Social Security Reform and Privatisation in Poland: Parallel projects or integrated agenda?[1]

by

Rainer Gesell, Katharina Müller and Dirck Süß

Frankfurt Institute for Transformation Studies (FIT)
European University Viadrina P.O.Box 1786
D-15207 Frankfurt (Oder) Germany
e-mail: kmueller@euv-frankfurt-o.de

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Abstract

Proposals to link privatisation and pension reform have been raised since the early 1990s in CEE. Although the methods of privatisation have been debated, the move towards a corporate system based on private ownership is generally undisputed. As regards social security, however, choices are less clear-cut: a shift towards private, individualised provision of old age security is not necessarily on the agenda. Nevertheless, some transformation countries - *inter alia* Poland - have been considering a partial privatisation of old age security. The paper addresses the issue of linking both reform agendas. In a first step, the current state of Polish pension reform and privatisation are considered. Subsequently, we first present and evaluate different suggestions of linking privatisation and pension reform by discussing both economic and political aspects of each proposal.

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1. Introduction

A substantial reduction of the role of the state in the economic process is one of the major goals of the transformation process currently going on in Central and Eastern Europe (CEE). Thus, the privatisation of state enterprises has been part and parcel of the standard package of transformation policy since the early days of the new democratic regimes. Although the methods of privatisation are vehemently debated, the move towards a corporate system based on private ownership is generally undisputed. As regards social security, choices are less clear-cut - a shift towards private, individualised provision of old age security is not necessarily on the transformational agenda. While the vast majority of CEE countries sticks to its public pension systems, some countries - Poland, Hungary, Slovenia and Croatia - have recently been considering a partial privatisation of old age security by setting up mandatory pension funds alongside a downgraded public pillar.

But whereas the privatisation of state enterprises potentially involves non-recurring **revenues**, the full or partial shift from pay-as-you-go (PAYG)[2] to fully funded (FF)[3] pension schemes implies considerable transition **costs**. Not only do current pensions have to be paid out: future pension claims of the middle-aged have to be honoured as well, even if the generational contract implicit in PAYG schemes no longer holds when the majority of contributors has switched to FF pension funds. Acquired pension entitlements must be recognised to obtain political support for this radical reform move. Consequently, a double burden is threatening the transitional generations that have to contribute to their own retirement plans, while also paying for current pension obligations in the form of higher general taxation. It may therefore come as no surprise that proponents of radical pension reform have been looking for ways of decreasing this burden, pointing to the possibility to link the process of social security reform with privatisation. In the case of CEE, such a linkage might be especially plausible since state-owned property has largely been built up by the efforts of the elderly and those who are now approaching pension age.

Proposals to link both reform agendas - privatisation and pension reform - have been raised since the early 1990s in CEE (Charlton, McKinnon and Konopielko 1998; Jenkins and LaMotte 1991; Jenkins 1992). There are different ways to explicitly link both reform agendas: Proceeds from privatisation or privatisation bonds can be directed to the public PAYG scheme to finance transition costs.

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[2] PAYG financing implies that current outlays on pension benefits are paid out of current revenues from pension contributions, thus calling for inter-generational solidarity as a necessary precondition.

[3] FF consists in the accumulation of pension reserves, totalling 100% of the present value of all pension liabilities owed to the insured. The fund, accumulated individually over the working life, is converted into an annuity when he/she retires.

Alternatively state assets or their equivalent in privatisation revenues can be credited to individual accounts in private pension funds. World-wide, the only country to have introduced an explicit linkage between privatisation and pension reform has been Bolivia (see Mesa-Lago, Santamaría and López 1997).[4] But does it make sense - from an economic and/or political perspective - to link these separate reform agendas?

Here, we will focus on the case of Poland, where pension reformers are explicitly considering to use state treasury assets to finance pension privatisation from 1999 onwards, the scheduled start of the Polish pension reform. If current plans are implemented, Poland would be the first transition country to attempt a linkage between pension reform and privatisation agendas. However, at the same time, the concept of '*powszechne uw≥aszczenie*' (general 'propertisation')[5] has been put forward. It translates into the transfer of state property back to individual Polish citizens, referring to the idea that the entire society should profit from privatisation since state enterprises have been build up with the resources of all Polish citizens. Furthermore, 'propertisation' is supposed to "truly enfranchise Poles in the new market economy (Bowdler 1997/98: 36). We will discuss whether, in the Polish context, it is possible to link privatisation and pension reform, while at the same time accomplishing the idea of 'propertisation'.

In this paper, we will first review the current pension reform blueprint, as well as the state of privatisation in Poland. Then, we will outline the latest proposals to link pension reform with privatisation. The proposed integration of both reform agendas will subsequently be submitted to a detailed analysis, taking both "purely economic and political economy considerations into account. Finally, we will summarise our findings for the Polish case. They are certainly applicable to other CEE countries attempting a similar link between pension reform and privatisation.

2. The state of pension reform

Economic transformation has severely affected the existing old age security schemes in Poland that are based on PAYG financing, the most prominent of

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[4] This precedent is quoted by World Bank (1996: 83) and Charlton, McKinnon and Konopielko (1998). Some details of the Bolivian case, implemented in 1997, seem worth mentioning. Assets of state-owned enterprises are not credited to individual accounts in Bolivian pension funds, the so-called AFPs, but to a "collective capitalisation fund in either of the two existing AFPs. These two "collective capitalisation funds consist of 50% of the shares of six partially privatised enterprises and will pay a life-long annual pension of 200 US-$ to all Bolivians who were 21 years old or older at the end of 1995 (Mesa-Lago, Santamaría and López 1997: 94).

[5] In the following, we will use the term 'propertisation' for *uw≥aszczenie* in order to facilitate understanding for the non-Polish reader, as suggested by Levitas and Strza≥kowski (1990). It should be noted, however, that a precise English translation of the term *uw≥aszczenie* does not exist.

which being ZUS (*Zakład Ubezpieczeń Społecznych*, or Social Insurance Institute).[6] Privatisation, restructuring, and closing-down of state enterprises have been accompanied by a mounting number of disability pensions and by early retirement policies. This policy, designed to avoid large-scale unemployment, led to an increased number of pensioners and a falling number of contributors to the scheme, resulting in a continuos worsening of the system dependency ratio of the existing public pension insurance. According to Lodahl and Schrooten (1998), the system dependency ratio[7] rose from 38.9% (1989) to 60.7% (1995), while the old age dependency ratio remained largely unchanged.[8] This suggests that the current pension crisis in CEE is mainly transformation-induced and not linked to population ageing. Besides, the financial viability of the public pension scheme in Poland has been affected by a deliberate policy to increase replacement rates: Whereas net old age pensions amounted to only 53.3% of net wages in 1989, the ratio had risen to 72.5% in 1996 (Lodahl and Schrooten 1998), contrary to a trend towards lower replacement rates in other CEE countries since 1989.

