of Contribution Payment*

2.3.1. **The Flow of Information and Money**

The flow of information and monies in the case when the contribution payer is the employer is shown in Chart 2. This procedure can be described as follows:

Employers deduct social contributions from wages and pay them together with the employer contribution every month as part of payroll accounting, no later than six days after the payment of wages. The payment is done by the bank in which the employer has a transaction account. The employer also has to supply the tax authorities with a notification list of wages disbursed and contributions due; for legal persons this is the so-called REK-1 form. This list has to be supplied at the latest on the day of payment of wages. These are aggregate, summary data for employees as a group and must be forwarded by the employer to the Tax Administration in paper format. If the employer is a self-employed person, he must provide the Tax Administration with an individualised payroll list. This means a separate list for each worker that the self-employed person employs. We reiterate that all disburers of wages (be they legal persons or self-employed) must pay social contributions and other taxes at the latest six days following the submission of the notification list.

Based on the payment order by the legal person, the bank (where the legal person has their transaction account) pays social contributions directly to the appropriate accounts of the social insurance institutions within the single treasury account. The banks are actually required by law to inform the Tax Administration of all payments of wages and salaries.⁹ As for the self-employed themselves, their contributions are paid through banks in a transient Tax Administration account, and the monies are then transferred to the accounts of the social insurance institutions (within the so-called single treasury account).

This slightly different payment procedure for the self-employed (i.e. passage through a transient Tax Administration account) is due to the fact that this “stop-over” provides better payment control by the Tax Administration, in that it facilitates comparison of account statements and actual payments of the self-employed. In case the self-employed do not submit an account statement, the Tax Administration issues a payment order for contributions due. It is interesting to observe that the Tax Administration fills in the annual M-4/M-8 form for the self-employed, farmers and some other categories which it then sends to the Office for Record-Keeping of the IPDI. In other words, for

⁹ The bank provides this information in an automated fashion.

the self-employed and farmers the Tax Administration assumes a similar role as the employer assumes for the employee, as the data provider to the IPDI. As for the employees, the Tax Administration compares the information from the REK-1 form and the actual money inflow into the Single Treasury Account. In principle, it reacts immediately in case of any inconsistency.

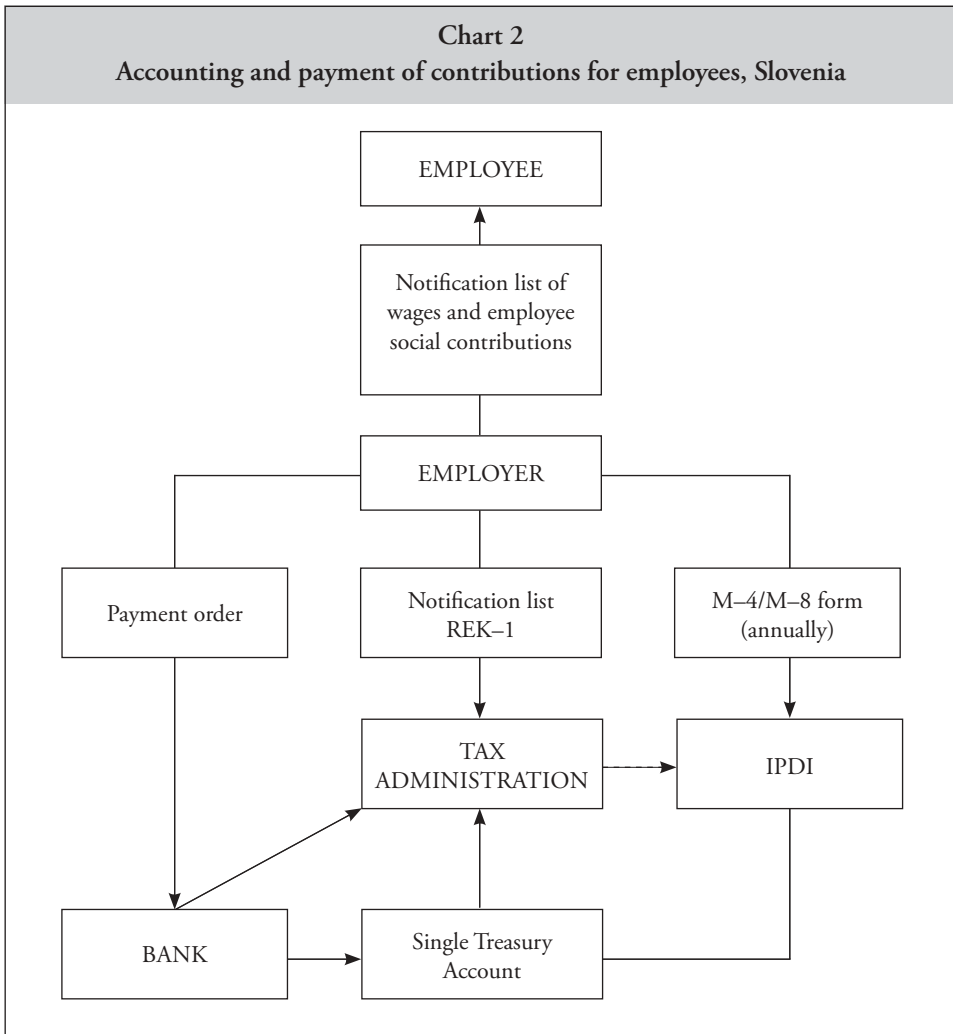
The dashed line representing the information flow between the Tax Administration and IPDI is still being developed and will be explained in Section 2.4.

