Pension Systems in Central and Eastern Europe:

in times of Crisis, Austerity and Beyond

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Objectives of pensions

- Provide adequate income security for the elderly
- Basic requirements
  - Sustainable in the long run
  - Credible for the commitment of future generations
- Pension reform addresses these issues while ensuring the main objective of the retirement income provision

Recent literature on pension reform

- World Bank, “Averting the old-age crisis”, 1994
- Beattie, R and McGillivray W, “A risky strategy”, ISSR, 1995
- Stiglitz, J. E. and Orszag. P.R., “Rethinking Pension Reform: Ten Myths about Social Security Systems”, 1999 (in H-S below)
- Holzmann, R. and Stiglitz, J. E. (eds.), “New ideas about old age security”, 2001
- Barr N, “Reforming Pensions: Myths, Truths and Policy Choices”, IMF Working paper, 2000 (ISSR 2002)
- Gillion et al., “Social Security Pensions: Development and Reform”, 2000, ILO/ISSA.
- ILO, “Social security: a new consensus”, 2001
- Holzmann R. and Hinz R. (eds.) “Old Age Income Support in the 21st Century”, 2005
- Holzmann R. and Palmer E. (eds.), “Pension reform: issues and prospects for non-financial defined contribution (NDC) schemes”, 2006.
- Barr N and Diamond P, “Reforming pensions”, Nov 2008

Trends of Pension Reforms in CEE countries

- Early 1990s
  - Pension system was used to resolve the unemployment problem
  - Rapid deterioration of the system demographic dependency
- From mid-1990s to mid-2000s
  - Reform adopting a Chilean type mandatory private funded pension pillar by scaling down the state pension
  - Parametric changes to tighten benefits (longer insurance period, higher retirement age, indexation from wage to price)
- From 2008 to present
  - Global economic crisis affected public and private pensions
  - Pressure to cut benefits in the context of fiscal consolidation in Europe (especially the countries receiving financial assistance)

Challenges in the Pension Systems in CEE countries

- Ensuring adequate pension benefits, retirement age and indexation method
- Non-compliance by undeclared work and evasion by underreporting of wages
- Weak enforcement for contribution collections
- Heavy financial dependence on the State budget
- Concerns with long-term sustainability in the ageing population
- Vulnerable to political interference
- Conflicting interest of key stakeholders

Typology of pension schemes

	Social insurance pension	Basic pension	Private pension	Pillar II	Sweden (NDC)	Sweden (FDC)
DB / DC	DB	DB	DC (or DB)	DC	DC	DC
PAYG / Pre-funding	PAYG	PAYG	Funding	Funding	PAYG	Funding
Public / private	Public	Public	Private	Private	Public	Public clearing house (PPM)
Mandatory / voluntary	Mandatory Employed	Mandatory Universal	Voluntary	Mandatory	Mandatory	Mandatory
Contribution / tax	Cont.	Tax or cont.	Cont.	Cont.	Cont. + tax	Cont.

Pension privatization in CEE and CIS states

- Countries which introduced mandatory, privately-managed pensions

  Hungary, Poland(*), Latvia(*), Bulgaria, Estonia, Croatia, Slovak Republic, Romania, Ukraine

  Kazakhstan(**), Russia, Azerbaijan, Kyrgyzstan(*), Tajikistan(*), Turkmenistan(*)

- Countries with PAYG pensions and considering the introduction of mandatory private pensions

  Albania, Bosnia and Herzegovina, Lithuania, Moldova, Serbia

  Armenia, Belarus, Georgia, Uzbekistan

- Countries with PAYG pensions and no mandatory private pensions(***)

  Czech Republic, Slovenia

Notes: (*) NDC, (**) Full privatization, (***) Recent developments

Comparison of Pillar II systems in selected CEE countries

	Hungary	Poland	Bulgaria	Croatia	Slovak Republic	Romania
Year of implementation	1998	1999	2000	2002	2005	2008
Contribution rate (Total pension cont)	8% (33.5%)	7.3% (19.52%)	5% (23%)	5% (20%)	9% (18%)	2.5% (29%)
Membership of the current workers at the start of the scheme	>49: stay out 30-49: option <30: comp	>49: stay out 30-49: option <30: comp	>=40: stay out <40: comp	>49: stay out 40-49: option <40: comp	optional	>44: stay out 35-44: option <35: comp
Membership of new entrants	compulsory	compulsory	compulsory	compulsory	optional (initially compulsory)	compulsory
Number of pension funds (2011)	19	14	10	4	6	9
Portfolio options	3	1	1	1	3	1
Central administration	Renationalization	Annuity payment		Central registry		

