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Pension reforms in Central and Eastern Europe – Public to private, and back to public

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Central and Eastern Europe's (CEE) experience of the pension reform process can illuminate some of the pitfalls of embracing systemic pension reforms too eagerly, with subsequent reversal of these reforms occurring some years later as governments found themselves increasingly under financial strain.

Employers in these countries (including U.S. multinationals with operations there) have lived through the reform process and must now shoulder an increasing pension burden.

The Polish Example

As the largest economy in CEE, the case of Poland provides a good example. In 1999, Poland enacted "public-to-private" systemic pension reforms of the then-existing pay-as-you-go (PAYG) state system. The reforms introduced private pensions and diverted a significant share of workers' contributions away from public pensions towards these private plans.

However, in a dramatic move in 2014, the Polish government then reversed these changes, with "private-to-public" reforms that saw the government transfer the equivalent of US $40 billion at present exchange rates of bond assets that had been accumulated within the nascent private pension system to the public system. By means of mandatory inclusion, the government also diverted a majority of contributions away from private pensions and back to public pensions.

In 2016, the government announced a further reversal of the previous system, although this is still to be fully formalised. The President recently signed legislation, which now obliges all Polish companies and multinational companies operating in Poland to offer a pension plan and automatically enroll all employees. The obligation will be phased in, with larger companies starting in mid-2019, but all companies eventually covered by 2021. With falling unemployment rates, there likely will be pressure on employers to ensure their plans are competitive by contributing above minimum levels.

Poland is not an isolated case, and public pension reforms across CEE countries have generally followed a similar pattern:

- Systemic reforms of existing public PAYG systems in the late-1990s and early-2000s
- Chosen reform model, often a defined contribution private pension that replaces part of public pension provision
- Subsequent reversal of these reforms, ranging from partial to complete

For example, in 2012 the government in Hungary seized a majority of assets that had accumulated within private pensions and effectively obliged almost all active workers to return to coverage under the public PAYG system.

Public-to-Private: drivers of pension reforms

Ex-communist countries in the early-1990s inherited relatively generous public PAYG pension systems, which had historically been shaped by socialist and other influences. Importantly, these systems often incorporated generous eligibility for early retirement, disability pensions, and preferential treatment of certain professions, such as the police or mineworkers.

With the fall of communism, the major socio-political-economic transitions brought strains as economies were restructured from centrally planned to market-based. Significant rises in unemployment ensued, and under the existing state benefit systems the newly unemployed were often granted early retirement pensions, increasing dependency ratios (i.e., the number of people receiving benefits divided by the number paying for those benefits).

These strains were exacerbated by demographic pressures, with sharp falls in birth rates and increases in life expectancy brought about by the same transitions. Existing public pension systems were increasingly viewed as unsustainable, with ever higher pension costs and lower contributions, and with dependency ratios projected only to worsen.

Parametric pension reforms therefore began in some cases. For example, CEE countries considered:

- an increase in the qualifying period for pensions;
- an increase in the pension age; and/or
- a move from indexing benefits in line with salaries to be in line with prices (or some combination of both).

Despite various measures taken to mitigate the strains, the governments recognized that additional reform was required. But which model should be chosen as the basis for a new pension system? In particular, should CEE countries try to ape the pension practices of Western Europe or instead look to follow an alternative path?

Public-to-private: model for systemic reform

The World Bank has long promoted a move away from total reliance on PAYG public pension systems. The Bank's preferred model is a "three-pillar" pension environment consisting of:

- Pillar 1 – Public pension (typically universal, PAYG), supplemented by the following two defined contribution private pension arrangements:
- Pillar 2 – funded by mandatory contributions from workers; and
- Pillar 3 – funded by workers' voluntary (but tax-advantaged) contributions to "top up" the benefits obtained via Pillars 1 and 2.

The original template for these funded pillars was the pension system of Chile and other Latin American countries. In the case of CEE, the Bank considered the introduction of the three-pillar system appropriate for pension reform.

At the same time, the Bank's three-pillar model was also particularly attractive to CEE countries because, in the process of restructuring their economies, a move to pre-funding of pensions was seen as encouraging:

- the development of capital markets;
- increased worker savings for retirement;
- wider risk diversification in investment portfolios; and
- stronger labour market incentives (e.g., more people seeking employment, encouragement toward individual self-dependence, and employers being able to attract or retain employees).

Also, the three-pillar model aligned well with the emerging new era of individual ownership and responsibility, and helped mitigate the effects of parametric reforms aimed at reducing the generosity of the existing PAYG pension promise.

Public-to-private: systemic reforms in CEE

Tentative reforms commenced in the mid-1990s in Hungary and the Czech Republic, and in 1999 Poland became the first country in the region to implement the full World Bank model. Subsequently other countries in CEE followed.

Although each country differed in the details adopted, all commonly introduced a mandatory, individual defined contribution component to replace part of public pension provision, with:

- a diversion of contributions from Pillar 1, to be invested in individual Pillar 2 accounts;
- the accumulation of contributions and investment income within these Pillar 2 accounts and then used to provide a pension at retirement; and
- tax-advantaged retirement savings generated under Pillar 3.