It was obvious that the existing old age security system had to be reformed, both to restore its financial sustainability and to adapt some of the previous design features to the new economic order. Still, a long-standing, polarised debate[9] about the design of a comprehensive reform of old age security was going on, which reflected the recent international pension controversy.[10] Was a fundamental regime change - the shift from a PAYG to a FF scheme - inevitable? Or would a reform of the existing public PAYG system suffice? The Polish controversy, basically between the Ministry of Finance and Ministry of Labour and Social Policy, was settled in 1996, when a pension compromise was worked out. This negotiated agreement was to be put in concrete terms by a special task group, the Office of the Government Plenipotentiary for Social Security Reform (OGPSSR), that presented its report entitled "Security Through Diversity - Reform of the Pension System in Poland in early 1997 (OGPSSR 1997). Only part of the relevant legislation was passed by the Polish Sejm before the September 1997 elections, thus not all relevant details of the reform have been decided upon yet. However, under the new AWS-UW government the pension reform project is continued and expected to come into force in 1999.

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6 Apart from ZUS, the Employees' Social Insurance Scheme, there is a separate Social Insurance Scheme for Farmers (KRUS). Non-contributory pension schemes cover the Military, Police and Prison Employees.

7 The system dependency ratio (SDR) is the number of pensioners, divided by the number of contributors to the pension scheme, in the same period of time.

8 Between 1989 and 1995, the old age dependency ratio - the number of over 60 year old people, divided by the number of 20-59 year old ones - fluctuated between 28.0% and 29.8% in Poland (Lodahl and Schrooten 1998).

9 For a summary of the Polish discussion see Żukowski (1995: 28-31), Golinowska et al. (1997) and Golinowska (forthcoming).

10 For a review of the recent international pension controversy see Müller (forthcoming).

Poland's new old age security system will be of a mixed type, combining a mandatory public PAYG pillar with a partially mandatory FF system. This two-tier scheme offers a purely public as well as a mixed pension option on a mandatory basis:

The first, PAYG tier (ZUS) remains mandatory for everybody, at least as first pillar. The public pension scheme will cover acquired pension claims by paying some sort of compensatory pension, to be topped up by post-reform pension claims if the insured decides to stick to the purely public pension option. The second, FF tier consists of a newly created pension fund system. For everyone younger than age 30 at the start of the reform, this tier is mandatory, complementing the first tier (mixed pension path). Those between 30 and 50 years of age by the time of reform are free to choose between the purely public and the mixed pension path. If they opt for the latter, private pension funds will replace part of ZUS' functions: About 35-40% of future pension of these people will be paid by private pension funds. Those above age 50 cannot enter the FF scheme, but have to stay in the public system (purely public pension path).

The split-up of contributions between the two tiers and between employers and employees will be the following: Employers will pay 24% of gross wage (currently 45%), which is to finance the first tier, regardless of their employees' choice to join the second tier. Employees will pay 21% of gross wage (currently 0%) to the first tier if they stick to it; they will pay 12% to the first and 9% to the second tier if they switch to the latter.

The range of first-tier reforms is considerable, reflecting the Office's co-operation with a Swedish advisory team.[11] The Polish reformers plan to set up entirely new rules for the first tier, that are yet to gain approval of the Sejm. While early retirement and the recognition of non-contribution periods will be abolished completely, deferred retirement will have a large positive impact on the size of retirement benefits. The most radical change consists in the introduction of the so-called "principle of Notional Defined Capital into the first tier, relating retirement benefits closely to the virtual capital accumulated by the individual during working life. Following the Latvian example, benefit determination will be based exclusively on the total amount of paid contributions, divided by the average (gender-neutral) life expectancy at retirement.[12] It should be noted that new rules concerning the PAYG pillar will not affect persons above age 50 (OGPSSR 1997: 27-49).

[11] See Kruse (1997) for details on the Swedish pension reform plans, that will include flexible retirement age, benefits affected by changes in life expectancy and partial funding.

[12] The new pension formula will be as simple as E = K/G, with E = retirement benefit, K = insured's virtual retirement capital, G = average life expectancy coefficient at the time of retirement. By contrast, the current formula is E = 0.24 x B + 1.3 x PW x contribution years + 0.7 x PW x non-contribution years, with B = average monthly salary (for previous quarter) and PW = base for calculating retirement benefits.

As to the funded pillar, it will consist of open pension funds, that are mutually competing and deal only with old age pensions, whereas the payment of disability and survivors' pensions remains a function of ZUS. Individual contributions are capitalised in one of the pension funds, that will invest them under strict supervision of a specialised, yet to be created government agency, UNFE (*Urząd Nadzoru nad Funduszami Emerytalnymi*, or Pension Fund Supervision Office). Pension assets will have to be separated, both legally and physically, from the respective pension fund company, being kept in an independent depository. A Guarantee Fund will have to be set up, financed by all pension fund companies. Additionally, pension fund safety will be assured by a number of other mechanisms, e.g. required diversification of a fund's investment portfolio, a minimum required rate of return, and the participant's right to change funds (OGPSSR 1997: 50-63). Costs and fees linked with pension funds' services are still unknown.

A minimum pension, amounting to 28% of average earnings, will be paid from the state budget to those who meet age and service requirements, but when combining their PAYG and FF pension entitlements obtain a pension below the pension minimum guaranteed by the state (OGPSSR 1997: 5).

