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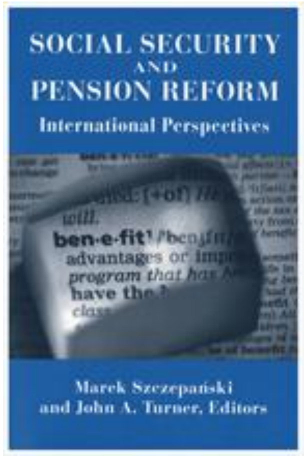

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International Perspectives

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Pension Reforms in Central and Eastern European Countries, 1998–2012

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Since the end of the 1990s, a number of countries in Central and Eastern Europe carried out structural pension reforms, including the introduction of a privately managed pension system, the so-called second-pillar pension system. The reforms were clearly influenced by the book *Averting the Old Age Crisis*, published in 1994 by the World Bank. The Central and Eastern European (CEE) countries that implemented this type of pension system include Hungary (1998), Poland (1999), Latvia (2001), Bulgaria (2002), Croatia (2002), Estonia (2002), the Former Yugoslav Republic (FYR) of Macedonia (2003), Slovakia (2005), and Romania (2008).

This chapter covers a wide topic: social security pension reform in Central and Eastern Europe. The chapter surveys the main tendencies and discusses the reforms in the region in general terms, with a more detailed discussion about Poland, which was one of the forerunners of both the structural reforms in the late 1990s and the reforms at the time of crisis. The chapter concentrates on structures and types of mandatory general pension systems without going into details of the systems' design.

The chapter starts with a brief description of the heritage of communism in pension systems and the early transition. The next section deals with the structural pension reforms in the late 1990s and early 2000s. The following section presents basic differences between countries, concerning solutions within pension systems and their situation. The next section is devoted to the impact of crisis on pension systems and the resulting "second wave of reforms." Conclusions follow.

HERITAGE OF COMMUNISM AND EARLY TRANSITION

When the CEE countries started their transition from communism to democracy and from a centrally planned economy to a market economy, the heritage of communism was largely negative. However, in the pension area, contrary to many others, the countries inherited existing and functioning institutions.

The pension systems in the CEE countries had many similar characteristics in the early 1990s (Barr and Rutkowski 2005; Hirose 2011):

- Social security pension systems, financed on a PAYG basis, were the only source of income in old age, as occupational or individual pension plans did not exist.
- The systems were fragmented, with privileges for some groups, such as lower retirement age or more generous benefit formulas.
- Access to pensions was easy: the normal retirement age was low, there were many early retirement possibilities, and disability pensions were granted relatively easily.
- Even if pensions were financed by contributions (the "Bismarck" approach), the entire contribution was paid by the employer and pensions were only partly related to contributions, due to many redistributive aspects in the benefit formulas.
- There were no records of contributions at an individual level and no clear lines of demarcation between the state budget and the budgets of the social security systems.

At the same time, there were also differences between CEE countries concerning solutions in the pension system or generosity of pensions. CEE countries entered the transition to the market economy with inherited pension systems that had been adjusted to the circumstances of a centrally planned economy. In the early transition, some changes were introduced that made the pension systems compatible with a market economy (Barr and Rutkowski 2005), including

- indexing pensions to cope with high inflation;
- improving incentives, such as through increasing the number of years used to calculate a pension; and
- strengthening administration.

Poland, like most other CEE countries, has a long tradition of social insurance that was still present under communism, although with some important elements of a state redistribution system. The Polish pension system was in a sense between the traditions of “Bismarck” and “Beveridge” (Żukowski 1994).

The transformation process influenced the Polish pension system: the number of contributors fell and the number of pensioners rose, partly as a result of special early retirement plans connected with unemployment. This, together with an increase in pension levels, led to a financial crisis. These were costs of a successful policy protecting incomes of retirees in the difficult time of an economic and social transformation.

Several reform plans met with political resistance, and changes introduced affected only some parameters of the system, without a structural reform (Żukowski 1996). Unlike many other areas of the economy, the pension system was reformed only in the “second wave” of the reforms.

There are several reasons why the pension reform was made only 10 years after the beginning of transformation. First, Poland had inherited from the communist era an old-age security system that was able to function under the changed circumstances, unlike many other areas that had to be built from the beginning, such as taxes, banks, capital market or—in the social policy area—labor market policy. Second, for exactly the above reasons, at the beginning of the transformation some important preconditions for functioning of pension funds, which were an element of almost every reform concept, were absent (capital market, banks, insurance). Third, a political consensus necessary for such a deep reform was absent in Poland for a longer period. Still, however, with time, the understanding of the problem, especially of the systematic burden of the system, has been growing.

