DEDUCTIBILITY OF CONTRIBUTIONS TO VOLUNTARY PRIVATE PENSIONS

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ABSTRACT: The present paper approaches the notion of public and private pension in Romania. Pension can be seen in terms of a replacement income to individuals whose age no longer affords to operate in the labour market. Pension reform in Romania has allowed besides the public pension system, called Pillar I, which is a distributive system based on solidarity between generations also a private pension system that records the contributions of participants in individual accounts, based on capitalization, investment and accumulation of these contributions.

KEY WORDS: public pension; private pension; pension system; distributive system.

JEL CLASSIFICATION: H55.

1. GENERAL CONSIDERATIONS REGARDING PENSIONS

Pensions are the main and traditional form of social security care for people. Pensions represent monthly entitlements that are granted throughout the life from retirement, outgoing people to achieve a certain limit due to age or disability, survivors' children to a certain age and surviving spouse, to ensure them decent living conditions. So, pension can be seen in terms of a replacement income to individuals whose age no longer affords to operate in the labour market.

In the Romanian public system are granted the following categories of pension: old-age pension, early retirement pension, invalidity pension, survivor pension. Financial security at retirement can be supported through diversification of the pensions’ sources, a pension system that is based on several components.
Pension reform in Romania has allowed besides the public pension system, called Pillar I, which is a distributive system based on solidarity between generations (according to Law 19/2000 on public pension and other social insurance rights, with subsequent amendments) also a private pension system that records the contributions of participants in individual accounts, based on capitalization, investment and accumulation of these contributions (Isac, 2009).

Table 1. Characteristics of pensions types in Romania

<table>
<thead>
<tr>
<th>Pension type</th>
<th>Contribution type</th>
<th>Type of fund management</th>
<th>Age of persons participating in the system</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public pension</td>
<td>Compulsory</td>
<td>Public</td>
<td>All employees aged over 45 years old, and optionally those aged between 35 and 45 years old</td>
</tr>
<tr>
<td>Mandatory private pension</td>
<td>Compulsory</td>
<td>Private</td>
<td>All employees aged under 35 years old and optional ones aged between 35 and 45 years old</td>
</tr>
<tr>
<td>Voluntary private pension</td>
<td>Voluntary</td>
<td>Private</td>
<td>Employees aged up to 60 years old</td>
</tr>
</tbody>
</table>

Private pension system is implemented in two forms:

Table 2. Private pension system in Romania

<table>
<thead>
<tr>
<th>Private Pension type</th>
<th>Pillar</th>
<th>Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mandatory private pension</td>
<td>Pillar II</td>
<td>Law 411/2004 on privately managed pensions, as republished</td>
</tr>
<tr>
<td>Voluntary private pension</td>
<td>Pillar III</td>
<td>Law nr.204/2006 regulated by law on voluntary pensions.</td>
</tr>
</tbody>
</table>

2. PENSION SYSTEMS CLASSIFICATION

The individual may be required to ensure in the public pension system or to a private insurance company. Generally, private companies use the fund type system and state systems are mandatory pay-as-you-go (PAYG).

In the fund type system, the insured person contributes to a personal fund, whose accumulation is invested in stocks, bonds, investment funds, generally speaking in financial values. Gained profit can be entrusted with the insured person and / or insurance company and the account value can be received in one sum or in annuities based on life expectancy of cohort (group) to which it belongs.

PAYG system is based on intergenerational solidarity, active people contributing to retired people.

This transfer can be represented by the formula:
Deductibility of Contributions to Voluntary Private Pensions

\[ SWL = PN \]  \hspace{1cm} (1)

\( S \) - contribution rate to the PAYG system;
\( W \) - average income;
\( L \) - number of workers;
\( P \) - average size of pension;
\( N \) - number of pensioners.

In general, you can use the concept of trust between people and generations to explain why our pension system continues to exist.

First, the current young generation has confidence in the future young generation that will contribute to her pension, and on the other hand has a sense of solidarity oriented thru today’s older generation by contributing to the PAYG system.

Pension systems classification as pension fund systems and PAYG systems can be superimposed with another type of classification, namely, defined contribution systems and defined benefit systems.

In defined contribution schemes, which are usually fund type, the policyholder knows only his contribution, because he can not evaluate the future retirement benefits, as they depend on interest rates and financial market developments.

Instead, he knows at any time the accumulated fund value. In defined benefit schemes, pension amount is calculated by a formula that includes the contribution period and salary amount.