2.3.2. Annual Submission of Relevant Data and Record-keeping

Upon each payment of wages, the employer is obliged to submit to the employee a slip showing the employee's wage and other labour remuneration, as well as the taxes and contributions paid. At the end of the year, the employer must submit to the employee information on income taxes and contributions paid during the year, including a statement of the dates of payment of the taxes and employee social contributions within the previous year. This must be done by January 31 and the information is needed for filling in the personal income tax form. The information contained on this slip must be kept by the employer for a period of 10 years, whereas the data provided on M-4/M-8 forms must be kept so long as the employer is in existence.

By April 30 the employer must also provide annual information on wages, contributions paid and period of insurance on forms M-4/M-8 to the IPDI, for the previous year. Small employers provide this in paper format, larger employers on other media. Direct transmission is not yet permitted. Every supplier of data provides one form on which individual data on wages, insurance base, insurance period and amounts of paid contributions from given insurance bases is stated, separately for every worker. Employers are also legally required to present to the insured person a document on all contributions paid (employer and employee), but compliance is weak, as employers think that the information on income taxes and employee contributions paid during the year is sufficient.

As yet, no government or social insurance institution collects individualised monthly data on contributions paid for insured persons.



2.3.3. Some Special Features for Reporting and Contribution Payment for the Self-employed, Farmers, and Persons Voluntarily Insured

The self-employed and all those contribution payers who choose their own contribution bases must pay social contributions no later than on the fifteenth day of the month for the previous month, and upon every payment they have to submit to the Tax Administration a special account form of calculated contributions.

Unlike the self-employed, farmers are not obliged to submit to the Tax Administration any account forms concerning contributions. The Tax Administration simply issues a ruling on the insurance base and amount of contributions due; it also sends monthly bills for social contributions due.

A fairly new category, but one that is gradually increasing in size are persons voluntarily included in the mandatory public pension system. They must not be in a dependent employment relation, or they must not be engaged in any business activity which would require their mandatory inclusion. Like the self-employed, these insured persons provide the tax authority with a statement regarding their choice of contribution base and pay contributions on a monthly basis. They usually do not receive any bills from the Tax Administration.¹⁰

2.4. Some Recent Developments on Individualisation of Contributions

The IPDI was obliged by the 1999 PDIA to establish an individual registry of contributions paid for pension and disability insurance, based on the data from the Tax Administration. The task, to be completed by January 1, 2003 would demand a large increase in the amount of information processed, as the Tax Administration has up to now collected monthly information in an aggregate form, i.e. the employer does not provide individualised lists for their employees – except for employees employed with the self-employed person. The project is still in its infant stage and there are a number of questions which will have to be resolved, such as the required data to be supplied to the Tax Administration, and the forms and provisions for transmission in electronic form. All this would also require an IT system capable of providing the necessary functions of transmission, control and storage.

The task of creating an individualised registry of contributions paid is necessary, as the employees at present cannot with certainty ascertain whether contributions have actually been paid in their name. The Tax Administration is not obliged to provide data on contributions paid by the employer, even if

¹⁰ Smaller regional tax offices send these bills regularly, although there is formally no legal obligation to do so. The rationale for this is that compliance is greater when the voluntarily insured persons regularly receive bills for contributions due.

the employee demands such information. We recall that the employee obtains (by January 31) only information on taxes and employee social contributions calculated on the basis of wages received. The employee does not receive information on the employer contributions paid.

As a “compromise” measure, geared towards a greater emphasis on actual contributions paid, the M-4/M-8 forms have been changed and these (annual) forms now also contain data on contributions paid, at the individual level. This change was introduced in the 2003 reporting, i.e. for the year 2002. Prior to 2003 the M-4/M-8 forms contained individual information on earnings (wages, etc.) which were subject to contribution payment, but did not contain data on the actual amounts of paid contributions.

2.5. Contribution Payments and the Second Pillar

The managers of the mutual pension funds, pension management companies and insurance companies (with pension schemes) are obliged by law to provide adequate information to their members who are voluntarily insured. This information is provided to members annually, i.e. by January 31 for the past year, and contains information relevant for the individuals’ filing of personal income tax return. It is interesting to observe that this information is being provided without the slightest difficulty.

3. Contribution Base and Contribution Rates

3.1. Contribution Base and Rates for Employees

The contribution base for both the employer and the employee is the gross wage, which includes various types of wage compensation, such as maternity leave and sickness pay.¹¹ In other words, persons receiving maternity benefits and sickness benefits are also insured for (almost) all risks covered by social

¹¹ In the case of employees the contribution payer is the employer.

insurance, including old age and disability. This is also valid for unemployed persons receiving unemployment benefits. For employees, fringe benefits and expenses related to work are also subject to personal income tax and contribution payment, but only amounts above a certain limit, prescribed by a government decree.