It is obvious that the Polish reform concept is by no means an identical replication of the much-discussed "Chilean Model .[13] Rather, its mixed set-up is similar to the Argentine pension reform of 1994.[14] As every partial or full shift from PAYG to FF financing, the reform blueprint designed by the Office implies considerable transition costs. Step by step, implicit social security debt is made explicit, requiring substantial budgetary means. Based on the 1992 pension expenditure data, Poland's total social security debt - the value of expected benefit rights that workers and pensioners have accrued under the old system - had been estimated by Holzmann (1994: 200) to amount to 20-30 times the annual pension expenditure, or 4.7-7.0 times GDP. Still, it is difficult to predict the exact amount of the costs resulting from current reform plans, as a host of macroeconomic variables and social insurance parameters affects the outcome. A crucial variable of unknown quantity is the percentage of those between 31 and 50 years of age that will choose the mixed instead of the purely public pension path. Part of the ZUS contribution of these people - 9% of gross wage, or 20% of the total contribution to ZUS - will be diverted to the second tier, while ZUS obligations will not decrease in the short and medium run.

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[13] In 1981, Chile has been the first country in the world to switch from a public PAYG system to a multipillar scheme based on private, FF pension funds. See Mesa-Lago and Arenas de Mesa (1997) and Müller (1997) for a critical review of the Chilean pension reform, whose impact as a role model in the pension debate reaches far beyond Latin America.

[14] The recent Argentine pension reform, known as the "democratic version of the Chilean Model , contains some interesting modifications of the Chilean blueprint, that have political and economic implications and should have facilitated its approval; see Arenas de Mesa and Bertranou (1997) for a comparison of both cases. For a discussion of the political economy implications of the mixed-type reforms of Poland and Hungary see Müller (forthcoming).

Polish pension reformers have presented simulation results regarding the financial effects of the pension reform blueprint (OGPSSR 1997: 19-20). According to their calculations, transition costs are mainly, though not only caused by the partial shift of ZUS contributions to private pension funds - here the Office assumes that half of those aged 30-50 will decide to switch to the mixed pension path, apart from those below age 30, that are obliged to do so. Part of the restructuring of the PAYG pillar also involves extra costs, such as the introduction of a 250% ceiling on contributions. Unfortunately, the Office's information policy regarding the costs of the proposed pension reform is far from transparent, as its lengthy report does not provide any information about the total estimated transition costs; it just gives annual costs for four selected years (2000, 2005, 2010, 2017), that rise from 1.48% of GDP in the year 2000 to 2.22% of GDP in 2017 (OGPSSR 1997: 19-20). The Office suggests that part of the high expected transition costs could be financed by means of a rationalisation of the PAYG pillar and the use of privatisation proceeds or bonds (OGPSSR 1997: 80-85). This proposal will be reviewed and discussed below.

3. The state of privatisation

3.1 Legal framework and evolution of privatisation process

After the appointment of the first reform government in October 1989 the 'Balcerowicz Plan' stated that privatisation should play an important role in the economic transformation and was to start immediately. Four alternative concepts of privatisation were discussed (cf., for example, B≥aszczyk and D≠browski 1993, B≥aszczyk 1995, Winiecki 1995):

- *Commercial privatisation* involves the privatisation of state enterprises by either direct sale to strategic investors or public sale via the stock market.
- *Employee ownership* intends to transfer the property rights of state enterprises to its workers and managers.
- The basic idea of *citizens' ownership* is the free transfer of state enterprises to the broad public.
- *Privatisation by institutional investors* assigns state enterprises to agencies that are supposed to restructure and later privatise them.

The initial debate was mainly concerned with the alternatives commercial privatisation versus employee ownership. Contrary to the round-table compromise between the last communist government and delegates from the Solidarnoś movement - proposing self-managed firms (Winiecki 1995: 50) - the

first non-communist government pursued commercial privatisation, in particular public sales at the stock market.

The slow progress of this privatisation track induced an ‘acceleration debate’ in which citizens’ ownership as an alternative to employee ownership was discussed. In particular, the above mentioned concept of “general propertisation” was put forward, supposed to be accomplished by a *Mass Privatisation Program* (MPP), in which state enterprises were to be transferred (virtually) free by the use of vouchers. Frequent changes in government led to the delay of the implementation of the MPP until 1994. But the issue of ‘propertisation’ still remained on the agenda: In a referendum held in February 1996, summoned by the former president Lech Wa≥| sa (Tycner 1996), a majority expressed approval of the proposed “free lunch . But because of low attendance the referendum had to be declared invalid (Chwila 1997).

Neither of the concepts - commercial privatisation, employee-ownership, privatisation by institutional investors, citizen ownership - was adapted as an exclusive method of privatising state enterprises. To be sure, the first privatisation law from July 13, 1990[15] gave priority to commercial privatisation (B≥aszczyk and D≠browski 1993: 16), but it also included a provision that allowed for other methods to be employed (Winiecki 1995). This multiple-method approach has not been changed by the new privatisation law from August 30, 1996 which has been in force since April 1997[16].

Basically, Polish privatisation methods can be classified into *capital privatisation* and *liquidation-privatisation*. Capital privatisation is based on the concept of commercial privatisation: state enterprises are first transformed into joint stock companies with the state as sole shareholder (‘incorporation’, in the Polish terminology *komercjalizacja*) and subsequently sold to strategic investors or floated at the stock exchange.

Liquidation-privatisation, which in the new privatisation law is called ‘direct privatisation’, refers to the concept of employee ownership as it is a method to allow for employee and management buy-outs: a state enterprise is liquidated and its assets are subsequently leased to a company that has been created for that purpose and is in most cases controlled by managers and workers of the former state enterprise (Frydman, Rapaczynski et. al. 1993: 188). In addition, *bankruptcy liquidation* is also possible on ground of the law on state enterprises.[17] It can be

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15 Law on the Privatisation of State Enterprises, *Dziennik Ustaw* (1990), No. 51, item 298.

16 Law on the Commercialisation and Privatisation of State Enterprises, *Dziennik Ustaw* (1996), No. 118, item 561.

17 Law on State Enterprises, *Dziennik Ustaw* No. 24 (1981), item 122.

initiated by the government if a state enterprise fails either to pay a compulsory dividend to the state or to service its debts.