Public-to-private: effects of reforms

The introduction of Pillar 2 in CEE was initially successful, and to the extent that it was voluntary, the take-up rate by workers (i.e., the proportion choosing to give up part of public Pillar 1 to save via private Pillar 2) was higher than expected. Although this was due in part to financial incentives that encouraged the initial move to Pillar 2, a strong desire by workers to embrace individual ownership also contributed. In addition, multinational insurers and other providers of Pillar 2 pension products had offered industry support for the reform initiatives and private defined contribution pension plan offerings.

The number of Pillar 2 pensions grew significantly in many CEE countries during the early- and mid-2000s, with high stock market returns and solid economic growth. Some issues began to emerge, however.

The intended benefits of choosing the World Bank model began to materialize for CEE economies, but this improvement was slower than many had anticipated. Also, the fees taken from private pension funds and contributions by product providers were seen as excessive in some cases, leading to tougher regulations.

More significantly, government budget deficits began to suffer from the diversion of contributions to Pillar 2 pensions while Pillar 1 PAYG benefit payments were unchanged. Poland, for example, experienced a fiscal cost of 1.5% - 2% gross domestic product (GDP) per year.

The effect was exacerbated by the higher-than-forecast take-up of Pillar 2 pensions while demographic changes were worse than forecast (e.g., further decreases in fertility rates, high levels of emigration of workers to European Union (EU) countries). Poland alone is estimated to have seen an outflux of between one and two million people since its entry into the EU in 2004.

These changes led to even higher government borrowing to cover the deficits, with consequent increases to both debt and deficits.

Private-to-public: drivers of reform reversal

Although some of the issues discussed above had already begun to strain the public-to-private pension reforms in CEE of the late 1990s and early 2000s, what triggered the start of making CEE pensions public again was the global financial crisis (GFC) of 2008/9.

The GFC had significant impacts on CEE economies. The value of private pension assets fell by 23% during 2008 (more than USD 5 trillion), and government finances suffered both lower revenue (due to rising unemployment, slower wage growth, and declining economic output) and higher expenditures (due to, among other things, increased unemployment and early retirement payments).

Private-to-public: reversal of reforms

Overall, the GFC led to large public budget deficits. For example, Poland's deficit rose from around 2% GDP in 2007 to around 7.5% GDP in 2010, together with rising public debt.

Pillar 2 pensions saving was seen as failing and various governments therefore modified their pensions policies in response to the GFC. The approaches generally took one of three forms:

- *Severe curtailment of private pensions* — Governments in this group sought to reduce their budget deficits radically and quickly, taking over some or all assets of the private pension system and/or indefinitely redirecting a large portion of future contributions to the public pension system. (Poland and Hungary are prime examples.)
- *Short-term modifications to mitigate crisis conditions* — Governments in this category did not interfere with the fundamental structure of their existing pension policy, but did make short-term changes to ease budget deficits while longer-term plans for other fiscal savings were drawn up. (Romania, Estonia)
- *Targeting of long-term financial stability and security* — Governments in this group recognized that one of the major contributors to the deterioration of their finances was demographic change, in particular the worsening dependency ratio evident in most European countries. These governments pushed ahead with reforms to increase savings rates, gradually moving the burden of funding retirement incomes from the public to the private sector. (Czech Republic, Moldova)

Conclusions

Reversal of the type of pension reforms carried out in CEE does represent a quick, short-term fix for troubled government finances. For example, in Poland some immediate effects of reform reversal were a projected budget surplus (from a budget deficit of 4.8% GDP in 2013) and effective cancellation of (currently) USD 40 billion of government debt.

But radical private-to-public pension reform reversal leaves considerable long-term concern, given that demographic changes looming this century have not gone away, with worsening dependency ratios and longer life expectancies.

In the long term, people in countries without funded systems are reliant on government PAYG pensions for retirement income. Those governments, however, may only be able to provide small pensions due to the large number of beneficiaries relative to workers.

CEE's experience of the pension reform process can highlight some of the pitfalls of embracing systemic pension reforms too eagerly, with overly optimistic economic and demographic forecasting and under-appreciation of reforms' high sensitivity to these (and other, potentially unknown) factors.

Full systemic reform places a huge bet on the choice of underlying reform model and concomitant exposure to political risks. The model adopted needs to be chosen appropriately for the profile of each country, economy, government, and population, but considering both the current situation and the projected future.

For example, the World Bank three-pillar model is widely acknowledged but CEE's experience illustrates that one size does not fit all, and partial or more graduated solutions may prove more sustainable. In particular, care is needed with any pension reform model that involves delivery of a significant part of retirement income via individual defined contribution accumulation. Key considerations include:

- a shift of significant risks (e.g., investment, longevity) to private individuals entail workers' ability to understand/manage these risks;
- potentially fickle public support (and contributions) for pension saving, as such sentiments may move in line more with market returns and government approval ratings than underlying retirement objectives; and
- the product offering and charging structure of providers (e.g., lifecycle/dynamic investment strategies), which will influence the pension outcomes. Although regulation and supervision can help here, well-intentioned but misguided regulations may potentially hinder appropriate product offerings. As well, there is the risk of the mis-selling of pension products.

Overall, the lessons of CEE indicate that designing more sustainable pension reform may mean ensuring that reforms are robust to economic and demographic risks (including "unknown-unknowns"), together with careful consideration of likely take-up rates (with calibration of incentives and mitigation of over- or under-subscription).

Lastly, the experience of CEE shows that it is vital to ensure that reforms are robust to political risk, with recognition and mitigation of likely short-term issues and fiscal imbalances, and restriction of government access to private pension assets.

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