Total contribution rates in 1995 were 19.9 percent for employers and 22.1 percent for employees; they were reduced for employers to 15.9 percent in 1996 and then slightly increased to 16.1 percent in 2001.

The contribution rates are shown in Table 2.

Table 2
Contribution rates in 2001 (%)

Insurance risk	Employee	Employer
Pension and disability insurance	15.50	8.85
Health insurance	6.36	6.56
Maternity leave	0.10	0.10
Unemployment	0.14	0.06
Work injury	—	0.53
Total	22.10	16.10

Source: The Law on Social Contributions (*Official Gazette of RS*, No. 5/96, 18/96, 34/96, 87/97, 3/98, 106/99, 81/00, 97/01)

3.2. Contribution Base and Rates for Self-employed

The contribution base for the self-employed is called the insurance base. It depends on profit, i.e. revenues minus expenditures. Expenditures thus defined do not include gross remuneration (taxes, social contributions and net remuneration) of the self-employed; profits therefore represent gross remuneration of the self-employed. This base is larger than the tax base for personal income tax, which is equal to profits minus social security contributions minus tax relief (mostly in the form of tax allowances). Various tax allowances are quite substantial for this group of taxpayers.

For the self-employed the term “insurance base” is used because the self-employed have somewhat more degrees of freedom in their choice of the base for paying contributions. Thus, based on the annual statement of profits, the self-employed are grouped in one of eight insurance groups. The lowest group are those whose profits are less than the minimum wage; their insurance base is equal to the minimum wage. In the highest, eighth group are those self-employed whose profits exceed 3.5 times the average annual wage in Slovenia; their insurance base must be at least equal to the highest pension base, grossed-up by the average personal income tax rate and social contribution rate.

The contribution rate for the self-employed is equal to the joint employee + employer contribution rate.

3.3. Contribution Base and Contribution Rates for Farmers

Farmers and members of farmer households are included in mandatory pension and disability insurance if the cadastral income per household member is at least equal to the minimum wage.¹² The contribution base for farmers is ascertained by adding agricultural income and possible income from other, auxiliary activities, such as poultry raising, cattle breeding, beekeeping, and fishery. The agricultural income is actually imputed income, and is a multiple of cadastral income. The multiplication factor is set by the Ministry of Labour, Family and Social affairs and was 2.5 in 2003; such multiplication is necessary because cadastral income substantially underestimates the actual agricultural income.

The minimum contribution base for this group of insured persons is the minimum wage. Just like the self-employed, farmers also have a ceiling for the contribution base, which is equal to the maximum pension base, grossed-up by the average personal income tax rate and social contribution rate.

¹² Cadastral income is a normative concept of income, i.e. it is imputed income from land. It depends on the quality grade of the land and not on the type of crop that is raised on this land. The Surveying and Mapping Authority of the Republic of Slovenia annually submits the values of cadastral income to the Tax Administration.

If the cadastral income per household member is less than the minimum wage, farmers are not mandatorily covered. Farmers and members of the farmer household can be voluntarily included in the mandatory system of pension and disability insurance. In that case their lowest possible insurance base is equal to 50 percent of the minimum pension base, grossed-up by the average personal income tax rate and social contribution rate.

For farmers the state pays the employer’s part of pension and disability contributions. This is financed from the state budget and applies to both groups of insured farmers – the mandatorily and voluntarily insured.

Farmers also have a “special” rate and “special” base for health care insurance. The base is cadastral income, and the contribution rate is 17.38 percent. Actually, most farmers take advantage of this “special” rate and “special” base, so that the insurance base and contribution rate for health care insurance for farmers that are included in mandatory pension insurance (see Table 3) rarely apply.

Table 3 shows the social contribution rates for farmers that are included in the mandatory pension system.

Table 3	
Contribution rates for farmers in mandatory pension insurance, Slovenia	
Insurance risk	Contribution rate (%)
Pension and disability insurance	15.50
Health care insurance	5.21
Maternity leave	0.20
Health insurance (income compensation for sickness, etc.)	1.15
Work injury	0.53

Source: The Law on Social Contributions (*Official Gazette of RS*, No. 5/96, 18/96, 34/96, 87/97, 3/98, 106/99, 81/00, 97/01)

3.4. *Contribution Base and Contribution Rates for Insured Persons that are Voluntarily Included in Pension Insurance*

Persons voluntarily included in pension insurance can choose their own insurance base, which cannot be lower than the minimum pension base, grossed-up by the average personal income tax rate and social contribution rate. However, as we have observed with farmers voluntarily included – some groups can choose a lower base, although it cannot be lower than 50 percent of the minimum pension base, grossed-up by the average personal income tax rate and social contribution rate. Groups which can pay contributions from this lower insurance base include: the already mentioned low-income farmers (who do not achieve sufficient income for mandatory inclusion), parents caring for a child, registered unemployed (who are not recipients of the unemployment insurance benefit) and others.

The contribution rate for this group is 24.35 percent, and is the same as that for the self-employed.