The MPP is a particular method of capital privatisation that incorporates elements of the concepts of citizens ownership and privatisation by institutional investors. State enterprises are not directly sold or floated, but assigned to 15 *National Investment Funds* (NIFs). Rather than being investment funds in a Western sense, the NIFs are holding companies that are supposed to restructure and privatise the enterprises. The idea of 'propertisation' was presumable accomplished by the distribution of 'investment certificates' (for a rather symbolic fee) that can be converted into shares of the NIFs. To be sure, the aim of instituting a wide spread of ownership among the population became marginal (B≥aszczyk 1995: 81), as most Poles sold their certificates. Thus, it is not surprising that within the last election campaign the idea of 'propertisation' was again propagated, resulting in new proposals for economic enfranchisement (see section 4 below).

3.2 The progress of Polish privatisation

A breakdown of enterprises by privatisation methods (*Table 1)* gives a good impression of the main direction of Polish privatisation so far.

Table 1: Enterprises undergoing ownership transformation (as of Dec. 31, 1997)

Privatisation Method	Liquidation-Privatisation	Bankruptcy Liquidation	Capital Privatisation	MPP	Total
Number of enterprises	1,489	1,489	227	512	3,717
% of total	17.6	17.6	2.7	6.1	44.0

Source: MoST 1997, own calculations

Additional to these completed privatisations, another 487 enterprises have been incorporated. No decisions on their privatisation have been taken so far, except that 155 of these companies are considered 'strategic' and special privatisation procedures will be applied for them (B≥aszczyk 1997: 47). Although capital privatisation has played a rather limited role in terms of the number of enterprises actually privatised, most privatisation revenues are stemming from that method (*Table 2).*

Table 2: Revenues from privatisation (in millions of new Z≥oty)

	1991[1]	1992[1]	1993[1]	1994[1]	1995[1]	1996[2]	1997[3]
Capital Privatisation (# of enterprises)	125.5 (22)	323.1 (22)	448.4 (47)	866.6 (39)	1,714.2 (30)	1,800.0 (21)	5,766 (43)
Other privatisation revenues	45.4	175.7	341.2	748.1	926.4	1,420	333
Total	1,701	499	790	1,615	2,641	3,220	6,098
% GDP	0.2	0.4	0.5	0.8	0.9	0.9	1.4

Sources: [1]MoST 1996, BMWi 1997, own calculations; [2]B≥aszczyk 1997, BMWi 1997, own calculations, [3]Estimations based on MoST 1997, BMWi, and own calculations

How can this be explained? On the one hand, considerable revenues cannot be expected from other methods:

- Bankruptcy liquidation does not generate any revenues at all. Enterprises are dissolved, assets sold and revenues used to pay off the enterprises' debts.

- Liquidation-privatisation generates little income because it favours managers and employees. Leasing - applied in about 65% of direct privatisations (MoST, 1997) - has become the most common form of ownership transfer. As leasing rates have to be served from enterprises profits and are therefore set at a level low enough not to strain enterprises' financial capacity and still allow restructuring investment (Woodward 1995).

On the other hand, capital privatisation is the method for privatising the crown jewels of Polish economy. The good shape of enterprises entering the capital privatisation process led to a better evaluation by potential investors. At the same time the enterprises were bigger and employed more people than others (B≥aszczyk 1997: 48-49). They were too expensive to be taken over by insiders, so the involvement of foreign capital was required. These factors led to higher revenues than the liquidations when managers and employees took over "their enterprises enjoying preferential treatment[18].

So far there are only modest revenues from the MPP. This is a specific feature of any mass privatisation scheme. But since in Poland 20% of the shares of

[18] It should be noted that in the capital privatisation procedure insiders also enjoyed substantial privileges. Under the first privatisation law they were entitled to buy up to 20% of the shares of the enterprise at a 50% discount, under the new privatisation law they get 15% of the shares for free (Mohlek 1997: 2). These privileges can be interpreted as an incentive for enterprise insiders to approve incorporation (Gesell and Jost 1997). Without these privileges for insiders, privatisation revenues from capital privatisation would have been even higher. For further discussion of these arguments see also Süß (1997).

enterprises included in the NIF program are still owned by the Treasury[19] there will be some revenues when these holdings are privatised.[20]

3.3 The Remaining Privatisation Potential

A precondition for successfully linking pension reform and privatisation is that the amount of property left in state hands can generate enough revenues to provide a considerable contribution to finance pension reform-related costs. Compared to other countries in the region Poland has so far generated relatively little income from privatisation[21] - 1997 was the first year in which privatisation revenues exceeded 1% of GDP.[22] This can be partly explained by the large number of enterprises still remaining in state ownership: only about 44% of the 8,441 formerly state-owned enterprises have entered the different tracks of privatisation. Those still remaining state-owned, include a number of enterprises that could generate considerable revenues when sold. For example a large part of the utility and infrastructure sector like *Telekomunikacja Polska SA* or most of the power and heat generating plants are still state-owned. As the case of Hungary shows, the privatisation of such enterprises can boost privatisation revenues: When in 1995 four major privatisations in the utility sector were completed, Hungarian privatisation income reached 8% of GDP (Agovino 1996: 20).

Unfortunately it is nearly impossible to estimate how much the remaining state sector might be worth and how much its privatisation could contribute to finance pension reform: First of all, market prices do not exist while book values suffer from improper accounting during socialism: Assets and liabilities were recorded at non-scarcity prices, land was often not valued at all and plants and equipment were depreciated in an extremely conservative way (Bornstein 1994: 238). Secondly, it is not clear which assets can be privatised and which assets will remain with the state permanently. Thirdly, it is uncertain when particular privatisations will take place. In the past, privatisation in Poland has always been a lengthy process. Despite these problems some very rough estimates do exist:

– Holzmann (1994: 199-201) roughly estimates that transferable assets amount to 0.25 to 1.44 times GDP in Poland, equalling 7 to 58% of the total social security debt estimated by the author, with the true value more likely to be found in the lower half of this range, between 7 and 20%.

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19 The state retains 25% of companies undergoing mass privatisation. 5% of them, are earmarked for restitution.

20 A good example is provided by the Czech Republic. After the completion of the voucher program considerable revenues were earned when shares that remained in state ownership were sold (Süß 1997).

22 For a comparison with Hungary and the Czech Republic and factors explaining differences in revenues from privatisation see Süß (1997).

- The Office of the Government Plenipotentiary for Social Security Reform states that the assets of the 50 largest state enterprises and state treasury corporations total 65.5 bio. PLN (≈ 14.5 % of GDP in 1997), while the book value of the 9 largest Polish enterprises yet to be privatised amounts to 21 bio. PLN (≈ 4.7 % of GDP in 1997) (OGPSSR: 83-84).