Questions on the multi-pillar pension reforms

- Are the objectives of the multi-pillar reform appropriate?
  - Primary goals: Protection against poverty in old-age
  - Secondary goals: Bolster economic growth through increased savings
- Did countries meet initial conditions on macroeconomic stability, financial market readiness, moderate indebtedness, and a low risk for corruption?
  - Many countries had poor records at the time of reform.
- Have the reform considered options to expand the coverage to those outside the formal pension system?
- Have multi-pillar reforms achieved the intended macroeconomic impact such as risk diversification in investment portfolio, increased savings, capital markets development, better labour market incentives?
  - These objectives remain largely unrealized.
  - Fiscal deficits have grown in many countries.
- Misleading terminologies
  - "Parametric reforms" versus "paradigmatic reforms"
  - "Single-pillar" versus "multi-pillar" reforms

Problems with “Pillar II” system

- Unpredictability of the future benefit level facing the volatile financial market risk
- Limited redistribution results in more inequality (e.g. gender inequality)
- Not enough attention is given to the payment phase, in particular the private market provision of life annuities and full indexation of benefits
- High administrative costs by private funds
- Transitional costs: The “gap” in the financing of the Pillar I system created by diverting part of the contributions to the new Pillar II system
- Transition cost will increase government spending (borrowing) in short- to medium-term.

Donor dependence: CEE and CIS

Countries with mandatory funded pillars		Countries with PAYG pensions	
Country	Amount of loans in $ million	Country	Amount of loans in $ million
Kazakhstan	323.8	Turkey	197.7
Russia	287.8	Bosnia and Herzegovina	43.5
Ukraine	147.0	Moldova	37.8
Hungary	124.1	Kyrgyz Republic	33.9
Romania	58.7	Serbia	25.2
Croatia	52.1	Georgia	14.7
Bulgaria	47.3	Uzbekistan	10.0
Lithuania	26.5	Armenia	8.9
FYR Macedonia	26.2	Slovenia	7.7
Slovak Republic	25.4	Albania	7.1
Latvia	20.9	Azerbaijan	5.9
Poland	2.6	Tajikistan	2.9
		Turkmenistan	0.6
Total	1,115.8	Total	422.3

Source: Independent Evaluation Group – World bank, “Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance”, 2006