3.5. *Comparison of Contribution Bases for Employees, Self-employed and Farmers*

Table 4 provides a comparison of the contribution bases for the three main and distinct groups of insured persons.

Table 4 Contribution bases for different groups of mandatorily insured persons, Slovenia			
Type of insured person	Contribution base	Lowest contribution base for pension insurance and maternity	Lowest contribution base for health insurance and unemployment insurance
Employee	Wage	Minimum wage	Actual wage
Self-employed	Insurance base	Minimum wage	Minimum wage
Farmers and members of farmer household	Insurance base	Minimum wage	Minimum wage

Note: For farmers the last column refers only to health insurance. The table refers to farmers who are mandatorily included in the social insurance system.

4. Contributors, Coverage and Measures of Efficiency of Contribution Collection

4.1. Contributors and Coverage of the Active Population

The structure of insured persons underwent considerable changes during the 1990s, as can be observed from Table 5. This structural shift is marked by the introduction of a new group of insured persons – the voluntarily insured, as well as the increase in the number of insured persons who pay lower average amounts of contributions; these are the self-employed and persons employed by the self-employed.

Table 5
Number of persons in the Slovene public pension system, 1992–2002

Year	Employed by legal persons	Employed by self- employed	Self- employed	Farmers	Voluntarily insured	Insured unem- ployed	Others	Total number of insured persons
1992	656,966	33,283	43,963	30,690	—	—	—	764,902
1993	626,806	37,003	47,120	28,251	7,500	35,569	321	782,570
1994	605,326	41,196	48,801	27,129	13,672	36,103	322	772,549
1995	593,848	48,709	52,168	26,827	17,243	29,883	283	768,961
1996	581,651	53,835	54,108	25,285	19,164	31,430	258	765,731
1997	593,086	58,364	54,000	21,799	20,892	34,586	469	783,196
1998	591,653	61,087	53,456	19,602	20,956	36,380	1,059	784,193
1999	606,927	63,793	52,465	18,789	20,221	36,429	1,843	800,467
2000	615,493	67,073	52,118	17,206	20,550	31,074	3,499	807,013
2001	626,444	67,844	52,062	16,506	21,021	25,902	4,371	814,170
2002	631,053	65,941	51,876	16,506*	22,161	22,587	4,531	814,655

* Estimate.

Source: *Annual report of IPDI*, 2002.

In 2002, the number of workers employed by legal persons was some four percent less than in 1992, whereas the number of those employed by the self-employed increased in the same period by 98 percent. In 2002 the self-employed employed some 64,000 persons, mostly in economically active employment; the number of persons employed in other occupations (such as family help, etc.) was negligible – fewer than 1,500 persons.

The number of self-employed persons increased from 44,000 in 1992 to 54,000 in 1997; since then it has declined somewhat and now stands at 52,000. The number of insured farmers and members of farmer households declined significantly – by almost 50 percent during the 1992–2002 period. It now stands at 16,500 insured persons. Of course, one must bear in mind that some farmers (or members of farmer households) are included in the group of voluntarily insured persons.

It is interesting to observe that the difference between the number of persons in employment and the number of insured persons (for pension and disability insurance) is quite large, and has in recent years amounted to some 80,000 to 100,000 persons, as can be observed from Table 6. This might imply that there are a number of persons who are economically active, but are not insured. While there is some truth in this, the very large difference is – in our view – caused by very high estimates of persons in employment, obtained from the Labour Force Survey. This survey also shows a much lower unemployment rate than the official unemployment rate, which is based on registered unemployed. Obviously, a large part of the unemployed group is not insured and they most probably engage in some small economic activity: formally they are labelled as persons in employment, but their employment is for a small number of hours and provisional.¹³

It is revealing to compare the coverage of health insurance with the coverage of pension and disability insurance. Here, health insurance coverage can serve as a benchmark, as it is virtually universal; even those persons who “fall through the net” and do not comply with any of the required criteria for mandatory health insurance are in fact covered. Namely, municipalities are required to pay health contributions (in a fixed amount) for them.

¹³ Only unemployed persons receiving unemployment benefits are pension-insured.

Table 6
Persons in employment and number of insured persons
(for pension and disability insurance), Slovenia, 1993–2001

Year	Persons in employment (in thousands)	Insured persons (in thousands)
1993	845	783
1994	851	773
1995	882	769
1996	878	766
1997	898	783
1998	907	784
1999	892	800
2000	894	807
2001	914	814

Source: Annual report of IPDI, 2003.
Statistical yearbooks of the Republic of Slovenia, 1995–2002.

The comparison for 2002 reveals close agreement between the IHI and IPDI data on the number of insured persons for several large groups of insured persons – these are employees, self-employed, farmers in mandatory pension insurance and unemployed receiving unemployment benefit. However, there are two large groups of “potentially” active persons that are included in health insurance, but are not included in pension and disability insurance. The first group consists of persons with some income sources (about 23,000 persons) whereas the second group consists of persons with no income sources (68,000 persons¹⁴). The former group refers to those persons that receive occasional income from rent, interest payments or contractual work, whereas the latter group refers to persons with no official income sources. This group includes students who have not passed their exams and have to wait one year for continuation of their studies, divorcees without any income, unemployed

¹⁴ According to information from the IHI, this group includes some 12,000 children and 2,000 other family members.

persons without any income, etc. It is necessary to reiterate that not all of these persons are necessarily labour active; what is important is that these persons are not pension-insured and that a number of these persons will have difficulty in acquiring a sufficient insurance period for obtaining a minimum pension.¹⁵

We now turn our attention to the two largest groups of insured persons: the employees and the self-employed. Table 7 provides data on average amounts of contributions paid for these two groups of insured persons.