- Unofficial estimates by the Ministry of Finance state that there are 140 bio. PLN (In 1996 prices, ≈ 38.9 % of GDP in 1996) of assets left to privatise of which 100 bio. PLN (≈ 27.8% of GDP in 1996) are concentrated in the 250 largest enterprises.

The short analysis of the previous privatisation process and remaining privatisation potential leads to the following conclusion: There is still some potential for earning privatisation revenues in the Polish economy. A number of large enterprises, especially the utilities and the 20% of the shares of enterprises in the NIF program, are still waiting to be privatised. The exact amount of a possible contribution from privatisation to financing pension reforms cannot be estimated due to the problems mentioned above and the dependency of privatisation revenues on numerous factors yet unknown (López-de-Silanes 1997; Süß 1997). Within the legal framework of Polish privatisation, capital privatisation is most suited to generate income. In the beginning of the Polish transformation there were a number of obstacles to the wider application of this privatisation method, e.g. the lack of capital market institutions, an unstable political environment and little experience and qualification of personnel in the privatisation institutions (Laier 1995; Berg 1994). In the meantime however, conditions have improved. Additionally, the aversion to the inclusion of foreign capital in privatisation - which has been strong in most transformation countries (cf. Winiecki 1996) - has diminished, contributing to a decrease in the initial lack of capital, together with the recent boom of the Polish economy. Together, these factors have resulted in a continuos application of capital privatisation and growing revenues from it in the past, as indicated in *Table 2*, but - yet unknown - future developments will be of crucial importance for the realisation of considerable privatisation revenues.

The possibility of generating considerable income out of existing privatisation potential does not necessarily mean that the money will be used to finance the reform of the pension system. As specified in the outline for privatisation of the Ministry of the State Treasury, there are at least two other conflicting claims on privatisation proceeds (MoST 1997): Restitution and compensation of citizens that have not yet been considered in the privatisation program. Also, as a result of constitutional court decisions, some parts of privatisation revenues are already earmarked to fulfil budgetary obligations incurred by improper indexation of pensions and salaries in the public sector.

4. Linking pension reform with privatisation: The integration of two separate agendas

It was in 1991 when Wojciech Topi ski and Marian Wi niewski proposed for the first time that Poland should seize the "historical opportunity to finance radical pension reform with privatisation proceeds (see Topi ski and Wi niewski 1991). However, until 1996 there was no political majority for a far-reaching restructuring of the existing old age security system. But when the Office of the Government Plenipotentiary for Social Security Reform presented its report entitled "Security Through Diversity - Reform of the Pension System in Poland in early 1997, it contained not only the suggestion to introduce a mandatory pension fund pillar to supplement the public old age security scheme, but also the proposal to finance the substantial transition costs with privatisation proceeds or bonds and by means of a rationalisation of the PAYG pillar (OGPSSR 1997: 80-85). Thereby, the authors of the report want to avoid, to the greatest possible extent, that the high costs of a transition to a FF pension scheme lead to an increased budget deficit, with all its negative implications. It is suggested that the costs of reform should mainly be financed by rationalising the public pension scheme, ZUS: via a higher effective retirement age, the introduction of price indexation, and the extension of the calculation base period.[23] Since PAYG pillar rationalisation will only gradually become effective in financial terms, there is a need for an additional source of financing during the first five to seven years of the reform. Although it is acknowledged that they will by no means suffice (see OGPSSR 1997: 19-20), proceeds from the privatisation of state property could be used to fill part of the gap. To this end, privatisation should be speeded up considerably, to ensure that the revenues are effectively available right after the start of the reform. In the Office's view, neither should privatisation "wait for pension reform nor a specific fund be created for earmarked privatisation revenues: If privatisation proceeds that accrue earlier are used to decrease public debt, this will help to finance the reform just the same (OGPSSR 1997: 82-84).

It should be noted that the Office of the Government Plenipotentiary supports only a specific linkage between privatisation and pension reform, that is, using privatisation proceeds - directly or indirectly, via a reduction of public debt - to cover the ZUS deficit. Only if privatisation does not proceed quickly enough to provide the necessary revenues in a given fiscal year, privatisation bonds, later to be converted into shares in privatised enterprises, might be a useful instrument. These bonds will be subject to public trading, the terms for their conversion into shares being specified in advance (OGPSSR 1997:82-84).

[23] For a detailed analysis of the financial effects of PAYG pillar rationalisation see OGPSSR (1997: 115-144).

However, the Office opposes the distribution of shares in state-owned enterprises to - yet to be created - private pension funds, a demand frequently being raised, especially by the Solidarność camp, under the label of 'propertisation'. According to the program of Solidarność, state-owned property is the result of the work and ideas of all generations of Polish citizens, who, therefore, are the legitimate heirs of these assets and should receive "enfranchisement vouchers (Chwila 1997). In the 1997 election campaign, 'propertisation' was among the promises of Solidarność's political wing, AWS: The new private pension funds, yet to be set up, were to be awarded controlling stakes in the remaining state-owned enterprises (Bowdler 1997/98).

After the new AWS-UW government had taken office, it turned out that the essence of the 'propertisation' label was somehow ambiguous: While in the AWS-UW coalition agreement it was pointed out that 'propertisation' should be the goal of privatisation, boiling down to the distribution of vouchers to those Poles who, so far, did not profit reasonably from privatisation, namely civil servants and those above age 50[24] (Umowa Koalicyjna 1997: 19), Emil W≠sacz, AWS' state treasury minister, within days of taking office announced a new privatisation scheme, the NFUs, to be linked to pension reform. Unlike the AWS' campaign promise, however, pension funds will not be credited with shares in state-owned enterprises, but with part of the revenue generated from the privatisation activities of NFUs - around 60 bio. PLN (Martecka 1997; Bowdler 1997/98). A different proposal was raised by AWS' Ewa Lewicka, Vice-Minister of Social Affairs and the new Government Plenipotentiary for Pension Reform: Privatisation proceeds should be credited on the individual accounts to be created by 1999 or 2000 at ZUS. By this means, everybody would profit from 'propertisation', since pension reform does not provide for the possibility to opt out of ZUS. According to Vice-Minister Lewicka, this proposal would have the advantage that privatisation revenues would visibly, though not tangibly be distributed to everybody, instead of the anonymous hole-plugging at ZUS suggested by the Office people.