STRUCTURAL PENSION REFORMS

Many CEE countries introduced structural social security pension reforms in a second wave of reforms. These reforms created “multitier pension systems” (Żukowski 1997), with a mandatory second tier (or pillar) of privately managed pension funds. As these new second pillars replaced a part of the previous social security PAYG systems, the structural reforms were also described as (partial) privatization of old-age security. These pension reforms in CEE countries were influenced by the World Bank report (1994) and followed the examples of some countries in Latin America (Müller 2003).

The first two CEE countries to introduce such a reform were Hungary (1998) and Poland (1999). Several other countries followed: Latvia (2001), Bulgaria (2002), Croatia (2002), Estonia (2002), the FYR of Macedonia (2003), Slovakia (2005), and Romania (2008).

As a result of these structural pension reforms, the new EU member states are a majority of countries within the EU with a mandatory second tier (Table 7.1). The exceptions were the Czech Republic, Slovenia, and Lithuania, which preserved their "Bismarckian" PAYG systems with no mandatory pension funds.

Apart from the common feature of replacing a portion of the PAYG plan with a fully funded plan, the exact reform patterns in these countries differed in many respects. In the PAYG social security systems (now called the first-pillar pension systems), some countries (such as Poland and Latvia) introduced notional defined contribution accounts, while the others kept the defined benefit formula, but often reformed through, for example, the extension of the qualifying period in terms of years of work needed to receive a benefit. Also, the second-pillar pension systems differed in terms of contribution rate, administration, and coverage.

There are various explanations of the structural pension reforms in CEE countries. The role of international organizations, especially the World Bank, was stressed, especially in relation to the high foreign debt of the countries involved (Müller 1999, 2003). It was shown that the reforms were fostered by a transnational advocacy campaign (Orenstein 2008).

Economic objectives, such as accumulation of capital and economic growth, played a crucial role. The pension reforms were treated as a vehicle of modernization to accelerate the development of market economies. The reforms were introduced in specific circumstances of transition: "extraordinary" conditions of a transformation of almost all economic, social, and political institutions. In this situation, the political will to enact deep reforms was stronger than the political resistance to change.

Table 7.1 Types of Old-Age Security Systems in the EU-27

General state pension system (first tier)		Supplementary pension plans (second and third tiers)		
Pensions	Based on:	Voluntary		Obligatory
Earnings-related	Insurance/earnings (defined benefit)	Austria	Germany	France (o)
		Luxembourg	Belgium	Hungary (i)
		Greece	Portugal	Estonia (i)
		Spain	Slovenia	Slovakia (i)
		Lithuania	Cyprus	Bulgaria (i)
		Czech Rep.	Malta	Romania (i)
		Finland		
	Insurance/contributions (notional defined contribution)	Italy		Latvia (i) Poland (i) Sweden (i)
Flat-rate	Insurance (paying contributions)	Ireland		UK (s, o, or i)
	Residence			Denmark (o) Netherlands (o)

NOTE: s = state; o = occupational; i = individual.

In Poland, after several years of discussions on pension reform, the reform concept “Security through Diversity” (Office of the Government Plenipotentiary for Social Security Reform 1997) was to a large extent implemented. The new system took effect on January 1, 1999. Three factors enabled such a structural change in the old-age security system: 1) the critique of the old system, 2) the reform concept, and 3) an appropriate organization of the work on the reform, including political consensus.

The main objectives of the reform were both microeconomic and macroeconomic. The first microeconomic concern was to create a tighter link between contributions and pensions, thus strengthening the incentive to work and the disincentive to evade making contributions. The other microeconomic objective was to lower—in the longer term—social insurance contributions paid by the employer in order to reduce labor costs and to increase employment. The key macroeconomic aim was to lower the level of public expenditures on pensions, as a proportion of gross domestic product, to relieve public finance for other aims toward growth. The other aim was to induce people to save more voluntarily.

The new old-age pension system covered younger insured workers (under age 30) in full. Those aged 30–50 were given the option until the end of 1999 to participate (and split pension contributions accordingly) in both new pillars (PAYG and funded) or to stay in the new PAYG one with the entire contribution. The insured who were older than age 50 were not covered by the reform—they will retire according to the old rules.

The pension reform in Poland replaced a one-pillar system with a multipillar one. The new system consists of two obligatory parts: the first is pay as you go, which is administered by Social Insurance Institution (ZUS), and the second one is fully funded and privately managed. Between 1999 and 2011, these plans had contribution rates of 12.22 percent and 7.30 percent, respectively. Additional sources of income security, among them occupational pension plans, constitute the third, voluntary pillar.