Pension systems can be classified according to several criteria. If we consider the promised benefits and how the promises are financed, we can speak of two types of plans:

![Figure 1. Classified of pension system](image)

Sponsors innovate to get adequate retirement plans for employees which will provide some income and also, to share the investment risk between the sponsor \ pension fund and beneficiaries.

Today, DB plans are under pressure due to legislative changes, environmental background, past years levels of investment gains and awareness of their costs in an environment with low interest rate. As a result, the attention is moving more increasingly towards to type DC plans (Hughes & Stewart, 2004).
2.1. Defined Benefit (DB) Pension Plans

Summary of DB plans is that they involve a defined benefit, i.e. a predefined specified amount, expressed either as a sum of money in a particular currency or as a percentage of final salary or average salary of a number of years before retirement. Pension level can thus be expressed in absolute terms - as a fixed amount or in relative terms - as a percentage.

The DB pension plans involve participants and / or sponsors certain amount of contribution over the years. The percentage which shows the part of final salary or average monthly salary a number of years is the DB pension is called replacement rate.

Most often, participants in such plans do not know the benefits level to be achieved nor the calculation mode. It is found that the calculation is amended even at short intervals of time, creating major disparities between individuals. System administrators and financial experts know that there are budgetary constraints which link contributions, the benefits of a certain replacement rate (Ambachtsheer, 2007).

Traditionally, retirement plans established by the DB type companies define annuities based on the number of working years multiplied by a factor whose product is the replacement rate. Including in the formula the number of working years creates a nonlinear growth.

However, some theorists argue that DB exclusive plans expose the employees before retirement to a low wages risk, which obviously affects the future pension level.

2.2. Defined Contribution (DC) Pension Plans

The type DC plans require that the participants and / or sponsors contribute with certain sums, established in the pension plan - expressed in absolute amounts or as a percentage of salary.

These contributions may be partially or totally voluntary. Participants invest the contributions in various types of assets, with no guarantee of any investment return, so the investor must face the entire investment risk.

Therefore, the pension level is uncertain even before retirement, because it depends entirely on investment performance of accumulated contributions. It is likely that two people who have contributed the same amount, but chose different types of assets allotment may receive different amounts at retirement.

Similarly, two persons with an identical contributions history may receive different pensions in different times.

Contribution levels may change for reasons such as changes in tax laws for any mandatory or optional schemes or as the contributions investment return results in an inadequate or excessive replacement rate.

Therefore, there is a crucial distinction between two types of plans. The main feature of the DB plan is that retirement income is defined - a fixed replacement rate will be paid to participants, while a DC type plan involves variable and unsecured incomes during retirement, which may be higher or lower depending on contributions investment performance (Matei, 2007).
By multiplying the contribution rate with nominal wage we can obtain the nominal contribution. In type DC plans, investment performances are volatile. If volatility is eliminated, either through an investment strategy or product backed by a present value of annuity during retirement, then earnings are based on wage growth. In other words, if the rate is guaranteed, the replacement rate - which is a salary percentage (average of years or last month), can be guaranteed, due to wage growth. This is the main feature of DB plans.

3. FINANCIAL POLICIES REGARDING TAX DEDUCTIONS IN THE PENSION SYSTEM

Under the applicable legal framework on voluntary pension scheme prospectus approval, the contribution to the Fund for each participant is deductible from his income, up to an amount equivalent in lei of 400 (four hundred) Euros in an year tax. The employer contributions to the Fund in proportion to its share of participation is deductible in calculating taxable income, up to an amount for each participant equivalent in lei of 400 (four hundred) Euros, for a fiscal year.

If the tax treatment of contributions modifies during the Fund changes will take effect in accordance with applicable regulations.