To sum up, four different suggestions for a linkage of privatisation and pension reform are currently on the table in Poland:

(1) Proceeds from privatisation or privatisation bonds are directed to ZUS, directly or indirectly (Office);

(2) Proceeds from privatisation are credited to the - yet to be created - accounts of the individual insured at ZUS (Lewicka);

[24] Unlike employees in former state-owned enterprises, civil servants could neither profit from insider privatisation nor from the preferred treatment in capital privatisation (see footnote 18). However, all Poles had the chance to participate in the MPP program. Also, it is not entirely clear why those above 50 should receive a special treatment under the 'propertisation' approach.

(3) Pension funds are awarded stakes in state-owned companies (Solidarność);

(4) Revenues from privatising the - yet to be created - NFUs are credited to private pension fund accounts (W≠sacz).

In our view, the important distinguishing criteria of these proposals are:

- Institutional destination of generated income from privatisation: The proposals (1) and (2) direct proceeds to ZUS, whereas (3) and (4) benefit pension funds.

- Functional destination of privatisation income: Only proposal (1) intends to effectively reduce part of pension reform costs covering claims to the former pension system. Proposals (2), (3) and (4) do not contribute to cover the high transition costs of pension reform but serve the idea of 'propertisation' in one or the other way.

- Extension of privatisation approach: Suggestion (3) and (4) not only link the two reform agendas, but also introduce new ways of privatisation. (1) and (2), on the other side, rely on existing privatisation methods.

- Explicit or implicit link: Proposal (2) and (4) intend to make the contribution of privatisation proceeds to individual pensions explicit, whereas (1) and (4) only generally finance ZUS respectively the pension funds.

- Revenues-based versus securities-based proposals: While proposals (2) and (4) suggest the use of privatisation revenues in form of cash contributions, proposal (3) relies on the transfer of securities. Suggestion (1) prefers a revenues-based financing of the ZUS deficit but a securities-based solution is not ruled out entirely (if privatisation does not proceed fast enough).

Table 3: Distinguishing Criteria of Proposals

	(1) Office	(2) Lewicka	(3) Solidarnoś	(4) W sacz
Institutional destination	ZUS	ZUS	Pension Funds	Pension Funds
Financing of transition costs	Yes	No	No	No
Extending privatisation approach	No (Yes, if bonds are used)	No	Yes	Yes
Explicit or implicit link	Implicit	Explicit	Implicit	Explicit
Revenues- or securities-based	Revenue (Securities)	Revenues	Revenues	Securities

5. Strengths and weaknesses of current proposals

The identification of strengths and weaknesses of the current proposals requires a clear formulation of criteria according to which the existing suggestions should be judged. We will first discuss the proposals from an economic point of view, focusing on the following questions:

- Does a proposal affect the main aim of the pension reform - to create a sustainable and secure system of old age provision - and does it help to cover the transition costs related to the introduction of a funded system?

- Does the proposal foster the main aim of privatisation, i.e. strengthening corporate governance and creating an efficient allocation of property rights?

- What are the distributive consequences of the proposal, who are the winners and who are the losers?

Some of the answers to these questions can already be found in the classification of *Table 3*, while others require some further examination of the different suggestions. Pension reform and privatisation are results of the political decision

making process. Since both programs can have enormous distributive consequences they receive a large amount of public attention. This turns them into extremely sensitive issues for politicians, especially in the Polish context. A linkage of the two reform agendas could reduce transparency, thus creating the possibility for politicians to make populist promises and raise voters' hopes. Therefore the different proposals should not be judged from a merely economic point of view. Thus, a political economy perspective is added to the discussion in the second part of the section to be able to grasp the different proposals to the full extent.

5.1 Economic Aspects

a) Creating new funds and channelling proceeds to the private pillar: The "Solidarnoś and the "W sacz proposals

The proposals of Solidarnoś and W sacz not only explicitly link privatisation with pension reform, but also seek new approaches to privatisation. At first sight, the Solidarnoś proposal seems to accelerate privatisation and to capitalise pension funds at the same time without additional costs in a painless way. However, a closer look reveals that the plan of Solidarnoś is likely to endanger the success of both agendas, privatisation as well as pension reform.

Although by assigning pension funds stakes in state enterprises, formal privatisation ('quantitative dimension of privatisation') will be surely accelerated,[25] it has to be stressed that privatisation is not an aim in itself, but supposed to spur enterprise restructuring and the adaptation to market conditions ('qualitative dimension of privatisation'). A change in corporate governance can be seen as an important - but not exclusive[26] - prerequisite to achieve such aims. The Solidarnoś proposal is unlikely to result in an efficient control of enterprises by pension funds, the objective of which is not to actively control enterprises (World Bank 1994: 270-271). Pension funds are usually risk averse, diversifying their portfolios to guarantee safe pensions. Additionally they are usually banned from taking high risks by holding significant stakes in individual companies (Barbone 1997). In the Polish pension reform blueprint, for example, private pensions funds will not be allowed to invest more than 5% of their assets in the securities of one issuer (OGPSSR: 1997: 59). This clearly limits the scope for pension funds to be actively engaged into corporate control of enterprises.

But even if there is no expected active corporate governance, pension funds may exert some passive control via the use of the 'exit mechanism'. Impavido (1997:

[25] To be sure, there may be some political debate about the list of state enterprises that should be included in the scheme. However, this is an inherent problem of all the mentioned proposals.

[26] Others include, for example, the hardening of budget constraints and an increase in competition.

128), for instance, asserts that these funds might stimulate the production of information about enterprise performance on the stock market. However, this is only true if there is an exit option for pension funds. This can be doubted: If pension funds are capitalised with stakes in state enterprises, the funds will be burdened by illiquid holdings of shares that are difficult to dispose of (Barbone 1997). Additionally, the production of information usually requires a free choice of the portfolio structure (within the limits of prudential regulation to reduce the risk of default). Forced assignments of stakes to pension funds cannot generate any additional information. To put it differently: funds usually first compete on deposits and then decide how to invest them rather than being given an illiquid portfolio and then compete to get the financial means to improve the value of such coerced investments.