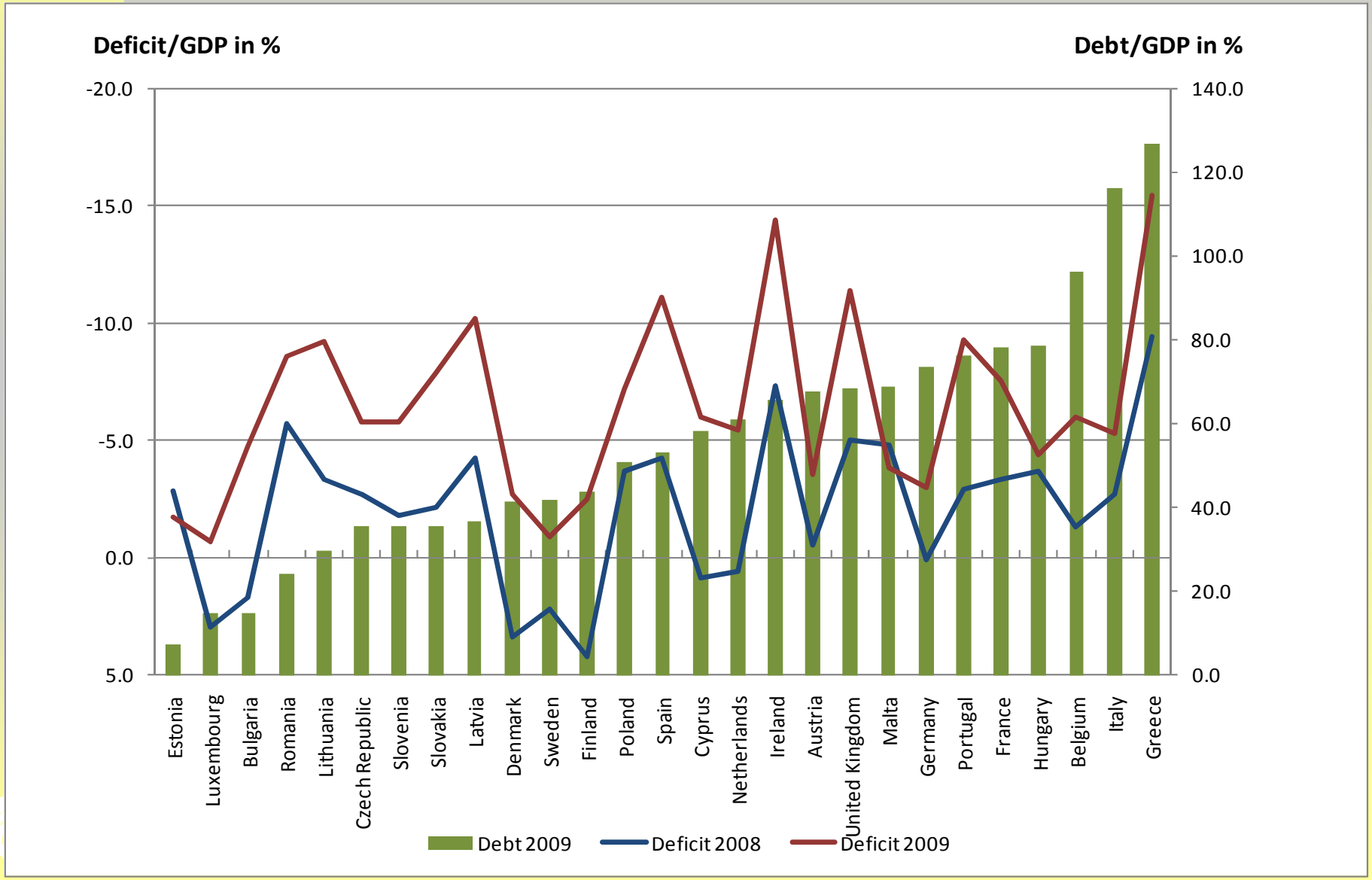
Direct impact of the crisis on pension systems: some lessons learned

- The crisis affected different categories of pension schemes in different ways. One lesson learned is the sensitivity of pension levels in fully-funded defined-contribution schemes with respect to the financial market volatility and the way its consequences had to be borne by workers.
- In defined-benefit pay-as-you-go pension systems, the immediate impact will be less severe than in fully-funded pension systems (private pension funds in OECD countries lost 23% of assets in 2008). However, long-term contraction of employment will also affect the pay-as-you-go pension system.
- The crisis hit different generations. The most affected are workers who are close to retirement, those with long periods of membership in the funded pension schemes, and in particular those whose investment portfolio is exposed to riskier assets such as stocks. Those pensioners in private pension plans who did not take annuities upon retirement were also seriously affected.