Table 7
Average annual amounts of contributions paid for Slovene employees and self-employed to the IPDI, 1992–2002 (in SIT)

Year	Average amount for employees (1)	Average amount for self-employed (2)	Ratio 2/1 (in %)
1992	172.739	61.233	35.4
1993	279.986	109.041	38.9
1994	354.808	132.354	37.3
1995	423.564	159.868	37.7
1996	418.399	175.963	42.1
1997	419.851	223.167	53.2
1998	468.022	297.385	63.5
1999	502.004	373.849	74.5
2000	550.634	408.861	74.3
2001	600.046	441.147	73.5
2002	657.001	473.707	72.1

Source: Author's own calculations based on *Annual report of IPDI*, 2002.

As observed from this table, employees pay – on average – more than the self-employed. However, the average amount of contributions paid by the self-

¹⁵ These persons will nonetheless probably qualify for the state pension, which is a means-tested social assistance pension, available to residents of Slovenia who are 65 years old and have lived in Slovenia for at least 30 years (between the ages of 15 and 65).

employed is increasing. Thus, in 1992 their average contribution was only 35 percent of the average amount for employees; in 2002 this ratio increased to 72 percent. The explanation for this is straightforward: the possibilities of the self-employed for choosing the contribution base and also their contribution rate has been gradually narrowing since 1992. In 1996 the possibility for insurance for a smaller bundle of insurance rights was terminated, and in 1998 the lowest statutory contribution base was increased considerably. These legal changes obviously did produce some results.

4.2. *Measures of Contribution Compliance*

There are several possible measures of contribution compliance. One measure would be simply to compare the planned contribution revenues with the contribution revenues actually collected. This measure is however subject to serious flaws, as the planned collection of contributions very much depends on the underlying assumptions on which this “plan” is based. For example, the IPDI computes the planned collection of contributions simply on growth estimates (of wages, GDP, prices, etc.) provided by the Institute for Macroeconomic Analyses, which is the main forecasting institution for the central government. Comparing planned and actual collected contributions would thus reveal very little about the efficiency of contribution collection, and would probably speak more of the quality (or precision) of the forecasts provided by the aforementioned institute.

Another measure of contribution compliance is arrears, i.e. the amount of contribution debt. This measure is also flawed, as it does not include estimates of contribution evasion. Also, the level of arrears depends on the policy of write-offs and debt relief, as well as on the technique of contribution collection. As we shall observe in Section 5, the advance tax (*acompte*) technique, which is in force for the self-employed results in the quite high contribution indebtedness by the self-employed.

Yet a third measure of contribution compliance is the covered wage bill. This represents the hypothetical wage bill of the national economy, which would have generated the actual observed amount of contribution revenues from recipients of wages and salaries, taking into account the given

contribution rate. Usually, the covered wage bill is measured as a percentage of GDP. Low values of the covered wage bill do not necessarily imply a low level of compliance and thus low levels of efficiency, as in less developed economies a large share of income is obtained from agriculture and other economic activities in which self-employment prevails. However, in developed market economies the covered wage bill ought to be high and stable.

The covered wage bill for Slovenia is shown in Table 8, from which we observe that the covered wage bill in 1992 was 42 percent of GDP and in 2002, 35.1 percent, representing a decrease of seven percentage points. The decrease in the contribution base (i.e. the covered wage bill), measured as a percentage of GDP, could also be observed from Table 1, which shows that own revenues of the IPDI (as percentage of GDP) have been steadily decreasing, in spite of the fact that there was no change in the joint contribution rate since 1997.

Table 8
The covered wage bill and actual wage bill (as percentage of GDP),
Slovenia 1992–2002

	Covered wage bill (1)	Actual wage bill (2)	(1)/(2) x 100
1992	42.0	53.6	78.4
1993	42.3	50.1	84.4
1994	40.0	48.7	82.1
1995	39.5	48.2	82.0
1996	38.8	47.5	81.7
1997	38.0	46.9	81.0
1998	38.0	45.6	83.3
1999	37.4	45.1	82.9
2000	36.1	45.5	79.3
2001	35.6	45.5	78.2
2002	35.1	45.0	78.0

Source: *Bulletin of Public Finance* No. 9/2003, Ministry of Finance; 1997 and 2002 *Statistical yearbooks of the Statistical Office of Slovenia*.