Additionally, the 'Solidarność proposal' encounters technical problems, since the market value of the transferred property to pension funds is unknown. This raises the question how yet to be privatised assets of unknown market value can be distributed among funds in a way assuring that every individual benefits from this 'propertisation' to the same extent. From the point of the pension funds, the unknown market value of parts of their assets burdens them with undetermined liabilities towards participants in the second pillar, which may ultimately lead to the collapse of the whole pension fund system (OGPSSR 1997: 85).

The 'W≠sacz proposal' avoids these technical problems. Here, the NFUs are first privatised, then proceeds are distributed to pension funds. Corporate governance problems are also tackled in a more convincing way since control and restructuring of enterprises are not assigned to pension funds, but to the NFUs. Like the NIFs, rather than being investment funds in the original meaning, they are holding companies that at least have the potential to exert corporate governance. However, the proposed sectoral orientation of the NFUs has to be criticised on grounds of political economy considerations (see below).

The most problematic issue of both proposals, however, is that they will not reduce the transition costs caused by the introduction of a second pillar into the pension system. Both schemes would only benefit the pension funds, either directly by assigning controlling stakes of state enterprises to them (Solidarność), or indirectly by channelling the receipts from the privatisation of NFUs to them (W≠sacz). Obviously, neither of these two projects will solve the problem of the reform-related ZUS deficit.[27] To cover the mounting deficit of ZUS, alternatively additional taxes or a higher budget deficit have to be incurred. Furthermore both proposals are contrary to the propagated idea of 'propertisation': Under the current pension reform proposals, not all Polish citizens are allowed or obliged to

[27] The proceeds from privatising NFUs could also be used for financing the ZUS deficit. Such a modification, however, would be not accomplish the idea of 'propertisation'. Hence, it seems unlikely that this is a real policy option.

join pension funds. Thus, the financial benefits of privatisation would be restricted to parts of the population, furthermore the costs of financing the ZUS deficit would have to be borne by the entire society, including taxpayers who do not profit from privatisation proceeds.[28]

Apart from that resulting unfair distribution of proceeds and costs, the planned schemes of Solidarność and W sacz are at odds with the intentions of introducing a private pillar into the pension system. The idea behind private pension funds is to induce people to take individual precautions for their retirement and to give them a choice between competing funds. The task of the state is to introduce and enforce prudential regulations of the funds, reducing their risk of default, not to endow pension funds with capital. Some initial financing by the state would only be justified if the funds had to incur significant outflows before private deposits were sufficient to cover them. This, however, is unlikely to be the case in Poland. Under the current pension reform proposals, there are no outflows from private pension funds to be expected within the first 12 years or so, as citizens entering the second pillar have to be under 50 and will not be entitled to receive pensions until they are 62.[29]

b) Selling of enterprises and channelling proceeds to ZUS: The 'Office' and the 'Lewicka Proposal'

The 'Office Proposal' and the 'Lewicka Proposal' have some features in common. First of all, the linkage of pension reform and privatisation is not related to the introduction of new privatisation methods, and both proposals suggest the use of revenues generated through the sale of enterprises. The above analysis has shown that this seems to be the only possible way how existing privatisation methods can contribute to partly cover the costs of pension reform. Furthermore it can be shown that the sale of enterprises to core investors or via the stock exchange is a good way to accomplish one of the main aims of privatisation, namely strengthening corporate governance and creating an efficient allocation of property rights. Neither of these approaches is at odds with this aim. But to what extent would they really permit to cover the transition costs resulting from pension reform? Here, the proposals differ significantly.

The 'Lewicka proposal' doesn't intend to channel revenues towards the regular expenses of the ZUS pillar, but to credit them to the - yet to be created - virtual individual accounts of future pensioners. Apart from some technical problems -

[28] To be sure, the proposal of W≠sacz can be modified by giving free handouts to those that would not profit from the additional capital endowment of pension funds. However, since identifying this group would be technically complicated, while leaving the ZUS deficit untouched, such a modification would still not accomplish the *uw≥aszcenie* idea.

[29] This point was also mentioned by W≠sacz's predecessor who claimed that the Treasurer should stop worrying about financing pension funds.

how would this "privatisation bonus be integrated into the new pension formula? - no solution of the underlying fiscal problem is provided: the proposal does not lighten the burden at all, since it does not intend to use privatisation revenues for the reduction of the transition costs of pension reform, but wants to accomplish 'propertisation'. This concept, however, always implies handing out "extra money - but it is just the regular ZUS expenditures, primarily claims accrued under the current system, that lack financing after a partial shift from PAYG to FF. These costs - that inevitably will occur when part of the implicit debt of the pension system are made explicit - will have to be covered from other sources, i.e. higher taxes or additional budget deficit.

This negative fiscal impact could, at least to a certain extent, be prevented if the 'Office proposal' was implemented (OGPSSR: 80-82). Here the deficit of ZUS - the main source of transition costs - will be reduced by privatisation revenues. According to this proposal pension reform will start at a specific date, after which the transition costs can only be influenced to a limited extent and will have to be covered whatsoever. Although the 'Office proposal' is currently the most convincing way of linking privatisation and pension reform - since transition costs are truly reduced - one should not overestimate the impact of privatisation proceeds on reducing the ZUS deficit, which is even admitted by the Office (OGPSSR: 81).[30] To start with, experience from previous privatisations has shown that the process is likely to protract over a longer period, with revenues flowing in at hardly predictable points in time and amounts. Furthermore the market value of available state treasury resources is highly uncertain. Facing the problems of unknown amounts of proceeds and synchronisation of (privatisation) income and (pension) expenditures raises the question if privatisation money can be used to finance pension reform at all. The idea of bridging the gap in time by issuing bonds that are later to be traded in for shares of yet to be privatised enterprises introduces additional uncertainty into the process. New technical and legal problems are raised due to the novelty of this instrument and consequently non-existent experience.

Finally, the distributional consequences of both proposals should be mentioned: The 'Office proposal' leads to a partial relief of all taxpayers from the pension reform costs, because otherwise costs would have to be covered by either higher taxes or additional budget deficit. But it should be stressed that this would also - *ceteris paribus* - be true if privatisation revenues would not be earmarked for pension reform, but be treated as an ordinary source of income to the budget. Earmarking privatisation revenues would, however, make clear that the pension reform is of certain priority having a disciplining effect on other budgetary categories. Crediting privatisation revenues to the virtual individual accounts as suggested by the 'Lewicka Proposal' benefits every Polish citizen insured in the

[30] This argument is also shared by Barbone (1996) .