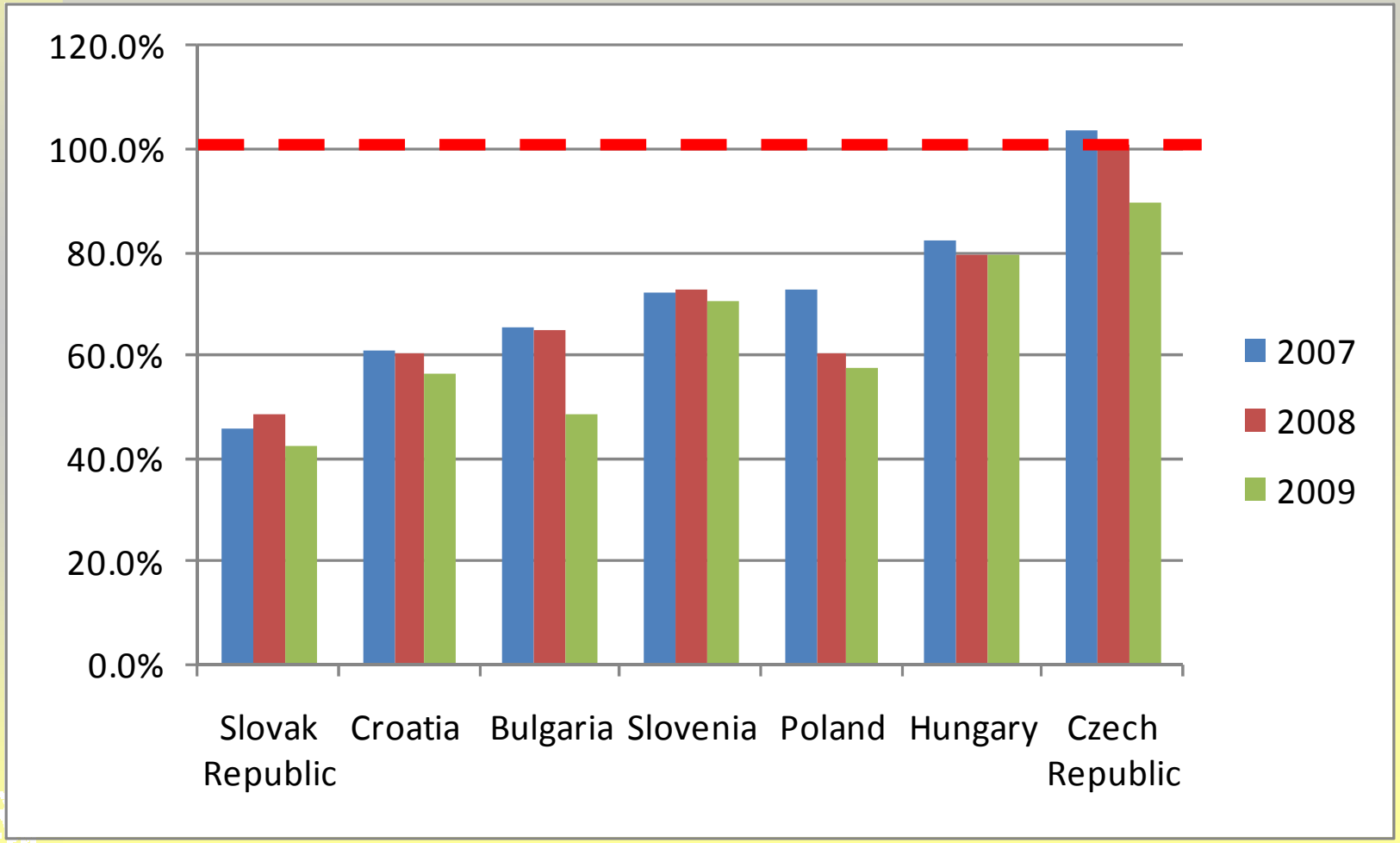
Indirect impact of the crisis on pension systems

- The crisis is seen as a justification for imposing fiscal austerity in particular for countries receiving emergency financial assistance from IMF and EU (e.g. Greece, Hungary, Latvia, Romania, Ukraine)
- Pension system was particularly vulnerable due to its large dependence on government budget to cover the deficit (partly caused by transition costs associated with Pillar II system)
- Severe cuts in pension rights motivated by reducing government deficits caused serious social uprisings (e.g. France, Greece, Spain)

Government debts and deficits in EU 27 countries, 2009



Ratio of pension contributions to the expenditure, 2007-09



National responses in 2009-2011: convergence or divergence

- Hungary
  - Increase in retirement age from 62 to 65 years by 2020
  - Indexation dependent on GDP growth
  - Re-nationalization of mandatory private pension funds
- Bulgaria
  - Increase in contribution rate by 1.8 %-points
  - Increase in insurance years 37/34 to 40/37 years
  - Increase in retirement age from 63/60 to 65/63 years from 2021 to 2026
- Romania
  - Continuous increase in women's retirement age from 60 to 63 years by 2030
  - Gradual shift to price indexation
- Croatia
  - Increase in women's retirement age from 60 to 65 years by 2030
- Czech Republic (proposal)
  - Decrease in contribution rate by 5 %-points
  - Introduction of mandatory private funded pensions

Normal retirement age and life expectancy

Country	Year	Normal retirement age (NRA) (years)		Life expectancy at NRA (years)	
		Men	Women	Men	Women
Germany	2010	65	65	17.0	20.7
	2030	67 (by 2029)	67 (by 2029)	16.1	20.1
United Kingdom	2010	65	60	17.0	24.5
	2020	65	65 (by 2020)	17.7	21.2
Bulgaria	2010	63	60	14.4	21.0
	2030	65 (by 2024)	63 (by 2026)	14.3	20.7
Croatia	2010	65	60	14.8	22.7
	2030	65	65 (by 2030)	16.5	20.6
Czech Republic	2009	62	60	16.1	21.8
	2030	65 (by 2030)	65 (by 2030)	16.3	20.6
Hungary	2010	62	62	14.5	19.9
	2020	65 (by 2018)	65 (by 2020)	14.0	19.4
Romania	2011	64	59	13.9	21.7
	2015	65	60	13.5	21.4
	2030	65	63 (by 2030)	14.4	20.5
Poland	2010	65	60	14.4	23.1

What is the sustainability of a pension system?