Though the decrease of the covered wage bill is worrisome, it might nevertheless reflect the fact that the *actual* wage bill is decreasing. Table 8 offers a comparison of the covered wage bill and actual wage bill. As seen from this table, the actual wage bill also decreased during this period: in 1992 wages accounted for 53.6 percent of GDP, whereas in 2002 this slipped to 45.0 percent of GDP. The ratio between the covered wage bill and the actual wage bill shows a steady decline since 1998, when it was 83.3 percent up to the present: in 2002 it was 78.0 percent. Thus, in a span of four years the ratio dropped by some five percentage points. The causes for this steady decline could be increased underreporting of wages (for tax and contribution purposes) and/or increasing numbers of persons receiving labour remuneration, but not included in the social insurance system.

How serious is the underreporting of wages of insured persons? In order to provide an estimate of this type of underreporting of wages for social contribution (and tax) purposes, we compute the hypothetical, i.e. “effective” contribution rate which is obtained by dividing (a) the total of contribution revenues collected with (b) the product of the average wage and number of insured persons.

If all insured persons would pay contributions from a contribution base which is equal to the average wage, this ratio would be equal to the statutory contribution rate. This is of course not true, as the contribution bases and thus also contributions paid are lower for the self-employed and the group “others.” The ratio between the effective contribution rate and statutory contribution rate, which is shown in Table 9, has been oscillating between 88 and 90 percent during the period 1992–98. However, since 1999 a small decrease can be observed. It remains to be seen whether this trend will continue in the future. Overall, one is inclined to believe that underreporting of income among insured persons has not worsened, and that the overall “quality” of insured persons has not deteriorated. Obviously, positive and negative changes in the “quality” of contributors very much cancel out. Thus, the number of some small contributors (farmers) has been decreasing, while the number of some other small contributors (voluntarily insured) has been increasing. Though the number of self-employed has increased, their compliance has improved, and

they now pay relatively higher contributions (relative to contributions paid by the employees) than in the early 1990s.

Table 9
The effective and the statutory contribution rate for pension
and disability insurance, Slovenia, 1992–2002

Year	Effective contribution rate (1)	Statutory contribution rate (2)	(1)/(2) x 100
1992	0.2602	0.2880	90.4
1993	0.2715	0.3084	88.0
1994	0.2719	0.3100	87.7
1995	0.2745	0.3100	88.6
1996	0.2361	0.2657	88.9
1997	0.2151	0.2435	88.3
1998	0.2177	0.2435	89.4
1999	0.2181	0.2435	89.6
2000	0.2153	0.2435	88.4
2001	0.2156	0.2435	88.5
2002	0.2151	0.2435	88.3

Note: The effective contribution rate is obtained as the ratio between (a) actual contribution revenues and (b) the computed aggregate contribution base. The “computed aggregate contribution base” is obtained assuming that the contribution base of every insured person is equal to the average wage. It is equal to the product between (a) average wage and (b) the total number of active insured persons.

It therefore seems that there are uninsured persons who receive labour income, which evades taxation and contribution payment. Table 6 provides some evidence for this, as it shows a considerable gap between the number of persons in employment and insured persons.

5. Non-compliance and Evasion

5.1. *The Control and Auditing Function of the IPDI*

The regular collection of contributions, control of these payments and enforcement are all quite important for the financial operations and liquidity position of the IPDI. These three functions, i.e. collection, control (which includes inspection) and enforcement are performed by the Tax Administration. The Tax Administration also regularly provides to the IPDI information on the payment of contributions and on non-compliance.

Apart from the Tax Administration, the IPDI also has a mandate to control the data on pension and disability contributions, and data on insured persons and contribution payers. The auditing of the relevant data is performed by a special auditing department within the IPDI, which includes 30 auditors. In actual fact, data supplied on the annual M-4/M-8 forms are compared with the wage statements from the individual worker's payroll list and with the data on paid contributions. This means comparing contributions with actual pay orders by the contribution payers.

There are problems with compliance, as persons who are by law required to provide the necessary data to the Registry frequently do not provide them or do not provide them in a timely manner. Though this sloppiness is subject to sanctions, a formal court procedure is rarely enacted, due to low penalties and long periods of court review.

The IPDI also has a legal obligation to verify and control the accuracy of the data supplied to the Registry. The data providers must enable the officials of the IPDI to review documentation with the employer. The auditing procedure is undertaken by IPDI, which ascertains whether the data supplied to the Registry comply with regulations and whether they are in accord with data at the employer's. In 2002 the auditing procedure was undertaken at 19,667 providers of data, for 407,936 insured persons. Also, individual auditing (when the insured person is self-employed, a farmer, or voluntarily insured) has been performed for 4,393 individuals.

Some of the more frequent errors or omissions which the auditors have observed are errors in the stated wage compensations (for maternity and sick

pay), mismatch between the entrance into insurance and disbursement of wages (wages were being disbursed prior to entrance into insurance), etc.

5.2. The Deferral of Contribution Payment and Arrears

The governing board of the IPDI can grant deferral of contribution payment, payment of contributions in instalments, complete write-offs and partial write-offs. The criteria for these actions are set by the Council of the IPDI (Article 228 of the PDIA). As a general rule, contributions can be written off only if they are uncollectable. For legal persons, this means that the contribution debt can neither be collected through debt guarantees nor from the legal successor. For natural persons, this means that the person is deceased and that there are no assets which could be sold and thus provide the financial resources for the repayment of contributions. Contributions are also uncollectable if the right to collect these contributions falls under the statute of limitation, which is five (absolute maximum ten) years.¹⁶

The right to defer contribution payments has been firmly bestowed upon the IPDI in 1999, and is “enshrined” in the 1999 PDIA. However, as we shall see below, the Minister of Labour can – under certain conditions – also grant deferment of contribution payment.