ZUS, that is, 83.2 % of the working population, but it does not contribute to cover transition costs, which will have to be paid by all taxpayers either through higher taxes or via increased budget deficit, again ceteris paribus.

5.2 The political economy of linking pension reform and privatisation

Since political decisions are not only made on basis of economic rationality it is important to consider the political economy underlying the idea of linking both reform agendas in general and of the different proposals in particular. From the point of view of reform-oriented politicians it would be particularly useful to link the programs if such a linkage was likely to foster at least one of the two reform agendas.

It has been argued that by linking privatisation with pension reform a new constituency for the former will be created, since people will benefit from the reduction of state ownership in the economy via an improvement of the social security system: "...it makes it hard for any new government to derail the privatisation without blowing a hole in the entire pension reform scheme (Meth-Cohn 1997: 31). By reducing opposition, the linkage is supposed to speed up privatisation. However, the discussion above should have made clear that this can only occur if proven methods of privatisation, like the sale of enterprises, are used. If, by contrast, new privatisation methods result from the integration of the agendas, as proposed by Solidarność and W sacz, new problems are inserted into the privatisation process. In particular, the sectoral orientation of NFUs may seriously slow down privatisation. A sectoral NFU may tend to apply for - and will more easily get - political support in form of subsidies and/or protectionism to avoid unpopular restructuring of industries and related dismissals.[31] This, however, would be contrary to the main idea of privatisation, namely to induce market-oriented behaviour of enterprises.

Also, Meth-Cohn's argument seems not entirely convincing from a political economy perspective: It can be doubted that radical pension reform, itself subject to opposition because of the cutback of acquired rights, will be attractive enough to overcome existing objections against privatisation in Poland, especially when it implies that 'propertisation' - perceived as a free lunch by many - has to be sacrificed on fiscal grounds. Instead, it might be more effective to lower resistance against privatisation by using the proceeds directly to compensate the opponents. The realisation of the popular 'propertisation' idea might achieve a similar result.

[31] This point is also indicated by Meth-Cohn, who argues that the funds will be "forced into thinking in sectoral terms (1997: 32). She also mentions the high exposure of the NFUs to industry-related risk as an additional critical issue of the scheme.

Thus, at first sight there seem to be good reasons to try to diversify the fiscal risk (inherent in the transition costs of radical pension reform) and the political risk (a stand-still in privatisation) by combining ‘propertisation’ and pension reform. But even if the proposals that try to connect pension reform with ‘propertisation’ - the ones by Lewicka, Solidarnoś , and W sacz - might build up an additional constituency for both reform agendas, it should be noted that this increased approval contains the danger of a fiscal illusion: Since transition costs of moving from a PAYG to a FF pension scheme are not reduced, higher taxes and/or larger budget deficits are unavoidable. Therefore, politicians implicitly or explicitly spreading the idea that it is possible to have both, ‘propertisation’ and radical pension reform, without additional costs are suspicious of populism.

The insight that privatisation revenues are no extra money and that there are already some other budgetary demands on privatisation proceeds is also a potential source of conflict within government, in particular if it is formed by a coalition. In Poland, the line of conflict is between the Ministry of Finance (MoF), headed by Leszek Balcerowicz, and the Ministry of the State Treasury (MoST), headed by Emil W≠sacz. A good example for this intra-governmental conflict is the argument on the list of enterprises of which privatisation revenues are earmarked for financing pension reform. By mid-January 1998 such a list had not yet been worked out and confirmed. While it seems to be of some importance for the MoF to keep the list as extensive as possible to reduce the budgetary impact of the pension reform, it seems to be in the interest of the MoST to shorten it to have more leeway for other possible uses of state assets, particularly ‘propertisation’. Meanwhile the number of available state assets is shrinking as the privatisation process continues.[32]

6. Concluding remarks

Our discussion has made it clear that, when it comes to practical politics, linking privatisation and radical pension reform is not as easy as it might seem from a theoretical perspective. Rather, the Polish government is facing difficult choices when it has to decide whether it wants citizens to tangibly profit from privatisation, i.e. ‘propertisation’, or a fiscally sustainable transition from a PAYG to a FF pension system. Since the non-recurring revenues from privatisation can only serve one of these purposes - not both of them at the same time -, a combination of both political desiderata requires extra budgetary

[32] In the “Office proposal , which is supported by the MoF, a number of enterprises are specified that are to be sold to support pension reform. These companies are: *Centrala Produktów Naftowych SA, Polskie Górnictwo Naftowe i Gazownictwo SA, Telekomunikacja Polska SA, KGHM SA, Bank Gospodarki ↓ywno ciowej SA, Petrochemia P≥ocka SA, Bank Handlowy SA, Orbis SA, LOT SA.* As the debate about the use of state assets continues, some of these enterprises have been partly privatised in 1997: *Orbis*, *Bank Handlowy*, and *KGMH*.

resources, which may boil down to higher taxation. The beneficiaries of ‘propertisation’ would then - indirectly - pay for the property value they receive.

From an economic point of view, an integration of both reform agendas - pension reform and privatisation - is desirable only if privatisation revenues are used to pay off the reform-related deficit of the public pension scheme. Simultaneously, the linkage should neither delay privatisation, nor endanger its primary aims. When political economy aspects are included into the picture, however, ‘propertisation’ might make sense to overcome political resistance to privatisation, thus ultimately providing some of the means to cover the high transition costs of radical pension reform.

But it is equally important to keep in mind that even if a sizeable part of the privatisation proceeds is channelled into the first pillar, they will not contribute substantially to a solution of the problem of transition costs resulting from radical pension reform. This suggests considerable caution concerning promises to get rid of the troublesome issue of transition costs without painfully burdening the taxpayers. Ultimately, this might even imply a reconsideration of agendas on both fronts to see if they are really appropriate. After all, pension reform does not necessarily imply a transition from PAYG to FF, and privatisation can also benefit ordinary citizens without explicit ‘propertisation’. The discussion of this kind of policy choices is, however, beyond the scope of the present paper.

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