Pensions from the first pillar will be based on the principle of notional defined contributions, whereas the old pensions have been defined benefit pensions. The new pension formula includes only two components: the sum of indexed contributions paid, divided by average life expectancy at retirement age in the calendar year of retirement. For persons born after December 31, 1948, who had been insured in social insurance before January 1, 1999, a "starting capital" according to the old pension rules will be assessed and recorded on the individual account in ZUS.

The same defined contribution formula (with real capital) will also be used in the second pillar. The newly created open-ended pension funds are administered by private pension fund societies, organized as joint stock companies. The insured may choose a fund and change the choice. The funds are supervised by a state agency, and there are strict regulations concerning functioning of the funds. A multistep procedure is foreseen in case of fund insolvency until another pension fund society overtakes a fund management. Every fund has to achieve a minimum rate of return, relative to the results of all funds.

IMPACT OF FINANCIAL CRISIS ON PENSION SYSTEMS—SECOND WAVE OF REFORMS

When the global financial crisis disrupted financial markets in 2008, the rate of return on investments from pension funds dropped dramatically. Moreover, the difficult state of public finances started to make further financing of the reform's transitional period increasingly difficult. This led to a discussion on "reforming the reform" in many countries. Extreme measures were taken in Hungary where the second pillar was renationalized in 2010. Poland, which pioneered the structural reforms with Hungary in the late 1990s, reacted also, but differently, reducing the contribution rate to the second pillar (Fultz 2012). A similar strategy to scale back the privatized pension systems, rather than to eliminate them, was developed in Slovakia, Romania, Bulgaria, Estonia, and Latvia (Hirose 2011; Orenstein 2011).

The crisis has also facilitated some pension system reforms to address both the current financial problems and future challenges, especially related to demographic developments. For example, later retirement has been legislated in several countries, including Poland (Hirose 2011).

In Poland, the pension system remained relatively stable in the 2000s. The reform debates concerned the "completing" of the reform started in 1999, and some issues have remained open until now (Golinowska and Żukowski 2011). In 2008, the issue of early retirement finally was solved, giving some restricted categories of workers who have worked under special (difficult) conditions bridging pensions starting in 2009.

The financial markets crisis revealed the weaknesses of the pension reform, which started in 1999. It was the reform itself that led to worsening of the financial situation of the Social Insurance Fund, and especially of its part related to old-age pensions. The reform created a large funded tier out of a part of a previously entirely PAYG system, which created a big deficit for the expenditure on current pensions. The financial markets crisis, which started in 2008, led to a further deterioration of old-age insurance finances: increasing subsidies to the social security system contributed to a growing deficit of the government budget. This provoked debates on introducing changes to the pension system, including the withdrawal of crucial structural elements of the new system.

A debate started in 2010 on a reduction of the contribution rate to the funded second pillar, with the money going to the notional defined contribution part, in order to lower the budget subsidies to the social security pension system and thus to lower the public debt. The discussions continued in 2011 with clear polarization of positions. Most economists criticized the proposal, claiming it was rescuing the present public finances at the cost of future generations (or at least governments) and dismantling the pension system and pension reform that had started in 1999. The government was successful in passing the law in Parliament. Beginning May 1, 2011, the contribution rate to the second pillar was reduced from 7.3 percent to 2.3 percent.

Another structural change that had not been tackled for political reasons was increasing the retirement age. Again, the financial markets crisis facilitated the reform. After the Parliamentary elections in October 2011, the new government, backed by the same Parliamentary coalition and led by the same prime minister, announced plans to increase the statutory retirement age. Starting in 2013, the statutory retirement age was raised by three months every year, reaching age 67 for both genders, in 2020 for men and in 2040 for women. After a short but intensive debate, the change was legislated in May 2012 and implemented in January 2013.

CONCLUSION

Most CEE countries introduced structural pension reforms as part of the transformation of their socioeconomic systems following the end of communism in Central and Eastern Europe. Modernization may thus be seen as the main objective in the first wave of pension reforms.

The second wave of pension reforms was closely related to the financial crisis that revealed problems of the pension systems and facilitated changes. However, contrary to some comments, no “death of pension privatization” occurred (Orenstein 2011). The second wave of pension reforms in CEE countries may be seen as an adjustment of pension systems to the circumstances.

There have been differences between the countries in terms of solutions and pension systems. In the first wave, most CEE countries opted for the introduction of the second pillar of privately managed pension funds. However, both the solutions in the main public PAYG systems differed, and the patterns of the second pillars were different. In the second wave, the countries again reacted differently.

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