In the early years of transition, deferral was mostly granted by specific laws. Thus, in 1993, a specific law deferred all contributions and taxes of firms which have transferred their assets to the Development Fund. These were mostly weak firms, in need of radical restructuring prior to privatisation. In the same year, a special law was enacted for the deferral of contribution and tax payments of the Slovene railways. In 1994, upon the recommendation of the government, the IPDI granted deferral of contribution payment to TAM, a large motor and truck factory in Maribor; these deferred payments were eventually transformed into equity shares.¹⁷ The contribution debt of the firms

¹⁶ The maximum is five years if no court action has been undertaken in that period. Ten years is the absolute maximum.

¹⁷ The IPDI was quite unhappy about this arrangement and strongly contested it.

which joined the umbrella of the Development Fund has mostly been repaid, whereas repayment of the debt of the Slovene railways started only in 2002.

At present, the IPDI can grant deferral of contribution payment to legal and natural persons for up to six months or permit debt repayment in (at most) six monthly instalments in two instances. The first occurs if the causes for financial hardship are actually a *force majeure*, such as natural disasters, severe illness or injury of the insured person (contribution payer). Deferment and/or repayment in monthly instalments is also granted to those persons who experience financial hardship and low liquidity because of unmet obligations of their main customers, who have filed for bankruptcy.

In 2002, the IPDI received 2,785 applications from natural persons and 70 applications from legal persons for deferment of contribution payment, partial write-off, write-off or repayment in monthly instalments. The governing board of the IPDI in the same year granted write-off or partial write-off to 1,027 natural persons and deferment of payment or payment in instalments to 50 natural persons and 10 legal persons. The IPDI also received additional recommendations for write-off of debt from the Tax Administration: this debt is actually uncollectable, and write-off was granted in all cases.

The 1999 PDIA (Article 229) also introduced a new channel for the deferral of contributions. Thus, in exceptional circumstances, meaning when the employer is in a process of financial consolidation or in cases of large employers (meaning firms employing a large number of workers), these employers turn to the Minister of Labour for contribution deferral. If the minister grants this request, the Tax Administration is informed and acts accordingly.¹⁸ In effect, “big” cases land on the minister’s desk, whereas small or medium cases are resolved by the IPDI. If deferment is granted, no penalty interest rates are applied.

Table 10 provides some information on the extent of arrears (contribution debt) during the period 1996–2002.

As seen from Table 10, the larger part of this debt is debt of natural persons. This is very much due to the technique of contribution collection. With legal

¹⁸ The minister can grant deferment for a maximum of six months. Firms can re-apply, provided they have cleared their previous debt.

persons, the payment of wages is closely tied to the payment of contributions; contributions must be paid at the most six days following the disbursement of wages. If this is not done, the employer cannot disburse wages the next month, at least not through the banking system. For natural persons the matter is quite different: they must pay contributions in regular instalments (monthly), regardless of the actual income they earn in a given period. It is though true that they can apply for a lower contribution base (but not less than the minimum wage) in case of a larger decline in current income.

Table 10
Structure of contribution debt of the IPDI, Slovenia, 1996–2002

Year	Legal persons	Natural persons	Debt as % of GDP
1996	21.8	78.2	0.62
1997	18.9	81.1	0.64
1998	17.2	82.8	0.59
1999	11.5	88.5	0.54
2000	5.2	94.8	0.47
2001	15.7	84.3	0.46
2002	11.6	88.4	0.45

Source: Annual reports of the IPDI.

Note: Debt as of December 31 of corresponding year.

The large drop in the share of the contribution debt by legal persons in 1999, 2000 and 2002 is due to the fact that legal provisions allowed them to be deleted from the business registry. Consequently, their debt is erased from the debt accounts of the Tax Administration. The increase in the share of contribution debt owed by natural persons is not only due to the aforementioned administrative measures involving legal persons, but also because the insurance base for natural persons (the self-employed) has been steadily increasing, and this directly translates into an increasing debt.

5.3. *Non-compliance and Evasion of Employees and Self-employed*

Contribution evasion in Slovenia takes different forms, depending mostly on the size of the firm, business activity and also on the ownership structure.

Small private firms do not register all of their workers in the Registry or employ these workers in the form of contractual work. Remuneration from contractual work is subject to personal income taxation and a “special” additional tax but was, until recently, not subject to any contribution payment. Even the special contribution rates introduced in 2000 are quite low. Unregistered employment is more frequent in smaller private firms and with the self-employed, particularly in the construction industry. Smaller employers frequently pay contributions from the minimum contribution base, though the workers receive higher remuneration than the minimum wage; this difference is paid out in cash.

In larger firms, even those owned by the state, employment through work contracts (contractual work) is frequent. Students who perform contractual work are taxed at even lower rates than others performing contractual work, as they pay for each work contract SIT 610 (about EUR 2.57) for health insurance and SIT 1,473 (about EUR 6.3) for pension and disability insurance. The former is mostly meant for disability insurance.

The extent of fictitious self-employment is not known. It is though hoped that the new personal income tax law will clamp down on such forms of evasion, as the nature of income produced will not be judged according to the legal form, but on the basis of the “dependency” relationship – i.e. how this income was actually gained. A related problem (i.e. unclear status) with regard to the self-employed is the position of owners or partners of private firms. According to the PDIA, these insured persons are included among the self-employed; but in actual fact most of them are registered as employees. This means that the firm submits to the tax authorities (on a monthly basis) the REK-1 form, which includes wages paid and contributions due of the partner(s). A survey carried out by the Tax Administration has even shown that some 10 percent of these owners (partners) do not submit the REK-1, meaning that they do not submit any evidence of disbursed wages and paid contributions (Vezjak, 2003, p.99).

5.4. *Non-compliance and Pension Rights*

What is counted as an insurance period? The main requirement is that contributions have been paid. However, there are exceptions to this rule. Thus, periods for which contributions have been, according to the documentation of the IPDI, accounted (but not necessarily paid) are also counted as an insurance period. This means that the employer submitted the M-4/M-8 forms. In principle, one could not go on “accounting” contributions without paying them, as non-payment of contributions in one month would prevent the employer from disbursing wages the following month.

Though, as a general rule, only years for which contributions have been paid are counted for the calculation of one’s pension, the Pension and Disability Insurance Act of 1999 permits a more generous or – should we say – lenient approach, and counts as contribution periods all the years for which it can be established that contributions were due (and not necessarily paid). In effect, this means that there must be proof that wages have been paid to workers.

6. Recommendations

6.1. *Establishing Documentation on Paid Contributions at the Individual Level*

At present neither the IPDI nor the Tax Administration collects and stores data on contributions paid, at the level of insured persons. This does not seriously endanger the social insurance rights of insured persons, as only proof of wages disbursed by the employer is required for ascertaining periods of insurance. This might change, however, and it is therefore necessary to make progress in this area.

6.2. *Submitting Notification of Contributions Due (The REK Form)*

The present system of contribution payment and its relevant regulations have a serious flaw. Namely, the self-employed are required to pay social contributions in regular instalments (monthly). On the other hand, employers have the obligation to pay social contributions only upon submitting the REK notification form to the Tax Administration. We recall that this form is submitted upon disbursement of wages, and it includes the amounts of social contributions due. Without submitting this form there is no obligation to pay social contributions. In other words, the employer can evade payment of contributions simply by not presenting this notification form.

This means that employers' contribution arrears are registered only if they submit the REK form and do not pay the amount of social contributions due, as stated in the REK form. As there is no formal legal time limit for submitting the REK form, the amount of actual contribution evasion by the employers is not known.

Of course, the decision to make the submitting of REK forms mandatory, and to proscribe a time limit for this is not an easy decision. A number of issues would have to be addressed, such as the simple question: if wages were not disbursed, what would be the contribution base for social contributions? An obvious solution would be to use the minimum contribution base, i.e. the minimum wage. Furthermore, the decision to make the submitting of REK forms mandatory would increase the contribution debt and also increase the work load of the tax personnel, mainly for enforcement procedures. It would also result in a sharp increase in the number of proposals for firm liquidation, bankruptcy, etc. On the other hand, the non-payment of wages and consequently the failure to submit the REK form means only a prolongation of agony: if the firm does not disburse wages and pay contributions, the liquidation or bankruptcy proceedings are imminent in any case.

6.3. *Weak Coordination of Control of Contribution Payments*

Though control of contribution accounting and payment is in the domain of the Tax Administration, both institutes for social insurance – the Institute for Health Insurance and Institute for Pension and Disability Insurance

– maintain independent control of contribution accounting and contribution payment for “their” contributions. Thus, auditors of the IHI perform auditing for matters concerning health insurance whereas auditors of the IPDI perform auditing for matters concerning pension and disability insurance. There is evidence of insufficient coordination of activities between these two social insurance institutes, and also insufficient exchange of information. This ought to be improved.

6.4. Submitting the Contribution Notification Form (REK Form) in Paper Format

There are at present some 80,000 legal persons, of which about 34,000 are employers. This means that 46,000 legal persons do not have any employees; they are formally registered but do not operate.

Some 34,000 REK–1 forms must be submitted monthly by legal persons, assuming that wages are disbursed once per month. Also, some 20,000 REK–2 forms must be submitted monthly; these forms refer to other forms of remuneration, such as remuneration for contractual work, royalties, rents, etc. The amount of REK–3 forms which refer to monthly awards to apprentices is negligible. Submitting these forms in paper format is time consuming and fraught with errors in transmission and coding.

Providing the possibility for submitting these forms in electronic format would improve the quality of the data. It would also be an efficient means of data transmission and would eliminate errors in data transfer and enable easy verification and less need for corrections. We have already mentioned that the Tax Administration embarked on this project, though without a clear schedule for completion. Obviously, much depends on the IT system which would have to be developed.

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