- In a narrow sense, the system is financially sustainable if
  - The size of pensions transfer in terms of output (pension-to-GDP ratio) does not diverge
  - The long-term actuarial pension liabilities are adequately met by the expected contributions and the reserves (long-term solvency)
- Since a public pension system relies on the intergenerational transfer, its sustainability critically depends on whether the working generation is committed to pay contributions for the elderly generation.

Dynamics of Pension-to-GDP ratio

The following formula holds:

$$\Delta(P/Y) = (N - D)/Y + (i - g)\, P/Y$$

where

Y : Output (or total payroll)
P : Pensions payment
N : Pensions for the newly retired
D : Pensions for the deceased retired
g : Rate of growth of output (or total payroll)
i : Rate of indexation of pensions

Hence, the condition for non-increasing P/Y is

$$\Delta(P/Y) \leq 0 \quad \Leftrightarrow \quad (N - D)/P \leq g - i$$

Tensions related to pension reforms

- Initial condition
- Demographic pressure
- Socio-economic changes
- Competitiveness pressure
- Political inertia (protecting vested rights)
- Political interference (populist measures related to election)
- Loopholes (non-declaration, evasion) with weak control
- Behavioural factors (financial literacy)
- Erosion of trust by the public, in particular by young generations
- Pressure from interest groups
- Supra-national pressure (EU, IMF)

Issues in future directions of pension reform
(1) Sustainability and adequacy

- The basic objective of pension reform is to make the system sustainable in the long run and credible for future generations, while ensuring its main function of providing adequate income security for the elderly, disabled and survivors.
- The pension systems in CEE countries are facing an imminent challenge of improving their financial stability and a long-term concern with sustainability in the face of the anticipated demographic change.
- The future pension reform will naturally address the sustainability problem through modifications of key scheme parameters such as the benefit level, retirement age, pension indexation and contribution rates. However, in view of the dominant role of the pension system in poverty reduction for the elderly, attention should also be paid on how to ensure the adequate benefit level under the financial constraint.
- In this regard, the ILO Social Security Minimum Standards Convention No. 102 which many European countries have already ratified, as well as the Social Protection Floor initiative which was recently endorsed by the ILO, will provide guideline for developing a mechanism to safeguard the adequacy of the pensions.

Issues in future directions of pension reform
(2) Extension of coverage by improved compliance

- Extending the coverage of pension system through improved law compliance and efficient contribution collections is crucial not only from a point of view of ensuring workers' basic right, but also from a point of view of creation of fiscal space necessary for sustaining the system in the long run.

- Further extension of coverage of the currently non-covered workers, coupled with the improved law compliance through tacking the problems of informal work, would result in more contributors, which would mitigate the upward pressure of the demographic dependency of the pension system. In addition, enhanced enforcement of contribution collections through effective inspection and fraud control would contribute to the extension of the tax base.

- All these will contribute to the increase in the revenue to the social security fund in the short run, and more importantly, to the reduction in the long run the need for social assistance for the poor and low income elderly population who do not receive pension due to non-coverage.

Issues in future directions of pension reform
(3) Process of pension reform

- The policy making process is an important aspect of pension reform. Since the reform inevitably affects the conflicting interests of tripartite stakeholders, it is important that the reform process should seek to build a national consensus on a package of measures acceptable to all stakeholders.

- Tripartite and social dialogue is of fundamental importance in the policy making process. However, in practice one often faces the situation in which the process is hampered with the conflict of interest between tripartite stakeholders and other pressure groups. In order to find a solution for balanced reform package, key stakeholders should exhibit willingness to make a pragmatic compromise, rather than protecting vested rights or persisting to the competitiveness argument. The proposed reform should be supported by the future contributing generations.

- Implementation of pension reform measures requires a sufficiently long transition period to avoid abrupt changes in the life plans of workers close to retirement. In addition, the demographic dependency is projected to worsen from around 2020. Therefore, it is crucial that policy makers should take proactive steps to implement the reform measures to ensure the long-term viability of the system.

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