Table 3. Calculation of tax deductibility of voluntary pension

<table>
<thead>
<tr>
<th>Gross income</th>
<th>CAS (9.5%)</th>
<th>Health (5.5%)</th>
<th>Unemployment (0.5%)</th>
<th>Net income (lines 1-2-3-4)</th>
<th>Personal deduction</th>
<th>Possible contributions</th>
<th>Employee contrib. pillar 3</th>
<th>Income base (lines 5-6-7-8)</th>
<th>Pay income tax (16%rd.9)</th>
<th>Difference after tax (lines 9 -10)</th>
<th>Net amount for employed (lines 11+8+7+6)</th>
<th>Withholding and payment of contributions on behalf of the Fund P3</th>
<th>Net &quot;tangible&quot; income / &quot;CASH&quot; (lines 12-13)</th>
</tr>
</thead>
<tbody>
<tr>
<td>500</td>
<td>47,5</td>
<td>32,5</td>
<td>2,5</td>
<td>417,5</td>
<td>250</td>
<td>0</td>
<td>60</td>
<td>107,5</td>
<td>17,2</td>
<td>90,3</td>
<td>400,3</td>
<td>60</td>
<td>340,3</td>
</tr>
<tr>
<td>1500</td>
<td>142,5</td>
<td>97,5</td>
<td>7,5</td>
<td>1252,5</td>
<td>190</td>
<td>0</td>
<td>60</td>
<td>1002,5</td>
<td>160,4</td>
<td>842,1</td>
<td>1092,1</td>
<td>60</td>
<td>1032,1</td>
</tr>
<tr>
<td>3000</td>
<td>285</td>
<td>195</td>
<td>15</td>
<td>2505</td>
<td>0</td>
<td>0</td>
<td>60</td>
<td>2445</td>
<td>391,2</td>
<td>2053,8</td>
<td>2113,8</td>
<td>60</td>
<td>2053,8</td>
</tr>
</tbody>
</table>
Calculation of income tax from wages influenced by the contributions to voluntary private pension fund is established by art. 57 of the Tax Code, as follows:

**Table 4. Calculation of income tax**

| Monthly tax = Income basis for calculation 16% |
| Income basis for calculation = Net income - personal deduction - union contribution - its own contribution to the voluntary pension fund |
| Net income = gross income - monthly mandatory contributions (CAS 9.5%, Health 5.5%, 0.5% unemployment). |

CSSPP contributes to stimulating the employers’ interest in providing voluntary private pensions and increasing its attractiveness to employers and employees.

Encouraging participation in voluntary pension system contributes to long-term savings stimulation through private pension and thus ensures an increase in life quality for future retirees, closer to the active period.

For employers, voluntary private pension can be an effective tool to motivate employees and human resource management but also an advantageous solution regarding tax policy - a tax deduction amount of 400 Euros per year per employee and 400 Euros / year for the employer.

Thus, there are some opportunities for employer:

- Lower tax base;
- Lower taxation for employer and employee;
- Tax advantages;
- The amount of voluntary pension fund contribution is deductible: for the participant (employee), the monthly gross income or other similar income thereof, up to 400 Euro per fiscal year; for employees, taxable income, up to 400 Euro per fiscal year.

Contributions to a voluntary pension fund will be monthly deducted from the salary (the employer is responsible), similar to other existing statutory deductions, but not more than 400 Euro (equivalent in lei) per year.

Exchange rate will be the central bank rate the last day of the month for which salary is paid. Any amount exceeding the limit of EUR 400 will not be deducted.
Table 5. Example - tax exemption for employer

<table>
<thead>
<tr>
<th>Company pays bonuses for employee 100 Employees</th>
<th>Company contributes for the employees to a voluntary pension fund 100 employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual bonus per employee - 700 RON (-200 EURO)</td>
<td>Annual employee bonus – 700 RON (-200 EURO)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>P&amp;L</th>
<th>P&amp;L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue 1000</td>
<td>Total Revenue 1000</td>
</tr>
<tr>
<td>Other expenses 500</td>
<td>Other expenses 500</td>
</tr>
<tr>
<td>Bonuses paid as wages 70</td>
<td>Contribution to voluntary pension fund 70</td>
</tr>
<tr>
<td>Tax on salary 21.21</td>
<td></td>
</tr>
<tr>
<td>Bonus wage costs 91.21</td>
<td></td>
</tr>
<tr>
<td>Total expenditure 591.21</td>
<td>Total expenditure 570</td>
</tr>
<tr>
<td>Profit before taxation 408.8</td>
<td>Profit before taxation 430</td>
</tr>
<tr>
<td>Corporation tax 65.4</td>
<td>Corporation tax 98.8</td>
</tr>
<tr>
<td>Profit after tax 343.4</td>
<td>Profit after tax 361.2</td>
</tr>
</tbody>
</table>

4. CONCLUSIONS

Without saying that Romanian pension system’s problems can be solved relatively easily and quickly, we believe that specialists in the field need to impose their views over policy options and subjective and largely inefficient levers for the management of public money. In conclusion we can say the following aspects regarding the objectives of pension reform in Romania:

- relevant legislation must be clear and to apply effectively;
- ensure optimal operation of the private pension system, namely Pillar 2, and an increasing employees' contributions to these funds;
- stimulate and promote effective Pillar 3, the voluntary private pensions;
- frequent participants information regarding the pension funds not only on request;
- part of the employer's contribution to be paid to the funds of their employees and not only to supply the state social insurance budget.

REFERENCES:


